Louisiana Corporate Credit Union

ECONOMIC & FINANCIAL DIGEST

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Profits Recession?

The U.S. economy is tracking a path very close to expectations – growing more slowly than last year but not decelerating to the edge of a recession. Yes, recession odds have risen in recent months, thanks mainly to a global backdrop that is turning weaker than expected. The International Monetary Fund just lowered its global growth forecast, reflecting harsher setbacks in some key economies, most notably Germany and China. Increased tariffs and other barriers that are impeding global trade are the most concerning influences behind the IMF's more downbeat outlook.

This would be the third global slowdown since 2010, but the third is not necessarily the charm that topples the world economy. There have been eight such global growth setbacks since 1980, and half of them have led to recessions. Most likely, the glass this time will turn out to be half- full rather than half empty and being drained of life. Indeed, encouraging signs are emerging. Recent indicators point to a modest growth pick-up in Europe during the first quarter and China is relaxing credit policy to help stimulate growth. What's more, trade tensions with the U.S. appear to be easing, as high-level negotiators are close to reaching a deal that would prevent further tariffs on Chinese imports. But anxiety over trade will not fade quickly, as the Trump administration continues to use the tariff hammer as a negotiating tactic against other countries, most recently Europe's auto industry.

As long as trade hawks play a prominent role in the administration, our relationship with trading partners will remain combustible. This is less ominous for the U.S. economy than for those overseas, which are much more dependent on trade for growth. But the ebb and flow of trade negotiations has a big influence on the financial markets, underscoring wild gyrations in stock prices over the past year. The risk is that these gyrations could infiltrate the mind-set on Main Street, creating uncertainty and more cautious spending and investing behavior. It is not uncommon for sentiment to waver during the mature stage of an expansion, when the endgame seems to be drawing closer. The challenge for policy makers is to prevent anxiety over trade – or any external event – from turning into a self-fulfilling prophecy. The more households and businesses fear the future, they more likely it is that they will they will behave in a way that brings that future about. That cause and effect may already be showing up among small and midsize firms.

Dialing Down Expectations

Clearly, large corporations have the most at stake if global conditions continue to deteriorate. About half the profits of S&P 500 companies are derived from overseas operations and these firms rely heavily on supply chains that are widely spread across national boundaries. Hence, not only do tariffs and other trade barriers threaten corporate profits from the demand side of the ledger, they also raise the cost of supplies that are imported from foreign sources. The weakening global backdrop has already taken a toll on manufacturers, causing cutbacks in production and hiring.

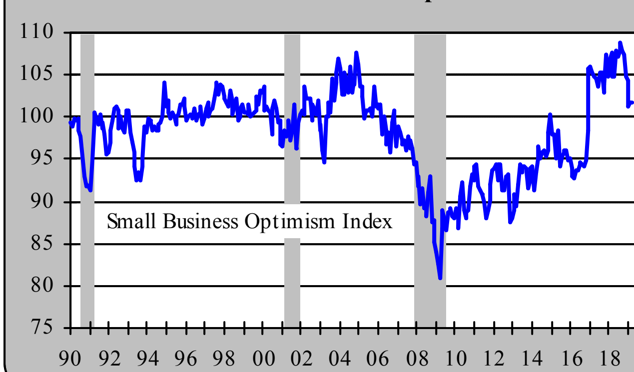
Then there is the collateral damage to the economy that comes through the trickle-down effects on smaller companies, which generate more than half the job gains in the U.S. Until recently, these firms benefited immensely from the administration's policies, including deregulation and the tax cuts enacted in late 2017. Small business optimism soared in 2018, reaching an all-time high in September of that year, according to an index compiled by the National Federation of Independent Businesses. But the optimism indicator turned south towards the end of the year as trade tensions intensified, and it continued to fall early this year.

So far, hiring plans have not been cut to any meaningful extent. In fact, the number one problem facing business owners is their inability to find qualified workers to fill positions. In March, unfilled job openings hit a record high. But this is creating another problem, as the higher wages needed to recruit workers are driving up labor costs. This, in turn, is squeezing profits and stifling expansion plans. Nor is this an issue confined to mom-and pop establishments. Large corporations are also feeling the pinch of rising labor costs, which has broader implications for the overall economy as well as for investors.

Profits in the Cross Hairs

Despite rising labor costs, corporations enjoyed a banner

Small Firms Are Less Upbeat



year for profits in 2018. Indeed, over the past five quarters, corporate after tax profits as a share of GDP has increased from 8.9 percent to 10.0 percent in the final quarter of 2018. This is a highly unusual development so late in a business cycle. Ordinarily, revenues tend to increase faster than labor compensation and other costs early in a recovery, leading to a rapid increase in profit margins. As the expansion matures and the job market tightens, the pattern flips; labor costs rise faster than top-line revenues, resulting in a late-cycle decline in profits that continues as the economy heads into a recession.

