Louisiana Corporate Credit Union

ECONOMIC & FINANCIAL DIGEST

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Healthy Slowdown On The Way

As the data roll in we are getting a better handle on how the economy is shaping up in the third quarter. So far, things are looking pretty good. To be sure, growth is unlikely to match the robust 4.1 percent annual rate reached in the second quarter. But a big part of that strength reflected delayed purchases from the first quarter, which was depressed by harsh weather, as well as a temporary surge in soybean exports in advance of China's imposition of tariffs. Without those temporary impulses, the second-quarter's growth rate would have come in closer to 2.8 percent, which is line with the pace over the past year. That is a decided improvement compared to the 2.2 percent average growth rate for the recovery, now entering its tenth year, but not great. The economy had been growing at about that pace in 2014 and 2015 before plunging oil prices decimated energy-related investment spending and put a severe crimp on activity over the next 18 months.

That said, a 3 percent growth rate or thereabouts would be a nice upgrade for an economy that has struggled to break out of a 2.0-2.5 percent trajectory during the past decade. The question is, can it sustain that pace over the long haul without stoking a serious upsurge in inflation? Probably not, despite the wishful hopes of the Trump administration. The economy's non-inflationary speed limit is still determined by growth in the labor force and productivity. Neither looks likely to speed up over the foreseeable future; indeed, the labor force is downshifting markedly, reflecting an aging population that is producing an ever- growing wave of retirements.

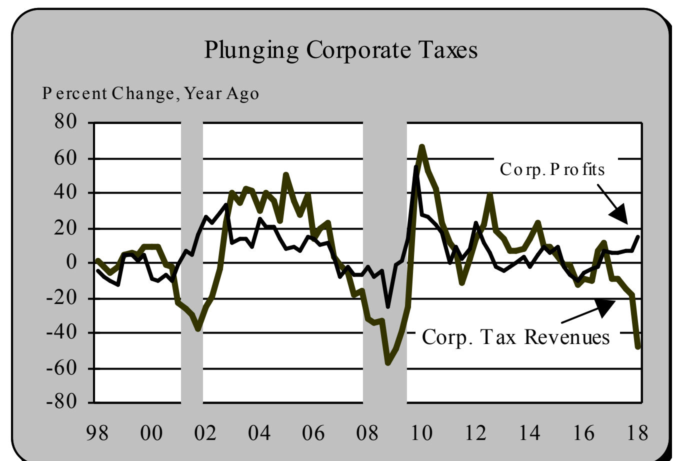
With the solid July reading on retail sales and some encouraging reports on capital spending, it's quite possible that a 3.0 percent growth rate can be achieved in the third quarter. Beyond that, however, things get dicey as some key catalysts that have driven growth this year will be fading, even as the economy is facing increasing headwinds. The tax cuts enacted last year gave households a significant bonus of extra cash to spend on everything from autos to restaurants, which clearly boosted consumption in the second quarter. That impetus will become less potent going forward, and spending will grow more in line with job and income trends, both of which are set to slow down. Meanwhile, the global landscape has turned darker and the Federal Reserve is on a steadily tightening path. The time for lowered expectations has arrived.

Small Bang For The Buck

The Trump administration is understandably patting itself on the back for the economy's robust performance in the second quarter, noting that the tax cuts on households and businesses enacted last year contributed mightily to the outcome. No doubt, the tax bill had a meaningful impact on consumer spending and business investment; putting more money in the hands of households and extra cash in corporate coffers is a time-honored incentive to make purchases that would otherwise not have been made. What's more, the positive impulse will continue in coming months, albeit with gradually diminishing force, reinforced by the spending bill passed earlier this year.

But how much bang for the buck the government is getting for its efforts is open to question. It's doubtful that tax cuts will fix the underlying causes of the economy's diminished long-term growth potential, namely the slowing labor force and productivity growth. True, if the steep reduction in corporate taxes leads to a big pick up in investment spending, that would help improve productivity growth. But so far, the primary result of the cut from 35 percent to 21 percent in the corporate tax rate is a huge reduction in government revenues that is bloating a deficit destined to run more than $1 trillion a year over the next decade.

Indeed, the results so far are astonishing. Corporate tax revenues plunged by 48 percent in the first quarter from a year earlier, a downturn exceeded only during the Great Recession, even as corporations continue to rack up strong profits. Not only was the corporate tax bill slashed by $115 billion in the first quarter, the government also lowered the tax on earnings repatriated from overseas affiliates, opening the floodgates for another $633 billion brought home during the first quarter. Together, the tax savings and the foreign earnings retrieved provided nonfinancial corporations with a windfall of $900 million more cash than was needed to finance capital spending. That's the largest surplus, or negative financing gap, ever recorded.



