Louisiana Corporate Credit Union

ECONOMIC & FINANCIAL DIGEST

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High Hopes

As the curtain rings down on 2016, expectations for the 2017 economy are running high. The financial markets are pricing in faster growth – and higher inflation – than envisioned a few months ago, consumer confidence has climbed to multi-year highs and even those long-term sourpusses in the business community are expecting better days ahead. That upbeat sentiment is being expressed not only by large corporations in the latest Business Roundtable Survey but also by the surge in the small business optimism index in December. Policy makers are making similar bets. The Federal Reserve hiked short-term interest rates at its December 13-14 meeting, and plans more hikes in 2017 than it did at the previous meeting.

This is not the first time, of course, that the winter ushered in a blast of optimism, reflecting strengthening data over the second half of the year. In most cases, however, the reality failed to live up to the hype. In five of the past six years, the economy's performance over the first six months of the new year turned out to be weaker than the second half of the previous year. Will the opening act of 2017 suffer a similar disappointing fate? Or should we cling hopefully to the notable caveat that past performance does not guarantee future results?

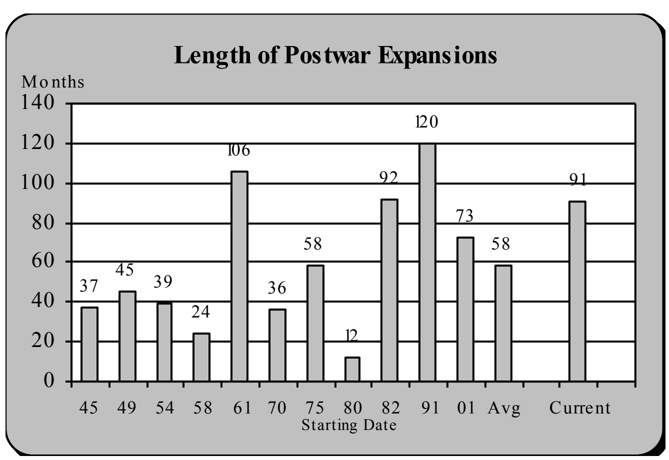
Time will tell. No doubt, much of the optimism is based on hope – as well as hype. Yes, the economy picked up some momentum over the second half of last year and the fundamentals pointing to future growth remain positive. But a 2.5-3.0 growth rate – the likely second-half pace – hardly represents the escape velocity that has eluded the recovery so far, which would propel it out of the lackluster 2 percent growth orbit. Indeed, the economy appeared to have lost some momentum towards the end of 2016; following the promising 3.2 percent increase over the July-September period, incoming data for October and November indicate that growth in GDP slowed to a 2.0 - 2.5 percent pace in the fourth quarter. At this juncture, the economy is poised to grow modestly faster in 2017 than in 2016, assuming it can avoid the first-half bust that damaged growth this year. That would not be a breakout year by any means, but it keeps the recovery on track to perhaps become the longest on record. At least pundits are no longer fretting about deflation and negative interest rates.

Growing Long In The Tooth

When Donald J. Trump is sworn into office on January 20, the nation's economy will be entering its 91st month of continuous expansion. Only twice before has a U.S. recovery lasted as long – the 106 and 120 months that began in 1961 and 1991. Not long after the inauguration, the details of the incoming administration's policies will start to be fleshed out. It's doubtful that all, or even most, will sail unscathed through Congress. But for the first time in seven years, all three branches of government are amenable to some fiscal pump-priming through a combination of tax cuts and increased spending. As much as anything, this prospective growth-boost coming from Washington has brightened the economic outlook for next year and beyond, and underpins the ebullient post-election action in the financial markets.

If all goes well, the recovery should move up from third place on the longevity list to second or even first. Indeed, the risk is that the economy will grow faster than the modest acceleration widely expected for 2017. That said there are downside risks that could materialize if certain wildcards come into play. From our lens, there are two prominent ones related to policy that could crimp growth and even short-circuit the expansion before it establishes a record. The first is that president Trump 'sticks to his guns' and follows through on his campaign rhetoric to clamp down harshly on immigration and rev up protectionist trade barriers. The mass expulsion of undocumented immigrants would crimp the labor force and slow growth. Likewise, calls for stiff unilateral tariffs on China and Mexico would result in higher import prices and inflation even as it reduces exports – and business investment— as nations retaliate in kind.

The second is that the Federal Reserve turns more hawkish than expected. At its December 13-14 meeting, the Fed hiked short-term rates by a quarter-point for only the second time in a decade in recognition of the economy's improved performance over the second half of the year. While it also increased the number of rate hikes planned for 2017 – from two to three – it still expects to only gradually push up interest rates as it navigates a highly uncertain



global, political and domestic economic environment. However, with little slack in the labor force, if inflation picks up more quickly than expected, the Fed might clamp down harder on the monetary brakes than planned, posing a threat to credit-sensitive sectors of the economy, like housing, that could stifle growth.

