Louisiana Corporate Credit Union
ECONOMIC & FINANCIAL DIGEST
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Volume 26 February 2018

Message to Policy Makers: Do No Harm

On January 21, the nation entered year two of the Trump administration. If year one is any indication, the rest if 2018 should be anything but boring. The president has a knack for stirring up headlines either intentionally or unintentionally, primarily through tweets and impulsive public comments. That said, the tumultuous political environment last year did not spill over into the financial markets, which were the model of tranquility. Indeed, the Standard & Poor's 500 index moved by more than 1 percent on only eight days in 2017, making it the least volatile year since 1964. The bond market was also exceptionally calm by historical standards, as long-term Treasury yields traded within a very tight range and ended the year virtually unchanged from where they started.

The takeaway from the 2017 experience is that investors are guided more by economic fundamentals than the tumult emanating from the Oval Office. Against this backdrop, there was more to like than to dislike last year, as the economy turned in a better performance than expected. Despite extreme weather-related disruptions, growth over the final three quarters of the year broke out of the lackluster 2.0 – 2.5 percent pace recorded during most of the recovery. Unemployment fell to a seventeen-year low, ending the year at 4.1 percent, and corporations enjoyed record profits, underpinning another remarkable year of rising stock prices. Inflation, meanwhile, remained tame, which kept a lid on long-term interest rates and prompted the Federal Reserve to gently remove its foot from the gas pedal rather than aggressively applying the brakes to counter an ever-tightening labor market.

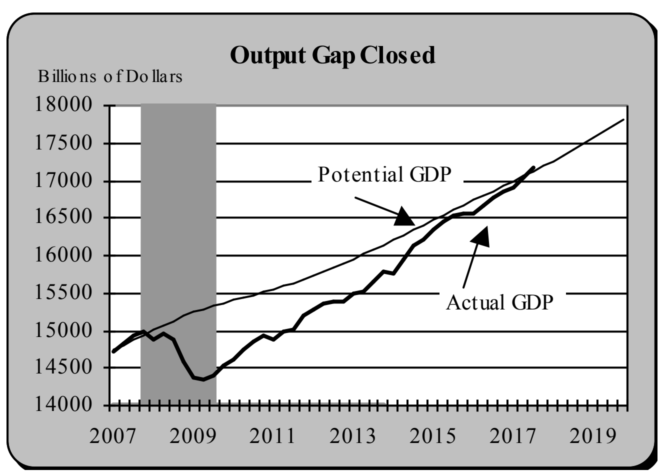
What's more, beneath all the Sturm and Drang surrounding the White House, the actual deeds of the administration were neither unexpected nor disruptive to the economy. The signature policies put into effect – the tax overhaul and deregulation – were actions that the president had long espoused, beginning with early campaign speeches, and their impact on the economy has so far been more positive than negative. But those typical Republican-friendly policies temporarily sidelined other, more controversial, priorities that the president campaigned on and is now vigorously pursuing, notably on trade, immigration and infrastructure. These policies are likely to meet with considerable public and Congressional resistance and could potentially have more harmful effects on the economy.

Reaching Potential

Before becoming a doctor, medical aspirants must first promise to "do no harm" to the patient. Unfortunately, legislators are not required to take the Hippocratic Oath, and their actions often do more harm than good to the patient. That becomes particularly frustrating when the patient, in this case the economy, is doing well. A year ago, it could be argued that the economy needed a growth injection to lift it out of the 2.0 percent torpor that was becoming the "new normal" in the eyes of most economists. Despite more than seven years of continuous, if languid growth, there was still considerable ground to make up following the Great Recession, not only here but also in the global economy, where the recovery was even weaker.

However, the growth engine revved up over the last three quarters of 2017, accompanied by a surprising pick-up in most major advanced economies. For the first time in a decade, the U.S. finally reached its output potential following a 3.3 percent growth spurt in last year's third quarter. A similar narrowing of the output gap is occurring overseas, and the World Bank expects the gap to close for most advanced economies sometime in 2018. Simply put, the U.S. as well as the global economic landscape has entered that much admired "sweet spot", turning out the maximum amount of goods and services in a stable inflation environment.

The challenge is to keep the growth engine running at maximum efficiency. That means preventing it from overheating and stoking inflationary pressures or gumming up the works with policies that can cause the engine to stall out. Striking such a balance will be no easy feat; since World War 11, it has probably been successfully accomplished in the U.S. for only a few years in the 1960s and 1990s. What's more, the risks facing policy makers in 2018 are symmetric, i.e., policies in the pipeline can either put too much strain on the engine or cause it to sputter. Complicating matters further is that there is more than one engineer handling the



controls; the Federal Reserve operates one lever while others are managed by lawmakers in Congress and the executive branch. At critical points in the business cycle, they often are at odds with each other.

