Louisiana Corporate Credit Union

ECONOMIC & FINANCIAL DIGEST

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

Volume 25 November 2017

Aging Expansion Still Has Life

Things are looking up for the U.S. and the global economy. Indeed, both emerging and advanced economies are posting the strongest growth rates since the end of the financial crisis in 2009. Just as important is that heightened activity is being synchronized across the board. During the earlier years of the global recovery, some problem areas always stunted the path forward. A sovereign debt crisis hobbled Europe over the first few years; collapsing oil and commodity prices precipitated deep recessions in emerging economies, particularly Brazil and Russia; the Brexit vote and the ascension of populist inward-looking political movements among advanced nations posed a threat to global trade, to highlight some key impediments.

At the moment, however, there are no major drags coming from any region. Indeed, the I.M.F. as well other world organizations upgraded global growth forecasts for this year and next. One blemish for the U.S. is that the stronger prospects are coming from overseas; America's growth outlook was actually reduced a tad, largely because of lowered expectations for a fiscal stimulus. That said, the U.S. economy is still outperforming most other rich nations and is expected to do so next year as well. By past standards, the recovery falls well short of the growth yardsticks seen in earlier cycles. But relative to the rest of the developed world, the U.S. is enjoying the steadiest, strongest and most consistent upturn.

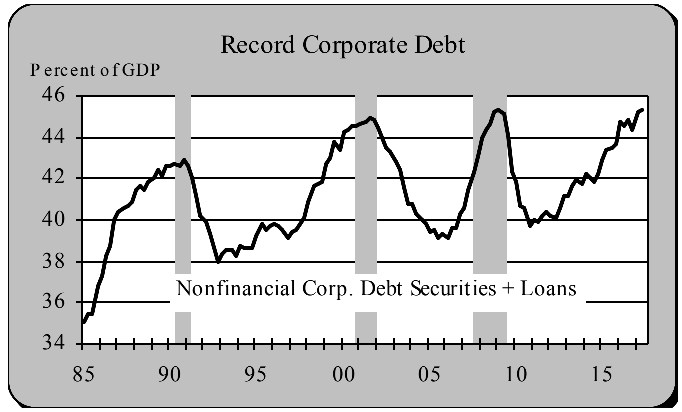
That's not to say there is nothing to worry about. Indeed, the synchronized growth among economies has generated an unhealthy degree of complacency in the financial markets as well as among forecasters regarding the near term outlook. That by itself should ring alarm bells, as adversity usually hits when least expected. Hardly anyone, including policy makers, anticipated the dot-com bust or the housing collapse that precipitated the last two recessions. Instead, widespread optimism prevailed throughout the economic and financial landscape in the years leading up to those downturns, much as is the case now. Indeed, history reveals that a high level of confidence on both Main Street and Wall Street is a recurring feature of a late-stage business cycle. With the U.S. expansion now the third longest on record, there is no question that it has moved into a mature phase. While expansions don't die of old age, they become increasingly vulnerable to adverse events as the years pile up. With the economic landscape looking brighter, the prime growth-killing threat could come from policy missteps.

Signs of Age

As noted, the forecasting community has a woefully bad record of predicting recessions. In fact, the experts are not even aware the economy is in a recession until well after it starts. It took an average of 9 months for the National Bureau of Economic Research, the organization officially responsible for dating business cycles, to recognize the start of the last five recessions going back to 1980. It wasn't until December 2008 that the NBER acknowledged the U.S. had sunk into the Great Recession, fully 12 months after it began.

Yet there are classic signs that appear during the late-stages of an expansion. Since some are flashing now, it may be appropriate to wonder if a recession is knocking on the door, despite the complacency of most forecasters regarding the near-term outlook. One such sign is the flattening of the yield curve, as the Federal Reserve has pushed up short-term interest rates even as long-rates have barely budged since the end of 2015. Hence, the spread between the 10-year Treasury and money market rates has narrowed by about 1.25 percentage points. Historically, no recession has started until the rates inverted, i.e. short-rates rose above long-term rates. That has not happened yet, but by mid-October the distance between long and short-term rates was the narrowest since early 2008.

Likewise, the spread between riskier and the safest of debt securities has narrowed by more than 1.5 percentage points over the past 18-months and is now the tightest since October 2007, only two months before the onset of the Great Recession. This is a sign that investors are so confident in the economy that they are willing to buy riskier assets for an ever-smaller yield pick-up. As a result, the cost of borrowing for less credit-worthy companies is driven down, encouraging them to add more leverage to their balance sheets than they may be able to carry. Not coincidentally, corporations have gone on a borrowing spree, sending corporate



debt as a share of GDP to 45.3 percent, matching or exceeding the peaks seen in previous credit cycles.

