Louisiana Corporate Credit Union

ECONOMIC & FINANCIAL DIGEST

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Consumer Retrenchment Not Alarming

As advertised, the economy is turning in an underwhelming performance in the first quarter, dragged down by softer consumer spending. Since households are the economy's main growth driver, many are fretting that the nation's third-longest expansion, about to enter its tenth year, is nearing the end of the road. Certainly, there are troubling signs that typically appear at the late stages of a business cycle. The Federal Reserve is leaning against the wind, raising short-term interest rates and shrinking its balance sheet. Inflation is picking up and the job market is nearing, if not at, full employment. In addition to these time-honored cyclical markers, the economy faces risks on the policy front, particularly regarding foreign relations and trade.

Just as the administration's tax cuts last year cheered the business community and pumped more energy into stock prices, president Trump's announced tariffs on steel and aluminum had just the opposite effect, drawing criticism from business leaders and wreaking havoc in the financial markets. Trump softened the tariff's bite by excluding Canada and Mexico, but that has not quelled fears his policies will veer towards a more protectionist stance. Reshuffling his inner circle to include advisors with more hawkish views on trade only brings the prospect of a trade war closer to reality, as other nations would almost certainly retaliate in kind. There are many flaws in current trade arrangements that need to be addressed. But erecting barriers to trade and ramping up geopolitical tensions will do more harm than good for the economy and pose the biggest threat to the growth outlook.

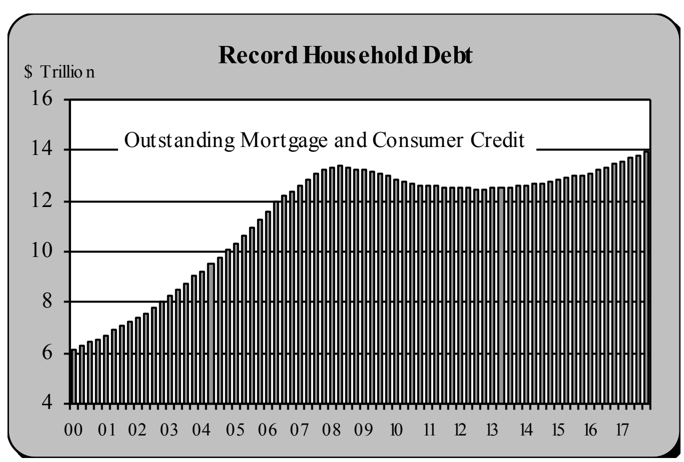
That said, there might be more bark than bite behind the administration's tough messages to trading partners, so we will just have to see how things actually play out. The risk is that the process could be unwieldy and create more uncertainty in the financial markets, leading to heightened volatility if not severe market corrections that could have a negative feedback on the economy. While not a trivial probability, the odds are that congressional pressure ahead of the midterm elections will force the administration to temper its more strident growth-stifling policies and not undercut the economy's solid fundamentals. If so, the momentum that was interrupted in the first quarter should resume, as the tax cuts find their way into the spending stream and businesses continue to ramp up investment.

Consumers Borrowing Again: Should We Worry?

Households spent a good part of the recovery working off the excessive debt burden acquired prior to the Great Recession. Much of the paydowns were involuntary, reflecting a tidal wave of defaults, foreclosures and short sales, stemming from massive layoffs during the downturn and the housing bust that forced millions of people to lose their homes or sell them at a deep discount. As well, lenders closed the credit spigot for several years to restore battered balance sheets and to comply with tougher regulations mandated by Congress following the financial crisis. On the other side of the ledger, the demand for loans shriveled as consumers, fearful of job security and whose nest eggs were decimated by the plunge in stock prices and housing values, refrained from taking on new debt for some time.

Deprived of the fuel that borrowing provides, consumer spending recovered much more slowly from the Great Recession than normally occurs during cyclical upturns. But the deleveraging process ended in 2014. Slowly but surely, the credit spigot reopened as lender balance sheets returned to health. Meanwhile, households regained both the confidence and wherewithal to start borrowing again, buoyed by the lengthening recovery and accelerating job growth. By late 2016, outstanding household debt finally exceeded the previous peak set in 2008 and continued to set new records through the end of last year.

Some feel that consumers dove back into the borrowing pool too rapidly and are ill-equipped to handle the mountain of new debt created over the past two years. That's particularly the case with interest rates rising and incomes lagging the growth in spending, resulting a much lower savings rate than a few years ago. Should the job market sputter and/or asset values fall, households might be hard pressed to service their debts, leading to an abrupt spending cutback that sets the stage for the next recession. In this context, the slump in retail sales over the past



three months sounds an ominous note.

