Louisiana Corporate Credit Union
ECONOMIC & FINANCIAL DIGEST
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The Tortoise And The Hare

As the curtain descends on an eventful 2017, the spotlight now shifts to a new year. The first act looks to be promising, as the economy is entering 2018 with considerable momentum. Consumers reopened their wallets and purses during the winter months after taking a breather in the third quarter. The holiday-shopping results were not available at the time of this writing, but households struck a festive chord in November, as retailers enjoyed a banner month of sales. With confidence sky-high and the job market generating healthy payroll growth, consumers likely imparted a muscular contribution to the economy's overall growth rate in the fourth quarter.

Consumer spending, of course, is the main driver of the nation's growth engine, accounting for 70 percent of total activity. But the economy needs to run on more than one cylinder if it is to embark on a long journey and households do not have the firepower to keep it running alone. Happily, others parts of the engine are kicking in. The revival in business investment that began a year or so ago is picking up momentum, underpinned by record profits, shrinking capacity, elevated business optimism and worker shortages; additional impetus will come from the recently-passed corporate tax cuts. Housing activity is also perking up, with home sales fueled by the strong job market, rising incomes and increased household formation. The major restraint in this sector is coming from the supply side; builders are having trouble finding qualified workers and land to build on. Our overseas partners are also providing fuel. For the first time since the Great Recession, growth is synchronized across all major economies, stoking demand for American products.

Against this backdrop, there is a high probability that 2018 will be recession-free. If so, that would mark 114 months of continuous growth, a stretch of prosperity exceeded only once before. Should the upturn extend for six more months into 2019, it would become the longest expansion on record, exceeding the 120 months set in the 1990s. Some growth-killing event could intervene between now and then, but barring an external shock there is a good chance this expansion has the legs to accomplish that record-setting feat. The primary internal threats that doomed past expansions – speculative excesses or disastrous policy mistakes – are not apparent, at least not yet. True, at 2.3 percent, the average growth of the expansion has been the weakest on record. But the slow-moving nature of this lengthy recovery has suppressed imbalances and kept the Federal Reserve from making drastic policy moves. The question is, with fiscal stimulus about to kick growth up another notch, will the hare overtake the tortoise and make 2018 more vulnerable to a policy mistake?

Missed Calls

Yogi Berra famously said that making a prediction is difficult, especially about the future. To their credit, however, economists in general got 2017 reasonably correct. Modest growth was expected, and that's what we got, with GDP advancing by another ho-hum pace of slightly over 2.0 percent. But the headline trend masks some dramatic misses in the underlying details. While unemployment fell much more than expected the big miss was on inflation, which the majority of economists (and policy makers) thought would be ramping up.

Indeed, at the start of year, the big bet on Wall Street was on the so-called "reflation trade". With the economy nearing full employment at the end of 2016 and the expansion moving into a mature stage, the widespread perception was that the time-honored sequence of rising wages, inflation and bond yields would naturally follow. That, in turn, would tamp down the rally in stocks, which delivered another solid gain of around 10 percent in 2016, partly in response to historically low interest rates that encouraged investors to buy riskier assets.

Of course, nothing of the sort occurred. While the job market tightened, wages failed to respond. At the end of 2016, average hourly earnings of all workers in the private sectors had increased by 2.9 percent over the previous twelve months. By November of 2017, the annual rate of increase had fallen to 2.5 percent. With labor costs – a major source of price pressure – held in check, so too was inflation. The core inflation rate actually fell by 0.5 percentage point, from 2.2 percent to 1.7 percent between the end of 2016 and November 2017. And with inflation dormant, bond yields hardly changed over the course of 2017; the 10-year

Treasury yield in late December held at around the same 2.40- 2.50 percent it started the year. Rounding out the missed calls for 2017, stock prices once again roared ahead, this time more than doubling the gains made in 2016.

Sticking With The Plan

The Fed was just as culpable as private economists in missing the inflation call and, by implication, the market response, as it doesn't explicitly forecast market-determined yields and stock prices. Like most private economists, the majority of Fed officials thought wages and inflation would respond to the ever-tightening job market, a relationship that is captured by the so-called Phillips curve. But while the unemployment rate fell more steeply than the Fed envisioned, the inflation rate remained stubbornly below its long-standing 2 percent target.

