Louisiana Corporate Credit Union

ECONOMIC & FINANCIAL DIGEST

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A Tumultuous Start

To say 2016 got off to a rocky start would be an understatement. The stock market suffered its worst opening ever to a new year, with the major indexes plunging by more than 10 percent over the first two weeks. And while financial markets often misjudge trends in the real economy, investors can point to a growing list of concerns to validate their jitters. The woes in China, the world's second largest economy, appear to be worsening, oil prices continue to fall amidst a ballooning glut, and an increasing number of economists think a recession is imminent, although the odds still remain low.

Fresh economic data in early January added to the doom and gloom in the markets. Hopes for a festive holiday shopping season were dashed by the December retail sales report, which showed that consumers pulled in their horns on a wide range of purchases, including cars, during the month. Factories cut production –again – as the strong dollar and weak foreign demand sliced into exports, even as customers slashed orders because of excess inventories. By all accounts, the broad economy ended the year on a limp note, with growth slowing to well below the 3.5 percent average pace of the second and third quarters.

Simply put, the positive feelings associated with strong job growth at the end of last year evaporated in the blink of an eye. It's unclear why perceptions of the economy turn so easily from joy to despair. It's tempting to put the blame on the Federal Reserve, as the worrisome news came after the central bank raised interest rates in mid-December. That would be a silly effort, however. It's a stretch to think that a 25 basis point increase in short-term rates from near zero exacerbates the weakness in China's economy or contributes to the persistent slump in oil prices. Nor should it be seen as a spending impediment; if anything, mortgage rates have actually declined since the hike was put into effect. More likely, this is a movie we have seen before, one in which the next scene puts things in a better light. At some point, the curtain will come down on this long-running recovery; but the final act is probably still a ways off.

Changing Perceptions About Oil

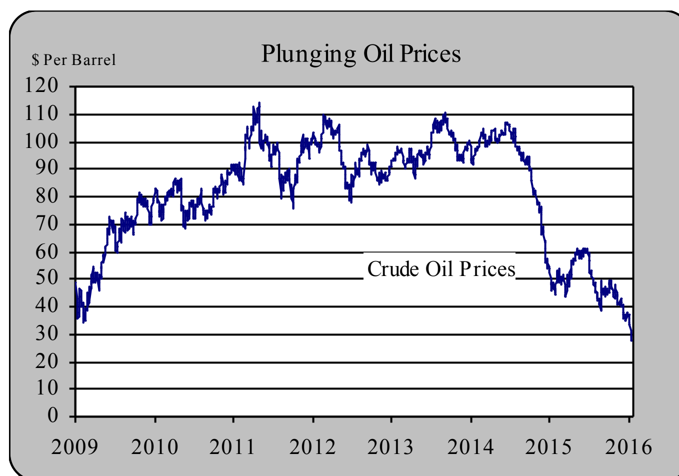
A number of influences are contributing to the heightened volatility in both the financial markets and perceptions of the economy. One lightening rod that stands out is the behavior of the oil market, particularly the remarkable change in the way oil price movements are perceived. Not too long ago, lower oil prices were thought to be unambiguously good for the economy, providing households with extra discretionary income and lowering operating costs for many businesses. Economists would dial up growth projections when oil prices fell and the stock market usually responded favorably, sending share values higher.

Hence the first leg down in oil prices, from a peak of just under $100 a barrel in mid-2014 to the $50-$60 range in early 2015, was widely viewed as a positive development. Not only did that precipitous drop promise to help jump-start growth in the economy; it reflected the emergence of the U.S. as a major oil producer, thanks to new hydraulic fracking techniques. The near doubling of domestic oil production pushed the U.S. close to energy independence even as it boosted global oil supplies enough to accommodate the rapid increase in demand from emerging markets, particularly China.

But the dynamics of the oil market changed dramatically about six months ago, when prices embarked on the next leg down from about $60 to under $30 early this year. Instead of generating positive vibes, the latest drop has unsettled the stock market and fostered a grimmer perception of the economy. Whereas earlier declines were viewed as a growth stimulant, they are now associated with deteriorating economic conditions, both domestically and globally. Put another way, declining oil prices are viewed kindly when it is the product of increased supply, but it becomes onerous when weaker demand is responsible. The headline-grabbing slowdown in China, the world's second largest consumer of oil, amplifies concerns that the burgeoning oil glut is symptomatic of intractable deflationary forces that are spreading to the U.S.

Another Dot-Com Episode?

Some believe that the collapse of oil prices is akin to the dot-com bust in early 2000. There are similarities between the two



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episodes. In the years leading up to the 2000 bust, tech-related spending contributed mightily to the capital-spending boom that propelled growth in the late 1990s. From 1998 to 2000, equipment spending alone accounted for 20 percent of the increase in real GDP, with spending on information and processing equipment accounting for most of the increase. That contribution far exceeded the 5 percent share of equipment spending in total output. When the dot-com bubble burst in 2000, the subsequent collapse in capital spending was the major drag on output during the 2001 recession.

