Louisiana Corporate Credit Union

ECONOMIC & FINANCIAL DIGEST

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

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Low Recession Risk

In the 1990s economists turned to the 19th century children's story of the three bears, invoking Goldilocks to describe the U.S. economy. The description was apt, as it painted a picture of an economy that was not too hot or too cold, much like the porridge tasted by the curly-haired girl of the fairy tale. While the decade endured some stumbles – including the so-called growth recession in 1995 – it turned into the longest expansion on record, one that was highlighted by low inflation as well. That sustained period of noninflationary growth is often looked up to as the yardstick that policy makers should strive for.

In some respects, the current recovery bears a resemblance to that period. The expansion, now into its ninth year, is the third longest on record and has a chance of becoming the longest. As was the case in the '90s, subdued inflation has allowed the central bank to keep its foot off the monetary brakes for an extended period of time. The sustained low rate environment, in turn, has nurtured growth, but also stoked increases in stock prices and property values, much as was the case in the earlier decade. Importantly, the two periods share another common feature: an unusual combination of historically low unemployment and low inflation. As much as anything, that happy combination led economists and pundits to bestow the Goldilocks label on the 1990s economy.

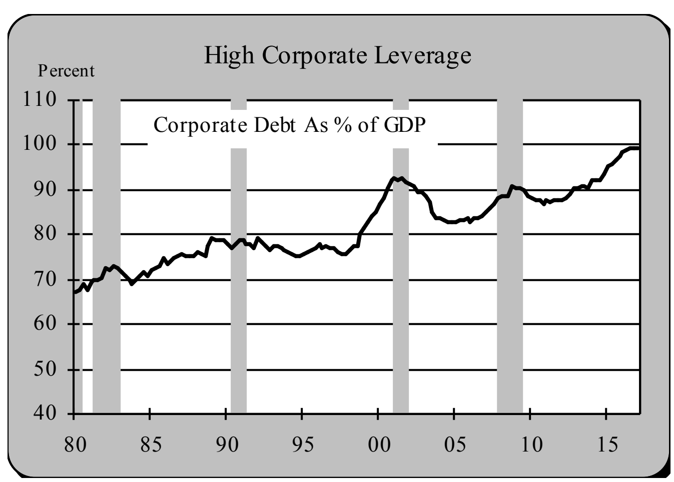
But like all stories, the Goldilocks expansion of the 1990s had a final chapter, as the dot-com boom that emerged late in the decade eventually collapsed and dragged the economy into a recession. Few saw the downturn coming, but there were signals that typically flicker in the later stages of a business cycle. Some of those signals appear now and, considering its length, there is no question that the current upturn is also in a late-cycle stage. But as the saying goes, expansions do not die of old age. The economy is usually brought to its knees either by some unforeseen external shock, like an oil crisis or war, or by government policies – whether deliberate or unintended. The former, by definition, is impossible to predict. The latter is more visible, particularly monetary policy because it responds to evolving developments that are transparent to everyone. From this vantage point, the odds of a recession occurring any time soon appear to be relatively slim.

Late Cycle Signals

Although they are in the minority, many wonder if a recession is not far off, considering the array of typical late-cycle signs that have emerged this year. The economy is near, if not at full employment, a condition that usually portends rising wage and price inflation. That prospect, in turn, spurred the Federal Reserve to start stepping on the monetary brakes, raising interest rates to short-circuit the economy from overheating. The Fed rate hikes contributed to a flattening of the yield curve – i.e., a narrowing of the spread between long and short-term interest rates – which is an infallible precursor of recessions.

Other signs the economy is nearing a cycle peak are also evident. Following years of ultra-low interest rates that have pumped up the appetite of yield-hungry investors, corporations have vastly stepped up borrowing, elevating their debt levels as well as service charges that could squeeze out investment spending. Likewise, historically low interest rates have driven investors into riskier assets, propelling stock prices to levels that are considered overvalued by many yardsticks. Equity prices typically peak out in advance of recessions as they incorporate forward expectations of sagging earnings and economic growth.

Finally, there is the growing risk late in a cycle that errant economic policies will inadvertently choke off the expansion. Usually, the prime culprit is the Federal Reserve, which hikes interest rates too rapidly relative to what is warranted by evolving economic conditions. Some feel that the Fed is repeating that mistake now, particularly since inflation remains well below the central bank's target. However, in this instance, political risks are more likely to stifle growth. It is unclear how much the post-election euphoria has boosted activity this year. But prospects for the growth-boosting fiscal measures that underpinned heightened expectations look increasingly grim owing to the chaotic political environment, punctuated by the recent debacle over health care legislation.



