Louisiana Corporate Credit Union

ECONOMIC & FINANCIAL DIGEST

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Better Start to the Year

The U.S. economy continues to ride a strong wave of optimism, both on Main Street and Wall Street; hopefully this upbeat mind-set will prevail longer than was the case at this time last year. Recall, that the nation entered 2016 on a high note as well; the stock market rallied strongly over the closing months of the previous year and the Federal Reserve raised short-term interest rates in December for the first time in a decade, expecting stronger growth and higher inflation in 2016 that would facilitate four more rate hikes during the year. But things rapidly turned sour when oil prices continued to sink and fears of a China meltdown and currency devaluation rattled the global financial markets and sent stock prices into a freefall. In the U.S. the S&P 500 stock index plunged by 12 percent from the end of December to early February.

The markets steadied shortly thereafter when it became apparent the global economy was not hurtling into the abyss. Still, things did not turn out quite the way the Federal Reserve expected. The economy never gained the momentum it sought, oil prices continued to sag until mid-year along with energy-related investment spending, and inflation was slow to pick up, remaining well below the Fed's 2 percent target. Instead of the planned four rate hikes, the central bank kept its finger off the rate trigger until the final month of the year when the second quarter-point increase was put into effect. As was the case a year earlier, the majority of Fed officials at the recent December policy meeting believed the economy has shown enough progress to justify several more rate increases in 2017, albeit this time the number was scaled back to three.

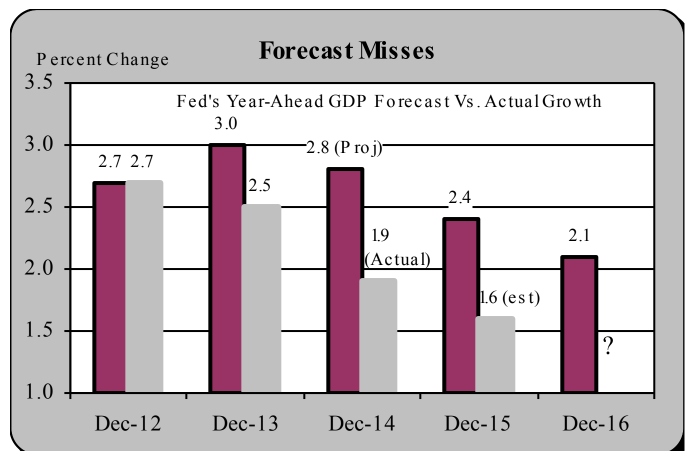
Needless to say, many in the forecasting community are viewing the Fed's intentions with a healthy dose of skepticism. For one, the central bank has repeatedly overstated the economy's prospects during the recovery, thus compromising its credibility as a forecaster. For another, the economy did not exactly enter the year like a lion, having ended 2016 more like a lamb. Final figures are not yet available, but monthly data were tracking a noticeably slower growth rate for the fourth quarter than the 3.5 pace registered for the third. Finally, a number of actual and potential headwinds could clog the economy's growth engine and slow the rise in inflation towards the Fed's 2 percent target. That said, there are more reasons to be optimistic this year than last. While the Fed may not hike rates as much as it intends, it should go further along in the process than was the case in 2016.

Bad Record

As we have learned the hard way in recent years, economic forecasting can be a perilous undertaking. A year ago, the Federal Reserve and most private economists were upbeat regarding the outlook. Indeed, the Fed seemed hell-bent on normalizing interest rates, viewing its quarter point increase in December 2015 as the first of four installments that would gradually bring rates up to more normal levels. While growth had slowed dramatically in the fourth quarter of 2015, Fed officials viewed that as a temporary setback, related mostly to the harsh weather conditions that prevailed during the winter months. At the December meeting, policymakers expected growth to rebound in the first quarter and to continue at an above-trend pace over the remainder of the year.

In hindsight, that proved to be wildly optimistic. Instead of rebounding, the winter doldrums extended through the spring, as the economy grew by a tepid 1.1 percent pace over the first half of last year. To be fair, the Fed could not have foreseen some of the headwinds that restrained growth, including the slump in global demand that along with the ongoing weakness in energy-related investment spending crimped manufacturing activity. Nor could it anticipate the Brexit vote in June that briefly sent tremors through the financial markets and raised anxious questions about whether the European Union would survive. Still, the uncertainty and sagging economy were enough to keep the Fed on the sidelines; instead of aggressively seeking to normalize interest rates, the central bank turned more cautious, fearing that a premature tightening of policy would stifle growth.

