Economic Review - Fourth Quarter 2016

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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.

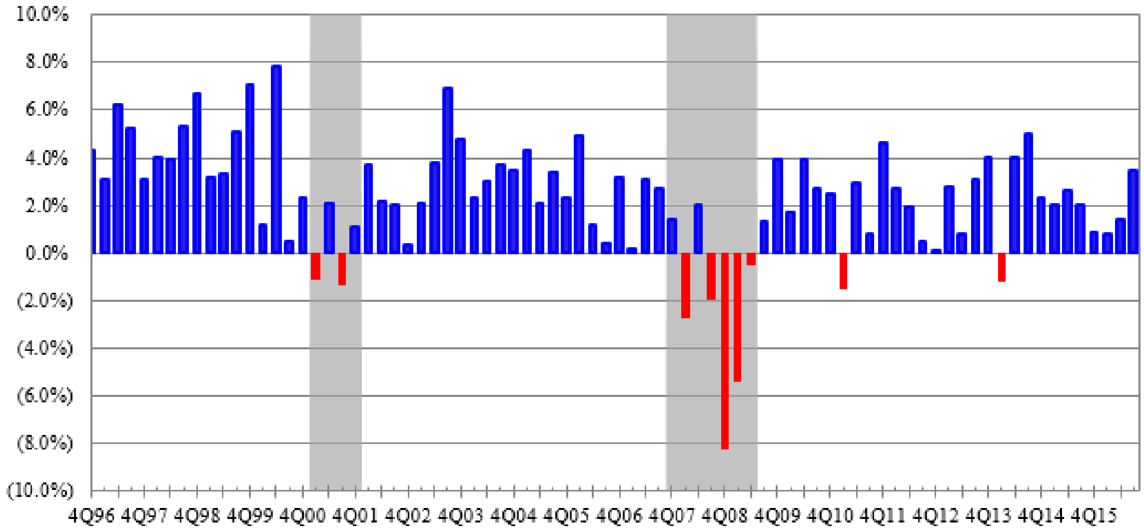
Following the December 13–14, 2016, meeting of the Federal Open Market Committee (the "Committee") of the Federal Reserve, the Committee issued a statement that economic activity was expanding at a moderate pace during the second half of 2016. Labor market conditions continued to strengthen as non-farm payroll employment has increased and the unemployment rate has declined. Additionally, the share of workers employed part time for economic reasons decreased. Industrial production was unchanged in October, reflecting gains in manufacturing production and mining output and a decline in utilities output. Household spending increased in the fourth quarter as employment, real disposable personal income, and households' net worth continued to increase. Housing market activity has improved, as starts on single-family and multi-family homes and building permit issuances for new single-family homes increased.

Offsetting these positive developments, however, were the decline in shipments for non-defense capital goods excluding aircraft and spending on commercial structures excluding those related to mining and drilling. Even though some measures of labor market conditions improved in the fourth quarter, the labor force participation rate and the employment-to-population ratio declined. Consumer price inflation continued to run below the Committee's long-run objective of 2 percent, restrained by decreases in consumer energy prices and non-energy import prices in the beginning of the year.

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 3.5 percent in the third 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

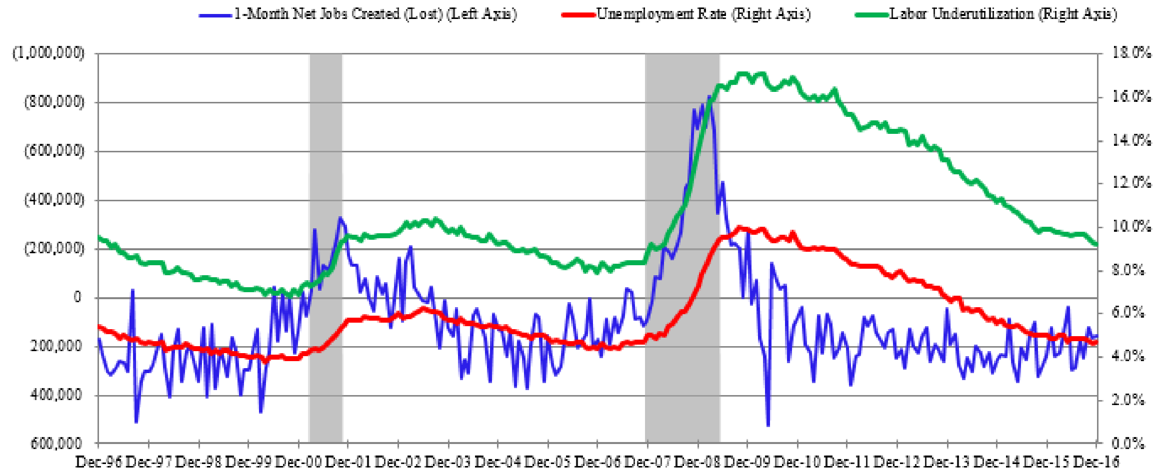


Sources: U.S. Bureau of Economic Analysis and National Bureau of Economic Research.
GDP percent change is based on chained 2009 dollars.

