Louisiana Corporate Credit Union

ECONOMIC & FINANCIAL DIGEST

3500 N. Causeway, Suite 1510 • Metairie, Louisiana 70002 • (800) 421-7030 • www.lacorp.com

Volume 26 July 2018

As Good As It Gets

As expected, the U.S. central bank hiked short-term interest rates by another quarter-point at its June 12-13 policy meeting, lifting the bellwether federal-funds rate up to a range of 1.75-2.00 percent. It was the second increase so far this year, and the seventh since the Fed moved away from its lengthy zero-rate policy in December 2015. While rates are still historically low and less than what Fed officials deem to be a neutral rate – i.e. a level that neither stimulates nor restrains economic activity – they won't be for long if the Fed follows through with its current plan. At the June meeting, most policy makers expected to pull the rate trigger two more times this year, followed by three increases in 2019.

Hence, some time in 2019, the Fed will have returned rates to a neutral level, currently estimated at just under 3.0 percent, assuming its upgraded growth and inflation forecast comes to pass. Of course, that's the rub: the economy was doing fine when policy makers convened in mid-June; unemployment had fallen to an 18-year low of 3.8 percent, growth was tracking a 4.0 percent pace or better for the second quarter – which would be the second strongest quarterly growth rate in a decade – and inflation was picking up. The Fed understandably believed that the economy no longer needed as much of a monetary crutch to keep forging ahead, and is gently stepping on the brakes to keep the growth engine from overheating.

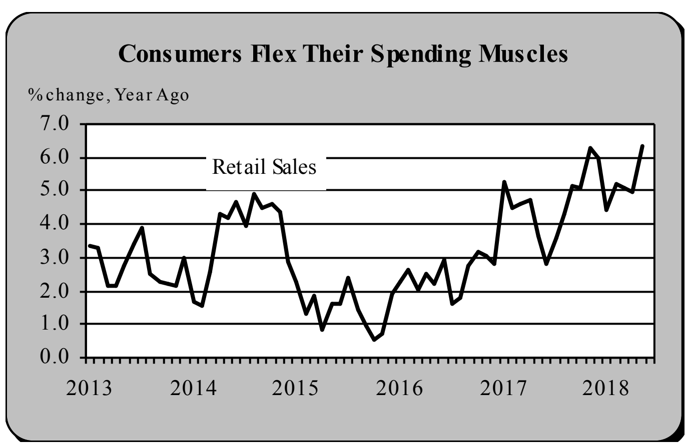
Given the current backdrop, this approach makes sense. But the second quarter is probably as good as it gets. The economy received a burst of energy this spring, fueled by massive tax cuts enacted last year and increased deficit spending Congress passed earlier this year. These catalysts still pack a punch, but they will start to fade as time goes on. Hence, the economy will need to rely more on organic sources to sustain growth, and it is unclear how well they will hold up. For sure, the fundamental underpinnings are solid, highlighted by a robust job market. But Fed rate hikes, high debt burdens, low savings and rising fuel prices against a backdrop of lagging wage growth are squeezing household purchasing power. Importantly, business leaders and investors are becoming increasingly concerned over heightened trade tensions and the potential disruptive effects a trade war would have on the economy and financial markets. The economy may be riding high now, but the road ahead will not be as smooth.

Consumers Splurge

When the Federal Reserve increased interest rates in March for the first time this year, it did so more on the basis of hope over reality. Recall that the economy was just finishing up a lackluster period of growth in the first quarter, as GDP slowed dramatically to a 2.2 percent pace from 3.0 percent or more in each of the previous three quarters. Consumers, the economy's main growth driver, were the biggest drag, as consumption expenditures slumped to a 1.1 percent rate from a robust 4.0 percent in the previous quarter. The Fed correctly believed that the slowdown from a post-hurricane influenced surge would be temporary, and that spending would pick up again in the spring.

But even the Fed could not envision the strength of the rebound that has since occurred. Following an eye-opening spike in retail sales during May, and upward revisions over the previous two months, consumption expenditures are tracking the strongest growth rate in nearly four years in the second quarter. Other sectors of the economy are also contributing to growth in varying degrees, prompting widespread upward revisions to the near-term outlook. It now looks like GDP could well advance by more than a 4.0 percent annual rate in the second quarter, and may move into the white-hot zone of 5.0 percent – a rare occurrence seen in only three other quarters this century.

But before uncorking the champagne to celebrate an economy off to the races, the likelihood is that this will be as good as it gets. True, the growth engine still has plenty of fuel, thanks to a robust job market and the added thrust coming from lowered taxes and increased deficit spending. The odds that the expansion will be short-circuited by a recession this year is practically nil. A $20 trillion economy does not shift gears on the dime unless buffeted by a confidence-shattering external shock. As long as households are collecting paychecks instead of pink slips, they will have the wherewithal to sustain spending and feed the economy's growth engine.



