Louisiana Corporate Credit Union

ECONOMIC & FINANCIAL DIGEST

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The Road Ahead Will Get Bumpier

With the economy closing in on the best year for growth in more than a decade, household and business spirits are understandably upbeat. Workers have enjoyed 95 consecutive months of job growth, the longest stretch on record, wages are finally starting to rise at a faster clip and personal finances continue to improve, with the savings rate at a healthy 6.7 percent. Not surprisingly, personal consumption staged the strongest increase in nearly four years during the second quarter, and the summer season appears to have fared nearly as well. Heading into the final quarter of the year, there is no reason to think that consumers will zipper up their wallets and purses; since consumer spending accounts for 70 percent of total output, the year should finish on a solid note.

Likewise, the business community has benefited immensely from lower taxes, deregulation and robust financial markets that provided companies with record amounts of capital at a relatively cheap cost. They have also rewarded shareholders profusely, returning a big chunk of their cash flow in the form of dividends and share buybacks. The virtuous circle of record profits, firm consumer demand and recycled cash flow back to shareholders have underpinned the astonishing run-up in stock prices, resulting in one of the longest bull markets on record. All things considered, one could say that businesses and investors have never had it better.

Indeed, more than a handful of economists are attributing the Goldilocks moniker to the current environment, portraying an economy that is 'just right' – not too hot, not too cold. It is hard to disagree with that sentiment, given an unemployment rate that is near the lowest since the 1960s and an inflation rate that is still historically tame. But just as trees don't grow to the skies, good times don't last forever. Make no mistake, a recession is not around the corner, barring some unforeseen shock or an egregious policy mistake that the Federal Reserve has so far avoided. But there is no question that the expansion, the second longest on record, is in its late stages and some signals that typically presage the endgame are starting to appear. It's not a question of whether, but when the next recession is upon us.

Watch Out For Noise

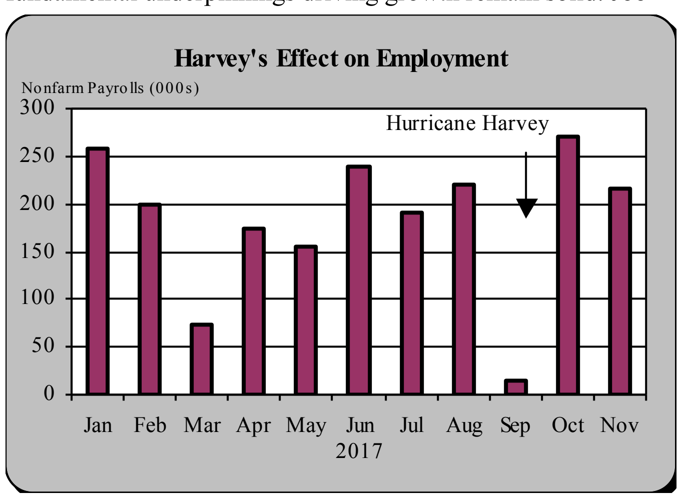
As is customary during the late summer and early fall hurricane season, Mother Nature tends to have a bigger impact on the economy. This year will be no exception. The first episode, Hurricane Florence, already made its presence felt, hitting the Carolinas with a vengeance in mid-September and destroying lives and wealth in its wake. Like major storms that preceded it, including three devastating ones in 2017, normal activity is upended in the regions affected. Foot traffic at restaurants and department stores comes to a halt, suppressing sales, workers can't get to their jobs, causing a temporary spike in unemployment, and forced closings of stores and factories results in lost output.

Past experience indicates that after a brief slowdown, activity will speed up for a while. Auto sales will get a temporary bump as households replace vehicles destroyed by the storms. Likewise, post-hurricane rebuilding efforts will spur an increase in construction activity. In other words, the economic data are likely to be distorted over the next several months, making the tea leaves difficult to read and complicating the task of the Federal Reserve. Recall that the Fed hit the pause button in its tightening policy last September when activity slumped in the wake of Hurricane Harvey.

Hurricane Florence came too late to derail the Fed's likely rate increase this September. But with other outside influences that are poised to muddy the economic waters – escalating trade tensions with China and a potential debt crisis among emerging market economies, to name the most visible – the future course of policy will become more challenging. The Fed currently plans another rate hike in December, but it remains to be seen if the noisy data in coming months or outside shocks prompt it to put things on hold once again.

Recession Signal: Inverted Yield curve.

Assuming outside influences do not throw incoming data completely off-kilter, the stage should be set for another rate increase in December, the ninth since The Fed abandoned its post-recession zero rate policy in December 2015. As noted, the fundamental underpinnings driving growth remain solid. Job



growth is outstripping the increase in the working age population, sending unemployment down to historically low levels. Wages are starting to pick up, with average hourly earnings in August rising at the fastest clip – 2.9 percent – in more than a decade. Rising labor costs combined with above-trend growth is putting upward pressure on prices.

