Louisiana Corporate Credit Union

ECONOMIC & FINANCIAL DIGEST

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Restraints on Growth

As the old adage goes, there are two sides to everything. When it comes to today's economy, that sentiment could not be more evident. For the sake of simplicity, the two sides can be divided into those who believe that the glass is half full and those who see it at half empty. At the moment, very few believe that the economy's glass has run dry or that it is overflowing. But a slight difference from the midpoint matters. A half- full perception would spur the Fed to raise interest sooner rather than later, encourage companies to step up hiring, and consumers to keep their wallets open. Conversely, a half-empty perception would likely produce an alternate scenario. The Fed would be more inclined to keep rates at their rock-bottom levels, businesses in a lock-down mode and consumers to pull back on spending while saving more for a rainy day.

So which is the more prevalent view at the present time? Within the Federal Reserve, the half-empty crowd still dominates, but sentiment is steadily shifting to the half-full position. At its September policy meeting, a relatively slim majority of Fed officials voted to keep the benchmark short-term rate unchanged for a while longer, fearing the economy is not ready to absorb an increase. Still, three out of the 10 voting members – an unusually large number of dissenters – wanted to pull the rate trigger immediately. This half-full group should gain more adherents before the end of the year if the economy stays on its improving path.

Among households and businesses, the verdict is mixed. The former seem more aligned with the half-full group, spending at a respectable pace, particularly for big-ticket items like autos and homes. That's to be expected as a steadily improving job market lifts income and bolsters confidence. The business community, however, remains firmly in the half-empty camp, expressing a high level of uncertainty heading into the elections and fretting over sagging profits, global headwinds and diminished long-term growth prospects. Don't expect this tug of war to end anytime soon. The crosscurrents buffeting policymakers, households and businesses are expected to persist well into next year. The good news is that they haven't driven the economy off the growth track, albeit the upturn since the Great Recession has been lackluster at best. The bad news is that the future may not look much different than the recent past, leaving us with an economic glass that is around half empty and in a constant state of wondering if the good old days will ever return.

Time To Upgrade

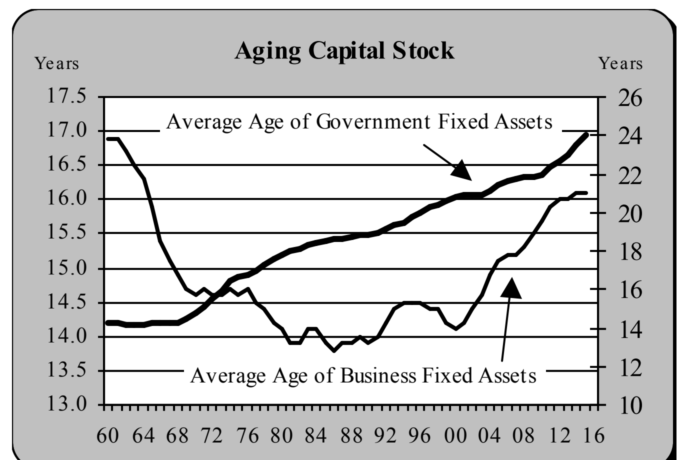
It's not likely that the nation will return to the good old days, when a trend growth rate of 3-3 ½ percent was the norm. The economy has not reached a 3 percent growth rate for a full year since 2005. The best since then was the 2.6 percent recorded in 2015; this year's performance will be far weaker, coming in under 2 percent. And that assumes growth over the balance of the year will accelerate from the first half's skimpy 1.1 percent pace.

There are myriad reasons why the current recovery, now in its eighth year, is the slowest of all post-war upturns. Essentially, all of the main growth drivers – government, business and consumer spending — have lagged past cyclical norms. They won't be catching up any time soon. But consumers, which have been doing most of the heavy lifting, should continue to provide modest support for growth, deriving strength from steadily improving job and income prospects. A belated contribution should also come from the Federal Government, as bipartisan support for expanded infrastructure spending is gaining traction.

The business community continues to drag its feet, but the persistent weakness in investment spending in recent years may be sowing the seeds for a pickup before long. That's because corporations are operating with aging plant and equipment as well as outdated software that is generating pent-up replacement demand. The average age of corporate fixed assets in 2015 stood at 16.1 years, the oldest since 1963. For the Federal government, the aging of assets has been startling; the 24-year average life of Washington's fixed assets is the longest on record. The urgency to fix crumbling roads, bridges and public structures is understandably receiving bipartisan support despite the highly polarized mind-set on Capitol Hill.

Lowered Potential

Hopefully, as corporations replace aging capital stock with



more efficient plant, equipment and software they will become more productive in the process. While not the only reason, weak investment spending this recovery has contributed importantly to the weak productivity growth during the period. Since 2007 productivity has increased at less than half the rate seen during the 1990s and significantly slower than the 1.7 percent postwar average.

