Louisiana Corporate Credit Union

ECONOMIC & FINANCIAL DIGEST

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Volume 25 June 2017

Washington Dysfunction

As the spring season heats up, so too is the economy. The first quarter's slowdown is already history and the financial markets along with policy makers are gearing up for what looks like a solid rebound in the second quarter. The labor market continues to do its part, generating jobs at a faster pace than population growth. The hefty increase in collective paychecks, reinforced by longer working hours, is forming a solid foundation that will sustain consumer spending in coming months. And, with inflation remaining relatively dormant, those paychecks are going a longer way.

Still, the actual performance of the economy has not lived up to the high expectations on Main Street. Household and business confidence soared following the elections, as the prospect of tax cuts, increased infrastructure spending and a relaxed regulatory environment promised to lift the economy out of the subpar 2-percent growth rut seen since the Great Recession. But the post-election euphoria is being sorely tested by a series of disruptive events in Washington that could derail or delay president Trump's economic agenda, punctuated by his abrupt firing of FBI Director Comey and subsequent reports of his meddling in the Russian investigations. Depending on how the fallout evolves, Trump's missteps may sap him of the political capital necessary to push his dramatic policy reform measures through Congress.

As it is, Congress has a lot on the table to mull over and the latest incidents are unneeded distractions that could further clog the gears of the legislative process. The Senate, for example, now has five simultaneous priorities to address: passing a budget by September 30, raising the debt ceiling by October, drafting its own healthcare bill, drafting a tax reform and infrastructure bill and addressing the Russian interference issue. Needless to say, that is a lot to bite off and only a diehard optimist could think that things will go smoothly, especially with the explosive divisions in Congress that the latest brouhaha exacerbated. Given this backdrop, the odds of a growth-boosting tax bill being passed this year have dwindled considerably.

Don't Blame Trade Deficits

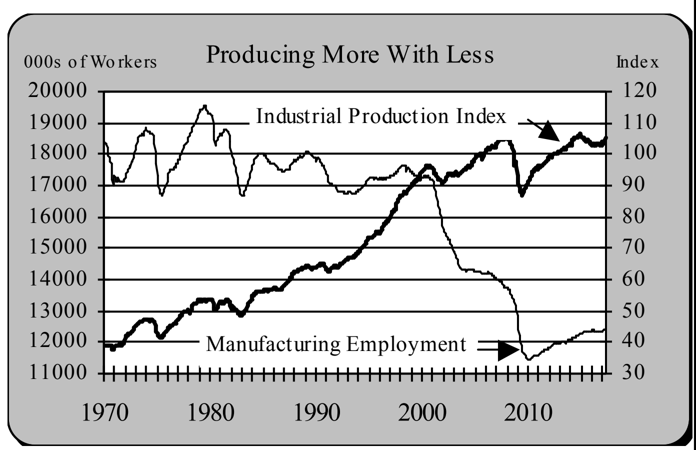
The administration's plan to cut taxes and increase infrastructure spending to jump-start the economy's underlying growth rate are clearly not new solutions for an age-old problem. If done in a timely and rational manner, they can have the desired effect. But another cornerstone of the president's policy to "make America great again" – making fairer trade deals – poses more risks than rewards, despite striking a positive chord with voters. President Trump's rationale for this strategy is that the large U.S. trade deficit reflects unfair advantages granted to our trading partners over the years, which have shifted output and jobs – particularly in manufacturing — from the U.S. to foreign firms

While the original terms of some trade agreements should be renegotiated, including Nafta, it is misguided to equate fair trade with balanced trade flows. The biggest reason the U.S. has been running deficits for decades is because we do not generate enough savings to finance what we consume and invest. True, outsourcing and lower labor costs overseas has hurt manufacturing more than other industries. But the loss of manufacturing jobs, which has been on a declining trend for thirty-five years, is primarily due to advances in technology and productivity. Even as manufacturing jobs have dwindled from 19.3 million to 12.4 million since 1980, industrial production has nearly doubled over the period. Simply put, thanks to greater efficiency, America is producing more goods with fewer workers.

If the government tries to penalize companies for outsourcing production overseas, where labor costs might be cheaper, it's doubtful that the effort would produce many more jobs in the U.S. Instead, the affected companies would likely minimize the use of expensive domestic labor and increase investment in automation to remain competitive. Similarly, if protectionist measures were imposed, such as higher tariffs on imports, other nations would respond in kind, resulting in reduced trade and weaker global growth. Nor are trade deficits responsible for the sluggish growth in the U.S. In fact, some of the fastest periods of growth have historically been associated with sharply rising deficits, including the boom years during the 1980s and late 1990s.