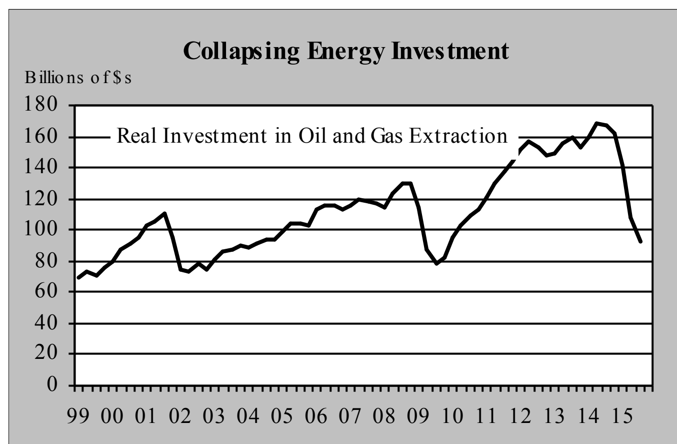
Likewise, the shale energy boom was a major growth driver early in the current recovery. From the third quarter of 2009 to mid-2014, business spending on mining exploration, shafts and wells combined with spending on mining and oilfield machinery increased from $78 billion to $168 billion in 2014 dollars, a growth rate twice as fast as that of GDP. But since oil prices peaked in the spring of 2014, the reduction in energy-related spending has been equally as swift, with the total plunging to $92 billion in the third quarter of last year. That reduction sapped as much strength from the economy as the earlier increases boosted it.

Indeed, the growth haircut from the drop in energy-related spending has actually been greater than the cut imposed by the drop in tech-related spending during the 2001 recession. The $75 billion decline in energy investment since the spring of 2014 chopped 0.5 percent from GDP, more than twice as much as the fraction that was cut by the high-tech bust. By all accounts, the downsizing is continuing, as an ever-growing number of oil companies are reducing rig counts. The good news is that the prospective damage to the economy is limited, as total capital spending in the energy field has shrunk to only 0.6 percent of GDP.

Asymmetrical Response

One of the mysteries about the dramatic oil price plunge over the past 18 months is why the damage to the economy has been so much greater than the expected benefits. After all, every penny decline in gasoline prices lowers energy costs for American consumers by $1 billion. That means the drop since mid-2014 should have boosted household discretionary incomes by about $200 billion, which far exceeds the $75 billion retrenchment in energy-related investment spending. Yet, there's been no discernible bump in consumer spending over the past year.

One reason for the asymmetrical effect is that the capital-spending cuts linked to the contraction in the energy sector tell only part of the story. The fallout is actually much greater when it includes the tens of thousands of workers in the energy industry who lost high-paying jobs over the past year. The retrenchment also reduced tax revenues in states hosting the downsized energy companies and laid-off workers, crimping budgets and spending. Then there is the toll on the financial markets and the ripple effects on household wealth. Since the middle of last year, about $7 trillion in equity values has been vaporized due to the swoon in the stock market. While oil is not entirely responsible for the stock market turmoil, it is a symptom of the many ills that beset it, including the slump in China.



That said, this is not a one-way journey. While the spending cuts and worker layoffs have immediate effects on the economy, the benefits accrue more gradually. It takes time for consumers to fully adjust to a dramatically lower price on such essential goods as gasoline or heating fuel. Indeed, the evidence suggests that smaller price adjustments produce more immediate spending results, whereas a drop as large as that seen over the past 18 months emits less of a response until people are sure it is real and sustainable. That turning point may not be far off.

Policy Confusion

Not surprisingly, the tumultuous start to the year has generated a lot of speculation regarding monetary policy. As noted earlier, it would pointless to blame the Fed for recent developments. While the timing of the rate increase may legitimately be questioned, it's highly unlikely that the small move had any impact on real events. Indeed, a major worry that the Fed's move would spur more growth-stifling strength in the dollar has not come to pass; the greenback has actually weakened against most currencies since the rate increase took effect.

A key reason the dollar's rise has stalled is that expectations of future rate increases have been scaled back. Recall that at the December policy meeting the median projection among Fed officials was for four interest rate increases this year, with the federal funds rate winding up at 1.4 percent. That seemed like a reasonable outlook following the strong December jobs report released a few weeks after the meeting; in fact, the prevailing sentiment on Wall Street was that the pace of rate increases might have to be accelerated. But that sentiment took a 180-degree turn as the oil plunge deepened and concerns over the global economy intensified amid worsening conditions in China.