Against this backdrop, the Fed's is striving to bring short-term interest rates up to a neutral level, one that neither stimulates nor retards growth, hoping to sustain a goldilocks balance of full employment and stable inflation. It currently sees that rate at just under 3 percent, so at the 2.00-2.25 percent range after the September increase, it is still about three quarter-point steps away from the target. Unless the economy falters, the bias among Fed officials will be slanted towards lifting rates three more times next year.

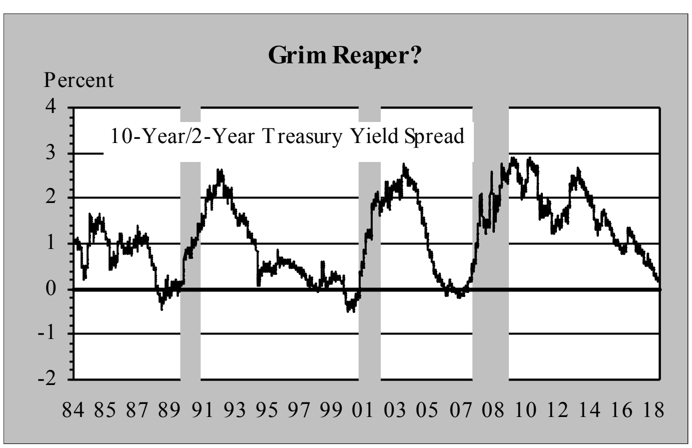
The problem is that the next increase may well bring about a time-honored recession indicator, the dreaded yield- curve inversion, which occurs when short-term rates rise above long-term rates. Until recently, the spread between 10-year and 2-year Treasury yields has narrowed significantly, as long-term rates have not increased as fast as the Fed-induced increases in short-term rates. However some, including several Fed officials, believe that the yield curve is not as meaningful a recession indicator as in the past.

They argue that special factors have been depressing long-term interest rates, including strong foreign demand for U.S. bonds, which offer higher yields and safety than available elsewhere, an unprecedented volume of purchases by central banks, and the reduced risk perceived by investors in tying up funds for longer periods. Hence, the mantra of these nonbelievers in the yield curve is that "this time is different" They may well turn out to be correct. But an inverted yield curve has been an infallible precursor of past recessions, so it should not be a trivial event dismissed out of hand.

How Will The Fed React?

No doubt, if the yield curve inverts, voices within the Fed to move more cautiously will become louder. The fear is that the central bank might repeat the mistakes of earlier cycles, when it moved too aggressively to stave off inflation and instead sent the economy into a recession. That's the message of an inverted yield curve, wherein bond investors accept lower long-term yields than they can obtain from short-term securities because they expect the economy to slow and inflation – and, hence, rates – to fall in the future.

That said, there is enough credibility behind the "this time is different" view that the Fed will not blindly change its policy course if a yield curve inversion occurs. Instead, it will monitor incoming data more closely for direction as it pushes short-term rates up to a neutral level. Indeed, the neutral level itself is not a fixed target. If the economy continues to grow strongly without stoking an upsurge in inflation when that target is reached, the Fed could decide that policy is still too accommodative and continue raising rates until growth slows.



In fact, one attention-getting feature of the current expansion is that inflation has remained so tame even as the economy is near full employment and growing above its potential. Some believe that the traditional relationships that have underpinned inflation in the past have broken down. For example, in previous expansions when the unemployment rate was as low as it is now, both wages and prices were rising at a faster pace. And while wages are picking up, there is some question as to how much power companies have to pass on higher labor costs to consumers in the form of higher prices. According to the latest survey of small businesses by the National Federation of Independent Business (NFIB) a record share of firms plans to increase labor compensation in coming months but a much smaller share plans to increase prices.

Tariffs Ugly Effects

Importantly, rising labor costs are not the only threat to stoke inflation. Higher tariffs are also on the way. Starting on September 24, the U.S. will impose 10 percent tariffs on $200 billion of imports from China, just three months after the administration announced 25 percent duties on $50 billion of Chinese imports. If China retaliates, Trump threatens to expand tariffs on an additional $267 billion of goods, covering all imports from that country. Hence, U.S. households will soon face higher prices on a litany of common goods imported from China.

Businesses will also be feeling the impact, as the tariffs will be applied on a wide range of supplies and materials that are critical to the production of goods sold in the U.S. Since the US production apparatus is not geared towards producing most goods imported from China, import substitution would not be a readily available solution. That means U.S. companies will either have to absorb the higher cost of foreign-bought inputs and accept lower profits, or pass the tariffs on to consumers.

