Economic Review - First Quarter 2017

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Summary

The state of the general economy can help or hinder a business' prospects by influencing the demand for its goods and services and the availability and price of inputs such as capital and labor. The prevailing economic conditions therefore directly impact the value of a business at a specific point in time. The economic expansion that began in June 2009 is the fourth longest since the 1850s,[1] but growth has been modest, especially considering the severity of the "Great Recession" of 2007–2009. Recoveries after severe recessions have historically been more robust, as the economy recovers lost ground. The absence of stronger growth is particularly noteworthy given the extraordinarily accommodative monetary policy in recent years.

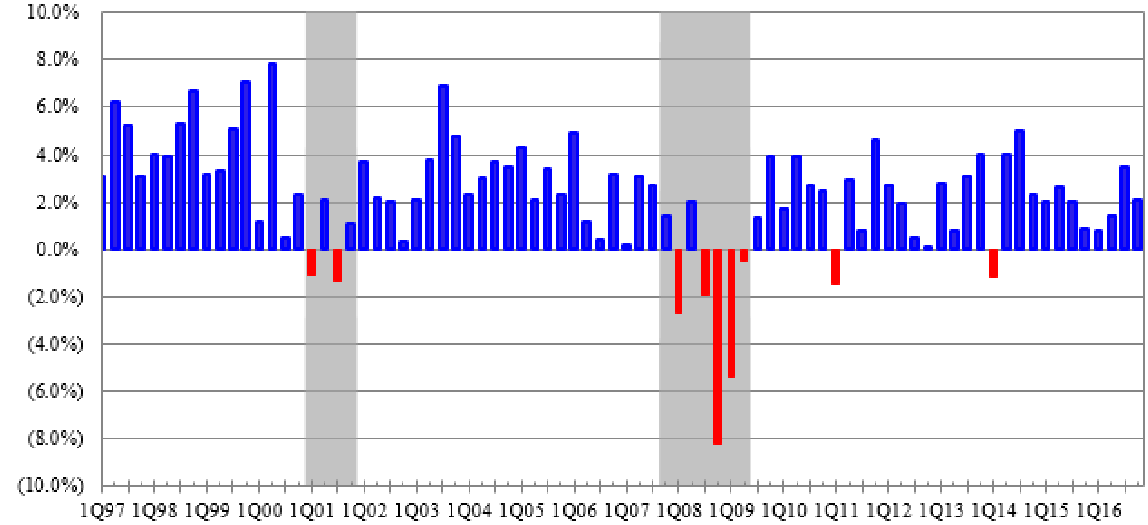
Following the March 14–15, 2017, meeting of the Federal Open Market Committee (the "Committee") of the Federal Reserve, the Committee issued a statement that economic activity was expanding at a moderate pace for the first quarter of 2017. Labor market conditions continued to strengthen as non-farm payroll employment increased, the unemployment rate decreased, and the labor force participation rate improved. Housing market activity continued to improve, as starts on single-family and multi-family homes strengthened, building permit issuances for new single-family homes increased, and sales on existing homes rose in January. Private expenditures for business equipment and intellectual property started to make gains in the first half of the quarter, as non-defense capital goods excluding aircraft improved in January and the number of crude oil and natural gas rigs in operation have increased through early March.

Offsetting these positive developments, however, was household spending improving at a slower pace in the first quarter than the fourth quarter of 2016, with modest motor vehicle sales and a decline in spending for energy services due to unseasonably warm weather. Despite strong mining output and manufacturing production data in the first quarter, industrial production fell as utilities output declined. Additionally, spending on commercial structures excluding those related to mining and drilling was stagnant in the first quarter. Consumer price inflation continued to run below the Committee's long-run objective of 2 percent, but closed in on 2 percent during the last 12 months.