Modest Investment Rebound

Not surprisingly, those powerful incentives did spur a meaningful increase in business investment spending in the first quarter. But the vast majority of the increased cash infusion that corporations received during the period was channeled into other uses, most notably into dividends, share buybacks, mergers and acquisitions, and balance sheet repair. What's more, following the solid 14.3 percent increase in the first quarter, outlays on plant and equipment slowed to a 7.3 percent pace in the second quarter, according to the latest GDP report. While that's still a healthy increase, much of it derived from energy-related investment spending, reflecting the rebound in oil prices over the past year.

Indeed, energy investment grew by a formidable 30 percent in the second quarter and, barring another collapse in oil prices, should provide support for overall investment spending going forward. But even if oil prices remain elevated, spending on oil and gas structures and equipment will not provide as much of a boost to investment outlays as in the past. The reason: The energy sector has become much more efficient in producing oil. To put this in perspective, U.S. oil field production since the start of the year has averaged 10.4 million barrels a day with just over 1000 rigs in operation. But just four years ago, it required 18000 rigs to produce 8.3 million barrels a day.

Meanwhile, another catalyst behind investment spending is starting to fade. Recall that there was much excitement last year over the synchronized upswing in global growth that included most emerging markets as well as developed nations. That, in turn, gave U.S. exports a sizeable boost, energizing manufacturers to step up investment spending. But recently, the global outlook has turned weaker. European momentum slowed in the first half of 2018 along with Chinese growth, and emerging markets are facing headwinds from a stronger dollar, elevated oil prices and higher interest rates. It's unclear if an all-out trade war will erupt, but if the reciprocal tariffs already imposed by the U.S. and its trading partners continue to escalate, it will surely have a negative impact on global growth.

Little Trickle Down Effect

Despite the headlines garnered by some high-profile companies claiming that they were rewarding employees with higher pay because of the tax cuts, wages overall have only increased modestly. Yes, the 2.7 percent increase in average hourly earnings over the past year (through July) is a notch better than the 2.-2.5 percent growth over the first seven years of the recovery. But over the past two years, there has been virtually no improvement — the 2.7 percent annual increase is precisely the same as it was in October 2016.

Meanwhile, the cost of living has steadily increased. In October 2016, the consumer price index increased 1.6 percent from a year earlier. This July, the CPI was up 2.9 percent. Simply put, the purchasing power of households actually deteriorated in recent years. Indeed, real average hourly earnings decreased 0.2 percent in July, so workers are actually worse off than they were a year ago. To be sure, the rebound in gasoline prices over the past year was a big factor pushing the CPI higher. But even excluding volatile food and energy prices, consumer inflation is moving higher. The 2.4 percent annual increase in the core CPI in July, which excludes energy and food, was the strongest in almost a decade.

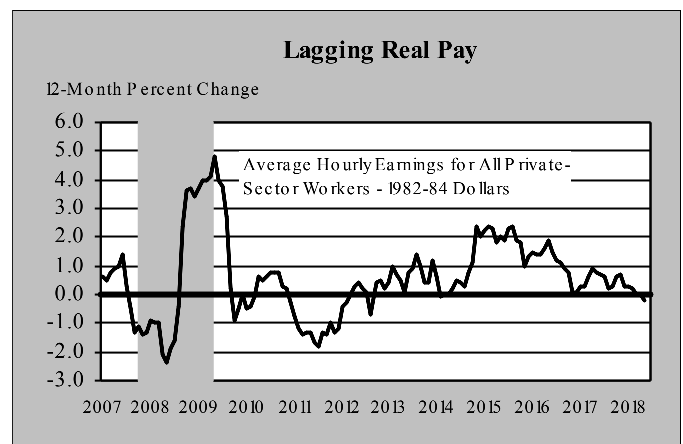
Needless to say, with inflation hitting the Federal Reserve's 2.0 percent target and the economy still registering above-trend growth, the stage is set for continued rate increases. So far, the Fed has raised its short-term policy rate seven times since moving away from its zero-rate policy in December 2015, lifting it to the current 1.75-2.00 percent range. Two more quarter point increases are planned this year, according to the Fed's dot plots, and three more in 2019, assuming the economy performs as the central bank expects over the next 18 months.

Leaning Against the Wind

So far, the Fed's rate-hiking campaign has not made a meaningful dent in economic activity, as evidenced by the robust second-quarter growth in GDP. At best, it is offsetting some of the stimulus provided by the government's tax cuts and spending increases, which many argue were ill-timed given that the economy is already running at near full capacity. As such, the Fed is acting appropriately, leaning against the wind before inflationary forces gain traction and provoke harsher growth-killing rate increases later. Hopefully, it will not modify its approach in response to political interference from President Trump, who has recently expressed displeasure with the Fed's rate increases. History clearly demonstrates that an independent central bank is essential to a healthy functioning economy.