Clearly, the Fed faces some difficult decisions in coming meetings. Its plan to gradually raise interest rates this year rests on the assumption that the oil-price weakness is transitory and the economy will continue to strengthen, lifting overall inflation in the process. That assumption is looking a bit shaky, as the oil glut is turning out to be more intractable than believed, due to both demand and supply forces, and is intertwined with a broader decline in commodity prices that is keeping inflation uncomfortably low. It is hard to believe that the Fed would continue to raise interest rates in the face of persistent low inflation, more signs of a global slowdown and turbulent financial markets, all of which threaten to harm the U.S. economy. The Fed has made mistakes in the past but it is not likely to ignore important signals this time, having repeatedly promised to assess conditions before raising rates again. The next probable date for an increase would be the March meeting and a lot can happen between now and then. Just look at how drastically perceptions of the world have changed over the past month.

KEY ECONOMIC AND FINANCIAL INDICATORS

FINANCIAL INDICATORS*

	December	November	October	September	August	July	June	12-Month Range High	12-Month Range Low
Prime Rate	3.37	3.25	3.25	3.25	3.25	3.25	3.25	3.37	3.25
3-Month Treasury Bill Rate	0.23	0.12	0.02	0.02	0.07	0.03	0.02	0.23	0.02
5-Year Treasury Note Rate	1.70	1.67	1.39	1.49	1.54	1.63	1.68	1.70	1.35
10-Year Treasury Note Rate	2.24	2.26	2.07	2.17	2.17	2.32	2.36	2.36	1.88
30-Year Treasury Bond Rate	2.97	3.03	2.89	2.95	2.86	3.07	3.11	3.11	2.46
Tax-Exempt Bond Yield	3.57	3.68	3.67	3.78	3.74	3.79	3.82	3.82	3.40
Corporate Bond Yield (AAA)	3.97	4.06	3.95	4.07	4.04	4.15	4.19	4.19	3.46
Conventional 30-Year Mortgage Rate	3.96	3.94	3.80	3.89	3.91	4.05	3.98	4.05	3.67
Dow Jones Industrial average	17543	17724	17182	16340	17062	17795	17927	18125	16340
S&P 500 Index	2044	2081	2025	1944	2040	2094	2099	2112	1944
Dividend Yield (S&P)	2.30	2.12	2.12	2.29	2.22	2.07	2.09	2.30	1.99
P/E Ratio (S&P)	18.3	18.6	18.6	17.0	17.4	18.6	18.2	18.6	17.0
Dollar Exchange Rate (vs. Major Currencies)	94.1	94.0	91.2	91.7	91.9	91.6	89.7	94.1	84.2

** Monthly Averages*

ECONOMIC INDICATORS

	December	November	October	September	August	July	June	12-Month Range High	12-Month Range Low
Housing Starts (In Thousands)	1149	1179	1071	1207	1116	1152	1211	1211	900
New Home Sales (Thousands of Units)		490	470	442	507	500	469	545	442
New Home Prices (Thousands of Dollars)		305	287	310	300	296	289	310	287
Retail Sales (% Change Year Ago)	2.4	1.6	1.8	2.2	1.9	2.5	1.9	3.7	1.5
Industrial Production (% Change Year Ago)	-1.8	-1.3	0.5	0.8	1.4	1.3	0.9	4.6	-1.8
Operating Rate (% of Capacity)	76.5	76.9	77.7	77.9	78.1	78.0	77.5	79.0	76.5
Inventory Sales Ratio (Months)		1.38	1.38	1.37	1.37	1.36	1.36	1.38	1.33
Real Gross Domestic Product (Annual % Change)				2.1			3.9	3.9	-0.2
Unemployment Rate (Percent)	5.0	5.0	5.0	5.1	5.1	5.3	5.3	5.7	5.0
Payroll Employment (Change in Thousands)	292	252	307	145	153	223	245	329	119
Hourly Earnings (% Change Year Ago)	2.5	2.3	2.5	2.3	2.2	2.2	2.0	2.5	1.8
Personal Income (% Change Year Ago)		4.4	4.6	4.6	4.7	4.8	4.6	5.2	4.0
Savings Rate (Percent of Disposable Income)		5.5	5.6	5.2	5.2	5.1	5.0	5.6	4.8
Consumer Credit (Change in Mil. Of Dollars)		13951	15610	28670	14597	18306	27323	28670	10774
Consumer Prices (% Change Year Ago)	0.7	0.5	0.2	0.0	0.2	0.2	0.1	0.8	-0.2
CPI Less Food & Energy (% Change Year Ago)	2.1	2.0	1.9	1.9	1.8	1.8	1.8	2.1	1.6
Wholesale Prices (% Change Year Ago)	-1.0	-1.1	-1.6	-1.1	-0.8	-0.8	-0.7	0.9	-1.6

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