



Economic Review - Fourth 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 third 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 12–13, 2017, meeting of the Federal Open Market Committee (the "Committee") of the Federal Reserve, the Committee issued a statement that economic activity increased at a solid rate in the second half of 2017. Labor market conditions continued to strengthen in the fourth quarter as non-farm payroll employment expanded, the unemployment rate decreased to 4.1 percent in October and remained at that level for the remainder of the fourth quarter, the labor force participation rate increased, and the rate of private sector job openings remained stable. U.S. consumer price inflation and core price inflation, which excludes consumer food and energy prices, remained below the Committee's long-run objective of 2 percent.

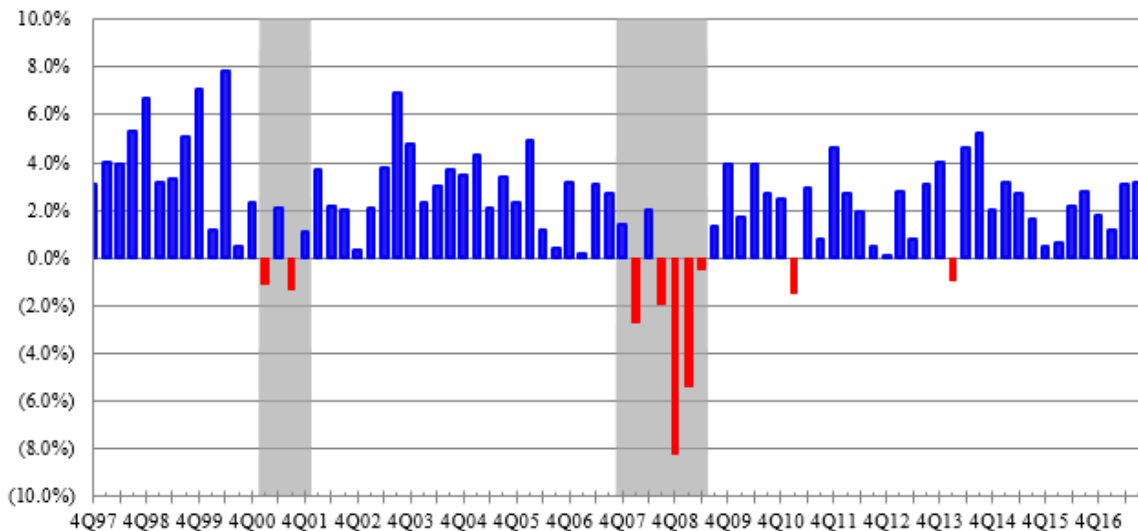
Industrial production rebounded somewhat in September and continued to recover in October, bolstered by the recovery since the landfall of Hurricanes Harvey, Irma, and Maria in August and September. Household spending improved from the temporary restraints of the hurricanes, with gains in employment, real disposable income, and households' net worth. Recent data on housing activity indicated that spending increased in the fourth quarter, after declining in the second and third quarters. Starts on single-family and multi-family homes, sales on new and existing homes, and building permit issuances for new single-family homes increased. Private expenditures for business equipment and intellectual property increased in the fourth quarter, as nominal shipments and new orders of non-defense capital goods excluding aircraft increased. Additionally, spending on commercial structures—excluding those related to mining and drilling—rose in October, and the number of crude oil and natural gas rigs in operation increased in November after declining earlier in the fourth quarter.

Gross Domestic Product

The U.S. Bureau of Economic Analysis 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 3.1 percent in the third quarter of 2017. 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



