Louisiana Corporate Credit Union

ECONOMIC & FINANCIAL DIGEST

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Don't Fear the Rate Hike

As the calendar page turns to 2016, the year ahead is fraught with a number of uncertainties. That's nothing new; the start of a new year always comes with some trepidation, particularly in a global environment where volatile geopolitical developments are heightened by the pernicious threat of terrorism. Nor are all things calm on the domestic front, as the nation girds itself for a presidential election year. It's a safe bet Congress will not upset voters by enacting controversial legislation that might disrupt the economy. But as the campaign season heats up, households and businesses will be bombarded with partisan rhetoric and some unsettling policy proposals. That tends to create doubt about the future and could well have an effect on spending and investment decisions.

That said, the economy is battling fewer headwinds than it did at the start of recent years. The severe winter weather that depressed activity in early 2014 and 2015 is clearly not an issue this time. If anything, the exceptionally mild conditions in the Northeast in November and December may be helping more than hurting. While certain cold weather related sales, such as coats and other apparel, are being put off, that loss is being more than offset by strength in construction, which usually fades as temperatures drop. And just as Mother Nature removed itself as a growth impediment, so too have policy makers resolved some issues that clouded the outlook in recent years.

The Federal Reserve finally pulled the rate-hiking trigger in mid-December after keeping short-term rates at near zero for seven years. The small quarter-point increase ended years of speculation – and resulting volatility in financial markets – over when the liftoff date would take place. Shortly after the Fed's momentous decision, Congress passed a bipartisan spending bill that eliminated the threat of a government shutdown, something that hung over the economy like the Sword of Damocles in recent years. Policy uncertainty is the enemy of growth, so the Fed along with a surprisingly compliant Capitol Hill did their part to provide a clear blueprint outlining monetary and fiscal plans. There is more to like than dislike about economic prospects as the curtain rises on 2016, which hopefully translates into a rewarding performance as the year unfolds.

Austerity Ends

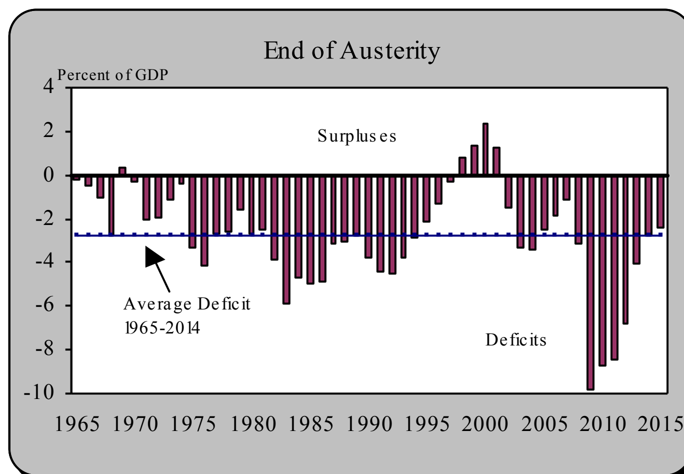
It's been a long slog for the U.S. economy since the Great Recession ended in mid-2009. Initially, Washington lent a helping hand, injecting nearly $1 trillion of tax cuts and deficit spending into the system, a stimulus that helped jump-start the nation on to the recovery road. But that initial impetus was not long-lasting. By 2010, political sentiment had shifted against mounting deficits and law-makers turned off the fiscal spigot. By 2011, fiscal austerity became the mantra in Congress, punctuated by sequestration and spending caps designed to shrink the government's role in the economy and bring down the deficit.

These efforts were a resounding success – at least in terms of accomplishing the fiscal goals. From a peak of $1.6 trillion in fiscal 2009, the deficit has since plunged to $438 billion in fiscal 2015. Meanwhile, the deficit's footprint in the economy has shrunk even more dramatically, sliding from 9.8 percent of GDP to 2.4 percent last year, which is a smaller share than normal. From 1965 through 2014, the budget deficit averaged 2.7 percent of GDP. But while the deficit hawks succeeded in achieving their goal, the belt-tightening by Congress also impeded the recovery. Indeed, fiscal policy was contractionary from 2010 through 2013, chopping about 25 percent off of the economy's growth rate in 2013.

The good news is that the contractionary effect of fiscal policy ended in 2013. In the following year, the Federal government's impact on the economy turned neutral and, over the first three quarters of 2015, it actually made a small positive contribution to growth. In 2016, it should be an even bigger tailwind, thanks to the $1.1 trillion omnibus-spending bill passed by Congress on December 18. Among other things, the bill busts through the discretionary spending caps put in place in 2011 by about $66 billion, which, along with a separate package of $680 billion of tax cuts, means that fiscal policy should add to growth for the first time in six years.

Policy Influences Flipped.