Households Stretched

But the second-quarter's growth spurt should not be viewed as a template for the rest of the year. For one, household fundamentals do not justify the outsized boost from consumption that took place during the period. While personal incomes continue to grow along with expanding payrolls, the increase is not keeping up with the spending pace. As a result, households have financed some of their purchases by drawing on savings, reducing the personal savings rate to precariously low levels. The overall rate dipped to 2.8 percent in April, one of only a small handful of times it fell below 3.0 percent during the recovery. And it is the budget-strapped households on the lower end of the income ladder that are mostly forced to dip into rainy-day funds. These individuals are being squeezed by the rising costs of fuel and shelter and are prime candidates to cut back spending to replenish depleted savings.

Perhaps more worrisome is that this segment of the population relies heavily on credit to support purchases and, hence, are more vulnerable to the rise in interest rates being engineered by the Federal Reserve. The strain may already be affecting their behavior, as consumers have sharply cut back their credit card borrowing this year. Through April, revolving credit – mainly credit card debt – has increased by an average of $1.5 billion a month, down from a $5 billion monthly average increase in 2017. The slowdown is highly understandable. Debt servicing charges on consumer credit increased considerably faster than incomes over the last three years; by the end of 2017, they accounted for 5.86 percent of disposable incomes, only a tad under the 6.0 percent that prevailed at the onset of the Great Recession.

Importantly, the interest rates charged on credit cards respond directly to changes in the Federal Reserve's short-term policy rate, usually with a lag of less than 60 days. Hence, the debt-servicing ratio at the end of last year – which is the latest period available – does not reflect the three quarter-point rate hikes implemented in December, March and June of this year. With total revolving credit outstanding topping $1 trillion, a quarter-percentage point rate increase translates into roughly a $2.5 billion increase in monthly interest payments. Multiply that by three rate increases, and you would need to see a meaningful acceleration in income growth to compensate for the increased debt servicing charges that is now unfolding. True, the tax reduction that took hold in the first quarter boosted disposable incomes significantly. We suspect, however, that a big chunk of the tax savings was used to pay down credit card debt, which contributed to the sharp consumer spending slowdown during the period.

Heightened Trade Anxiety

While workers are starting to see stronger wage growth, so too is inflation picking up, even as the positive contribution from the tax cuts are beginning to wane. Hence, households are not likely to enjoy a meaningful acceleration in purchasing power in coming months. The combination of low savings, high debt burdens and modest income growth is a recipe for a slowdown in consumer spending from the torrid second-quarter pace.

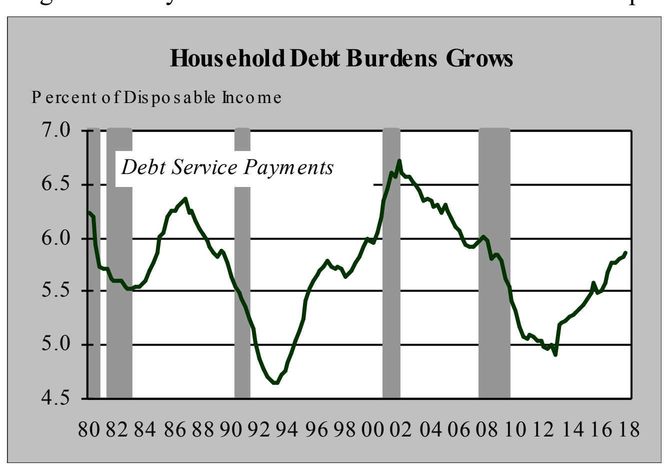
Happily, some of the slack should be taken up by business investment spending, which the Fed sees as a critical source propelling the economy forward this year and next. However, business leaders are already expressing concern over the administration's increasingly protectionist trade policy, which is drawing stern reactions from our trading partners. At this juncture, there is little sign that the Trump administration is backing down. Instead, it is ramping up the bellicose trade rhetoric, particularly against China, with threats of increasing tariffs on virtually all of the $500 billion in Chinese imports.

More broadly, it is also threatening to pull out of Nafta, the long-standing pact with Canada and Mexico that involves $1.1 trillion in trade and $840 billion of cross-border investments. That would not only disrupt supply chains of U.S. companies, but also push prices higher on goods for consumers and inputs for businesses. Importantly, the uncertainty regarding trade is prompting companies to rethink their investment decisions, something that poses a direct threat to the growth outlook.

Markets React

Until recently, the financial markets have taken the trade spats in stride, as has the Federal Reserve. In his press conference following the June policy meeting, Chairman Powell acknowledged the risk of a trade war, but said that so far it has not had any impact on the economic data. The implication is that the Fed will continue on its rate-hiking course until some negative effects become visible. Again, there is justification for that position given the economy's robust performance in the second quarter and rising inflation pressures. Clearly, the central bank is not overly concerned with the potential growth-dampening impact of trade tensions; instead, it is more concerned with preventing the economy from overheating.