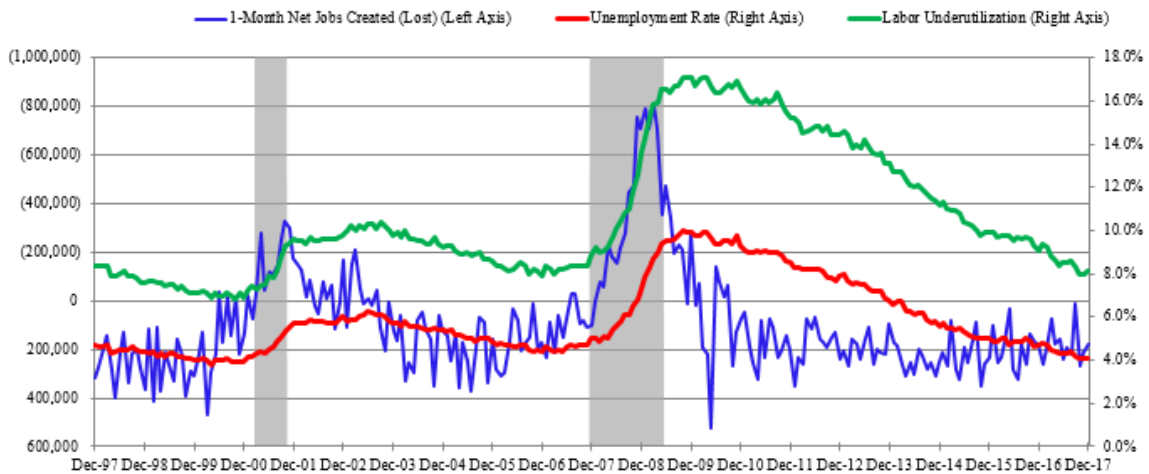
Sources: U.S. Bureau of Economic Analysis and National Bureau of Economic Research.
GDP percent change is based on chained 2009 dollars.

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 94 consecutive months from March 2010 to December 2017, 17.9 million non-farm jobs (net) were created.² The unemployment rate peaked at 10.0 percent in October 2009 and reached a low of 4.1 percent in October 2017, the lowest unemployment rate since December 2000.³ 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 8.1 percent as of December 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.

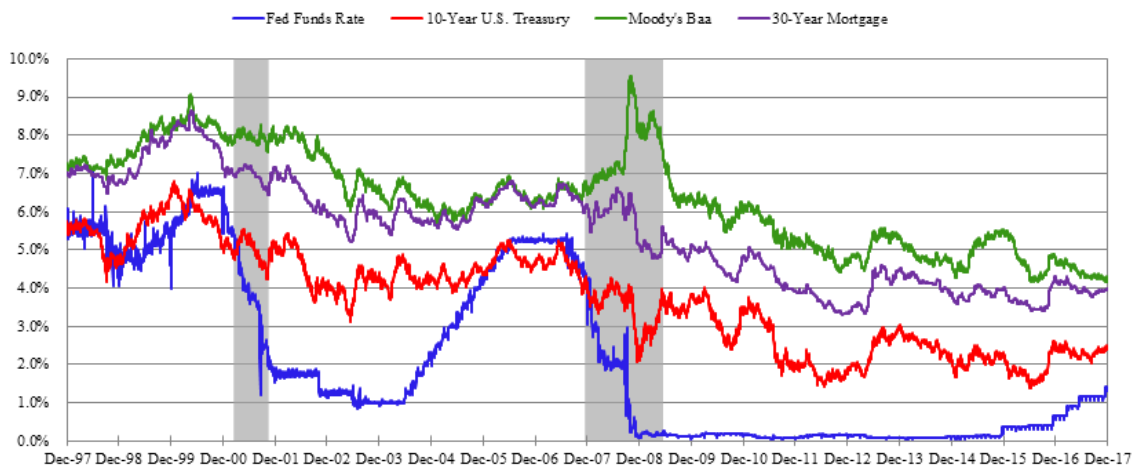
Interest Rates

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 December 12–13, 2017, meeting, the Committee considered the outlook for economic activity, the labor market, and inflation. Recent hurricanes were considered by the Committee; accordingly, the Committee weighed the uncertainties associated with the economic outlook and raised the federal funds rate to a range of 1.25-to-1.50 percent.