No Alarm Bells Yet

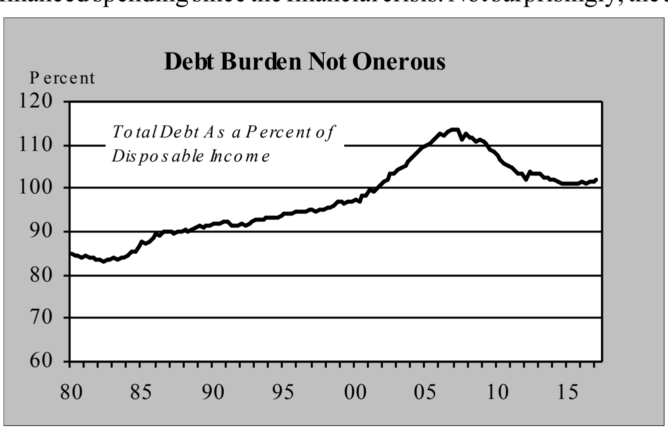
To be sure, the increase in consumer debt in recent years has generated pockets of distress. In particular, the delinquency rate is rising on new credit card borrowing and the share of delinquent auto loans is higher now than before the financial crisis. These trends certainly need careful monitoring. But households have hardly embarked on a reckless borrowing binge. Nor have lenders ignored the lessons of the financial crisis, extending credit to just about anyone with a heartbeat, as was the case in the run-up to that unfortunate episode.

To gauge the distress level of consumer debt, it is best to view the borrowing trend in the broader context of a rising population, higher asset values and stronger incomes. Relative to incomes, for example, total household debt remains 15 percent smaller than in the run-up to the financial crisis, and 20 percent below the peak distress level during the crises – 107 percent of disposable income versus 135 percent in 2007. And with interest rates on both mortgages and other consumer loans remaining well below pre-recession levels, households are devoting a much smaller share of income to debt repayments than was the case a decade ago. They also have more collateral to back up their loans. At $114 trillion, total household assets are nearly 10 times larger than liabilities, the largest coverage since 1989.

True, the remarkable 10-year rally in stock prices has underpinned the appreciation in asset values, with most of the gains accruing to wealthier households. These individuals had little trouble servicing debt before the bull market began. However, the squeeze on the middle class has also eased considerably, thanks to the run-up in home values in recent years. Whereas 11.9 million homeowners were underwater in their mortgages in the fourth quarter of 2009, or 26 percent of all mortgaged properties, only 2.5 million are stuck with negative equity today, less than 5 percent of the total. Looked at another way, households in the aggregate have recovered all of the home equity lost during the housing bust, having nearly a 60 percent equity stake in their properties in the fourth quarter of last year.

Taking a Breather

Simply put, households have stepped up borrowing in recent years, but, by most yardsticks, they are not overextended. That's important, because consumer willingness to borrow plays a critical role in spending behavior. For example, in the final quarter of 2017, roughly 27 percent of total consumer purchases (excluding home purchases) were financed by credit – the largest share of credit-financed spending since the financial crisis. Not surprisingly, the 3.8 percent growth rate in personal consumption expenditures during that period was the strongest in three years.



While first-quarter borrowing figures are not yet available, consumer credit slowed considerably in January, coincident with the pullback in consumer spending. As noted, retail sales slumped in February as well, which may also be linked to weaker credit-financed purchases, particularly since auto sales were a big drag that month. On the surface, these are ominous signs, signifying that households are once again abstaining from taking on new debt; if that's the case, consumers could be a significant drag on growth for the rest of the year.

But that prospect is inconsistent with the positive fundamentals underpinning household behavior. Aside from the healthy financial yardsticks noted above, the robust job market, rising incomes and elevated confidence strongly indicate that consumers should regain their spending mojo in coming months. What's more, disposable incomes will be getting an extra boost from last year's tax cuts, which are just finding their way into worker paychecks through lowered withholding rates – too late to impact spending in February. Indeed, a delay in the disbursements of earned income tax credits to lower income households probably took a bite out of spending that month.

Modest Rebound Ahead

The growth slowdown in the first quarter, led by the pullback in consumer borrowing and spending, is not particularly worrisome. Temporary setbacks are common in recoveries and there is no reason to believe that this one is any different. All the signs point to a rebound in consumer spending that will be reinforced by strengthening business investment and increased fiscal stimulus. However, don't expect households to go on a spending and borrowing binge.

While consumer fundamentals are sound, households are saddled with some restraints. For one, spending has outpaced income growth over the past two years. In large part, savings, not more borrowing, has financed the spending excess. As a result, the personal savings rate has declined to just over 3.0 percent, about half the level of two years ago. This is an unsustainably low level that leaves households with little in the way of reserves should an adverse shock batter their balance sheets or income prospects. The last time the savings rate was this low were the years leading up to the financial crisis.