Low Odds Of Recession

Despite these financial market omens, most economists give low odds that the economy will fall into a recession over the next year or so. True, signs that the expansion is getting long in the tooth are visible in the real economy as well as in the financial markets. The labor market, for example, generated 83 months of continuous job growth –the longest stretch on record – before Hurricane Harvey caused payrolls to contract in September. The unemployment rate, at 4.3 percent, already indicates the economy is near full employment, a condition that historically portends supply restraints and other bottlenecks that occur near the end of a business expansion.

But there are compelling reasons to discount – although not entirely ignore – these early-warning portents of recession. Financial market indicators are hardly infallible predictors of economic turning points. While every postwar recession has followed an inversion of the yield curve, not every inversion has led to a recession. Metaphorically, this is analogous to the adage expressed by economist Paul Samuelson, who famously opined that the stock market has predicted nine of the last five recessions. In this regard, it is important to recognize that interest rates during this recovery have been mightily influenced by policy actions, which kept rates artificially low and distorted the shape of the yield curve.

In particular, the Federal Reserve embarked on a multi-trillion dollar program of bond purchases, known as quantitative easing, in the wake of the 2008 financial crisis aimed at suppressing long-term interest rates even as it drove short-term interest rates down to near zero. It is currently unwinding that program, but the process may be having unequal effects on interest rates. Since the end of 2015, the Fed lifted short-term rates four times and a fifth is expected in December, resulting in a cumulative rise of 1.5 percentage points. However, the planned monthly reduction in bond holdings just started in October with a miniscule $10 billion cutback. The size of the planned monthly reductions is slated to increase every quarter in coming years, so the impact on long-term rates may intensify as well. Put simply, the shape of the yield curve is being influenced more by policy actions than economic developments.

Still Room To Run

Nor is the advanced age of the recovery particularly worrisome. True, there are physical limits to growth, which occurs when the labor market runs out of workers and the product market runs out of capacity. The supply constraints associated with labor shortages and bottlenecks, in turn, ignite wage and price inflation, prompting the Federal Reserve to impose aggressive growth-dampening rate increases. This sequence of events has typically ushered in the next recession.

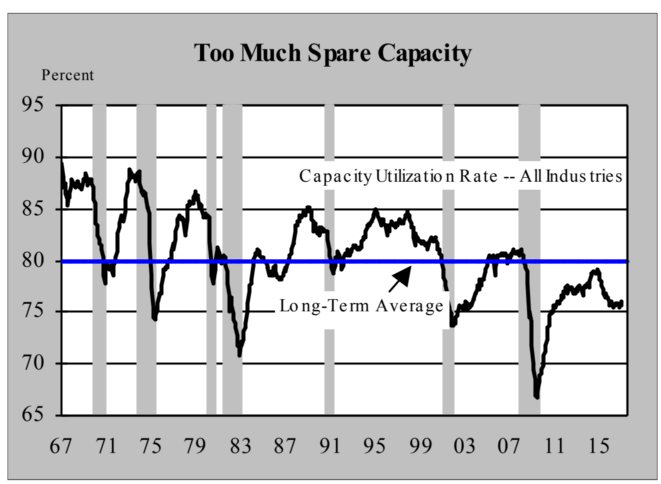
But the current expansion, while long in the tooth, has hardly run out of room either in the labor or the product markets. Although the unemployment rate is down to historically low levels, matching the lows set at the endpoints of past expansions, millions of workers remain on the sidelines that are not counted as unemployed. One basic measure of labor force slack, the share of prime-age workers holding jobs, has been steadily ticking up with the recovery, but it is still well below its pre-recession peak. Many of these potential workers have permanently left the labor force for medical reasons, such as disability and opioid addiction. But that still leave a large pool of sidelined workers for companies to draw on. What's more, there are more than 5 million part-time workers that want full-time positions; that pool has shrunk dramatically in recent years, but is still 1 million more than at the peak of the last expansion.

Like the labor market, there is also a ways to go before companies reach capacity limits. Industrial firms are currently operating at 76 percent of capacity, nearly 4 percentage points below the long-term average and well below the pre-recession peak. Adding to that slack in domestic capacity is the huge existing output capacity from a vast network of foreign producers that are ready and willing to provide American consumers with needed goods. An abundant supply of untapped labor and unused industrial capacity are key reasons wage growth has been lackluster and inflation kept in check.

Don't Rock The Boat

Simply put, rather than nearing an end, the recovery has nestled into the mature stage of the business cycle that still has room to run. The devastating hurricanes of the summer did take a bite out of activity during the third quarter, but the tailwinds that propelled growth earlier in the year are very much intact. A strong job market, slowly accelerating wage growth, ebullient consumer sentiment and rising stock as well as home values all point to solid household fundamentals that should result in a respectable holiday shopping season. The post-hurricane rebuilding efforts will impart an additional boost to the economy later this year and early 2018, reminiscent of the growth spurt that followed Hurricane Katrina in 2005.

