Louisiana Corporate Credit Union
ECONOMIC & FINANCIAL DIGEST
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Irrational Exuberance?

Bucking the ominous Ides of March, two happy anniversaries were celebrated during the month. The economic recovery became the third longest in U.S. history, and the bull rally in stocks marked its eighth birthday, having been born on March 3, 2009. The journey, of course, has not been entirely pleasant by any means, as several near calamities along the way could have derailed the trip. But as they say, setbacks build character and make us stronger. With spring now in full bloom, so too is the season for optimism, raising hopes that the happy voyage still has legs.

But things are never that tidy or simple. Indeed, when everyone is optimistic, as is currently the case, the shock effect of any downside surprise could wreak havoc. By definition, it's impossible to see where a surprise might come from. If history is any guide, outside forces would be the most likely candidate. Indeed, the geopolitical backdrop is particularly volatile now, given the uprising of populist sentiment that is threatening mainstream governing parties among developed countries. The biggest risk is that protectionist policies will gain traction, leading to diminished trade and immigration that crimps global growth and stokes inflation.

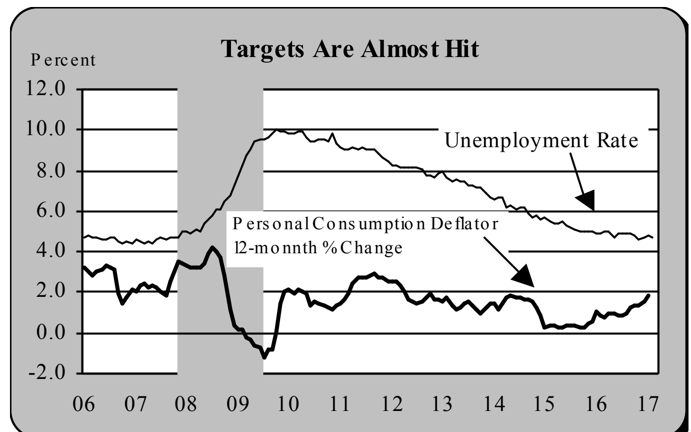
That said, the domestic economic backdrop remains favorable. The labor market continues to churn out more jobs than expected, lifting household incomes and confidence. Business sentiment is sky-high, portending greater capital spending and sustained hiring, and financial markets are still buoyant. Even the Federal Reserve's decision to hike rates on March 15 did not upset investors, who viewed the decision as a vote of confidence in the economy's resilience. But there is still a gap between reality and expectations, which continue to portray far more strength in the economy than has been demonstrated so far or is likely to evolve in the immediate future. Some believe that "animal spirits" unleashed since the election can close the gap and keep the party going. These spirits, however, derive largely from expected fiscal policies – large tax cuts, increased Federal spending and deregulation – that are far from certain to materialize. Unless the hard data begins to justify the heightened expectations that are boosting household and business spirits, the reasons for celebration will soon fizzle.

This Time, The Fed Means It

It may not rise to the level of the "crying-wolf" syndrome, but on multiple occasions over the past several years the central bank indicated that it was almost ready to start raising interest rates, but then failed to follow through. To be sure, there was always a good reason for it to back down: The economy was too weak; inflation was too low; financial markets were too skittish; external threats were too imminent. Even after it finally put through the first increase since the summer of 2006 – the quarter-point hike in December 2015 – it failed to follow up with the three more increases that were planned for 2016. Again, the Fed had good reason to go back on its word, as the economy hit the skids over the first half of last year and inflation remained dormant.

So it's understandable that when the Federal Reserve hiked the federal funds rate by a quarter-point for the second time in December 2016, its expressed plan to raise rates three more times this year was met with a good deal of skepticism. The widespread view was that the Fed would at most hike twice, and the first would probably not occur before June. This time, however, the central bank wasn't crying wolf as it pulled the rate trigger three months later with another quarter point increase on March 15. Not only did the latest rate increase come earlier than thought possible a month or so ago, few now dispute that three increases this year are in the cards; some even believe that a fourth might be snuck in.

What changed? Unlike the earlier failed attempts, the stars aligned correctly this time. Keep in mind that the Fed's dual mandate is to bring about maximum employment in a stable price environment. The targets for both since the Great Recession have been just under 5 percent for the unemployment rate and 2 percent for inflation. While the unemployment rate hit 5 percent in late 2015, it did so amid lackluster growth that put a lid on inflation and inflation expectations. The Fed's preferred inflation gauge, the personal consumption deflator, was running closer to zero than 2 percent, keeping deflation fears front and center. But by the middle of last year, the deflator finally climbed above 1 percent on a sustainable basis and has since moved steadily higher, thanks to rebounding oil and other commodity prices. With the labor



market continuing to tighten and inflation finally hugging the 2 percent target for the first time since April 2012, the Fed is understandably more confident that it is close to meeting its dual mandate.