Remedial Measures

In some ways, larger deficits spurred by rising imports,



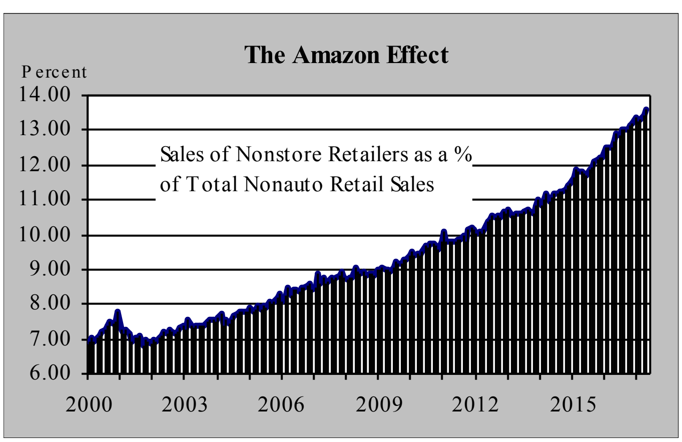
actually benefit the U.S. economy. A recent study by the Federal Reserve Bank of St. Louis illustrates this point. Between 2000 and 2007, the study notes that 800 thousand manufacturing jobs were lost to an upsurge in Chinese imports. But over that span, that loss was more than made up for by new jobs in other sectors, most notably in services, construction and wholesale and retail trade. The increased labor supply coming from the displaced manufacturing workers together with the cheaper imports of Chinese materials helped reduce production costs in these other sectors, resulting in lower prices for their goods and services than would otherwise be the case. The study concluded that these lower prices saved American consumers $260 per year over their lifetime.

To be sure, many of the displaced manufacturing workers are unable to find jobs. Their skill sets may have become redundant and incompatible with the demands in the services sector, or they may not have the mobility to go where the jobs are, among other reasons for their unemployment. But a hard turn towards protectionist measures would do little to bring those jobs back and, in fact, might only undermine the benefits of free trade. A more useful solution would be to develop programs or beef up existing ones that offer retraining for displaced workers and facilitate their ability to relocate where the jobs are.

Such remedial measures would also help ease the pain caused by automation, which has displaced far more workers than trade deficits. Indeed, replacing humans with machines has caused considerably more job losses outside of the manufacturing sector. In retail, for example, which employs 3 million more workers than factories, new technology has eviscerated jobs at an escalating pace. Online shopping now accounts for 13.5 percent of nonauto retail sales, up from 4 percent in 1994, when Amazon was founded, resulting in massive store closings and worker layoffs. And while the surge in e-commerce has led to a proliferation of warehouses and distribution centers, these buildings are not an alternative source of employment for laid-off retail workers, as they increasingly rely on robots to do the heavy lifting and moving of merchandise.

Common Ground

One thing that automation and imports have in common is that they suppress inflation. As noted earlier, lower prices encourage American consumers to purchase foreign products even as cheaper labor lowers production costs for businesses, both of which drive up imports. To the extent these imports replace higher-priced U.S-made goods, they contribute directly to lower inflation. They also do so indirectly as imports force American companies to operate more efficiently – and, hence, keep prices lower than otherwise—to remain competitive in the global marketplace.



Likewise, automation increases productivity, which lowers unit labor costs and enables companies to maintain profit margins while holding the line on prices. The upsurge in e-commerce, which relies far more heavily on technology than brick-and-mortar establishments, has had as much of an inflation-depressing impact as any development in the past 20 years. Not only do Internet retailers operate with much lower costs than department stores – and, hence, are eating their lunch – they obliterated geographical boundaries to shopping and brought transparent pricing to consumers. Consumers can easily compare prices virtually around the world and shop for the lowest-cost option available.

With companies under great restraints to keep prices in check, they also do their best to control labor costs, their main operating expense. That's particularly the case in a slow-growth environment, which limits the revenues that can be used to pay workers. The confluence of these forces goes a long way towards explaining why wage increases have been far weaker than would be expected as the economy is close to, if not at, full employment. It is also primarily responsible for the cautious approach being taken by the Federal Reserve to normalize interest rates, which are expected to wind up at much lower levels than at the end of past tightening cycles.

Cutting Through The Noise

Indeed, some are questioning whether the ongoing turmoil in Washington will derail the Fed's plan to raise interest rates two more times this year as well as the administration's ambitious fiscal agenda. After all, uncertainty is the enemy of growth and there is clearly an abundance of unknown consequences stemming from the chaotic first four months of the Trump administration. Should the cumulative effects of Washington mishaps shatter household and business confidence, that could well weigh on growth and cause policy makers to rethink their rate-hiking strategy.