If there are headwinds on the horizon, they spring from the captains of the economic ship. The Federal Reserve seems intent on , raising short-term rates in a gradual and steady pace through 2019 despite an inflation rate that remains stubbornly below its 2 percent target. The central bank's conviction that the tightening labor market will soon lift inflation to the target may turn out to be correct. But if low inflation persists in the face of rising short-term interest rates, households and businesses will be saddled with a heavier real debt burden that could stifle spending and investment decisions. Indeed, the recently enhanced prospect that sizeable tax cuts will materialize next year could spur the Fed into a more aggressive tightening stance. Hopefully, policy makers will not rock the boat, but the risk of a misstep suggests less complacency and more caution about the outlook is warranted.



KEY ECONOMIC AND FINANCIAL INDICATORS

FINANCIAL INDICATORS*

	September	August	July	June	May	April	March	12-Month Range High	12-Month Range Low
Prime Rate	4.25	4.25	4.25	4.13	4.00	4.00	3.88	4.25	3.50
3-Month Treasury Bill Rate	1.03	1.01	1.07	0.98	0.89	0.80	0.74	1.07	0.29
5-Year Treasury Note Rate	1.80	1.78	1.87	1.77	1.84	1.82	2.01	2.01	1.18
10-Year Treasury Note Rate	2.20	2.21	2.32	2.19	2.30	2.30	2.48	2.49	1.63
30-Year Treasury Bond Rate	2.78	2.80	2.88	2.80	2.96	2.94	3.08	3.11	2.35
Tax-Exempt Bond Yield	3.57	3.53	3.56	3.55	3.76	3.78	3.90	3.91	2.93
Corporate Bond Yield (AAA)	3.63	3.63	3.70	3.68	3.85	3.87	4.01	4.06	3.41
Conventional 30-Year Mortgage Rate	3.81	3.88	3.97	3.90	4.01	4.05	4.20	4.20	3.46
Dow Jones Industrial average	22173	21914	21581	21318	20937	20685	20823	22173	18185
S&P 500 Index	2493	2456	2454	2434	2395	2359	2367	2493	2143
Dividend Yield (S&P)	1.97	2.00	1.99	1.99	2.00	2.01	2.01	2.17	1.97
P/E Ratio (S&P)	21.4	21.2	21.2	20.9	21.4	21.2	21.1	21.8	19.9
Dollar Exchange Rate (vs. Major Currencies)	87.1	88.20	89.60	91.8	93.2	94.0	94.5	95.4	87.1

* Monthly Averages

ECONOMIC INDICATORS

	September	August	July	June	May	April	March	12-Month Range High	12-Month Range Low
Housing Starts (In Thousands)	1127	1183	1185	1217	1129	1154	1189	1328	1062
New Home Sales (Thousands of Units)		560	580	614	606	590	638	638	548
New Home Prices (Thousands of Dollars)		300	320	316	324	311	322	333	234
Retail Sales (% Change Year Ago)	4.3	3.8	3.8	3.1	4.2	4.5	4.8	5.6	3.1
Industrial Production (% Change Year Ago)	1.6	1.2	1.8	2.1	2.2	2.1	1.4	2.2	-1.2
Operating Rate (% of Capacity)	76.0	75.8	76.5	76.6	76.5	76.6	75.9	76.6	75.5
Inventory Sales Ratio (Months)		1.38	1.38	1.38	1.37	1.37	1.37	1.41	1.37
Real Gross Domestic Product (Annual % Change)				3.1			1.2	3.1	1.2
Unemployment Rate (Percent)	4.2	4.4	4.4	4.4	4.3	4.4	4.5	4.9	4.2
Payroll Employment (Change in Thousands)	-33.0	169	138	210	145	207	50	249	-33
Hourly Earnings (% Change Year Ago)	2.9	2.7	2.6	2.5	2.5	2.5	2.6	2.9	2.5
Personal Income (% Change Year Ago)		2.8	2.6	2.7	3.0	2.9	3.4	3.4	1.5
Savings Rate (Percent of Disposable Income)		3.6	3.6	3.7	3.9	3.7	3.9	4.5	3.2
Consumer Credit (Change in Mil. Of Dollars)		13065	17718	11531	18115	12825	14012	24520	11531
Consumer Prices (% Change Year Ago)	2.2	1.9	1.7	1.6	1.9	2.2	2.4	2.7	1.5
CPI Less Food & Energy (% Change Year Ago)	1.7	1.7	1.7	1.7	1.7	1.9	2.0	2.3	1.7
Wholesale Prices (% Change Year Ago)	2.6	2.4	1.9	2.0	2.4	2.5	2.3	2.6	0.7