Few experts believe that productivity will return to the trend growth rates seen in earlier years. In its latest forecast, made in August, the Congressional Budget Office estimates that productivity growth will average 1.3 percent a year over the next five years. That, together with the projected slowdown in the labor force, to an annual rate of 0.4 percent from a postwar average of 1.5 percent, is why the agency believes the economy's potential growth rate is much weaker than in the past. The CBO is projecting a 1.7 percent annual growth rate in potential GDP from 2016 to 2021, a significant haircut from the postwar average of 3.2 percent.

Simply put, it may be time to get used to the lackluster growth seen in recent years. Instead of bemoaning the tepid 2 percent average increase in output seen since the end of the recession, that pace appears to be the new normal. It should also be noted that the forces underpinning the diminished potential growth rate of the U.S. economy are having the same effect globally. The IMF and other international organizations have also lowered the long-run outlook for most other advanced as well as emerging market economies.

Short Versus Long-Term

That said, it would be mistake to assume that the best days are over for the U.S. economy. For one, the lowered output capacity reflects long-term forces that do not put a limit on growth over the foreseeable future. Keep in mind that the economy is still operating nearly 2 percent below its potential, a $300 billion shortfall, as sluggish growth throughout the recovery failed to close the huge output gap created by the Great Recession. Hence, there is ample room to grow faster before capacity limits are reached. Indeed, the CBO is projecting a 2.4 percent growth rate in real GDP next year, which would exceed the 1.6 percent increase in potential GDP and still leave room to spare for speedier growth in 2018.

For another, the capacity restraints implied by lowered estimates of the economy's growth potential are not written in stone. Yes, some limitations on supply appear to be fairly rigid. Demographic forces, such as the increase in retirements by aging baby boomers, assure that the labor force will grow more slowly than in the past. But even here there is wiggle room. An increasing fraction of older workers are drawing paychecks for a variety of reasons, and that trend looks set to continue. The slowdown in immigration has also crimped labor force growth, but that trend could be reversed if future immigration policy is relaxed.

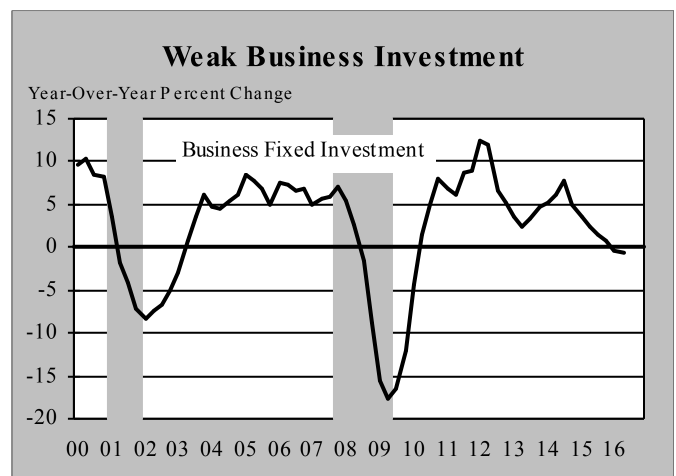
Finally, the long decline in the labor force participation rate – the share of working-age adults either working or looking for a job – has contributed importantly to the slower growth in the labor force. The CBO assumes that trend will continue after holding constant for the next year or so at the 62.7 percent seen in August. But with the labor force getting steadily tighter and lifting wages, thanks to the solid pace of job growth, workers that dropped out of the labor force in recent years are starting to return. The participation rate has already bounced off its low, hitting 62.9 percent in September. Over the long term the declining trend will likely continue as the population ages, but the recent uptick in labor force growth could well continue for a while as sidelined workers are drawn back to the job market.

Flexible Speed Limit

The recent pickup in the labor force participation rate is an indication that supply constraints may be more flexible than thought. Recall that back in the 1990s, inflation hawks were urging the Federal Reserve to tighten monetary policy as the unemployment rate dipped below 5 percent in early 1997. They claimed that the economy and labor market had reached capacity limits and was on the verge of an inflation breakout unless growth slowed. But the Fed chairman, Alan Greenspan, argued that the economy's speed limit had been lifted by the accelerated growth in productivity, spurred by technological innovations, including the Internet. He was right, as both the unemployment rate and core inflation both fell by another percentage point over the ensuing three years even as economic growth remained robust through the end of the decade.

A parallel situation may be emerging today. In the 1990s, critics of easy monetary policy argued that the upper ceiling for growth was 3 – 3 ½ percent and the lower bound for unemployment was 5 – 5 ½ percent. Today, the consensus of economists believes the "new normal" is 2 percent growth combined with 5 percent unemployment. But just as the economy was able to push past those limits for a while in the late 1990s, the Fed is not likely to regard 2 percent as a rigid upper limit for growth or 5 percent as the lowest rate for unemployment that would trigger an abrupt shift towards a tighter policy.