Gross Domestic Product

The U.S. Bureau of Economic Analysis (BEA) estimates that real gross domestic product (GDP) — the output of goods and services produced by labor and property located in the United States — increased at an annual rate of 2.1 percent in the fourth quarter of 2016. Quarterly GDP data for the preceding 20 years is shown in the following figure.

QUARTERLY U.S. GDP GROWTH
Seasonally Adjusted Annualized Rates; Shaded Bar Indicates Recession



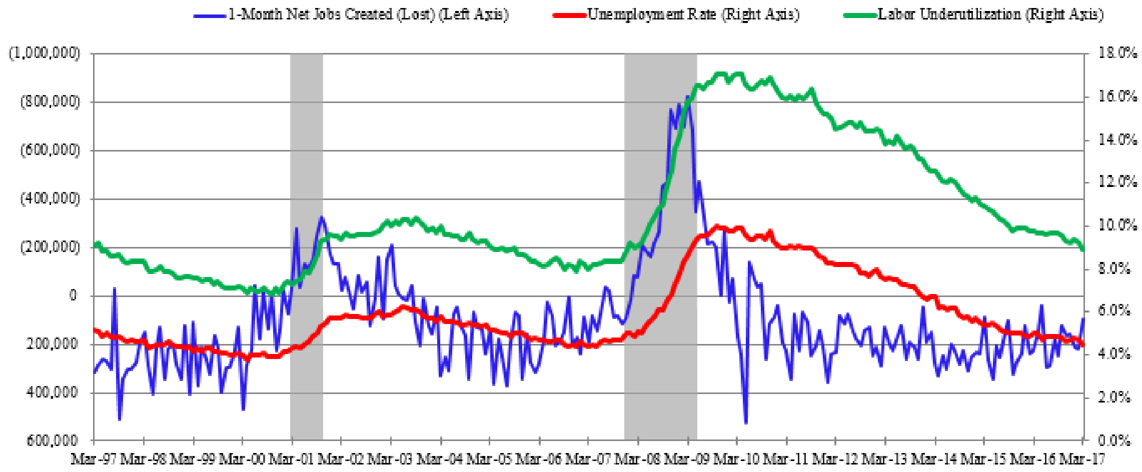
Sources: U.S. Bureau of Economic Analysis and National Bureau of Economic Research.
GDP percent change is based on chained 2009 dollars.

Employment

Employment conditions in the United States have been improving. In the 25 consecutive months from February 2008 to February 2010, 8.7 million non-farm jobs (net) were lost. In the 85 consecutive months from March 2010 to March 2017, 16.1 million non-farm jobs (net) were created.[2] The unemployment rate peaked at 10.0 percent in October 2009 and reached a low of 4.5 percent in March 2017, the lowest unemployment rate since May 2007.[3] This statistic, however, omits discouraged workers who have left the workforce and part-time workers who would prefer full-time work. A more expansive measure of labor underutilization was 8.9 percent as of March 2017.[4] Underemployment restrains economic growth as consumers are unable or hesitant to spend. The past 20 years of employment data are presented in the following figure.

MEASURES OF STRESS IN THE LABOR MARKET

Shaded Bar Indicates Recession



Sources: Department of Labor, Bureau of Labor Statistics, and National Bureau of Economic Research. Data represents non-farm payrolls.