More Fuel in the Tank

While we are clearly in the advance stage of an expansion, there is little on the near-term horizon that suggests it is about to fizzle out. True, the economy has been stuck in a listless 2 percent growth mode, about half the pace that typically prevails during an upturn. What's more, growth has been uneven, slipping to under 1.5 percent in four of the last seven quarters. In earlier expansions that would have been considered precariously close to a stall speed, making the economy highly vulnerable to any sudden shock.

Still, as lackluster as the recovery has been, it doesn't meet the informal "3 P's" rule, which states that a recession is an economic slowdown that is profound, pervasive and prolonged. As noted, the growth pattern has been uneven, with periods of weakness followed by a decent rebound that lifted the economy comfortably out of harm's way. That pattern has been repeated over the first half of this year. Importantly, the downshifting of the growth engine should not be attributed to normal cyclical weaknesses. Instead, the recovery has been restrained by structural changes that may well persist in the foreseeable future.

In particular, an aging population has slowed the growth of the labor force, as an army of baby boomers are entering their golden years and retiring in ever-growing numbers. This mass exodus, which is set to continue, has sliced about a percentage point from the labor force growth rate in recent years – from an average of 1.7 percent between 1950 and 2001 to 0.7 percent since 2001. Fewer workers translate into less output unless worker productivity picks up the slack. Unfortunately, that has not been the case, as productivity growth has also slowed dramatically since the turn of the century. Unlike demographic forces, however, the productivity slowdown is not destined to persist, as new technology and the ability of businesses to ramp up capital spending can alter that trajectory.

Solid Foundation

As we noted earlier, recoveries do not die of old age; they buckle under some growth-killing shock or a policy mistake. While the current upturn lacks speed, it does have a solid foundation that enhances its longevity prospects. In particular, the economy continues to generate jobs at a healthy clip, exceeding growth in the working –age population and driving the unemployment rate down to near historic lows. As long as households are drawing a paycheck and have job security they are likely to spend, sustaining the most important driver of growth.

True, despite the sustained strength in the job market, consumer spending has been far weaker than in earlier recoveries. Following the confidence-shattering experience of the financial crisis and Great Recession, households have understandably turned risk averse. Throughout most of the recovery, they have focused on repairing balance sheets, paying down debt and rebuilding nest eggs that were decimated during the harsh 2007-09 downturn. That more cautious mindset toward spending has been slow to change.

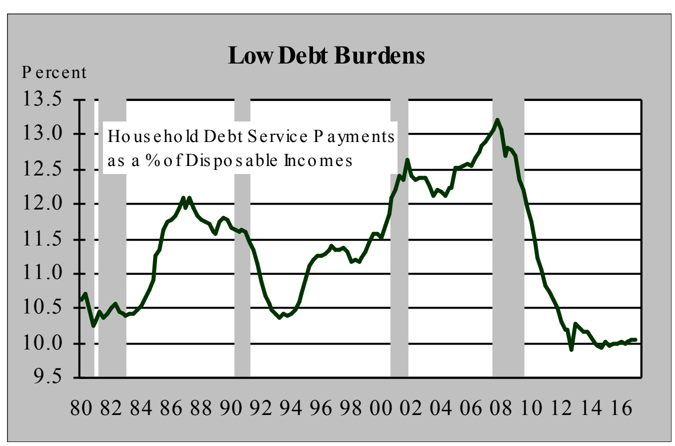
However, after years of mending their financial condition, households are gradually removing the shackles. They are not returning to the earlier practice of using housing equity as cash-dispensing machines, which fueled the spending binge and surge in property values leading up to the housing collapse. Mortgage borrowing has been restrained since the recession, but consumers are stepping up borrowing with credit cards again and have taken on copious amounts of auto debt that underpinned record car and light truck sales over the past two years. Yet households have stayed within their means, holding debt-servicing charges to historically low levels relative to incomes.

Soft Landing

With balance sheets restored to health, debt burdens manageable and job growth steady, households are well positioned to sustain spending at a modest pace and keep the recovery going. Confidence has eased a bit from the post-recession high in recent months, but the drop probably has less to do with deteriorating fundamentals than with the political dysfunction in Washington, which undermines confidence that the administration will be able to push through its growth-boosting tax and spending measures. We suspect that a watered-down package will ultimately come to fruition, providing the economy with some thrust next year albeit not as much as hoped.

That said, if the current gridlock persists and no fiscal help is forthcoming, the recovery would be on shakier grounds, with a higher recession risk on the radar. Indeed, the recession risk would loom larger if the administration imposed protectionist measures, such as broad-based tariffs, which would invite retaliation and restrict global trade. Fortunately, the president appears to be toning down the threat of punitive actions to redress perceived unfair practices among our trading partners.