However, if, as we expect, the second quarter marked the peak growth for the economy and momentum slows in coming quarters, the impact of a trade war would become more pronounced. The risk is that the Fed would be tightening policy into a slowing economy, and the lagged effects of higher short-term interest rates would hasten the onset of a recession. Indeed, investors are forward looking, and the combined effect of a tightening policy and heightened trade tensions is starting to weigh on the financial markets. Stock prices have become much more volatile, responding negatively to ramped up trade tensions, and long-term interest rates are lagging behind the upward climb in short-term rates. That lag reflects many factors, of course, including a flight to quality by investors into U.S. Treasury bonds seeking refuge from the turmoil caused by trade tensions. But it is also a sign that bond investors see weaker growth ahead than does the Federal Reserve. Time will tell who is right, but the spring surge in activity is about to cool off as the summer heats up.



KEY ECONOMIC AND FINANCIAL INDICATORS

*FINANCIAL INDICATORS**

								12-Month Range	
	May	April	March	February	January	December	November	High	Low
Prime Rate	4.75	4.75	4.58	4.50	4.50	4.40	4.25	4.75	4.00
3-Month Treasury Bill Rate	1.86	1.76	1.70	1.57	1.41	1.32	1.23	1.86	0.89
5-Year Treasury Note Rate	2.82	2.70	2.63	2.60	2.38	2.18	2.05	2.82	1.77
10-Year Treasury Note Rate	2.98	2.87	2.84	2.86	2.58	2.40	2.35	2.98	2.19
30-Year Treasury Bond Rate	3.13	3.07	3.09	3.13	2.88	2.77	2.80	3.13	2.77
Tax-Exempt Bond Yield	3.88	3.90	3.89	3.82	3.56	3.43	3.56	3.90	3.43
Corporate Bond Yield (AAA)	4.00	3.85	3.87	3.82	3.55	3.51	3.57	4.00	3.51
Conventional 30-Year Mortgage Rate	4.59	4.47	4.44	4.33	4.03	3.95	3.92	4.59	3.81
Dow Jones Industrial average	24573	24304	24582	24982	25804	24545	23558	25804	20937
S&P 500 Index	2701	2654	2703	2705	2790	2664	2594	2790	2395
Dividend Yield (S&P)	1.95	1.97	1.96	1.90	1.79	1.87	1.87	2.00	1.79
P/E Ratio (S&P)	20.6	20.1	20.2	22.0	22.8	21.7	22.0	22.8	20.1
Dollar Exchange Rate (vs. Major Currencies)	88.7	86.4	86.2	85.7	86.3	88.7	89.2	93.2	85.7

** Monthly Averages*

ECONOMIC INDICATORS

								12-Month Range	
	May	April	March	February	January	December	November	High	Low
Housing Starts (In Thousands)	1350	1286	1327	1290	1334	1210	1303	1350	1129
New Home Sales (Thousands of Units)		662	672	659	633	636	712	712	556
New Home Prices (Thousands of Dollars)		312	335	329	330	340	343	343	312
Retail Sales (% Change Year Ago)	5.9	4.8	5.1	4.5	3.9	5.3	6.1	6.1	3.5
Industrial Production (% Change Year Ago)	3.5	3.6	3.6	3.6	2.8	2.9	3.4	3.6	1.1
Operating Rate (% of Capacity)	77.9	78.1	77.5	77.2	77	77.3	77.1	78.1	75.7
Inventory Sales Ratio (Months)		1.35	1.35	1.36	1.36	1.35	1.35	1.39	1.35
Real Gross Domestic Product (Annual % Change)			2.2			2.9		3.2	1.2
Unemployment Rate (Percent)	3.8	3.9	4.1	4.1	4.1	4.1	4.1	4.4	3.8
Payroll Employment (Change in Thousands)	223	159	155	324	176	175	216	324	14
Hourly Earnings (% Change Year Ago)	2.7	2.6	2.6	2.6	2.8	2.7	2.5	2.8	2.3
Personal Income (% Change Year Ago)		3.8	3.6	3.6	3.8	4.4	4.0	4.4	2.4
Savings Rate (Percent of Disposable Income)		2.8	3.0	3.3	3.1	2.4	2.5	3.8	2.4
Consumer Credit (Change in Mil. Of Dollars)		9262	12278	13757	14499	13074	30268	30268	8596
Consumer Prices (% Change Year Ago)	2.2	2.5	2.4	2.2	2.1	2.1	2.2	2.5	1.6
CPI Less Food & Energy (% Change Year Ago)	2.8	2.1	2.1	1.8	1.8	1.8	1.7	2.8	1.7
Wholesale Prices (% Change Year Ago)	3.1	2.6	3.0	2.8	2.7	2.6	3.1	3.1	1.9