The modest fiscal thrust highlights a dramatic role reversal



for policymakers. Over the three years from 2010 through 2013 the contractionary effects of fiscal policy were strenuously countered by an aggressively easy monetary policy. The Fed lowered short-term interest rates to near zero in December 2008 and engaged in a series of pump-priming measures, including three rounds of asset purchases, that injected trillions of dollars into the economy, and a so-called operation twist episode aimed at suppressing long term interest rates. These unprecedented measures may not have had as big a bang for the buck on the economy as Fed officials desired, but they offset the fiscal drag and contributed mightily to the recovery

But with the long-anticipated decision in December to raise short-term interest rates, the Fed took the first step towards unwinding these extraordinary measures. If its expectations regarding economic conditions, including inflation, are met, the central bank plans to increase short-term rates an additional full percentage point by the end of next year, lifting the benchmark rate to 1.4 percent. Simply put, the relationship between monetary and fiscal policy has been flipped 180 degrees relative to recent years. They are still moving in different directions, but it is fiscal policy that is becoming more pro-growth while monetary policy less so.

That said, it would be a gross exaggeration to say that monetary policy is becoming restrictive. Even with another 1 percent increase tacked on to December's quarter-point rise, the planned 1.25 percent increase over the coming year would be far smaller than historical standards. During the first year of the previous five tightening cycles, for example, the federal funds rate was lifted by an average of 2.25 percent, ranging from a high of 3 percent in 1994-95 to a low of 1.75 percent in 1999-2000. The Fed does not plan to reach its long run goal of 3.5 percent for at least several years, and that end point itself is far lower than the levels reached at the end of previous tightening cycles.

Less Medicine Needed

In essence, while the scars of the Great Recession have not completely healed, the Fed believes the recovery no longer warrants the full dose of monetary aid provided over the past seven years to continue. Hence less medicine is needed to nurse the economy back to full health. Clearly, the modest rate hike is not intended to slow growth, which continues to run around the lackluster 2 percent pace seen since the end of the recession.

Indeed, the economy has not delivered a full-year growth rate of 3 percent since 2006, the longest stretch of subpar growth since World War 11. Historically, the economy has expanded at a 3.3 percent pace. Small wonder then that some reputable economists believe the U.S. economy is mired in a state of secular stagnation, a condition that makes it highly vulnerable to external shocks. In fact, given the array of headwinds that are poised to impede growth in the year ahead, most notably the slowdown in the global economy, the steep cutbacks in the energy sector and the export-stifling effect of the strong dollar, many believe that the Fed is more likely to rescind the December rate increase than impose additional ones in 2016.

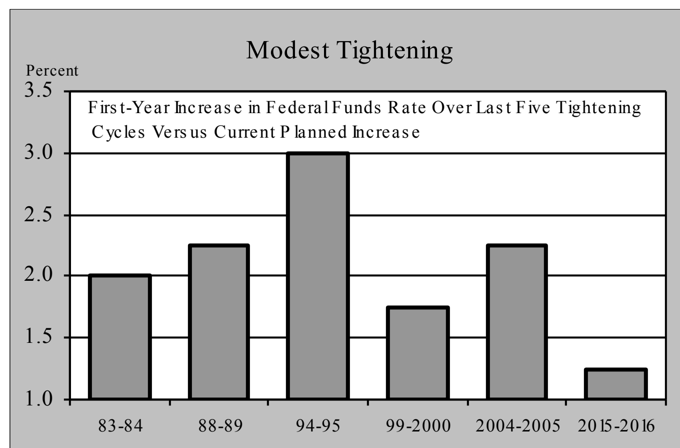
That view underpins a somewhat cynical explanation as to why a rate increase was taken at all. With interest rates at near zero for the past seven years, the Fed has no room to cut them if the economy weakens or, worse, slides into a recession. Hence, the reason to lift rates now is to give the central bank a cushion that would enable it to counter such a setback by cutting rates again. But that argument does not make too much sense. If the Fed thought the economy was too fragile to withstand higher interest rates, a rate hike would only become a self-fulfilling prophecy, bringing about the very setback in activity that could have been avoided by not raising rates in the first place.

Prolonging Life.

A more compelling explanation offered by Fed chair Janet Yellen is that a small interest rate increase is necessary to prevent a more abrupt tightening move down the road. In her press conference following the December policy meeting, Yellen pointed out that expansions do not die of old age, but rather by some unforeseen shock, such as an oil crisis, or a policy mishap. With regard to the latter, what usually happens is that monetary policy overstays its welcome, remaining easy for too long. That, in turn, fosters inflationary pressures that require policy makers to clamp down more harshly on the monetary brakes than would otherwise be the case if they moved earlier. The abrupt tightening of policy ultimately stifles growth and brings on a recession.

A preemptive and gradual move taken before these pressures gain traction is consistent with the widely held notion that monetary policy affects the economy with a lag. If you wait to see the whites in inflation's eyes, it is already too late to apply the gradual steps that would stem an inflation outbreak if taken earlier. Hence, by nudging rates gradually higher before inflation signs start flashing, the Fed is hoping to avoid the harsh growth-stifling measures that killed past expansions. In other words, small steps now are designed to prolong the life of the recovery, not slow it down.