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 82 consecutive months from March 2010 to December 2016, 15.6 million non-farm jobs (net) were created.[2] The unemployment rate peaked at 10.0 percent in October 2009 and reached a low of 4.6 percent in November 2016, the lowest unemployment rate since August 2007.[3] The unemployment rate was 4.7 percent as of December 2016. 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 a still-elevated 9.2 percent as of December 2016.[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.

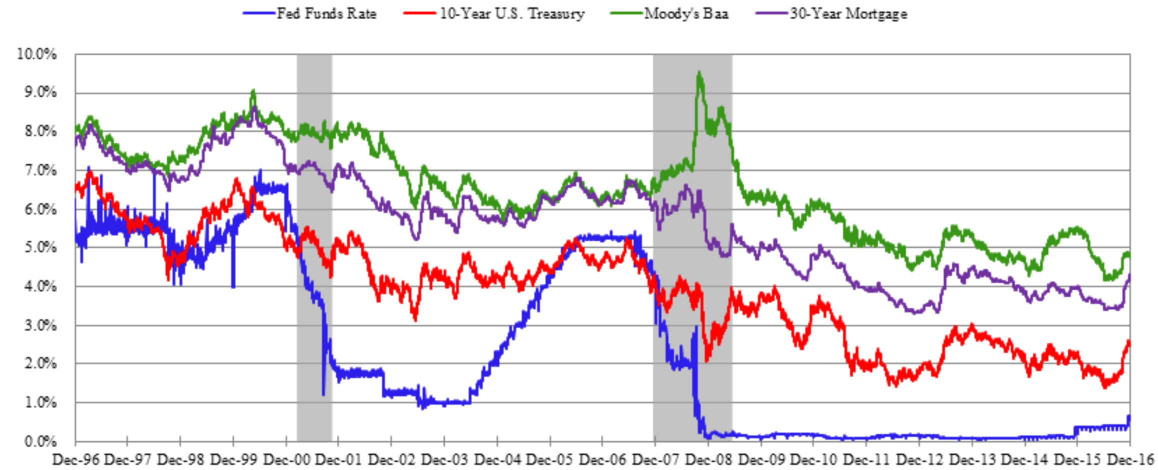
Interest Rates

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 December 13–14, 2016, 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 of 0.25 percent to a range of 0.50-to-0.75 percent, only the second 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 fourth quarter of 2016. Corporate bond spreads continued to narrow and 30-year mortgage rates increased in line with Treasury yields, although rates remained historically low. Treasury yields across all maturities increased during the quarter, as did the rates on Treasury inflation-protected securities. The issuance of commercial and industrial loans picked up in the fourth quarter, while corporate bond issuance slowed down. 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 fourth quarter, with declines early on due to concerns of tighter global monetary policy and political uncertainty surrounding the November elections. Positive economic data led to a consensus — ultimately correct — that the Federal Reserve would hike interest rates before the end of the year. Additionally, the uncertainty surrounding the presidential and congressional elections caused stocks to slump. Political uncertainty was resolved once Donald Trump was elected as President of the United States, with the market rallying through mid-December. Several factors may have contributed to this rally, including expectations of higher economic growth and corporate profits due to anticipated tax cuts, increased infrastructure spending, and deregulation.

In addition to raising the federal funds rate at its December 13–14, 2016, meeting which was widely anticipated, the Committee indicated that it expected three rate hikes in 2017, compared to two anticipated at its September meeting. This information may have contributed to the S&P 500 Index sliding for the remainder of December.

Major stock market benchmarks recorded gains in the fourth quarter; the Dow Jones Industrial Average, S&P MidCap 400 Index, and Russell 2000 Index outperformed the large-cap S&P 500 Index, while the technology-focused NASDAQ Composite Index recorded modest gains. Performance varied by sector, with financial stocks rising sharply due to a steeper yield curve and greater prospects for deregulation. Industrial stocks also rose on the prospect of infrastructure spending. The interest rate hike in December affected real estate and consumer staples stocks, and fears over healthcare policy led to sharp drops in healthcare technology, equipment, and services stocks. Total returns for U.S. stock indices during the fourth quarter of 2016 are shown in the following figure.

TOTAL RETURNS OF MAJOR U.S. STOCK INDICES

Index	Fourth Quarter 2016	Twelve Months 2016
S&P 500	3.82%	11.96%
Dow Jones Industrial Average	8.66%	16.50%
NASDAQ Composite (1)	1.34%	7.50%
S&P MidCap 400	7.42%	20.74%
Russell 2000	8.83%	21.31%

Note:
(1) Return represents principal only.

