Louisiana Corporate
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ECONOMIC & FINANCIAL DIGEST

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Fiscal Stimulus: Too Much Of A Good Thing?

Once again, the economy is behaving like Lucy from the old Peanuts cartoon, removing the football just as Charlie Brown is about to kick it through the goal posts. Recall that the growth engine revved up last year, building momentum that appeared firmly set to carry over into 2018. But alas, the expected growth trajectory, like Charlie Brown's football, is being waylaid. Instead of following up a robust holiday shopping season with sustained vigor, consumers pulled back in January, as retail sales suffered an unexpected drop during the month. At the same time, the nation's industries scaled back output, as industrial production slipped for the first time in six months. With these two key indicators stumbling out of the starting gate, it looks like the economy may hit a speed bump in the first quarter, growing about a half-percentage points slower than what was expected a month or so ago.

In all fairness, this would not be an earth-shattering experience. The economy has a recent history of losing momentum at the start of the year. Indeed, growth slowed in the first quarter in nine of the last ten years. In four of those years, GDP actually declined in the opening quarter. In just about all cases, however, growth snapped back, which suggests that Washington statisticians are not correctly adjusting the first quarter figures for seasonality. That said, the year is expected to start out in decent shape compared to past performance. Even with the January stumble, the economy is tracking a 2.5 percent growth rate in the first quarter, which would only be a tad weaker than the 2.9 percent average pace in the second half of 2017 and a much smaller drop-off than seen in previous years.

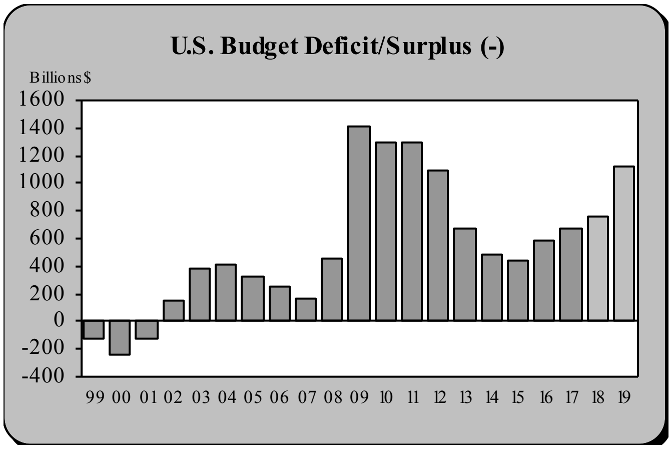
More important, the growth engine is poised to rev up again and deliver the strongest full-year performance since 2005. The reason: it's getting a lot of help from the government. In addition to the $1.5 trillion tax cut passed late last year, congressional lawmakers agreed to an extensive two-year spending bill in February that will provide even more fiscal stimulus to the economy. The extra $300 billion in federal spending should boost growth by another quarter-percentage point this year on top of the 0.40 percentage points coming from last year's tax cuts. But that much stimulus so late in the business cycle when the economy is already growing above potential is unsettling the financial markets, where fears of higher inflation and interest rates have recently surfaced. After a year of historical tranquility, turbulence returned to the markets with a vengeance in February. Inflation and interest rates will probably increase more than they otherwise would without the additional fiscal stimulus, but not by enough to derail the expansion. Nor does it justify the recent market turmoil, which hopefully will not become more virulent and impart a negative feedback on the economy.

The Return of $1Trillion Deficits

The burning question among congressional critics is, what happened to the deficit hawks? Not too long ago, Republicans lambasted President Obama for running deficits in excess of $1 trillion for four consecutive years from 2009 through 2012. The red-ink spillage, more than double the size ever before recorded, emboldened deficit hawks and led to the Budget Control Act of 2011, which put tight ceilings on federal spending. Many believe that the austerity measures put in place held back the recovery, removing a key source of growth that a normal increase in federal spending would have provided. Indeed, from 2011 to 2015, federal outlays were an outright drag on growth; in 2015, federal cutbacks sliced half percent from that year's 1.7 percent increase in GDP.