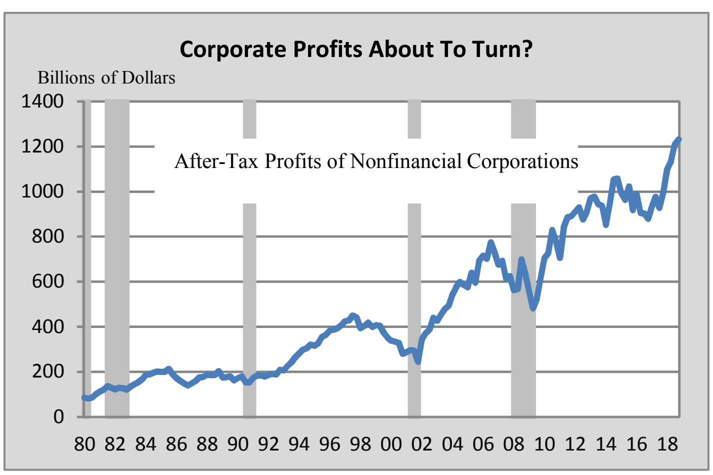
The pattern last year broke with that time-honored cyclical trend for a number of reasons. For one, the tax cuts enacted in late 2017 slashed corporate tax bills, giving after-tax earnings a sizeable boost. For another those very tax cuts also jump-started the economy's growth engine last year, giving top-line revenues an extra lift. Additionally, productivity growth picked up, which enabled corporations to raise worker pay without damaging the bottom line.

But the tailwinds that boosted profits last year are fading. The after-tax boost from the tax cut is behind us and revenue growth is slowing along with the slowdown in the broader economy. As the first quarter earnings season ramps up, many of the S&P 500 companies are reporting faster increases in costs than in revenues, resulting in narrowing profit margins. Just how much of a margin compression is likely to occur this year will depend on the strength of worker bargaining power and the ability of companies to pass on higher costs to consumers. Both sides of the ledger are facing constraints.

Lagging Wages

After lagging for the first seven years of the recovery, wage growth finally picked up in 2017 as the steady fall in the unemployment rate prompted companies to compete more aggressively for workers. By late 2018, hourly earnings increased at the fastest pace of the expansion, raising fears that inflation would soon gain traction. That prospect underscored the Fed's decision to raise interest rates again at last December's meeting and project two more hikes for this year.

But the Fed has since rescinded that prediction. At its latest policy meeting in March, it announced that it would keep rates unchanged for the foreseeable future and slow the unwinding of its balance sheet. Many economists now believe that the next move is more likely to be a cut in rates than an increase. The reasons for the Fed's dramatic U-turn in March are not hard to understand. The economy showed more signs of slowing than expected and the global backdrop continued to deteriorate. Meanwhile, neither wage nor price inflation have become a problem.



While the tightening job market should continue to exert upward wage pressure, it is not likely to drive labor costs much higher than they are now. Indeed, wage growth has since steadied around 3.0 percent and should continue to hover around that pace or slightly higher. The reason: worker bargaining power is deeply constrained by some firmly entrenched influences, such as globalization, automation and shrinking union membership, which are not going away. These are powerful offsets to the upward wage pressures normally caused by reduced slack in the labor market.

Stubbornly Low Inflation

Echoing the struggle of workers to obtain bigger pay raises, companies have also seen their pricing power constrained by secular forces. Some are the same that beset workers, such as globalization, which has expanded the competitive sphere that American companies operate in. Others are relatively new, most notably the emergence of the Internet and the ever-growing penetration of e-commerce that enables consumers to shop for the lowest prices among a vastly expanded universe of sellers.

Importantly, the persistence of low inflation continues to be an unexpected thorn in the side of the Fed. Despite the upward drift in labor costs in recent years, inflation has stubbornly remained below the central bank's 2.0 percent target since that target was officially made public in 2012. In January, the annual increase in the Fed's preferred inflation gauge – the personal consumption deflator – actually slipped to 1.4 percent, the lowest since September 2016. Not surprisingly, Fed officials, including chairman Powell, has stated that lifting inflation up to the target is the main challenge that they currently face.

With labor compensation exceeding the inflation rate last year, the key driver of higher profits in 2018 was a pick-up in productivity growth. The annual growth rate in non-farm productivity accelerated from 1.0 percent in the fourth quarter of 2017 to 1.8 percent in the fourth quarter of 2018. That, in turn, more than offset the increase in labor compensation, resulting in an actual decline in unit labor costs from 2.2 percent to 1.1 percent over the same period. But with economic activity now slowing even as worker hours are increasing, that productivity boost will not be forthcoming this year.