That will not be easy. Consumers, of course, have many more options than businesses to shop for cheaper goods, thanks in good part to the rapid growth of online commerce, which greatly reduces the pricing power of companies. What's more, wage growth is barely outstripping inflation, so tariff-induced higher prices will eat into household purchasing power and restrict the volume of goods purchased, Hence, higher tariffs are likely to have more of a negative impact on output than inflation.

Simply put, a trade war, which is now well underway, results in the worst of both possible worlds – stoking higher inflation and lowering growth. Over the near-term, the economy's growth engine has enough fuel to overcome the growth-retarding protectionist measures of the administration. But with fiscal stimulus from tax cuts set to fade next year, global growth moderating, inflation rising and monetary policy tightening, the escalation of trade tensions adds an unwelcome threat to the expansion. Depending on how the financial markets – not to mention the Federal Reserve – react to this growing threat, the endgame may come sooner rather than later.

KEY ECONOMIC AND FINANCIAL INDICATORS

*FINANCIAL INDICATORS**

	August	July	June	May	April	March	February	12-Month Range High	12-Month Range Low
Prime Rate	5.00	5.00	4.89	4.75	4.75	4.58	4.50	5.00	4.25
3-Month Treasury Bill Rate	2.03	1.96	1.90	1.86	1.76	1.70	1.57	2.03	1.01
5-Year Treasury Note Rate	2.77	2.78	2.78	2.82	2.70	2.63	2.60	2.82	1.78
10-Year Treasury Note Rate	2.89	2.89	2.91	2.98	2.87	2.84	2.86	2.98	2.20
30-Year Treasury Bond Rate	3.04	3.01	3.05	3.13	3.07	3.09	3.13	3.13	2.77
Tax-Exempt Bond Yield	3.96	3.88	3.89	3.88	3.90	3.89	3.82	3.96	3.43
Corporate Bond Yield (AAA)	3.88	3.87	3.96	4.00	3.85	3.87	3.82	4.00	3.51
Conventional 30-Year Mortgage Rate	4.55	4.53	4.57	4.59	4.47	4.44	4.33	4.59	3.81
Dow Jones Industrial average	25630	24978	24790	24573	24304	24582	24982	25804	21914
S&P 500 Index	2858	2794	2754	2701	2654	2703	2705	2858	2456
Dividend Yield (S&P)	1.87	1.92	1.96	1.95	1.97	1.96	1.90	1.97	1.79
P/E Ratio (S&P)	21.0	20.5	19.8	20.6	20.2	20.2	22.0	22.8	19.8
Dollar Exchange Rate (vs. Major Currencies)	90.4	90.0	89.7	88.7	86.4	86.2	85.7	90.4	85.7

** Monthly Averages*

ECONOMIC INDICATORS

	August	July	June	May	April	March	February	12-Month Range High	12-Month Range Low
Housing Starts (In Thousands)	1282	1174	1177	1329	1276	1327	1290	1334	1158
New Home Sales (Thousands of Units)		627	638	654	633	672	663	712	558
New Home Prices (Thousands of Dollars)		329	310	314	314	335	327	343	310
Retail Sales (% Change Year Ago)	6.7	6.6	6.3	6.4	4.8	5.1	4.5	6.7	3.7
Industrial Production (% Change Year Ago)	4.9	4.0	3.5	2.9	3.8	3.6	3.7	4.9	1.1
Operating Rate (% of Capacity)	78.1	77.9	77.8	77.4	78.2	77.5	77.2	78.2	75.7
Inventory Sales Ratio (Months)		1.34	1.33	1.34	1.35	1.35	1.36	1.39	1.33
Real Gross Domestic Product (Annual % Change)			4.2			2.0		4.2	2.0
Unemployment Rate (Percent)	3.9	3.9	4.0	3.8	3.9	4.1	4.1	4.2	3.8
Payroll Employment (Change in Thousands)	201	147	208	268	175	155	324	324	14
Hourly Earnings (% Change Year Ago)	2.9	2.7	2.8	2.8	2.6	2.6	2.6	2.9	2.3
Personal Income (% Change Year Ago)		4.7	4.8	4.5	4.6	4.3	4.2	4.8	4.2
Savings Rate (Percent of Disposable Income)		6.7	6.8	6.8	6.9	7.2	7.4	7.4	6.2
Consumer Credit (Change in Mil. Of Dollars)		16646	8467	21839	8561	8255	11241	30269	8255
Consumer Prices (% Change Year Ago)	2.7	2.9	2.8	2.5	2.4	2.2	2.1	2.9	1.6
CPI Less Food & Energy (% Change Year Ago)	2.2	2.4	2.2	2.2	2.1	2.1	1.9	2.4	1.7
Wholesale Prices (% Change Year Ago)	2.8	3.3	3.4	3.1	2.6	3.0	2.8	3.4	2.4