Still, by late in Obama's term, the deficit had been cut in half – to $438 billion in fiscal 2015. Meanwhile, the recovery's slow and steady progress continued, helped in large part by the massive infusion of monetary stimulus. The upturn gained traction last year, allowing the Federal Reserve to gradually move away from the ultra-loose policy of keeping short-term interest rates at near zero between 2008 and 2015 and start unwinding the massive balance sheet built up in the wake of the financial crisis. Since late 2015, the Fed has increased rates five times and at least three more are expected this year.

Ordinarily as expansions mature, the Federal deficit continues to shrink, as the inflow of tax revenues accelerates and spending on unemployment and other safety-net programs declines. But that path is not to be this time, as the two budget initiatives passed by Congress in recent months will blow up the deficits to levels not seen since the financial crisis and normally



associated with deep recessions. The red-ink is expected to climb to $755 billion this year and then jump to over $1 trillion in fiscal 2019, when the full impact of the tax cuts will take effect. If not for the improving economy, the deficits would likely be even larger.

Low Priority

With the return of eye-opening $1 trillion deficits, one might ask, where's the outrage? Clearly, not among Congressional Republicans, the usual party of probity, who spearheaded the tax cuts. Keep in mind that heading into critical mid-term elections the incumbent party benefits from a strengthening economy, an outcome that is facilitated by additional fiscal stimulus. To be fair, this is a time-honored practice of both parties, whose members know that "it's the economy, stupid" that sways voters more than anything.

Indeed, voters as well as the general public tend to condone higher deficits during expansions. In the latest Pew Research Center survey, getting the deficit under control ranked near the bottom of the public's list of priorities. By contrast, it was high on the list back in 2013, when the economy was still struggling to emerge from the recession. Intuitively, those preferences would seem to make sense to the public. After all, families strive to tighten their belts when times are tough, paying down debt and becoming more frugal with their spending. Alternatively, they are more expansive with spending and borrowing when conditions are good and incomes are rising. Not surprisingly, these habits are projected on to the government, which may explain why the public thinks budget-busting spending is normal during an expanding economy.

But what may seem like logical behavior for the public is entirely irresponsible when it comes to economic policy. It makes financial sense for households to rein in spending and borrowing when times are tough; but that's precisely when the lawmakers should be opening the spending spigot to jump-start the economy's growth engine. Conversely, when the economy is cruising at near capacity and in little need of help, the government should be getting its budget house in order, building up firepower to use against the next recession. Instead, it is imparting more fuel to the growth engine that may cause the economy to overheat.

Market Jitters

To be sure, investors have a different perspective than the public. Fears that the outsized deficits will stoke too much demand and drive up inflation have contributed to a major selloff in stocks and bonds in early February. Stock prices suffered their first 10 percent correction in two years and the bellwether 10-year Treasury yield climbed to over 2.90 percent for the first time since 2014, up half-percentage point from the beginning of the year.

Recent data are adding substance to these inflation fears. Wages increased at the fastest annual rate of the recovery in January, according to that month's jobs report, even as core consumer prices staged the strongest increase since 2005. Meanwhile, the dollar's weakness is making foreign goods more expensive, as import prices are moving sharply higher, particularly for such big-ticket consumer goods as autos. At the very least, the deflation threat that was so dominant a force in the financial markets for several years following the Great Recession has been totally vanquished.

No doubt, inflation fundamentals have changed in recent months. With the unemployment rate at a 17-year low 4.1 percent, employers are competing more aggressively for workers, putting upward pressure on labor costs. Companies, in turn, can more easily pass some of these costs on to consumers, as the economy is growing faster than its output potential. Add to this mix the sluggish productivity backdrop and the recipe for higher inflation is in place. But these developments are normal during the mature stage of an expansion, and fears that they will get out of hand are probably overblown.