To be fair, the Fed did not expect inflation to hit 2 percent in 2017, only to start moving up towards the target. Indeed, the central bank didn't waver in that conviction even as the trend moved in the opposite direction. For the most part, policy makers forgave that recalcitrant behavior by blaming transitory factors for pulling inflation down. The most notable of those was the astonishing freefall in the prices of cell phone plans, reinforced by a mysterious slowdown in medical costs.

As a result, the Fed stuck to its plan to gradually lift short-term interest rates, believing that once the transitory forces ebbed the Phillips curve would kick in and spur higher inflation. As unemployment fell further, that conviction hardened and served to justify the three quarter-point rate increases put into effect during the year, including the last hike at the December policy meeting. But by late in the year, even the Fed admitted that it was befuddled by the persistence of low inflation and wondered if something more fundamental than transitory forces was responsible. A growing minority among Fed officials wanted to proceed more cautiously in lifting rates, preferring to wait for actual evidence that inflation is increasing before stepping on the monetary brakes.

Policy Implications

At its December meeting, the central bank reaffirmed its commitment to gradually lift rates, expecting to hike three more times in 2018. Although internal resistance to that plan grew, including two Fed officials that actually voted against the December rate increase, the decision to move ahead was influenced by the ongoing strength in the labor market and the improved outlook for the upcoming year. Accordingly, the Fed revised up its 2018 growth forecast to 2.5 percent from the 2.1 percent estimate made three months earlier, in part reflecting the fiscal stimulus from the just-enacted $1.5 trillion tax cut.

Paradoxically, while the Fed upgraded its growth outlook, it did not change the inflation forecast; it still expects the inflation rate to remain under the 2 percent target until 2020. One way to interpret this incongruity is that the policy makers are willing to let the economy run hotter than otherwise in light of the reduced sensitivity of inflation to growth. By this reckoning, stronger growth will not trigger more rate hikes unless it stokes a quicker inflation response than it has in recent years. Indeed, the plan to hike rates three times in 2018 is unchanged from the prediction made in September, despite the upward revision to the growth forecast.

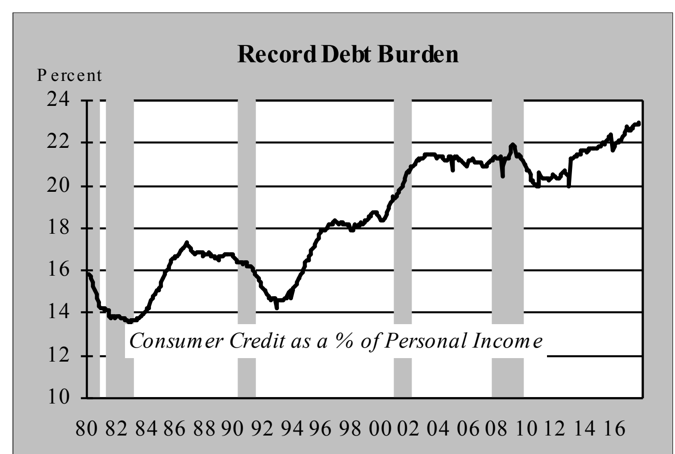
However, this interpretation conflicts with the way monetary policy unfolded in 2017, which may portend a more aggressive rate strategy in 2018. Keep in mind that the Fed increased short-term rates three times over the course of the year even though the inflation rate actually fell. Simply put, it placed more emphasis on the economy's performance and, in particular, the job market, both of which are expected to strengthen in 2018. If, as expected, inflation also firms up along with strengthening underlying fundamentals, it seems reasonable to expect that the Fed will be more aggressive in hiking rates than it was in 2017.

More Hawks Calling The Shots

That prospect becomes more compelling because the committee that makes interest rate decisions will undergo a significant changing of the guard in 2018. Thanks to the annual rotation of four voting members on the Federal Open Market Committee, the four new members will have a more hawkish inflation bias than the ones they replace. This new mix may well be more trigger-happy in lifting rates if the economy and job market continue to outperform expectations, even if inflation is slow to perk up.

As a result, the odds that monetary policy will tighten too aggressively in the year ahead have increased, reminiscent of overreactions that short-circuited previous expansions. The threat looms larger because last-minute changes in the tax bill front-loads about $200 million of additional fiscal stimulus into 2018. That could impart a bigger boost to growth, which is already outpacing the economy's output capacity, in 2018. More important, the acceleration would probably be more than the Fed is willing to tolerate and quicken the pace of rate increases. That, in turn, raises the odds of an earlier recession than otherwise.