Bad Timing

As noted, the prospect of a more expansionary fiscal policy since the election has raised hopes that the economy will finally break out of its slow-growth orbit of roundly 2 percent since the recovery began in mid-2009. Aside from the $800 billion stimulus package aimed at jump-starting growth shortly after the Great Recession, the central bank has had to do all of the heavy lifting, driving interest rates down to zero and engaging in three rounds of massive bond purchases, known as quantitative easing. That unprecedented effort provided fuel for the recovery, but its bang for the buck has diminished over time; even Fed officials admit that keeping rates at rock-bottom levels longer may be more harmful than beneficial by encouraging excessive risk taking and financial instability.

At various times during the recovery, the Fed has urged Congress to help remove slack in the economy by augmenting weak private demand with more public spending. It correctly argued that the lackluster growth rate for most of the period was due to low-octane demand from consumers and businesses that kept the economy from operating at its full potential. But that argument carries less force now. It may have taken longer than necessary, but after more than seven years of subpar growth, most spare capacity has been wrung out of the labor and product markets. At the press conference following the December policy meeting, Fed Chair Yellen asserted that calls for Federal help came when unemployment and spare capacity were much higher than now; as a result, fiscal stimulus is currently less of a priority to bolster growth.

Two significant implications underpin this assertion. First, stronger demand at this stage of the cycle would more likely bring on higher inflation than growth in output. After all, when there is little or no slack in the economy and demand outstrips supply, the inevitable result is higher prices. The second implication is that the economy's growth rate is being constrained more by the lack of supply than weak demand. Hence, policies ought to be geared more towards stimulating the output capacity of the economy than the demand side of the ledger. While many would dispute that notion, there is considerable evidence to support it.

Supply Constraints

The most obvious place to look for supply constraints is the labor market. Currently at 4.6 percent, the unemployment rate is already below its 5.8 percent post World War 11 average as well as the 4.8-5.0 percent that the Fed views as consistent with full employment. True, this rate does not capture the millions of workers that have dropped out of the labor force and, hence, are not counted as unemployed. Yellen has often asserted that stronger growth would draw some of them off the sidelines, but the share of adults in the labor force has stubbornly remained near 40-year lows despite the third-quarter pick-up in activity. This suggests that more stimulus would not meaningfully reverse the depressing impact on the participation rate that demographic forces, such as retiring boomers, are bringing about.

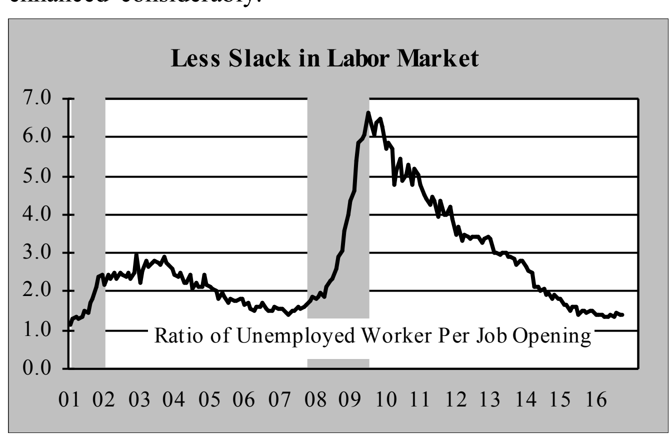
Indeed, competition in the job market has been flipped 180 degrees since the recovery began. Early on, there were far too many workers competing for jobs, which was a vivid illustration of excess slack in the labor force. Now, just the opposite is the case, as companies are struggling to find workers to fill positions. Seven years ago, there were 6.6 unemployed workers competing for every job opening; in October, that ratio had shrunk to 1.4. The shortage is particularly acute in construction and several manufacturing industries where workers with specific skill sets are hard to find. The latest survey by the National Federation of Independent Business reveals that more than 30 percent of small businesses have openings they can't fill, the highest share in more than fifteen years.

But what about excess capacity in the product market that suggest there is room to grow faster without stoking inflationary pressure? In November, the industrial sector was operating at only 75 percent of capacity, well under the 80 percent long-term average. But much of the unused plant, equipment and software is old and outdated; bringing them onstream would not increase worker productivity and, hence, do little to stem inflationary pressures brought on by stronger demand. To be sure, there is a feedback loop here. In a tight labor market, many companies may be hesitant to invest in new machinery and software because they can't find qualified workers to use them.