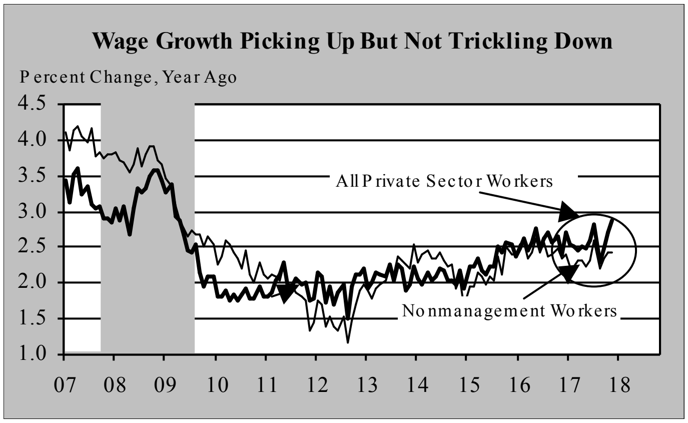
Heightened Recession Threat

The expansion, now 8.8 years old and the third longest on record, is showing its age. But it is hardly becoming as feisty as the late stages of previous expansions. True, recent indications of rising labor costs and price pressures are sounding alarms in the financial markets. But the spurt in wages revealed in the January jobs report would not be the first time that a breakout in this volatile series seemed about to happen, only to ease back to a lower trend in subsequent months. What's more, the January increase did not trickle down to blue-collar workers, as the increase for production and nonsupervisory positions remained at the lackluster trend of recent years. Likewise, the spike in consumer prices in January may well be a one-off event, propelled in part by a transitory jump in apparel prices.

For inflation to gain sustained traction, inflationary expectations would also have to ramp up, something that has yet to occur. Two widely followed surveys by the Conference Board and University of Michigan reveal that inflationary expectations among households remain well anchored. The inflation rate will likely edge up to around 2.0 percent from the current 1.5 percent unless wage growth accelerates more rapidly than expected. But the wage trend has a built-in relief valve, as much stronger increases could well lift the labor force participation rate, which remains near the lowest in 30 years. By luring more workers off the sidelines, the increased supply would provide a check on wages.

Recent trends in wages and the consumer price index should not spur the Federal Reserve into a more aggressive tightening stance than is currently underway. However, the extra growth torque implied by the latest fiscal initiatives has prompted several Fed officials to raise their growth forecast at the January policy meeting, which could lead to a faster pace of rate increases than planned back in December. Little harm will come from the widely expected hike at the next meeting on March 20-21, but if the Fed slams on the monetary brakes and interest rates climb much higher later on, the odds of a recession next year would certainly increase. That would be just the opposite result of what the fiscal lawmakers hoped to accomplish.

Wage Growth Picking Up But Not Trickling Down



KEY ECONOMIC AND FINANCIAL INDICATORS

*FINANCIAL INDICATORS**

								12-Month Range	
	January	*December*	*November*	*October*	*September*	*August*	*July*	*High*	*Low*
Prime Rate	*4.50*	*4.40*	*4.25*	*4.25*	*4.25*	*4.25*	*4.25*	*4.50*	*3.75*
3-Month Treasury Bill Rate	*1.41*	*1.32*	*1.23*	*1.07*	*1.03*	*1.01*	*1.07*	*1.41*	*0.51*
5-Year Treasury Note Rate	*2.38*	*2.18*	*2.05*	*1.98*	*1.80*	*1.78*	*1.87*	*2.38*	*1.77*
10-Year Treasury Note Rate	*2.58*	*2.40*	*2.35*	*2.36*	*2.20*	*2.21*	*2.32*	*2.58*	*2.19*
30-Year Treasury Bond Rate	*2.88*	*2.77*	*2.80*	*2.88*	*2.78*	*2.80*	*2.88*	*3.08*	*2.77*
Tax-Exempt Bond Yield	*3.56*	*3.43*	*3.56*	*3.61*	*3.53*	*3.53*	*3.56*	*3.91*	*3.43*
Corporate Bond Yield (AAA)	*3.55*	*3.51*	*3.57*	*3.60*	*3.63*	*3.63*	*3.70*	*4.01*	*3.51*
Conventional 30-Year Mortgage Rate	*4.03*	*3.95*	*3.92*	*3.90*	*3.81*	*3.88*	*3.97*	*4.20*	*3.81*
Dow Jones Industrial average	*25804*	*24545*	*23558*	*23036*	*22173*	*21914*	*21581*	*25804*	*19908*
S&P 500 Index	*2790*	*2664*	*2594*	*2557*	*2493*	*2456*	*2454*	*2790*	*2275*
Dividend Yield (S&P)	*1.79*	*1.87*	*1.87*	*1.94*	*1.97*	*2.00*	*1.99*	*2.06*	*1.79*
P/E Ratio (S&P)	*23.0*	*21.8*	*22.0*	*21.7*	*21.3*	*21.1*	*21.2*	*23.0*	*20.9*
Dollar Exchange Rate (vs. Major Currencies)	*86.3*	*88.7*	*89.2*	*88.7*	*87.1*	*88.20*	*89.60*	*94.7*	*86.3*