Aligning Policy With Fundamentals.

Clearly, the Fed's latest rate increase was justified on a number of fronts. The improved job and inflation backdrop was no doubt the most important. But equally significant is that the prior hike on December 15 did not entirely accomplish what it was set out to do. Usually, when the Fed moves to tighten policy, a predictable sequence occurs. Long-term interest rates increase, in anticipation of more tightening moves, and the currency markets drive the dollar higher, as higher rates make U.S. assets more attractive.

However, neither occurred this time. Bond yields actually drifted lower after the December increase and the dollar weakened against major currencies. Hence, along with another strong leg up in the stock market, financial conditions actually eased, not tightened, which dilutes the impact of the Fed's rate hike. The reason for this atypical reaction in the markets is unclear. It may be that investors and currency traders were not as confident in the economy's strength as the Fed, viewing the December increase as a one-off affair rather than the next installment in a series of tightening moves.

One thing is clear. The central bank's latest rate hike, as well as the one before in December, was taken to align monetary policy with evolving economic conditions, not to slow down growth. It is hard to believe Fed officials feared that growth was overshooting expectations. While the job market is on solid ground and the increase in inflation has obliterated deflation fears, the broader economy has yet to grow fast enough to justify a more aggressive tightening policy. Indeed, data through February indicate that growth in GDP is on track to slow from the fourth quarter's 1.9 percent pace, with many pegging it at a meager 1 percent. Consumer spending, the main growth driver, has shown much less vigor so far this year than over the last half of 2016.

Fiscal Priorities Upended

The economy's lagging performance so far this year highlights the yawning gap that has opened up between reality and expectations. Simply put, the elevated level of optimism among households, businesses and investors is not yet reflected in the hard data. While the economy is eight years into the recovery, long by historical standards, it remains the weakest upturn in the postwar era. The question is, how long can optimism be sustained at a high level without receiving confirmation from the hard data?

To be sure, it is only a few months since the election, which stoked confidence that the Trump administration would jump-start growth through its tax and spending initiatives as well as regulatory reform. It takes time for Congress to agree on the details of the administration's policy proposals and for these policies to have an actual impact on the economy. But the timeline is being stretched out by an unfortunate sequence of policy announcements. Instead of starting out with the pro-growth agenda trumpeted during the campaign, Congress and the administration are using valuable time grappling with health-care reform, a highly complicated and divisive political issue that is confusing the public and meeting stiff resistance from legislators.

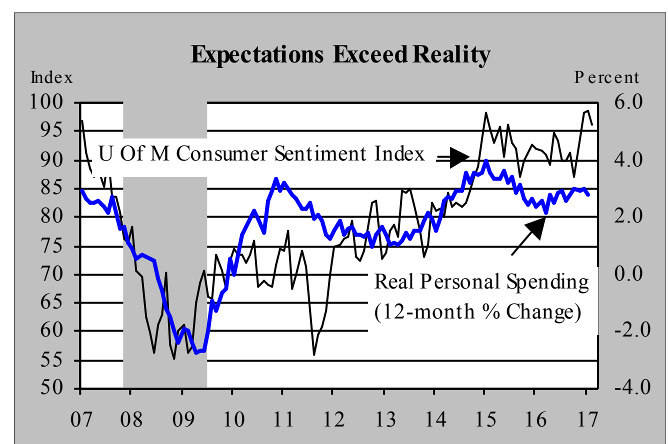
The longer it takes to settle the health care imbroglio, the longer the wait for tax and spending proposals to see the light of day. As it is, uncertainty over the fiscal package is growing. A key component of the tax reform measure being considered in Congress, the border adjustment tax, is already under attack in many quarters, and even the president gives it a lukewarm acceptance. Odds are, a package of tax cuts and infrastructure spending will wend its way through Capitol Hill some time later this year, but its growth-boosting effects will not be felt until 2018.

Splitting The Difference

No surprisingly, the Fed did not take into account the possible growth boost from fiscal policy when it hiked interest rates on March 15. As Chair Yellen noted in her press conference following the policy meeting, uncertainty regarding the composition and timing of what might come out of Capitol Hill makes it impossible to gauge the impact fiscal measures might have on the economy. In fact, the central bank's forecast of growth, inflation and unemployment remained the same as it was in December.

Which brings us back to the question of how to reconcile the high expectations for the economy – which are largely derived from the pro-growth agenda of the Trump election – with the reality of the economy's mediocre performance. Most likely, something will have to give on both sides of the ledger. The post-election euphoria is already showing signs of fading a bit, as investors and the public recognize that any tax cuts and, particularly, spending increases on infrastructure are being pushed back to the fall at the earliest. It also remains to be seen how much of a potential fiscal boost will be accepted by an austerity-minded Republican-controlled Congress.