That said, the Fed's gradual nudging up of short-term rates is another headwind that will restrain growth going forward. The need to continue on this path assumes that the second-quarter growth spurt was not just a sugar high, driven by deficit-bloating tax cuts that will soon evaporate and open a trap door for a deep dive in activity. While the impact of the fiscal stimulus will fade over time, the economy's underpinnings are solid, buoyed by a strong job market and growing incomes that will keep households in a spending mood, at least for the foreseeable future. A $20 trillion economy does not reverse direction abruptly unless it is derailed by a powerful external shock.

But while the economy is still on a solid footing, myriad signs point to slowing momentum. The job-creating engine is set to downshift, if only because fewer workers are available to hire. Supply constraints are also appearing in the product market, as many industries are reporting stretched out delivery schedules. Slower growth does not mean the endgame is around the corner for the expansion, but it does indicate that the economy is more vulnerable to a policy mistake or external shock. Indeed, if the slowdown is gradual and handled correctly, the expansion should live beyond next July, setting a new record for longevity.



KEY ECONOMIC AND FINANCIAL INDICATORS

*FINANCIAL INDICATORS**

	July	June	May	April	March	February	January	12-Month Range High	12-Month Range Low
Prime Rate	5.00	4.89	4.75	4.75	4.58	4.50	4.50	5.00	4.25
3-Month Treasury Bill Rate	1.96	1.90	1.86	1.76	1.70	1.57	1.41	1.96	1.01
5-Year Treasury Note Rate	2.78	2.78	2.82	2.70	2.63	2.60	2.38	2.82	1.78
10-Year Treasury Note Rate	2.89	2.91	2.98	2.87	2.84	2.86	2.58	2.98	2.20
30-Year Treasury Bond Rate	3.01	3.05	3.13	3.07	3.09	3.13	2.88	3.13	2.77
Tax-Exempt Bond Yield	3.88	3.89	3.88	3.90	3.89	3.82	3.56	3.90	3.43
Corporate Bond Yield (AAA)	3.87	3.96	4.00	3.85	3.87	3.82	3.55	4.00	3.51
Conventional 30-Year Mortgage Rate	4.53	4.57	4.59	4.47	4.44	4.33	4.03	4.59	3.81
Dow Jones Industrial average	24978	24790	24573	24304	24582	24982	25804	25804	21581
S&P 500 Index	2794	2754	2701	2654	2703	2705	2790	2794	2454
Dividend Yield (S&P)	1.92	1.96	1.95	1.97	1.96	1.90	1.79	2.00	1.79
P/E Ratio (S&P)	20.50	19.80	20.6	20.2	20.2	22.0	22.8	22.8	19.8
Dollar Exchange Rate (vs. Major Currencies)	90.0	89.7	88.7	86.4	86.2	85.7	86.3	90.0	85.7

** Monthly Averages*

ECONOMIC INDICATORS

	July	June	May	April	March	February	January	12-Month Range High	12-Month Range Low
Housing Starts (In Thousands)	1168	1158	1329	1276	1327	1290	1334	1334	1158
New Home Sales (Thousands of Units)		631	666	641	672	663	633	712	556
New Home Prices (Thousands of Dollars)		302	310	315	335	327	330	343	302
Retail Sales (% Change Year Ago)	6.4	6.2	6.4	4.8	5.1	4.5	3.9	6.4	3.7
Industrial Production (% Change Year Ago)	4.2	4.0	3.0	3.9	3.6	3.7	2.8	4.2	1.1
Operating Rate (% of Capacity)	78.1	78.1	77.5	78.3	77.5	77.2	77	78.3	75.7
Inventory Sales Ratio (Months)		1.33	1.34	1.35	1.35	1.36	1.36	1.39	1.33
Real Gross Domestic Product (Annual % Change)		4.1			2.0			4.1	2.0
Unemployment Rate (Percent)	3.9	4.0	3.8	3.9	4.1	4.1	4.1	4.4	3.8
Payroll Employment (Change in Thousands)	157	248	268	175	155	324	176	324	14
Hourly Earnings (% Change Year Ago)	2.7	2.7	2.8	2.6	2.6	2.6	2.8	2.8	2.3
Personal Income (% Change Year Ago)		4.9	4.6	4.6	4.3	4.2	4.4	4.9	4.2
Savings Rate (Percent of Disposable Income)		6.8	6.8	6.9	7.2	7.4	7	7.4	6.2
Consumer Credit (Change in Mil. Of Dollars)		10211	24259	10219	8787	11195	11964	30258	8274
Consumer Prices (% Change Year Ago)	2.9	2.8	2.5	2.4	2.2	2.1	2.2	2.9	1.6
CPI Less Food & Energy (% Change Year Ago)	2.3	2.2	2.2	2.1	2.1	1.9	1.8	2.3	1.7
Wholesale Prices (% Change Year Ago)	3.3	3.4	3.1	2.6	3.0	2.8	2.7	3.4	1.9

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