** Monthly Averages*

ECONOMIC INDICATORS

								12-Month Range	
	January	*December*	*November*	*October*	*September*	*August*	*July*	*High*	*Low*
Housing Starts (In Thousands)	*1326*	*1209*	*1299*	*1261*	*1159*	*1172*	*1185*	*1326*	*1129*
New Home Sales (Thousands of Units)		*625*	*689*	*599*	*639*	*559*	*564*	*689*	*559*
New Home Prices (Thousands of Dollars)		*335*	*335*	*319*	*332*	*314*	*323*	*335*	*298*
Retail Sales (% Change Year Ago)	*3.6*	*5.2*	*5.9*	*5.0*	*5.0*	*3.5*	*3.7*	*5.9*	*3.0*
Industrial Production (% Change Year Ago)	*3.7*	*3.4*	*3.8*	*3.3*	*1.8*	*1.4*	*1.7*	*3.8*	*0.0*
Operating Rate (% of Capacity)	*77.5*	*77.7*	*77.5*	*77.3*	*76.1*	*76.0*	*76.4*	*77.7*	*75.7*
Inventory Sales Ratio (Months)		*1.33*	*1.33*	*1.34*	*1.36*	*1.38*	*1.38*	*1.38*	*1.33*
Real Gross Domestic Product (Annual % Change)		*2.6*			*3.2*			*3.2*	*1.2*
Unemployment Rate (Percent)	*4.1*	*4.1*	*4.1*	*4.1*	*4.2*	*4.4*	*4.3*	*4.8*	*4.1*
Payroll Employment (Change in Thousands)	*200*	*160*	*216*	*271*	*14*	*221*	*190*	*271*	*14*
Hourly Earnings (% Change Year Ago)	*2.9*	*2.7*	*2.5*	*2.3*	*2.8*	*2.6*	*2.6*	*2.9*	*2.3*
Personal Income (% Change Year Ago)		*4.1*	*3.8*	*3.4*	*2.9*	*2.6*	*2.4*	*4.1*	*2.4*
Savings Rate (Percent of Disposable Income)		*2.4*	*2.5*	*3*	*3.0*	*3.5*	*3.5*	*4.1*	*2.4*
Consumer Credit (Change in Mil. Of Dollars)		*18447*	*31018*	*22976*	*9204*	*9939*	*14693*	*31018*	*9204*
Consumer Prices (% Change Year Ago)	*2.1*	*2.1*	*2.2*	*2.0*	*2.2*	*1.9*	*1.7*	*2.7*	*1.6*
CPI Less Food & Energy (% Change Year Ago)	*1.8*	*1.8*	*1.7*	*1.8*	*1.7*	*1.7*	*1.7*	*2.3*	*1.7*
Wholesale Prices (% Change Year Ago)	*2.7*	*2.6*	*3.1*	*2.8*	*2.6*	*2.4*	*1.9*	*3.1*	*1.6*

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