That said, the growth slowdown in the first quarter overstates the weakness in the economy. Consumers are probably taking a temporary breather, as most pent-up demand has been satisfied and about $20 billion in tax refunds that should have arrived in February were pushed back due a quirky change in IRS regulations. Those refunds were sent out in March, which should give spending a belated boost. With household optimism still elevated and solid job growth lifting incomes, consumer spending should pick up in the spring, underpinning a growth rebound that will also be nurtured by firmer residential construction and capital spending. The economy will probably not live up to the high growth expectations on Wall Street and Main Street but it will deliver a better performance than last year. While the Fed never bought into the post-election euphoria, it should have enough justification to stay on its gradual rate-hiking course.



KEY ECONOMIC AND FINANCIAL INDICATORS

*FINANCIAL INDICATORS**

	February	January	December	November	October	September	August	12-Month Range High	12-Month Range Low
Prime Rate	3.75	3.75	3.64	3.50	3.50	3.50	3.50	3.75	3.50
3-Month Treasury Bill Rate	0.52	0.51	0.51	0.45	0.33	0.29	0.30	0.52	0.23
5-Year Treasury Note Rate	1.90	1.92	1.96	1.60	1.27	1.18	1.13	1.96	1.07
10-Year Treasury Note Rate	2.42	2.43	2.49	2.14	1.76	1.63	1.56	2.49	1.50
30-Year Treasury Bond Rate	3.03	3.02	3.11	2.86	2.50	2.35	2.26	3.11	2.23
Tax-Exempt Bond Yield	3.91	3.80	3.82	3.59	3.27	2.93	2.85	3.91	2.83
Corporate Bond Yield (AAA)	3.03	3.03	3.11	2.86	2.56	2.48	2.34	3.11	2.30
Conventional 30-Year Mortgage Rate	4.17	4.15	4.20	3.77	3.47	3.46	3.44	4.20	3.44
Dow Jones Industrial average	20424	19908	19712	18697	18185	18267	18495	20424	16300
S&P 500 Index	2330	2275	2247	2165	2143	2158	2177	2330	1918
Dividend Yield (S&P)	2.01	2.06	2.09	2.11	2.17	2.12	2.11	2.31	2.01
P/E Ratio (S&P)	21.8	20.9	20.6	20.5	19.9	20.4	20.4	21.8	17.6
Dollar Exchange Rate (vs. Major Currencies)	94.0	94.7	95.4	93.7	91.9	90.1	89.8	95.4	89.4

** Monthly Averages*

ECONOMIC INDICATORS

	February	January	December	November	October	September	August	12-Month Range High	12-Month Range Low
Housing Starts (In Thousands)	1288	1251	1275	1149	1320	1052	1164	1320	1052
New Home Sales (Thousands of Units)		555	535	575	568	568	559	622	525
New Home Prices (Thousands of Dollars)		313	316	316	302	234	302	322	234
Retail Sales (% Change Year Ago)	5.7	6.0	4.4	3.9	4.2	3.3	2.2	6.0	1.7
Industrial Production (% Change Year Ago)	0.3	0.2	0.7	-0.3	-0.7	-1.1	-1.1	0.7	-2.0
Operating Rate (% of Capacity)	75.4	75.5	75.6	75.2	75.5	75.3	75.5	75.6	74.9
Inventory Sales Ratio (Months)		1.35	1.35	1.38	1.37	1.38	1.39	1.41	1.35
Real Gross Domestic Product (Annual % Change)			1.9			3.5		3.5	0.8
Unemployment Rate (Percent)	4.7	4.8	4.7	4.6	4.8	4.9	4.9	5.0	4.6
Payroll Employment (Change in Thousands)	235	238	155	164	124	249	176	297	43
Hourly Earnings (% Change Year Ago)	2.8	2.6	2.9	2.7	2.7	2.7	2.5	2.9	2.4
Personal Income (% Change Year Ago)		4.0	3.6	3.7	3.7	3.7	3.4	4.0	3.4
Savings Rate (Percent of Disposable Income)		5.5	5.4	5.7	5.7	5.7	6.0	6.2	5.4
Consumer Credit (Change in Mil. Of Dollars)		8794	14758	25841	16590	21008	26614	26614	8794
Consumer Prices (% Change Year Ago)	2.7	2.5	2.1	1.7	1.6	1.5	1.1	2.7	0.8
CPI Less Food & Energy (% Change Year Ago)	2.2	2.3	2.2	2.1	2.1	2.2	2.3	2.3	2.1
Wholesale Prices (% Change Year Ago)	2.2	1.6	1.6	1.3	0.8	0.7	0.0	2.2	-0.2

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