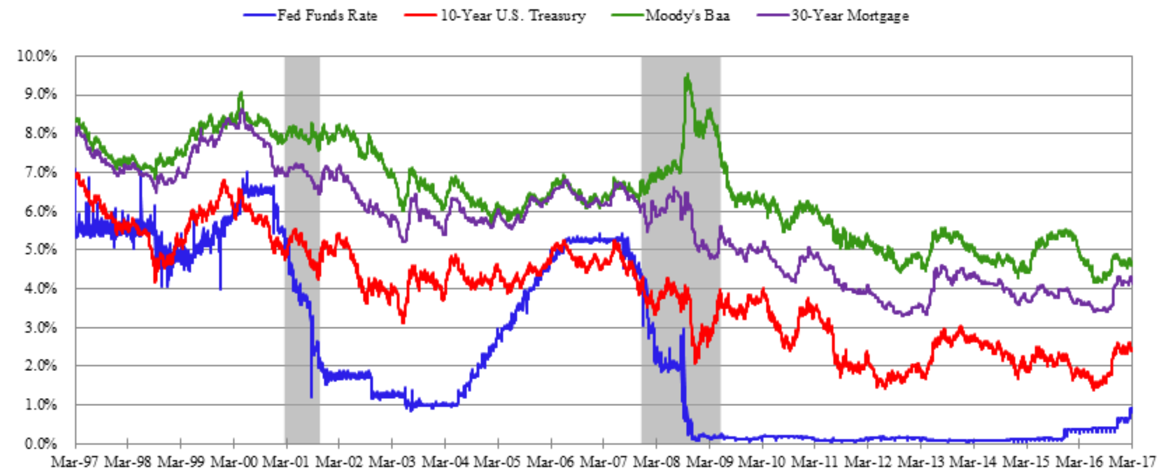
Interest Rates

The Committee meets periodically to assess economic conditions and determine appropriate policies to fulfill its dual mandate of fostering maximum employment and price stability. At its March 14–15, 2017, meeting, the Committee considered the outlook for economic activity, the labor market, and inflation. The Committee weighed the uncertainties associated with the outlook and raised the federal funds rate from a range of 0.50-to-0.75 percent to a range of 0.75-to-1.00 percent, the second increase in two quarters and the third increase in a decade. The Committee is continuing its policy of reinvesting proceeds from maturing bonds that it purchased in previous rounds of "quantitative easing."

United States financial markets were supportive of economic growth and employment in the first quarter of 2017. Corporate bond spreads and 30-year mortgage rates were relatively unchanged during the first quarter. Shorter maturity treasury yields increased during the quarter as did the rates on Treasury inflation-protected securities, while longer-term Treasury yields finished the quarter relatively unchanged, on net, from the end of the fourth quarter of 2016. The issuance of commercial and industrial loans continued to grow in the first quarter and corporate bond issuance improved. Financing for consumers remained accommodative, as consumer loan balances expanded and there was continued growth in the issuance of commercial real estate loans. Mortgage refinancing activity declined in November, reflecting the increase in mortgage rates in the fourth quarter. The past 20 years of historical interest rate data are shown in the following figure.

SELECTED INTEREST RATES

Shaded Bar Indicates Recession



Source: Federal Reserve Statistical Release H.15 (519) Selected Interest Rates.

Current Events

Stocks increased in the first quarter, as 2017 began with strong manufacturing data domestically and globally, wages and job growth increased, and corporate earnings grew modestly on a year-to-year basis for the second quarter in a row, bringing an end to a five-quarter corporate earnings slump. Additionally, optimism about deregulation, tax cuts, increased infrastructure spending, and higher economic growth positively improved market sentiment. However, later in the quarter, stocks suffered their biggest decline as doubts grew over the passage of the Republican's proposed health care reform bill, which was later withdrawn from the House of Representatives. The raising of the federal funds rate at the Committee's March 14–15, 2017, meeting for the second time in three months had little influence on stocks in the first quarter.

The major stock market benchmarks recorded gains in the first quarter. The technology-focused NASDAQ Composite Index outperformed other major indexes after lagging in the fourth quarter of 2016, while the smaller-cap indexes had modest gains following a strong 2016. Performance varied by sector, with technology, consumer discretionary, and health care stocks rising while energy and telecommunication stocks suffering losses. Financial stocks underperformed the broader stock market but remained the best-performing sector since the November 2016 elections. Total returns for U.S. stock indices during the first quarter of 2017 are shown in the following figure.