Having been burned in 2016, the Fed is understandably worried about potential headwinds that could upset its rate-hiking plans for this year. Indeed, a cursory review of its forecasting record underscores this more cautious mind-set. In each of the past three years, the Fed has lowered its growth forecast for the



U.S. economy for the following year. Despite these lowered expectations, the projections for real GDP made in December of 2013 through 2015 still exceeded the actual growth rates by substantial margins in every year. In December 2015, Fed officials expected the economy to grow by 2.4 percent in 2016, almost a full percentage point faster than the estimated 1.6 percent that actually took place. At its recent policy meeting last December, the Fed once again lowered its year-ahead forecast, expecting a growth rate of 2.1 percent for 2017.

Too Cautious?

Interestingly, this time the Fed may have taken too large of a step back. True, the economy lost some of its momentum in the fourth quarter relative to the third. But more than 1 percentage point of the 3.5 percent increase in GDP during the third quarter came from a temporary soybean-fueled 14.4 percent surge in exports of goods. That boost has already unwound and exports declined in October and November, which likely dragged down growth during the fourth quarter. But the underlying fundamentals have remained strong and the economy is not likely to suffer the same abrupt setback in the first quarter as it did in 2016.

That's particularly the case for consumer spending, which accounts for about 70 percent of total activity. Due mostly to harsh weather conditions, households were deterred from going to shopping centers and malls during last year's first quarter, resulting in an abrupt slowdown in spending. Weather should not be a factor this year, as the winter so far is turning out to be one of the warmest on record. What's more, households entered the new year with more spending muscle than a year ago. Workers received the largest pay increase of the recovery in December and the ever-tightening labor market points to even stronger wage increases in 2017. Higher disposable incomes and steadily improving job prospects are time-honored ingredients that encourage households to keep their wallets and purses open.

Meanwhile, two misfiring cylinders in the economy's growth engine last year are starting to kick into gear. The fitful housing recovery following the frightful collapse during financial crisis stalled out in the middle of 2016, as residential outlays fell in the second and third quarters. But homebuilders ramped up construction in the fourth quarter and building permits for single-family homes surged to the highest level since 2007 in December, pointing to increasing residential outlays at least through the first quarter. As well, some key tailwinds may finally lift business investment out of the doldrums. The prospect of reduced corporate taxes and regulation should release "animal spirits" in the business community, spurring capital spending; as well, the rebound in oil prices over the past year is already giving a lift to energy-related spending, with hundreds of oil rigs being brought back into operation.

Dissension in the Ranks

Odds are, the economy will not travel as rocky a road over the first half of the year as was the case in 2016. That said, the recent surge in business and consumer sentiment is largely based on heightened expectations underpinned by the new administration's pro-business and pro-growth agenda. We doubt, however, that changes in the economy's underlying fundamentals justify the post-election euphoria. While some pick-up is expected, the economy's speed limit is restrained by the slower growth of an aging labor force and the absence of a visible catalyst that would put a spark under the lackluster pace of productivity.

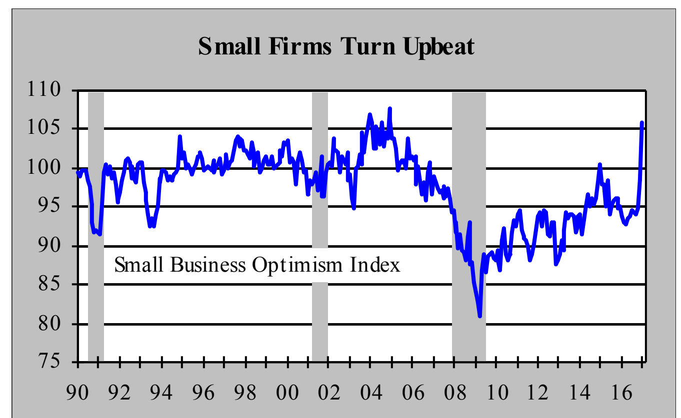
What's more, there is a real question as to whether president Trump can deliver on his campaign promises. Keep in mind that the president can only propose, but it is Congress that disposes. Aside from the predictable opposition from the Democrats, Trump may have a hard time convincing his Republican cohorts, which represent the party of budget restraint, to go along with his plans. Even if they have similar goals, such as with corporate tax reform, dissension between the congressional and executive branches over details is sure to erupt. Recently, president Trump indicated that he is opposed to the proposed corporate border tax adjustment favored by congressional Republicans.

Still, elections have consequences. Just as former president Obama was able to push through a large stimulus package, the Affordable Care act and tougher regulations during his first two years in office when his party ruled Congress, President Trump should find some success with his proposals, including tax cuts and increased infrastructure spending. We suspect that a fiscal package of slightly over $1 trillion will get through Capitol Hill, although its timing and the mix between tax cuts and spending increases remain open questions.

Growth Impediments

Most likely, the tax cuts will come first and the spending increases later in the year, indicating that the fiscal thrust will have its biggest impact heading into 2018. But the impact could be felt earlier if corporations step up spending in anticipation of faster growth, something that is already suggested in recent business sentiment surveys. That said, businesses as well as households do not always follow through on how they feel. The post-election euphoria may turn out to be a sugar high that deflates when confronted with some unpleasant realities.