One reason to worry is that consumers – the economy's main growth driver – would be most immediately affected by higher interest rates. And it is the consumer that is the weakest link in the outlook. Not only have they spent at a faster pace than their incomes increased, depleting savings in the process, they have increasingly relied on debt, particularly credit cards, to finance purchases. Delinquency rates on installment loans are already on the rise and higher interest payments on these loans, which Fed rate hikes would quickly bring about, would further stretch household budgets and restrain spending. Simply put, the stronger the economy looks in the immediate future, the quicker the Fed will apply the brakes to slow growth. For the expansion to continue beyond next year, the tortoise is a better bet than the hare to extend the journey.



KEY ECONOMIC AND FINANCIAL INDICATORS

FINANCIAL INDICATORS*

	November	October	September	August	July	June	May	12-Month Range High	12-Month Range Low
Prime Rate	4.25	4.25	4.25	4.25	4.25	4.13	4.00	4.25	3.50
3-Month Treasury Bill Rate	1.23	1.07	1.03	1.01	1.07	0.98	0.89	1.23	0.45
5-Year Treasury Note Rate	2.05	1.98	1.80	1.78	1.87	1.77	1.84	2.05	1.60
10-Year Treasury Note Rate	2.35	2.36	2.20	2.21	2.32	2.19	2.30	2.49	2.14
30-Year Treasury Bond Rate	2.80	2.88	2.78	2.80	2.88	2.80	2.96	3.11	2.78
Tax-Exempt Bond Yield	3.56	3.61	3.53	3.53	3.56	3.55	3.76	3.91	3.53
Corporate Bond Yield (AAA)	3.57	3.60	3.63	3.63	3.70	3.68	3.85	4.06	3.57
Conventional 30-Year Mortgage Rate	3.92	3.90	3.81	3.88	3.97	3.90	4.01	4.20	3.77
Dow Jones Industrial average	23558	23036	22173	21914	21581	21318	20937	23558	18697
S&P 500 Index	2594	2557	2493	2456	2454	2434	2395	2594	2165
Dividend Yield (S&P)	1.87	1.94	1.97	2.00	1.99	1.99	2.00	2.11	1.87
P/E Ratio (S&P)	22.3	21.7	21.3	21.1	21.2	20.9	21.4	22.3	20.5
Dollar Exchange Rate (vs. Major Currencies)	89.2	88.7	87.1	88.20	89.60	91.8	93.2	95.4	87.1

* Monthly Averages

ECONOMIC INDICATORS

	November	October	September	August	July	June	May	12-Month Range High	12-Month Range Low
Housing Starts (In Thousands)	1297	1256	1159	1172	1185	1217	1129	1297	1129
New Home Sales (Thousands of Units)		685	645	565	564	619	606	685	548
New Home Prices (Thousands of Dollars)		313	325	312	323	315	324	333	298
Retail Sales (% Change Year Ago)	5.5	4.8	4.8	3.8	3.8	3.1	4.2	5.6	3.1
Industrial Production (% Change Year Ago)	3.4	2.9	1.9	1.5	1.9	2.0	2.3	3.4	-0.4
Operating Rate (% of Capacity)	77.1	77.0	76.2	76.1	76.5	76.6	76.5	77.1	75.5
Inventory Sales Ratio (Months)		1.35	1.36	1.38	1.38	1.38	1.37	1.38	1.35
Real Gross Domestic Product (Annual % Change)			3.2			3.1		3.2	1.2
Unemployment Rate (Percent)	4.1	4.1	4.2	4.4	4.4	4.4	4.3	4.8	4.1
Payroll Employment (Change in Thousands)	228	244	38	208	138	210	145	244	38
Hourly Earnings (% Change Year Ago)	2.5	2.3	2.8	2.6	2.6	2.6	2.5	2.9	2.3
Personal Income (% Change Year Ago)		3.4	2.9	2.6	2.4	2.4	2.8	3.4	1.5
Savings Rate (Percent of Disposable Income)		3.2	3.0	3.4	3.4	3.6	3.8	4.1	3.0
Consumer Credit (Change in Mil. Of Dollars)		20519	19211	11448	14961	11707	18380	24520	11448
Consumer Prices (% Change Year Ago)	2.2	2.0	2.2	1.9	1.7	1.6	1.9	2.7	1.6
CPI Less Food & Energy (% Change Year Ago)	1.7	1.8	1.7	1.7	1.7	1.7	1.7	2.3	1.7
Wholesale Prices (% Change Year Ago)	3.1	2.8	2.6	2.4	1.9	2	2.4	3.1	1.3

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