TOTAL RETURNS OF MAJOR U.S. STOCK INDICES

Index	First Quarter 2017
S&P 500	5.19%
Dow Jones Industrial Average	6.07%
NASDAQ Composite (1)	9.82%
S&P MidCap 400	3.94%
Russell 2000	2.47%

Note:
(1) Return represents principal only.

The number of initial public offerings (IPOs) and the amount of capital raised was strong in the first quarter of 2017, with 25 IPOs raising $9.9 billion. The capital raised represented a seven-quarter high, due in part to the $3.4 billion offering of Snap Inc., the largest IPO for a U.S. tech company since Facebook, Inc., and Blackstone Group's $1.5 billion offering of Invitation Homes, a home rental REIT. IPO activity was up drastically from eight IPOs in the first quarter of 2016, and total proceeds increased from $700 million in the first quarter of 2016. IPOs for the first quarter of 2017 were up 10.9 percent on average from their offer prices; excluding poor returns on energy IPOs, first quarter IPOs were up 17 percent on average from their offer prices. Snap Inc. experienced a first-day gain of 44 percent, the largest first-day gain for an IPO over $2 billion since 2000.

Donald Trump took office as the 45th President of the United States on January 20, 2017. Since his inauguration, President Trump's actions include executive orders to: (i) withdraw the U.S. from the Trans-Pacific Partnership trade deal with Asia; (ii) complete the Dakota Access oil pipeline and restart the process for the construction of the Keystone XL oil pipeline; (iii) ease regulations on the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010; (iv) direct federal agencies to evaluate existing regulations in an act to eliminate "job-killing" restrictions; and (v) review the U.S. trade deficit to examine forms of "trade abuse". Despite some early actions, the Trump administration failed to garner support among House leadership for its proposed healthcare bill, the American Health Care Act, and the bill was pulled from the House of Representatives in late March. Although the economic impact of these steps are uncertain some of the administration's priorities include the "repeal and replace" of the Affordable Care Act, tax reform, infrastructure spending, and immigration policy changes.

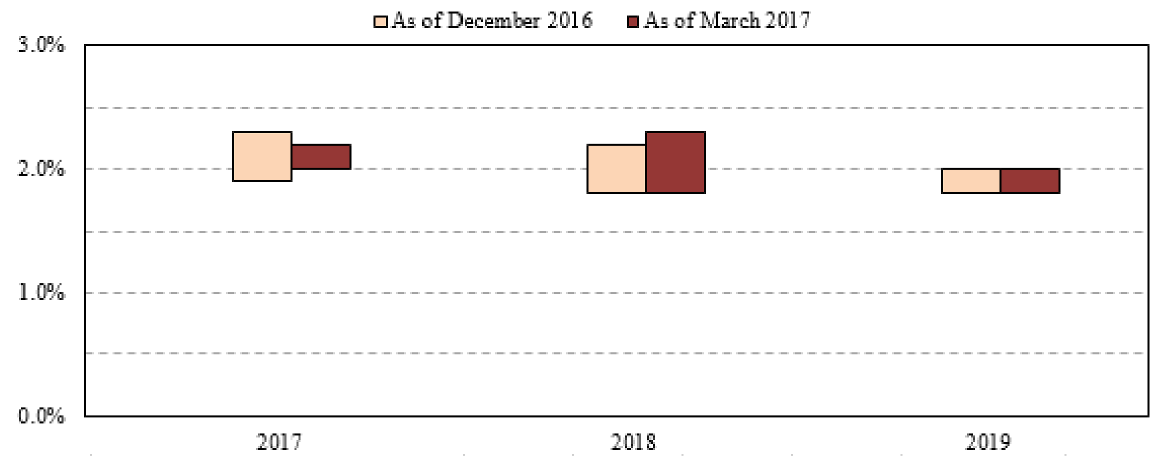
At its August 3, 2016, meeting, the Bank of England's Monetary Policy Committee (MPC) announced a 25 basis point cut in the Bank of England's base interest rate to 0.25 percent, a resumption of its asset purchase program (corporate bond purchases of up to £10 billion and government bond purchases of £435 billion), and a new bank funding program, all in an effort to abate a potential economic slowdown following the June referendum to exit the European Union. Longer-term U.K. yields and the pound fell immediately following the announcement but retraced these declines following better-than-expected economic data later in the inter-meeting period.