United States financial markets were supportive of economic growth and employment in the fourth quarter of 2017. Corporate bond spreads were relatively unchanged during the fourth quarter while 30-year mortgage rates increased slightly. Both short-term and long-term treasury yields increased during the quarter, except for 20-year and 30-year treasury yields. Measures of inflation compensation based on treasury-inflation-protected securities were relatively unchanged in the fourth quarter. Municipal bond and equity issuance was strong and the issuance of institutional leveraged loans was robust; however, growth in bank-intermediated credit to nonfinancial firms was modest. Financing for consumers remained accommodative, as consumer loan balances increased at a moderate pace. The issuance of commercial real estate loans was mixed, as there was strong loan growth at smaller banks and slowed growth at larger banks. 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.

Stock Market Activity

Stocks increased in the fourth quarter, driven early by third quarter earnings reports and encouraging economic data. Third quarter earnings reports encouraged investors, even though the S&P 500 Index's earnings only increased by 6.4 percent year-over-year in the third quarter—a significant slowdown from the gains in the first and second quarters of 2017. It should be noted that the overall earnings slowdown for the third quarter was primarily due to the disrupted operations of businesses in August and September from the hurricanes, and the related losses to insurers. Despite a slowdown in payroll gains in September due to hurricane disruptions, the labor market improved in the fourth quarter, with payroll gains rebounding robustly in October and November, and the unemployment rate falling to 4.1 percent in October and remaining there for the rest of the fourth quarter. Consumer confidence increased, as Americans are more optimistic about their job and financial prospects and sales for existing and new homes reached its highest level since 2007.

Bolstering the steady gains in stocks in the fourth quarter were assurances by the Federal Reserve that there was no underlying weakness in the economy due to low inflation during 2017 (inflation has been below the Federal Reserve's 2 percent mandate) and that the Federal Reserve would not steer away from its intended path of gradual rate hikes. Accordingly, the Federal Reserve eventually increased rates by a quarter point during its December 12–13, 2017, meeting. Additionally, investors were relieved when President Donald Trump selected Jerome Powell to succeed Janet Yellen as Federal Reserve chair, as Powell is a long-time ally of Yellen. Stocks finished the second half of the quarter with gains, as the stock market rallied due to the progress made on tax reform legislation, and its priority of cutting the corporate tax rate.

The major stock market benchmarks recorded gains in the fourth quarter, bringing the returns for all of the benchmarks into the double digits for the year. The S&P 500 Index had its ninth consecutive quarter of positive gains. Volatility in the stock market remained low in the fourth quarter, with no gains or losses more than one percent for the S&P 500 Index during this period and the Chicago Board Options Exchange Volatility Index (VIX) reaching its lowest level since its 1993 inception. Large and mid-cap stocks outperformed small cap stocks, and growth stocks outperformed value stocks across all market capitalizations. Stocks within the consumer discretionary, information technology, and financial sectors performed best in the S&P 500 Index and health care and utility stocks were the weakest performers. Total returns for U.S. stock indices during the fourth quarter of 2017 are shown in the following figure.



TOTAL RETURNS OF MAJOR U.S. STOCK INDICES

Index	Fourth Quarter 2017	Twelve Months 2017
S&P 500	6.64%	21.83%
Dow Jones Industrial Average	10.96%	28.11%
NASDAQ Composite (1)	6.27%	28.24%
S&P MidCap 400	6.25%	16.24%
Russell 2000	3.34%	14.65%

Note:

(1) Return represents principal only.

The number of initial public offerings (IPOs) in 2017 increased by 50 percent over 2016 (105 IPOs) with 160 IPOs, and the amount of capital raised nearly doubled to \$35.5 billion (\$18.8 billion in 2016). IPOs averaged a 26 percent return, on par with major stock market benchmarks, and was driven by gains in industrial, biotechnology, and technology companies. Every major sector saw increased activity in 2017, as health care, technology, financials, and energy rebounded from multi-year lows. Health care topped IPO activity for the fifth consecutive year, driven by biotechnology companies. Despite a strong IPO market in 2017, the ten largest IPOs finished with an average return of negative one percent, and six of those IPOs finished below their issue price.