For another, the Federal Reserve is lifting interest rates, highlighted by the sixth quarter-point increase at the policy meeting on March 20-21. This will immediately boost borrowing costs on credit cards and auto loans, the two areas that are already showing signs of distress. Not only will the increase in debt servicing charges discourage some credit-financed purchases. Banks are also tightening lending standards where loan performance quality is deteriorating, indicating that the supply of credit for auto and credit card purchases will not be as abundant going forward. This "composed caution" on the part of banks, expressed in the Federal Reserve's latest Senior Loan Officer Opinion Survey, will put a check on the reckless type of lending that precipitated the financial crisis. While that also moderates growth prospects, it keeps the economy – and banking system – on a sound footing, which enhances the prospects for a longer expansion than otherwise.

KEY ECONOMIC AND FINANCIAL INDICATORS

*FINANCIAL INDICATORS**

	February	January	December	November	October	September	August	12-Month Range High	12-Month Range Low
Prime Rate	4.50	4.50	4.40	4.25	4.25	4.25	4.25	4.50	3.75
3-Month Treasury Bill Rate	1.57	1.41	1.32	1.23	1.07	1.03	1.01	1.57	0.52
5-Year Treasury Note Rate	2.60	2.38	2.18	2.05	1.98	1.80	1.78	2.60	1.77
10-Year Treasury Note Rate	2.86	2.58	2.40	2.35	2.36	2.20	2.21	2.86	2.19
30-Year Treasury Bond Rate	3.13	2.88	2.77	2.80	2.88	2.78	2.80	3.13	2.77
Tax-Exempt Bond Yield	3.82	3.56	3.43	3.56	3.61	3.53	3.53	3.91	3.43
Corporate Bond Yield (AAA)	3.82	3.55	3.51	3.57	3.60	3.63	3.63	4.01	3.51
Conventional 30-Year Mortgage Rate	4.33	4.03	3.95	3.92	3.90	3.81	3.88	4.33	3.81
Dow Jones Industrial average	24982	25804	24545	23558	23036	22173	21914	25804	20424
S&P 500 Index	2705	2790	2664	2594	2557	2493	2456	2790	2330
Dividend Yield (S&P)	1.90	1.79	1.87	1.87	1.94	1.97	2.00	2.01	1.79
P/E Ratio (S&P)	21.9	22.8	21.7	22.0	21.7	21.3	21.1	22.8	20.9
Dollar Exchange Rate (vs. Major Currencies)	85.7	86.3	88.7	89.2	88.7	87.1	88.20	94.5	85.7

** Monthly Averages*

ECONOMIC INDICATORS

	February	January	December	November	October	September	August	12-Month Range High	12-Month Range Low
Housing Starts (In Thousands)	1236	1329	1207	1299	1261	1159	1172	1329	1129
New Home Sales (Thousands of Units)		593	643	696	616	639	559	696	559
New Home Prices (Thousands of Dollars)		323	337	343	320	332	314	343	298
Retail Sales (% Change Year Ago)	4.0	3.9	5.1	5.9	5.0	5.0	3.5	5.9	3.0
Industrial Production (% Change Year Ago)	4.4	3.5	3.5	3.8	3.3	1.8	1.4	4.4	0.4
Operating Rate (% of Capacity)	78.1	77.4	77.8	77.5	77.3	76.1	76.0	78.1	75.8
Inventory Sales Ratio (Months)		1.34	1.33	1.33	1.34	1.36	1.38	1.38	1.33
Real Gross Domestic Product (Annual % Change)			2.5			3.2		3.2	1.2
Unemployment Rate (Percent)	4.1	4.1	4.1	4.1	4.1	4.2	4.4	4.7	4.1
Payroll Employment (Change in Thousands)	313	239	175	216	271	14	221	313	14
Hourly Earnings (% Change Year Ago)	2.6	2.8	2.7	2.5	2.3	2.8	2.6	2.8	2.3
Personal Income (% Change Year Ago)		3.8	4.3	4.0	3.5	3.1	2.7	4.3	2.4
Savings Rate (Percent of Disposable Income)		3.2	2.5	2.6	3.0	3.0	3.5	4.1	2.5
Consumer Credit (Change in Mil. Of Dollars)		13906	19209	30938	22878	8718	9958	30938	8718
Consumer Prices (% Change Year Ago)	2.2	2.1	2.1	2.2	2.0	2.2	1.9	2.7	1.6
CPI Less Food & Energy (% Change Year Ago)	1.8	1.8	1.8	1.7	1.8	1.7	1.7	2.2	1.7
Wholesale Prices (% Change Year Ago)	2.8	2.7	2.6	3.1	2.8	2.6	2.4	3.1	1.9

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