For now, though, the Fed will probably overlook the noise and focus on incoming data, which is still providing support for its gradual plan to normalize interest rates. Keep in mind that the Fed never fully incorporated fiscal stimulus into its growth and inflation forecasts, so the latest chapter of the Washington political saga should have little impact on its decisions over the near term. Only if the data fail to validate expectations would policymakers reconsider their strategy.

At this point, however, the economy remains on a solid footing, with the job market still tightening and consumers regaining their mojo. What's more, some headwinds that have crimped growth are easing. For the first time since the recession all major economies are pulling in the same direction, which is boosting exports and reducing upward pressure on the dollar, making U.S. goods more competitive. Business investment spending is finally perking up and, as the labor market continues to tighten, so too will wages. If Washington can get its act together and push through a credible tax and spending plan, the economy will get another welcome boost. If not, some optimists will be disappointed, but the modest, slow expansion will remain on track even without government help.

KEY ECONOMIC AND FINANCIAL INDICATORS

*FINANCIAL INDICATORS**

	April	March	February	January	December	November	October	12-Month Range High	12-Month Range Low
Prime Rate	4.00	3.88	3.75	3.75	3.64	3.50	3.50	4.00	3.50
3-Month Treasury Bill Rate	0.80	0.74	0.52	0.51	0.51	0.45	0.33	0.80	0.23
5-Year Treasury Note Rate	1.82	2.01	1.90	1.92	1.96	1.60	1.27	2.01	1.07
10-Year Treasury Note Rate	2.30	2.48	2.42	2.43	2.49	2.14	1.76	2.49	1.50
30-Year Treasury Bond Rate	2.94	3.08	3.03	3.02	3.11	2.86	2.50	3.11	2.23
Tax-Exempt Bond Yield	4.05	3.95	3.91	3.80	3.82	3.59	3.27	4.05	2.83
Corporate Bond Yield (AAA)	3.87	4.01	3.95	3.92	4.06	3.86	3.51	4.06	3.28
Conventional 30-Year Mortgage Rate	4.05	4.20	4.17	4.15	4.20	3.77	3.47	4.20	3.44
Dow Jones Industrial average	20685	20823	20424	19908	19712	18697	18185	20823	17692
S&P 500 Index	2359	2367	2330	2275	2247	2165	2143	2367	2067
Dividend Yield (S&P)	2.01	2.01	2.01	2.06	2.09	2.11	2.17	2.18	2.01
P/E Ratio (S&P)	21.6	21.7	21.8	20.9	20.6	20.5	19.9	21.8	19.2
Dollar Exchange Rate (vs. Major Currencies)	94.0	94.5	94.0	94.7	95.4	93.7	91.9	95.4	89.4

** Monthly Averages*

ECONOMIC INDICATORS

	April	March	February	January	December	November	October	12-Month Range High	12-Month Range Low
Housing Starts (In Thousands)	1172	1203	1288	1236	1268	1149	1328	1328	1062
New Home Sales (Thousands of Units)		621	587	585	551	573	568	622	551
New Home Prices (Thousands of Dollars)		315	293	308	333	318	302	333	234
Retail Sales (% Change Year Ago)	4.5	4.8	4.7	5.6	4.0	3.7	4.0	5.6	2.1
Industrial Production (% Change Year Ago)	2.2	1.5	0.4	0.0	0.8	-0.4	-0.8	2.2	-1.7
Operating Rate (% of Capacity)	76.7	76.1	75.8	75.8	76.0	75.5	75.7	76.7	75.2
Inventory Sales Ratio (Months)		1.35	1.35	1.35	1.35	1.37	1.37	1.40	1.35
Real Gross Domestic Product (Annual % Change)		0.7			2.1			3.5	0.7
Unemployment Rate (Percent)	4.4	4.5	4.7	4.8	4.7	4.6	4.8	5.0	4.4
Payroll Employment (Change in Thousands)	211	79	232	216	155	164	124	297	43
Hourly Earnings (% Change Year Ago)	2.5	2.6	2.8	2.6	2.9	2.7	2.7	2.9	2.5
Personal Income (% Change Year Ago)		4.5	4.5	4.1	3.6	3.7	3.7	4.5	3.4
Savings Rate (Percent of Disposable Income)		5.9	5.7	5.4	5.2	5.5	5.6	6.0	5.2
Consumer Credit (Change in Mil. Of Dollars)		16431	13748	9731	13933	25491	21471	25491	9731
Consumer Prices (% Change Year Ago)	2.2	2.4	2.7	2.5	2.1	1.7	1.6	2.7	0.8
CPI Less Food & Energy (% Change Year Ago)	1.9	2.0	2.2	2.3	2.2	2.1	2.1	2.3	1.9
Wholesale Prices (% Change Year Ago)	2.5	2.3	2.2	1.6	1.6	1.3	0.8	2.5	-0.2