Fiscal Challenge

The economy's potential growth rate is determined by growth in the labor force and productivity. Both have slowed considerably from their long-term trends over the past decade, underpinning the notion that the economy's speed limit has also been lowered. Many consider the new normal to be around 2 percent growth compared to the historical average of over 3 percent. President-elect Trump campaigned on the promise to lift growth to 4 percent and the financial markets are clearly buying in to a more bullish outlook.

For a while it is possible that increased demand, helped by fiscal stimulus, can lift growth to 4 percent or even more by drawing more workers into the labor force, lifting the participation rate, and having them put in longer hours. However, the closer the U.S. economy is to full employment and capacity usage, the more inflation will rise in response to increased demand. Hence, the challenge of the Trump administration will be to design policies that pumps up supply as well as demand, thus putting a check on inflationary pressures. If that can be done – a big if – the odds that the recovery will live a long and prosperous life would be enhanced considerably.



KEY ECONOMIC AND FINANCIAL INDICATORS

*FINANCIAL INDICATORS**

	November	October	September	August	July	June	May	12-Month Range High	12-Month Range Low
Prime Rate	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.25
3-Month Treasury Bill Rate	0.45	0.33	0.29	0.30	0.30	0.27	0.27	0.45	0.12
5-Year Treasury Note Rate	1.60	1.27	1.18	1.13	1.07	1.17	1.30	1.70	1.07
10-Year Treasury Note Rate	2.14	1.76	1.63	1.56	1.50	1.64	1.81	2.26	1.50
30-Year Treasury Bond Rate	2.86	2.50	2.35	2.26	2.23	2.45	2.63	3.03	2.23
Tax-Exempt Bond Yield	3.59	3.27	2.93	2.85	2.83	3.20	3.29	3.68	2.83
Corporate Bond Yield (AAA)	2.86	2.56	2.48	2.34	2.30	2.43	2.51	2.86	2.30
Conventional 30-Year Mortgage Rate	3.77	3.47	3.46	3.44	3.44	3.57	3.60	3.96	3.44
Dow Jones Industrial average	18697	18185	18267	18495	18341	17755	17692	18697	16300
S&P 500 Index	2165	2143	2158	2177	2149	2084	2067	2177	1918
Dividend Yield (S&P)	2.11	2.17	2.12	2.11	2.11	2.17	2.16	2.31	2.11
P/E Ratio (S&P)	20.6	19.9	20.4	20.4	20.4	19.8	19.5	20.6	17.6
Dollar Exchange Rate (vs. Major Currencies)	93.7	91.9	90.1	89.8	90.9	89.7	89.8	95.3	89.4

** Monthly Averages*

ECONOMIC INDICATORS

	November	October	September	August	July	June	May	12-Month Range High	12-Month Range Low
Housing Starts (In Thousands)	1090	1340	1052	1164	1218	1195	1128	1340	1052
New Home Sales (Thousands of Units)		563	574	567	622	558	566	622	508
New Home Prices (Thousands of Dollars)		305	314	300	295	322	296	322	291
Retail Sales (% Change Year Ago)	3.8	4.0	3.4	2.4	2.3	2.8	2.2	4.0	1.6
Industrial Production (% Change Year Ago)	-0.6	-0.8	-1.0	-1.1	-0.8	-0.6	-1.3	-0.6	-2.3
Operating Rate (% of Capacity)	75.0	75.4	75.4	75.6	75.7	75.4	75.1	75.7	74.9
Inventory Sales Ratio (Months)		1.37	1.38	1.39	1.39	1.39	1.40	1.41	1.37
Real Gross Domestic Product (Annual % Change)			3.2			1.4		3.2	0.8
Unemployment Rate (Percent)	4.6	4.9	5.0	4.9	4.9	4.9	4.7	5.0	4.6
Payroll Employment (Change in Thousands)	178	142	208	176	252	271	24	280	24
Hourly Earnings (% Change Year Ago)	2.8	2.8	2.7	2.5	2.7	2.6	2.5	2.8	2.3
Personal Income (% Change Year Ago)		3.9	3.7	3.4	3.5	3.4	3.4	4.0	3.4
Savings Rate (Percent of Disposable Income)		6.0	5.7	6.0	5.8	5.8	6.0	6.2	5.7
Consumer Credit (Change in Mil. Of Dollars)		16018	21797	27469	18886	14449	22583	27469	6561
Consumer Prices (% Change Year Ago)	1.7	1.6	1.5	1.1	0.8	1.0	1.0	1.7	0.5
CPI Less Food & Energy (% Change Year Ago)	2.1	2.1	2.2	2.3	2.2	2.3	2.2	2.3	2.0
Wholesale Prices (% Change Year Ago)	1.3	0.8	0.7	0.0	-0.2	0.3	-0.1	1.3	-1.1