To be sure, the Fed seems ready to pull back from its ultra-easy policy, which was forged in a crisis environment that no longer exists. It took a small step back last December with a quarter-point rate increase and another such hike is widely expected before the end of this year. But these moves are not designed to curb growth or stifle inflation, which are still too low to be of immediate concern. They would be preemptive steps taken in anticipation of faster growth next year that might require an even harsher response if nothing is done now. It will be interesting to see how much above the speed limit the Fed will tolerate as it gently steps on the monetary brakes. Chair Yellen recently wondered if stronger demand might actually create more supply – bringing workers back to the labor force and perhaps stimulating productivity-enhancing investments – that would lift the economy's growth potential. At this juncture, however, the challenge is get demand high enough to verify that notion.



KEY ECONOMIC AND FINANCIAL INDICATORS

*FINANCIAL INDICATORS**

	September	August	July	June	May	April	March	12-Month Range High	12-Month Range Low
Prime Rate	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.25
3-Month Treasury Bill Rate	0.29	0.30	0.30	0.27	0.27	0.23	0.29	0.31	0.02
5-Year Treasury Note Rate	1.18	1.13	1.07	1.17	1.30	1.26	1.38	1.70	1.07
10-Year Treasury Note Rate	1.63	1.56	1.50	1.64	1.81	1.81	1.89	2.26	1.50
30-Year Treasury Bond Rate	2.35	2.26	2.23	2.45	2.63	2.62	2.68	3.03	2.23
Tax-Exempt Bond Yield	2.93	2.85	2.83	3.20	3.29	3.30	3.38	3.78	2.83
Corporate Bond Yield (AAA)	3.41	3.32	3.28	3.50	3.65	3.62	3.82	4.07	3.28
Conventional 30-Year Mortgage Rate	3.46	3.44	3.44	3.57	3.60	3.61	3.69	3.96	3.44
Dow Jones Industrial average	18267	18495	18341	17755	17692	17844	17302	18495	16300
S&P 500 Index	2158	2177	2149	2084	2067	2076	2022	2177	1918
Dividend Yield (S&P)	2.12	2.11	2.11	2.17	2.16	2.18	2.17	2.31	2.11
P/E Ratio (S&P)	20.4	20.4	20.4	19.8	19.5	19.2	19.1	20.4	17.4
Dollar Exchange Rate (vs. Major Currencies)	90.1	89.8	90.9	89.7	89.8	89.4	91.5	95.3	89.4

** Monthly Averages*

ECONOMIC INDICATORS

	September	August	July	June	May	April	March	12-Month Range High	12-Month Range Low
Housing Starts (In Thousands)	1047	1150	1218	1195	1128	1155	1113	1218	1047
New Home Sales (Thousands of Units)		609	656	579	566	570	537	656	457
New Home Prices (Thousands of Dollars)		284	293	321	296	321	311	321	284
Retail Sales (% Change Year Ago)	2.8	2.2	2.3	2.8	2.2	3.0	1.7	3.6	1.6
Industrial Production (% Change Year Ago)	-1.0	-1.3	-0.7	-0.6	-1.3	-1.4	-2.0	-0.3	-2.3
Operating Rate (% of Capacity)	75.4	75.3	75.8	75.4	75.1	75.2	74.9	76.4	74.9
Inventory Sales Ratio (Months)		1.4	1.39	1.39	1.40	1.40	1.41	1.41	1.38
Real Gross Domestic Product (Annual % Change)				1.4			0.8	2.0	0.8
Unemployment Rate (Percent)	5.0	4.9	4.9	4.9	4.7	5.0	5.0	5.1	4.7
Payroll Employment (Change in Thousands)	156	167	252	271	24	144	186	295	24
Hourly Earnings (% Change Year Ago)	2.6	2.4	2.7	2.6	2.5	2.5	2.3	2.7	2.3
Personal Income (% Change Year Ago)		3.1	3.2	3.1	3.1	3.4	3.6	4.0	3.1
Savings Rate (Percent of Disposable Income)		5.7	5.6	5.5	5.7	5.8	6.2	6.2	5.5
Consumer Credit (Change in Mil. Of Dollars)		25873	17779.0	14418	22575	50589	23156	50589	6561
Consumer Prices (% Change Year Ago)	1.5	1.1	0.8	1.0	1.0	1.1	0.9	1.5	0.0
CPI Less Food & Energy (% Change Year Ago)	2.2	2.3	2.2	2.3	2.2	2.1	2.2	2.3	1.9
Wholesale Prices (% Change Year Ago)	1.2	0.0	-0.2	0.3	-0.1	0.0	-0.1	1.2	-1.6

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