Assuming the administration "does no harm" to the economy, the expansion should still have legs for at least another year or so. At some point, however, the good times will come to an end as all upturns do. The question is, will the recovery end with a bang or a fizzle? One of the positive omens of a recovery that has been as sluggish as this one is that it hasn't generated the imbalances that in the past have prompted harsh growth-killing policy reactions by the Federal Reserve. Yes, Federal Reserve Chair Janet Yellen has opined that some assets – stocks and real estate, for example – are richly valued, raising the prospect of asset bubbles that foreshadowed the last two recessions. But those bubbles were associated with real-world imbalances – a technology-related capital spending boom in the late 1990s, resulting in overcapacity, and excessive homebuilding activity related to surging home prices in the mid-2000s – that do not exist now. And with a data-dependant Fed responding more to the real side of the economy, which is hardly overheating or showing inflationary tendencies, it is not likely to overreact and risk terminating the upturn with a bang.



KEY ECONOMIC AND FINANCIAL INDICATORS

*FINANCIAL INDICATORS**

	June	*May*	*April*	*March*	*February*	*January*	*December*	*12-Month Range High*	*Low*
Prime Rate	4.13	4.00	4.00	3.88	3.75	3.75	3.64	4.13	3.50
3-Month Treasury Bill Rate	0.98	0.89	0.80	0.74	0.52	0.51	0.51	0.98	0.27
5-Year Treasury Note Rate	1.77	1.84	1.82	2.01	1.90	1.92	1.96	2.01	1.07
10-Year Treasury Note Rate	2.19	2.30	2.30	2.48	2.42	2.43	2.49	2.49	1.50
30-Year Treasury Bond Rate	2.80	2.96	2.94	3.08	3.03	3.02	3.11	3.11	2.23
Tax-Exempt Bond Yield	3.55	3.76	3.78	3.90	3.91	3.80	3.82	3.91	2.83
Corporate Bond Yield (AAA)	3.68	3.85	3.87	4.01	3.95	3.92	4.06	4.06	3.28
Conventional 30-Year Mortgage Rate	3.90	4.01	4.05	4.20	4.17	4.15	4.20	4.20	3.44
Dow Jones Industrial average	21318	20937	20685	20823	20424	19908	19712	21318	17755
S&P 500 Index	2434	2395	2359	2367	2330	2275	2247	2434	2084
Dividend Yield (S&P)	1.99	2.00	2.01	2.01	2.01	2.06	2.09	2.17	1.99
P/E Ratio (S&P)	21.5	21.4	21.2	21.1	21.8	20.9	20.6	21.8	19.8
Dollar Exchange Rate (vs. Major Currencies)	91.8	93.2	94.0	94.5	94.0	94.7	95.4	95.4	89.7

** Monthly Averages*

ECONOMIC INDICATORS

	June	*May*	*April*	*March*	*February*	*January*	*December*	*12-Month Range High*	*Low*
Housing Starts (In Thousands)	1215	1122	1154	1189	1288	1236	1268	1328	1062
New Home Sales (Thousands of Units)		610	593	644	615	599	548	644	548
New Home Prices (Thousands of Dollars)		346	310	320	297	317	333	346	234
Retail Sales (% Change Year Ago)	2.8	4.1	4.5	4.8	4.7	5.6	4.0	5.6	2.1
Industrial Production (% Change Year Ago)	2.0	1.9	1.8	1.3	0.4	0.0	0.8	2.0	-1.3
Operating Rate (% of Capacity)	76.6	76.4	76.4	75.8	75.8	75.7	76.0	76.6	75.5
Inventory Sales Ratio (Months)		1.38	1.37	1.37	1.37	1.37	1.37	1.41	1.37
Real Gross Domestic Product (Annual % Change)				1.4			2.1	3.5	1.2
Unemployment Rate (Percent)	4.4	4.3	4.4	4.5	4.7	4.8	4.7	4.9	4.3
Payroll Employment (Change in Thousands)	222	152	207	50	232	216	155	297	50
Hourly Earnings (% Change Year Ago)	2.5	2.4	2.5	2.6	2.8	2.6	2.9	2.9	2.4
Personal Income (% Change Year Ago)		3.5	3.5	3.9	4.0	3.4	2.8	4.0	2.8
Savings Rate (Percent of Disposable Income)		5.5	5.1	5.1	5.2	5.0	4.5	6.0	4.5
Consumer Credit (Change in Mil. Of Dollars)		18410	12929	14723	16588	14213	11402	25121	11402
Consumer Prices (% Change Year Ago)	1.6	1.9	2.2	2.4	2.7	2.5	2.1	2.7	0.8
CPI Less Food & Energy (% Change Year Ago)	1.7	1.7	1.9	2.0	2.2	2.3	2.2	2.3	1.7
Wholesale Prices (% Change Year Ago)	2.0	2.4	2.5	2.3	2.2	1.6	1.6	2.5	-0.2