According to a preliminary estimate by the U.K's Office of National Statistics, the U.K. economy grew by 0.6 percent in the fourth quarter, the same rate of growth as in the second and third quarters. The U.K's GDP was 2.2 percent higher in the fourth quarter of 2016 than the fourth quarter of 2015. Growth in GDP was driven by the services industry, which represents about 80 percent of the U.K.'s economy; services increased by 0.8 percent, while construction and agriculture increased by 0.1 percent and 0.4 percent, respectively, and production remained unchanged. On March 29, 2017, Prime Minister Theresa May activated Article 50 of the European Union's Lisbon Treaty, officially starting the two-year window under which Britain will negotiate its new relationship with the European Union. Talks are expected to begin in May or June 2017.

Outlook

Various statistical reporting agencies provide estimates of the U.S. economy's near-term and longer-term growth rates. The Federal Reserve's projected growth rates for the U.S. economy for 2017–2019 were generally unchanged from December to March. The slight increase in projected growth in 2018 is based on expected changes to fiscal and regulatory policies. The estimates for U.S. GDP growth are presented in the following figure.

U.S. GDP GROWTH ESTIMATES



Source: Federal Reserve.

The U.S. Department of the Treasury's February 2017 Monthly Treasury Statement of Receipts and Outlays of the United States Government states that the federal budget deficit for fiscal year 2016 was $587 billion, an increase of 33.7 percent from $439 billion in fiscal year 2015. For the first five months of fiscal year 2017, the federal budget deficit was $192 billion.[5] The U.S. Congressional Budget Office's (CBO) January 2017 report expects that the growth in real GDP from 2017 through 2020 will be driven largely by consumer spending and business and residential investment.[6] Real GDP is projected to grow 2.3 percent in calendar year 2017 and 1.9 percent in calendar year 2018.[7] The CBO estimates that the gap between actual GDP and the economy's potential (that is, maximum sustainable) GDP will be eliminated by the end of 2018.[8] Real GDP is expected to grow, on average, at an annual rate of 1.6 percent from 2019 through 2020 and 1.9 percent from 2021 through 2027.[9]

Inflation, as measured by the Core Consumer Price Index, which excludes the effects of food and energy, is forecast to be 1.9 percent in 2017, 2.0 percent in 2018, and remain at an average of 2.0 percent per year in the 2019–2027 period.[10]

Endnotes:

1. National Bureau of Economic Research. <https://www.nber.org/cycles.html>

2. Bureau of Labor Statistics. "Employment, Hours, and Earnings from the Current Employment Statistics survey (National)." <http://data.bls.gov/timeseries/CES0000000001?output_view=net_1mth>.

3. Bureau of Labor Statistics. "U-3 total unemployed, as a percent of the civilian workforce (official unemployment rate)". Reported on a seasonally adjusted basis. <http://www.bls.gov/news.release/empsit.t15.htm>.

4. Ibid. "U-6 total unemployed, plus all persons marginally attached to the labor force, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all persons marginally attached to the labor force." Reported on a seasonally adjusted basis.

5. U.S. Department of Treasury, "February 2017 Monthly Treasury Statement of Receipts and Outlays of the United States Government," March 2017. <https://www.fiscal.treasury.gov/fsreports/rpt/mthTreasStmt/mts0217.pdf>.

6. U.S. CBO, "The Budget and Economic Outlook: 2017–2027," January 2017. <https://www.cbo.gov/sites/default/files/115th-congress-2017-2018/reports/52370-budeconoutlook.pdf>.

7. Ibid.

8. Ibid.

9. Ibid.

10. Ibid.