Economic Review

with Nicholas S. Perna, Ph.D., Webster Bank Economic Advisor

Musings & Amusings: *Muhammed Ali*

"How tall are you? So I can know in advance how far to step back when you fall down."

About Sonny Liston: "He's too ugly to be world champ. The world champ should be pretty like me!"

"I'm so fast that last night I turned off the light switch in my hotel room and was in bed before the room was dark."

Why so glum, chum? Muhammed Ali's passing got me to thinking about how life has changed since he beat Sonny Liston in 1964. The "Louisville Lip" brought wit and charm to an otherwise dreary sport. He really could "float like a butterfly and sting like a bee" in and out of the ring.

For most of us, economic life has become more complicated and uncertain. Getting by in the '50s and much of the '60s was "a piece of cake" compared to the Great Depression of the 1930s and WWII. Today people seem less content or less at ease than in the past – even though unemployment and inflation are low by historic standards and the stock market is high.

The Conference Board's Consumer Confidence Index shows some of these trends. Each month, interviewers ask a sizable sample to assess their current and future economic conditions. It not only measures economic factors, but probably also picks up changes in perceptions about the broader political and social backdrop.

CONSUMER CONFIDENCE (1985 = 100).

June 1969	143	**Feb 2007**	111
July 1975	43	**Dec 2008**	39
Jan 2000	145	**May 2016**	93

Confidence peaked in the late 1960s and again in 2000. Not surprisingly, it has plunged during recessions and rebounded in recoveries. Confidence is currently one-third below the peak reached at the start of the millennium. After collapsing to the lowest reading of the past half century during the depths of the Great Recession, it has since made only a partial recovery.

Economists are big believers in present discounted value calculations. If you have to wait for something, it's worth less to you now. Think Lotto! The lump sum option always pays less than spreading your winnings out over a number of years. We use an interest rate to calculate present values. So, if the risk rises, we have to increase that discount factor, and, thereby, further reduce that present value.

I can think of several examples of why people now discount the future more heavily. The switch from defined benefit to defined contribution pensions over the past couple of decades has shifted the risk of financing largely to employees. Then there's all the talk about the need to cut future Social Security benefits. Furthermore, faith in institutions, especially government, to alleviate problems has eroded. And house prices were never supposed to fall.

Psychologists have also been looking into how people perceive gains vs. losses. I've been reading Daniel Kahneman's book, *Thinking Fast and Slow*, a psychologist's view of how people perceive risk, losses, and prosperity. He develops a theoretical framework and provides many fascinating examples and experiments. Kahneman was awarded a Nobel Prize in economics for his important work. Warning: this is not easy reading.

Fortunately, there's a really neat one page discussion of some of the current relevance of this research by James Surowiecki in the *New Yorker* (June 6 & 13, 2016). In a nutshell, people value their losses twice as much as their winnings. So, people will go to great lengths to avoid losses and to recover what they've lost. This helps explain why those who feel they are worse off than a decade ago might take what amounts to a big chance in supporting political outsiders for president as a way of recouping their losses. And even if they are better off than they were some years ago, they may feel relatively worse off if others have done even better or their expectations have not been fulfilled.

Thus, rising risk and loss aversion can make current and future economic conditions "worth" less than in the past. People might once again feel better off if they can have greater faith in the future. Maybe politicians should work on being less negative and less divisive, but that's asking too much!

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On a more upbeat note, Ali wasn't just a likeable self-promoter ("I'm young; I'm handsome; I'm fast. I can't possibly be beat."), he was a bit of a philosopher "Live every day as if it were your last because someday you're going to be right."

Interest rates in limbo... how low can they go? When I was young and wild, we used to do the "limbo" at parties. Squeezing under the broomstick became increasingly difficult as it was lowered and the volume of beer consumed was increased. The bystanders would chant "Limbo, limbo, how low can you go?"

The Federal Reserve chose not to raise rates in June. They also lowered forecasts of the Fed funds over the next several years. Around the same time, the yield on 10-year German government bond went negative for the first time ever and the benchmark U.S. 10-year Treasury note yield fell to 1.5 percent.

Then my phone rang. It was my broker informing me that a really great municipal bond I bought (it was "we bought" when he sold it to me) a couple of years ago was being called! Back then, it seemed like a really good deal: a nice tax-free yield with low credit risk. I worried a little about the long maturity, but paid next to no attention to the *call provision* which allowed the issuer to buy the bond back at par (face value) after a certain date. The consensus at that time was for bond yields to be rising, making it unlikely for the call provision to be utilized.

With interest rates so low right now, it is very attractive for the issuers to buy back bonds even if they have to pay some premium over par because they can issue new bonds at lower interest cost. Before he hung up, my broker also informed me that more bonds in my portfolio were quite likely to be called. No wonder why they call him a *broker*. By the way, if you've ever refinanced your home mortgage, you too have exercised the call option "embedded" in most mortgages. You turned in the old mortgage for a nice new one with a lower interest rate!

This global slide in interest rates results from a number of factors. The erosion of confidence in future growth is pretty much worldwide, making people and businesses less likely to borrow. Furthermore, the European Central Bank is buying up bonds to stimulate the economy.

U.S. interest rates are still not negative for a couple of reasons. The U.S. economy is growing faster than Europe or Japan. The Federal Reserve still says it plans to raise short-term rates in the not-too-distant future. While negative interest rates are unlikely here, I wouldn't rule them out if we face another recession.

If interest rates rise, which seems to be the current consensus among forecasters, you don't have to worry much about your bonds getting called. However, the market value of that 10-year Treasury note yielding 1.5 percent that you purchased with the proceeds of the bond call will decline depending on the size of the interest rate rise. If market rates rise by 2 percentage points to 3.5 percent, then the bond's market value will fall more than 15 percent!

Of course, you'll get back the full face value if you hold it to maturity. And if rates stay at 3.5 percent, the value will improve until it approaches par 10 years from now. This relationship between market interest rates and bond prices is called interest rate or duration risk. Whoever though buying a few bonds could be so complicated?

The Region's Labor Markets show considerable variation. The higher unemployment rates for Connecticut and Rhode Island reflect their slower recoveries from the recession. Massachusetts is benefitting from the boom in greater Boston where the 3.5 percent jobless rate is one of the lowest in the nation. The state with the lowest unemployment is tiny South Dakota where I think one person was laid off in May! The state with the highest is Alaska where the big oil price drop has hurt. Maybe Alaska can earn tourist dollars by setting up coin-operated telescopes to view Russia, which according to some people is visible from there...

LABOR MARKET DATA: *May 2016*

States	Unemployment %	Jobs % Change
Connecticut	5.7	0.8
Massachusetts	4.2	1.5
Rhode Island	5.4	0.2
New York	4.7	1.0
Metro Areas		
Boston	3.5	1.2
Hartford	5.7	1.0
New York	4.6	1.9
Philadelphia	4.9	2.1
Providence	4.8	0.3
United States	4.7	1.7

Metro unemployment rates are for April and are not seasonally adjusted.
Job change is from May 2015

Even when looking at percent changes from a year ago, regional state jobs data are volatile. In Boston, for example, job growth was running about 1.7 percent in the previous several months before suddenly slowing to 1.2 percent in May. The quick deceleration was even larger for Providence where gains have slowed from 1.5 percent to 0.3. Things are still hot in greater Philly and pretty good in metro NYC. I think that the sudden decelerations are part statistical noise, but they could reflect the slower national job growth momentum.

One of my favorites from Ali's repertoire, "I'm so mean I make medicine sick."

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