The number of initial public offerings (IPOs) and the amount of capital raised decreased from 2015 to 2016, with 105 IPOs (the lowest level since 2009) raising $18.8 billion (the lowest total proceeds since $15.2 billion in 2003). The slowdown in the IPO market began in August 2015 when markets declined, resulting in 57 percent of 2015-vintage IPOs finishing 2015 trading below their offer prices. Poor IPO returns in 2015, another market sell-off in January 2016, the Brexit vote in June 2016, and the U.S. election in November further delayed some IPOs in 2016. Despite the setback in IPO activity in 2016, 2016-vintage IPOs were up 23.1 percent on average from their offer prices, the highest total return since 2013. Most IPOs finished the year trading above their offer prices, with 70.2 percent of IPOs trading above issue at year-end (up from 42.9 percent of IPOs in 2015).

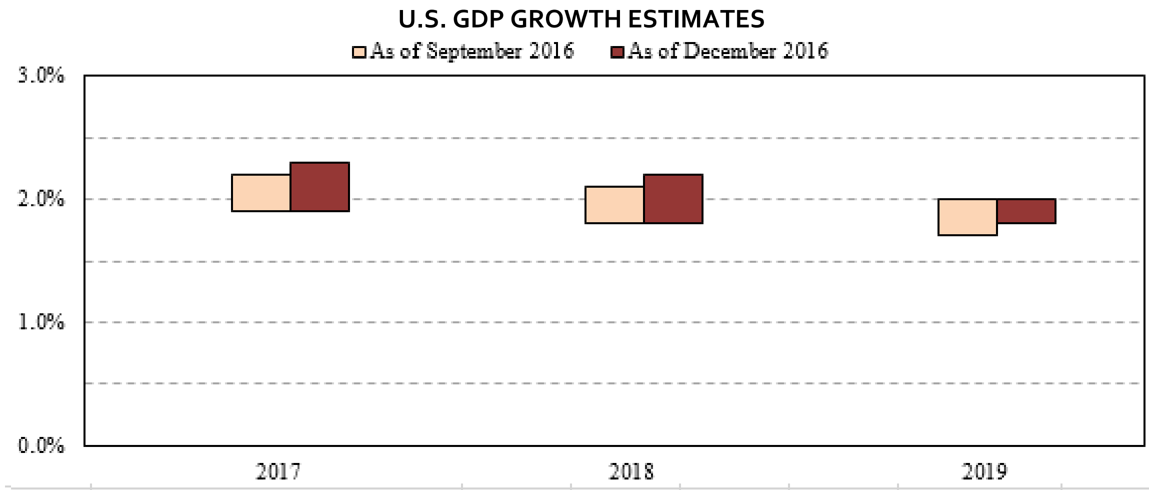
Donald Trump won the 2016 U.S. presidential election on November 8, 2016, and the Republican party retained control of both the Senate and the House of Representatives. Although the economic impact of the election remains uncertain, the "repeal and replace" of the Affordable Care Act, tax reform, infrastructure spending, and immigration policy changes seem likely.

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. Once Britain invokes Article 50 of the European Union's Lisbon Treaty, which Prime Minister Theresa May is expected to do by the end of March 2017, the U.K. will have a two-year window to negotiate its new relationship with the European Union. The global economic impact of these future discussions remains uncertain.

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 September to December. The slight increases in projected growth in 2017 and 2018 are based on expected changes to fiscal and regulatory policies. The estimates for U.S. GDP growth are presented in the following figure.



Source: Federal Reserve.

The U.S. Department of the Treasury's November 2016 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 two months of fiscal year 2017, the federal budget deficit was $181 billion.[5] The U.S. Congressional Budget Office's (CBO) August 2016 report expects that the growth in real GDP from 2016 through 2020 will be driven largely by consumer spending and business and residential investment.[6] Real GDP is projected to grow 2.0 percent in calendar year 2016, 2.4 percent in calendar year 2017, and 2.1 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 2017.[8] Real GDP is expected to grow, on average, at an annual rate of 1.7 percent from 2019 through 2020 and 2.0 percent from 2021 through 2026.[9]

Inflation, as measured by the Core Consumer Price Index, which excludes the effects of food and energy, is forecast to be 2.3 percent in 2016, 2.2 percent in 2017, and eventually increase to an average of 2.3 percent per year in the 2018–2026 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, "November 2016 Monthly Treasury Statement of Receipts and Outlays of the United States Government," December 2016. <https://www.fiscal.treasury.gov/fsreports/rpt/mthTreasStmt/mts0816.pdf>.

6. U.S. CBO, "An Update to the Budget and Economic Outlook: 2016–2026," August 2016. <https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/51908-2016_Outlook_Update-2.pdf>.

7. Ibid.

8. Ibid.

9. Ibid.

10. Ibid.