Simply put, companies will be hard-pressed to deliver higher profits this year; indeed, a setback could well be seen in the first quarter. As noted earlier, profits are a leading indicator of recessions, as every postwar downturn has followed a decline in corporate earnings. That said, not every profits recession has led to a recession in the broader economy. The most recent false signal occurred during the current expansion, as profits fell for four consecutive quarters in 2016 without resulting in a recession.

What's more, when a recession does follow, it's usually with a considerable time lag, ranging from one to three years following a profits downturn. Given the robust profits growth in recent years and the ample cushion of reserves in corporate coffers, it is not likely that a modest setback this year would bring the economy to its knees. Even if it leads to a recession, history suggests that it won't start until at least sometime in 2020.

KEY ECONOMIC AND FINANCIAL INDICATORS

*FINANCIAL INDICATORS**

	March	February	January	December	November	October	September	12-Month Range High	12-Month Range Low
Prime Rate	5.50	5.50	5.50	5.35	5.25	5.25	5.03	5.50	4.75
3-Month Treasury Bill Rate	2.40	2.39	2.37	2.37	2.33	2.25	2.13	2.40	1.76
5-Year Treasury Note Rate	2.37	2.49	2.54	2.68	2.95	3.00	2.89	3.00	2.37
10-Year Treasury Note Rate	2.57	2.68	2.71	2.83	3.12	3.15	3.00	3.15	2.57
30-Year Treasury Bond Rate	2.98	3.02	3.04	3.10	3.36	3.34	3.15	3.36	2.98
Tax-Exempt Bond Yield	3.96	4.22	4.21	4.13	4.30	4.32	4.12	4.32	3.88
Corporate Bond Yield (AAA)	3.77	3.79	3.93	4.02	4.22	4.14	3.98	4.22	3.77
Conventional 30-Year Mortgage Rate	4.27	4.37	4.46	4.64	4.87	4.83	4.63	4.87	4.27
Dow Jones Industrial average	25723	25606	24158	23806	25252	25569	26233	26233	23806
S&P 500 Index	2804	2755	2607	2567	2723	2785	2902	2902	2567
Dividend Yield (S&P)	2.01	2.04	2.08	2.22	1.99	2.02	1.88	2.22	1.87
P/E Ratio (S&P)	18.7	18.3	17.8	16.6	18.9	18.7	20.1	21.0	16.6
Dollar Exchange Rate (vs. Major Currencies)	91.9	91.4	91.8	92.1	91.7	90.8	90.0	92.1	86.4

** Monthly Averages*

ECONOMIC INDICATORS

	March	February	January	December	November	October	September	12-Month Range High	12-Month Range Low
Housing Starts (In Thousands)	1139	1142	1298	1140	1206	1209	1237	1329	1139
New Home Sales (Thousands of Units)		667	636	588	612	552	609	672	552
New Home Prices (Thousands of Dollars)		315	304	323	309	328	328	335	304
Retail Sales (% Change Year Ago)	3.6	2.3	2.9	1.6	4.0	4.6	4.0	6.6	1.6
Industrial Production (% Change Year Ago)	2.8	3.5	3.7	3.8	4.1	4.1	5.4	5.4	2.8
Operating Rate (% of Capacity)	78.8	79.0	79.1	79.5	79.6	79.3	79.3	79.6	78.4
Inventory Sales Ratio (Months)		1.39	1.39	1.38	1.36	1.35	1.34	1.39	1.33
Real Gross Domestic Product (Annual % Change)				2.2			3.4	4.2	2.2
Unemployment Rate (Percent)	3.8	3.8	4.0	3.9	3.7	3.7	3.7	4.0	3.7
Payroll Employment (Change in Thousands)	196	33	312	227	196	277	108	312	33
Hourly Earnings (% Change Year Ago)	3.2	3.4	3.1	3.3	3.3	3.3	3.0	3.4	2.8
Personal Income (% Change Year Ago)		4.2	4.3	5.0	4.3	4.4	4.3	5.0	4.2
Savings Rate (Percent of Disposable Income)			7.5	7.7	6.2	6.4	6.4	7.7	6.2
Consumer Credit (Change in Blns. Of Dollars)		15.2	17.7	14.1	19.7	22.2	14.1	26.1	1.6
Consumer Prices (% Change Year Ago)	1.9	1.5	1.6	1.9	2.2	2.5	2.3	2.9	1.5
CPI Less Food & Energy (% Change Year Ago)	2.0	2.1	2.2	2.2	2.2	2.1	2.2	2.4	2.1
Wholesale Prices (% Change Year Ago)	2.2	1.8	2.0	2.5	2.6	3.2	2.8	3.4	0.3

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SimpliCD Issuance

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First Quarter 2019 – By the Numbers

$4.34 billion	Total credit union issuance outstandings.
1,451	Number of credit unions that have issuance agreements in place, prepared to issue share certs, should the need arise.
$212 million	Total outstandings for SimpliCD's largest share certificate issuer.
415	Number of credit unions that currently have share certificate issuance balances through SimpliCD.

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