Tax Reform

The U.S. Congress passed the “Tax Cuts and Jobs Act”, which was signed by President Trump on December 22, 2017. Major provisions of the tax reform include: (i) reduction of corporate and individual tax rates; (ii) increase in standard deductions and family tax credits; (iii) suspension of the personal exemption and reduction or elimination of certain itemized deductions, such as the mortgage interest deduction; (iv) cap on deduction of state and local income taxes and property taxes; (v) reduction in the alternative minimum tax for individuals and elimination of it for corporations; (vi) increase in the estate tax exemption; and (vii) end of the individual mandate of the Affordable Care Act in 2019.

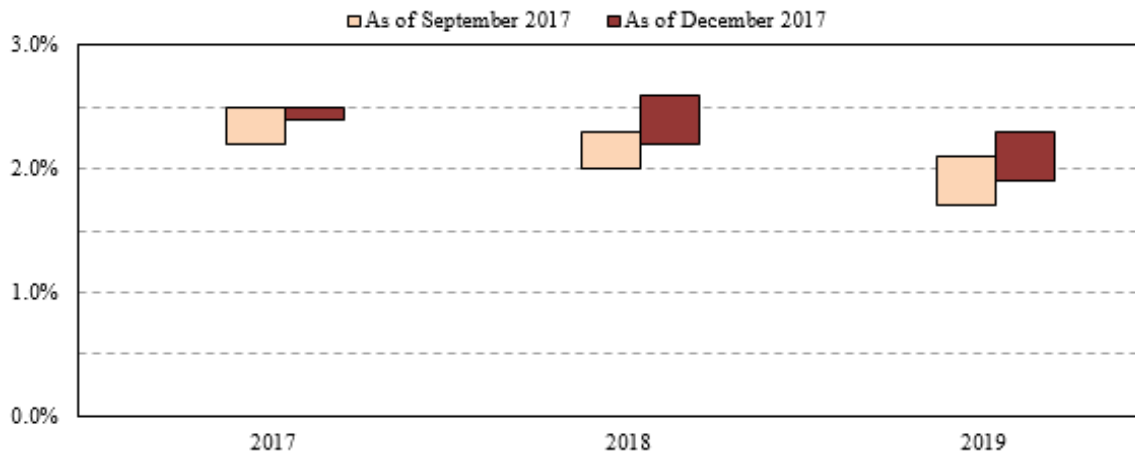
The Congressional Budget Office (CBO) and the staff of the Joint Committee on Taxation (JCT) estimated that through the tax law individuals and pass-through entities would receive about \$1.125 trillion in net benefits from 2018 to 2027, while corporations would receive approximately \$320 billion in benefits over those ten years.⁵ However, enacting the tax law would lead to an increase in the federal budget deficit of \$1.455 trillion from 2018 to 2027.⁶ Additionally, the CBO reported that the repeal of the individual mandate on the Affordable Care Act is likely to reduce federal deficits by around \$338 billion from 2018 to 2027, but leave 13 million more people without health insurance by 2019 and increase premiums up by an average of approximately 10 percent.⁷

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 improved from June to September. 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 November 2017 Monthly Treasury Statement of Receipts and Outlays of the United States Government states that the federal budget deficit for the first two months of fiscal year 2018 was \$202 billion, in comparison to \$666 billion for fiscal year 2017.⁸ The CBO June 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.⁹ Real GDP is projected to grow 2.2 percent in calendar year 2017 and 2.0 percent in calendar year 2018.¹⁰ 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 2018.¹¹ Real GDP is expected to grow, on average, at an annual rate of 1.5 percent from 2019 through 2020 and 1.9 percent from 2021 through 2027.¹²

Inflation, as measured by the Core Consumer Price Index, which excludes the effects of food and energy, is forecast to be 1.6 percent in 2017, 1.9 percent in 2018, and remain at an average of 2.0 percent per year in the 2019–2027 period.¹³

Disclaimer: this article has content that is general and informational in nature. This document is not intended to be accounting, tax, legal, or investment advice. Data from third parties is believed to be reliable, but no assurance is made as to the accuracy or completeness.



Endnotes:

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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.
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11. Ibid.
12. Ibid.
13. Ibid.