Most worrisome, perhaps, is the president's anti-trade rhetoric. Even as the new administration puts forth its pro-growth agenda, if it also follows through on its protectionist stance – imposing tariffs or otherwise engaging in trade wars with China and Mexico, for example –the economy could suffer greatly. Put simply, the election outcome may generate more policy uncertainty, not less, which is a time-honored source of financial instability that could undermine confidence and threaten to drag down activity. Our sense is that the positive forces will outweigh the negative ones, but the latter – reinforced by a strong dollar and modest global growth – will temper the growth pickup this year and, perhaps, limit the rate hikes the Fed can put through.



KEY ECONOMIC AND FINANCIAL INDICATORS

*FINANCIAL INDICATORS**

	December	November	October	September	August	July	June	12-Month Range High	12-Month Range Low
Prime Rate	3.64	3.50	3.50	3.50	3.50	3.50	3.50	3.64	3.37
3-Month Treasury Bill Rate	0.51	0.45	0.33	0.29	0.30	0.30	0.27	0.51	0.23
5-Year Treasury Note Rate	1.96	1.60	1.27	1.18	1.13	1.07	1.17	1.96	1.07
10-Year Treasury Note Rate	2.49	2.14	1.76	1.63	1.56	1.50	1.64	2.49	1.50
30-Year Treasury Bond Rate	3.11	2.86	2.50	2.35	2.26	2.23	2.45	3.11	2.23
Tax-Exempt Bond Yield	3.65	3.59	3.27	2.93	2.85	2.83	3.20	3.65	2.83
Corporate Bond Yield (AAA)	3.11	2.86	2.56	2.48	2.34	2.30	2.43	3.11	2.30
Conventional 30-Year Mortgage Rate	4.20	3.77	3.47	3.46	3.44	3.44	3.57	4.20	3.44
Dow Jones Industrial average	19712	18697	18185	18267	18495	18341	17755	19712	16300
S&P 500 Index	2247	2165	2143	2158	2177	2149	2084	2247	1918
Dividend Yield (S&P)	2.09	2.11	2.17	2.12	2.11	2.11	2.17	2.31	2.09
P/E Ratio (S&P)	21.0	20.6	19.9	20.4	20.4	20.4	19.8	21.0	17.6
Dollar Exchange Rate (vs. Major Currencies)	95.4	93.7	91.9	90.1	89.8	90.9	89.7	95.4	89.4

** Monthly Averages*

ECONOMIC INDICATORS

	December	November	October	September	August	July	June	12-Month Range High	12-Month Range Low
Housing Starts (In Thousands)	1226	1102	1320	1052	1164	1218	1195	1320	1052
New Home Sales (Thousands of Units)		592	563	571	559	622	558	622	525
New Home Prices (Thousands of Dollars)		305	303	320	302	295	322	567	291
Retail Sales (% Change Year Ago)	4.1	3.9	4.1	3.4	2.4	2.3	2.8	4.1	1.7
Industrial Production (% Change Year Ago)	0.5	-0.7	-0.7	-1.1	-1.1	-0.9	-0.6	0.5	-2.3
Operating Rate (% of Capacity)	75.5	74.9	75.4	75.4	75.6	75.7	75.4	75.7	74.9
Inventory Sales Ratio (Months)		1.4	1.37	1.38	1.39	1.39	1.39	1.41	1.37
Real Gross Domestic Product (Annual % Change)				3.5			1.4	3.5	0.8
Unemployment Rate (Percent)	4.7	4.6	4.8	4.9	4.9	4.9	4.9	5.0	4.6
Payroll Employment (Change in Thousands)	156	204	135	208	176	252	271	271	24
Hourly Earnings (% Change Year Ago)	2.9	2.8	2.8	2.7	2.5	2.7	2.6	2.9	2.3
Personal Income (% Change Year Ago)		3.5	3.7	3.6	3.4	3.5	3.4	4.0	3.4
Savings Rate (Percent of Disposable Income)		5.5	5.7	5.6	6.0	5.8	5.8	6.2	5.5
Consumer Credit (Change in Mil. Of Dollars)		24532	16174	22218	26801	18101	14459	26801	6561
Consumer Prices (% Change Year Ago)	2.1	1.7	1.6	1.5	1.1	0.8	1.0	2.1	0.7
CPI Less Food & Energy (% Change Year Ago)	2.2	2.1	2.1	2.2	2.3	2.2	2.3	2.3	2.1
Wholesale Prices (% Change Year Ago)	1.6	1.3	0.8	0.7	0.0	-0.2	0.3	1.6	-1.0

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