Ill-Timed Stimulus

With the U.S. already running at full potential, the immediate risk is that things will get too hot over the near term. The economy entered 2018 under a full head of steam, and the recent tax cuts will give growth an added impetus. Unlike a year ago, a fiscal boost is not needed now and may, instead, put too much strain on the nation's resources. If the president also doubles down on his next priority to rev up infrastructure spending – which would likely get bipartisan approval — that would put a further strain on capacity.

To be sure, there is no precise way of determining when the economy is hitting capacity limits. The output gap noted earlier is one barometer; but the economy's output potential is a moving target, depending on trends in productivity and the labor force. Both have slowed dramatically in recent years, lowering the economy's output potential in the process. However, both can rebound under certain conditions. The most likely candidate for improvement would be productivity growth, thanks to the revival in business capital spending that has been underway since early last year.

But it takes years to determine if the productivity trend has shifted gears. Hence, policy makers and economists tend to use the unemployment rate as a more immediate barometer of slack in the economy. Unfortunately, that too, is a moving target, depending on the labor force participation rate, the age composition of the population and other factors. Still, an unemployment rate in the 4 – 5 percent range has long been viewed to be consistent with full employment, which suggests that the current 4.1 percent is close to the point of overheating. In the past, when the rate has fallen below 5 percent, the fiscal deficit has averaged less than 1.0 percent of GDP. The deficit share is currently at 3.5 percent and the $1.5 trillion tax cut is expected to pump it up to over 4.5 percent. In the eyes of many, that confluence will spur faster growth than the economy can accommodate, thus stoking a significant inflation pick up.

Role Reversal

The injection of fiscal stimulus into the economy marks a dramatic role reversal for policy makers. For several years following the Great Recession the government embarked on a crusade of fiscal austerity, spurring the Federal Reserve to counter this growth-retarding influence by consistently priming the monetary pump. Only after the unemployment rate dipped below 5 percent in late 2015 did the Fed start to lift its foot off of the gas pedal, initiating the first of five increases in short-term rates, including the last quarter-point increase this past December.

At that December policy meeting, the Fed acknowledged that the tax cuts would contribute to faster growth, which solidified its commitment to keep raising short-term interest rates over the next two years. But the strategy of removing monetary accommodation at a gradual pace remained in place. The reluctance to step up the rate hiking campaign, at least for now, reflects the still-low inflation rate, which needs to convincingly show signs of moving up to the Fed's 2 percent target. Under the 2017 regime led by Chairwomen Janet Yellen, several Fed officials believed that the stubbornly low inflation rate is a sign that the economy still has more slack than the low 4.1 percent unemployment rate suggests.

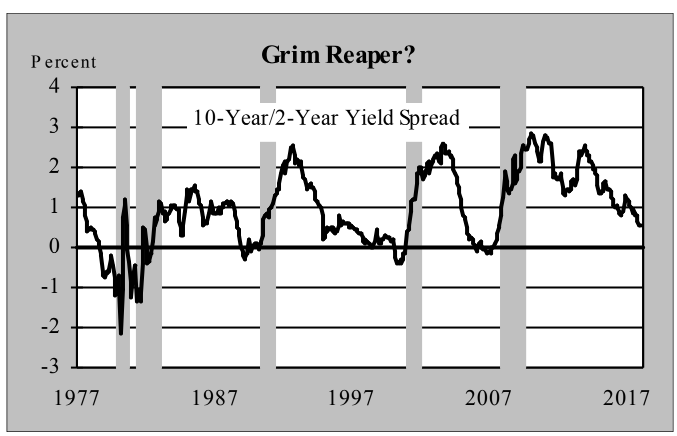
But a new Chair will lead the 2018 Fed, and the policy setting committee will have several new members who are more hawkish on inflation than the ones they replace. The risk is that they will be more trigger-happy and aggressive in lifting rates if the unemployment rate continues to fall, which is a distinct possibility. The risk becomes greater if the economy's momentum from last year carries over into 2018, resulting in another above-trend growth in the first quarter.

Heightened Risk Of Policy Mistake

The Fed's challenge will be to keep the economy from overheating while not stifling growth by hiking rates too aggressively. Although the fiscal stimulus from the tax cut complicates the task, fears that it will send the economy into overdrive are probably overblown. Most of the benefits accrue to wealthy households and businesses, which will impart less of a growth boost than if lower-income households were the main beneficiaries, since they would spend a higher fraction of the additional after-tax dollars. Economists estimate that the tax cuts will add about 0.4 percent to this year's growth rate.

What's more, the administration is now focused on other policies that could well dampen growth. Tighter restrictions on immigration are already crimping the labor force and worsening labor shortages in several industries. There is a real possibility that the U.S. will withdraw from NAFTA even as it pursues other protectionist measures, such as increasing tariffs on imported steel and aluminum and imposing penalties on China for alleged unfair trade practices. In the short run, these actions could actually widen the U.S. trade deficit – and lower GDP – as imports are accelerated before the tariffs are imposed.