Another advantage of taking small steps earlier and less frequently than in past tightening cycles is that the central bank can monitor their economic effects as they unfold. That enables policy makers to adjust the timetable for rate increases. As noted, the current plan is to move slowly and to keep rates low relative to past episodes. That's in deference to the economy's lackluster growth rate and the difficulty of bringing inflation up to the long-held 2 percent target. But if growth exceeds expectations and fans inflation fears, the Fed has promised to speed up the rate-hiking process. Conversely, it would slow down the process – and even cut rates again – if just the opposite occurred. Despite the brouhaha surrounding the first rate increase, it tells us little about where rates will wind up a year or so from now. Like the rest of us, the Fed will be watching the data.



KEY ECONOMIC AND FINANCIAL INDICATORS

FINANCIAL INDICATORS*

	November	October	September	August	July	June	May	12-Month Range High	12-Month Range Low
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25
3-Month Treasury Bill Rate	0.12	0.02	0.02	0.07	0.03	0.02	0.02	0.12	0.02
5-Year Treasury Note Rate	1.67	1.39	1.49	1.54	1.63	1.68	1.54	1.68	1.35
10-Year Treasury Note Rate	2.26	2.07	2.17	2.17	2.32	2.36	2.20	2.36	1.88
30-Year Treasury Bond Rate	3.03	2.89	2.95	2.86	3.07	3.11	2.96	3.11	2.46
Tax-Exempt Bond Yield	3.68	3.67	3.78	3.74	3.79	3.82	3.76	3.96	3.40
Corporate Bond Yield (AAA)	4.06	3.95	4.07	4.04	4.15	4.19	3.98	4.19	3.46
Conventional 30-Year Mortgage Rate	3.94	3.80	3.89	3.91	4.05	3.98	3.84	4.05	3.67
Dow Jones Industrial average	17724	17182	16340	17062	17795	17927	18125	18125	16340
S&P 500 Index	2081	2025	1944	2040	2094	2099	2112	2112	1944
Dividend Yield (S&P)	2.12	2.12	2.29	2.22	2.07	2.09	2.04	2.29	1.96
P/E Ratio (S&P)	18.6	18.6	17.0	17.4	18.6	18.2	18.6	18.6	17.0
Dollar Exchange Rate (vs. Major Currencies)	94.0	91.2	91.7	91.9	91.6	89.7	89.2	94.0	82.8

* Monthly Averages

ECONOMIC INDICATORS

	November	October	September	August	July	June	May	12-Month Range High	12-Month Range Low
Housing Starts (In Thousands)	1173	1062	1207	1116	1152	1211	1072	1211	900
New Home Sales (Thousands of Units)		495	447	513	500	469	513	545	447
New Home Prices (Thousands of Dollars)		282	309	295	296	289	287	309	282
Retail Sales (% Change Year Ago)	1.5	1.8	2.2	1.9	2.5	1.9	2.2	4.7	1.5
Industrial Production (% Change Year Ago)	-1.2	0.3	0.8	1.5	1.3	0.9	1.4	4.7	-1.2
Operating Rate (% of Capacity)	77.0	77.5	77.9	78.1	78.0	77.5	77.6	79.0	77.0
Inventory Sales Ratio (Months)		1.4	1.4	1.37	1.36	1.36	1.36	1.37	1.30
Real Gross Domestic Product (Annual % Change)			2.1			3.9		3.9	-0.2
Unemployment Rate (Percent)	5.0	5.0	5.1	5.1	5.3	5.3	5.5	5.8	5.0
Payroll Employment (Change in Thousands)	211	298	145	153	223	245	260	423	119
Hourly Earnings (% Change Year Ago)	2.3	2.5	2.3	2.2	2.2	2.0	2.3	2.5	1.8
Personal Income (% Change Year Ago)		4.6	4.6	4.7	4.8	4.6	4.6	5.2	4.0
Savings Rate (Percent of Disposable Income)		5.6	5.3	5.2	5.1	5.0	4.8	5.6	4.6
Consumer Credit (Change in Mil. Of Dollars)		15982	28566	14613	18395	27307	19529	28566	10774
Consumer Prices (% Change Year Ago)	0.5	0.2	0.0	0.2	0.2	0.1	0.0	1.3	-0.2
CPI Less Food & Energy (% Change Year Ago)	2.0	1.9	1.9	1.8	1.8	1.8	1.8	2.0	1.6
Wholesale Prices (% Change Year Ago)	-1.1	-1.6	-1.1	-0.8	-0.8	-0.7	-1.1	1.3	-1.6

What if there's only a marginal move in rates next year?

Will your margins continue to compress?

How will your earnings be effected? Is your Credit Union prepared?

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