The risk of a policy mistake, either on the fiscal or monetary side, has increased in recent months as policy makers are becoming more actively involved in the economy's performance. It's unlikely that any measures will derail the expansion in the foreseeable future. The economy's fundamentals are strong and the financial markets seem undaunted by the foibles in Washington so far. While the odds of a recession this year are low, the markets are sending signals that a downturn looms not far beyond 2018. One such signal is the dramatic narrowing spread between short and long-term yields, reflecting investor fears that aggressive central bank rate hikes could tip the economy into a recession. The spread is still comfortably positive, so the Fed has time to figure out the correct course to take. Let's hope it meets the challenge.



KEY ECONOMIC AND FINANCIAL INDICATORS

FINANCIAL INDICATORS*

								12-Month Range	
	December	November	October	September	August	July	June	High	Low
Prime Rate	4.40	4.25	4.25	4.25	4.25	4.25	4.13	4.40	3.64
3-Month Treasury Bill Rate	1.32	1.23	1.07	1.03	1.01	1.07	0.98	1.32	0.51
5-Year Treasury Note Rate	2.18	2.05	1.98	1.80	1.78	1.87	1.77	2.18	1.77
10-Year Treasury Note Rate	2.40	2.35	2.36	2.20	2.21	2.32	2.19	2.49	2.19
30-Year Treasury Bond Rate	2.77	2.80	2.88	2.78	2.80	2.88	2.80	3.11	2.77
Tax-Exempt Bond Yield	3.43	3.56	3.61	3.53	3.53	3.56	3.55	3.91	3.43
Corporate Bond Yield (AAA)	3.51	3.57	3.60	3.63	3.63	3.70	3.68	4.06	3.51
Conventional 30-Year Mortgage Rate	3.95	3.92	3.90	3.81	3.88	3.97	3.90	4.20	3.81
Dow Jones Industrial average	24545	23558	23036	22173	21914	21581	21318	24545	19712
S&P 500 Index	2664	2594	2557	2493	2456	2454	2434	2664	2247
Dividend Yield (S&P)	1.87	1.87	1.94	1.97	2.00	1.99	1.99	2.09	1.87
P/E Ratio (S&P)	22.5	22.3	21.7	21.3	21.1	21.2	20.9	22.5	20.6
Dollar Exchange Rate (vs. Major Currencies)	88.7	89.2	88.7	87.1	88.20	89.60	91.8	95.4	87.1

** Monthly Averages*

ECONOMIC INDICATORS

								12-Month Range	
	December	November	October	September	August	July	June	High	Low
Housing Starts (In Thousands)	1192	1299	1261	1159	1172	1185	1217	1299	1129
New Home Sales (Thousands of Units)		733	624	635	559	564	619	733	548
New Home Prices (Thousands of Dollars)		319	320	329	314	323	315	333	298
Retail Sales (% Change Year Ago)	5.2	6.0	5.0	5.0	3.5	3.7	3.0	6.0	3.0
Industrial Production (% Change Year Ago)	3.6	3.5	3.4	1.7	1.4	1.7	2.1	3.6	0.0
Operating Rate (% of Capacity)	77.9	77.2	77.4	76.1	76.0	76.4	76.6	77.9	75.7
Inventory Sales Ratio (Months)		1.33	1.34	1.36	1.38	1.38	1.38	1.38	1.33
Real Gross Domestic Product (Annual % Change)				3.3			3.1	3.3	1.2
Unemployment Rate (Percent)	4.1	4.1	4.1	4.2	4.4	4.3	4.3	4.8	4.1
Payroll Employment (Change in Thousands)	148	252	211	38	208	138	210	252	38
Hourly Earnings (% Change Year Ago)	2.5	2.4	2.4	2.8	2.6	2.6	2.6	2.9	2.4
Personal Income (% Change Year Ago)		3.8	3.4	2.9	2.6	2.4	2.4	3.8	1.5
Savings Rate (Percent of Disposable Income)		2.9	3.2	3.0	3.5	3.5	3.6	4.1	2.9
Consumer Credit (Change in Mil. Of Dollars)		27951	20532	17820	10095	14750	11603	27951	10095
Consumer Prices (% Change Year Ago)	2.1	2.2	2.0	2.2	1.9	1.7	1.6	2.7	1.6
CPI Less Food & Energy (% Change Year Ago)	1.8	1.7	1.8	1.7	1.7	1.7	1.7	2.3	1.7
Wholesale Prices (% Change Year Ago)	2.6	3.1	2.8	2.6	2.4	1.9	2	3.1	1.6