



Economic Review - Third Quarter 2018

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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 September 25-26, 2018, meeting of the Federal Open Market Committee (the "Committee") of the Federal Reserve, the Committee issued a statement that economic activity increased at a strong rate in the third quarter of 2018. Labor market conditions continued to strengthen in the third quarter as non-farm payroll employment expanded, the unemployment rate decreased to a low of 3.7 percent in September, and the labor force participation rate declined slightly, although the rate remained similar to a year earlier. Additionally, the rate of private sector job openings grew steadily with the expanding economy, and average hourly earnings increased 2.0 percent over the 12 months ending in August.² U.S. consumer price inflation and core price inflation, which excludes consumer food and energy prices, have remained near the Committee's long-run objective of 2.0 percent.

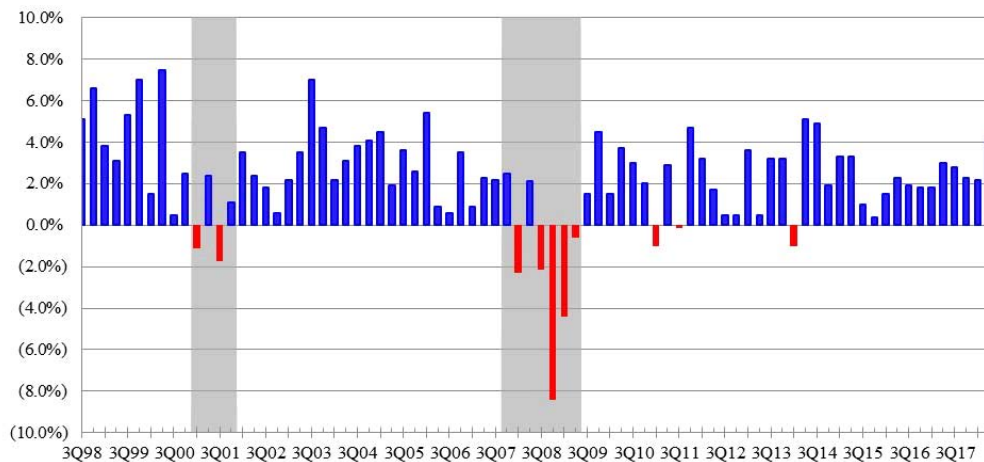
Industrial production expanded in the third quarter of 2018. Household spending continued to grow in the third quarter, supported by gains in employment, real disposable income, and the tax cuts in December 2017. Housing activity was poor, with starts on single-family and multi-family homes declining below second quarter rates, issuance of building permits falling, and sales of new and existing homes declining slightly. Real private expenditures flattened in the third quarter following exceptional growth in the first half of 2018. Nominal shipments and new orders of non-defense capital goods excluding aircraft rapidly grew in July, although spending for transportation equipment declined. Additionally, real business spending for nonresidential buildings declined in July, and the number of crude oil and natural gas rigs in operation have flattened recently, following modest growth earlier in the third 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 4.2 percent in the second quarter of 2018. 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



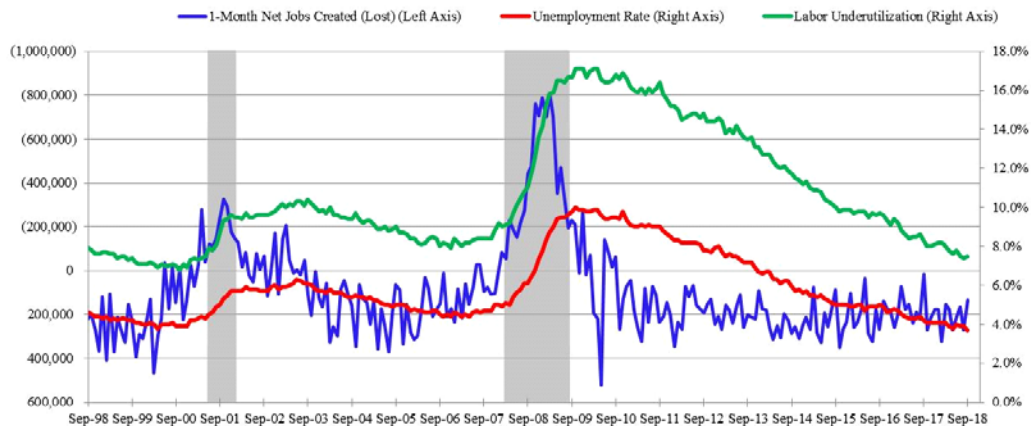
Sources: U.S. Bureau of Economic Analysis and National Bureau of Economic Research.
GDP percent change is based on chained 2012 dollars.

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 103 consecutive months from March 2010 to September 2018, 19.8 million non-farm jobs (net) were created.³ The unemployment rate peaked at 10.0 percent in October 2009, and has since reached 3.7 percent in September, a 49-year low.⁴ 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 7.5 percent as of September 2018, near the 17-year low of 7.4 percent in August 2018.⁵ 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 September 25-26, 2018, meeting, the Committee considered the outlook for economic activity, the labor market, and inflation. The Committee weighed the uncertainties associated with the economic outlook and raised the federal funds rate from a range of 1.75-to-2.00 percent to a range of 2.00-to-2.25 percent. The Committee expects that gradual increases in the target range for the federal funds rate to be consistent with the sustained growth of economic activity, labor conditions, and inflation near the Committee's symmetric 2 percent objective over the medium term.

United States financial markets were supportive of economic growth and employment in the third quarter of 2018. Both corporate bond spreads and 30-year mortgage rates increased considerably over the quarter, but both rates remained near the lower end of their historical range. Additionally, both short-term and long-term Treasury yields increased moderately during the quarter. Measures of inflation compensation based on treasury-inflation-protected securities remained relatively unchanged. Municipal bond issuance remained solid in the third quarter. The issuance of institutional leveraged loans was strong; however, corporate bond issuance slowed, likely reflecting seasonal patterns. Financing conditions for consumers remained supportive of growth in household spending; however, consumer credit slowed and financing for consumers with sub-prime credit scores remained tight. Conditions for commercial real estate loans remained accommodative and consistent with previous quarters' growth. Conditions for residential mortgage financing remained accommodative for most borrowers, except for borrowers with low credit scores. 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

The third quarter of 2018 provided one of the more robust stock market performances in recent years, with all major U.S. stock market indices reporting very strong growth, including the S&P 500 Index posting its best quarter in five years. Optimism in the market was fueled by continued strong corporate earnings following the December 2017 tax cuts.

The stock market became more stable in the third quarter as volatility subdued. However, the recent trade dispute between the United States and China led to additional rounds of tariffs from both sides, leading to uncertainty if and when the conflict will settle. Not only is there general uncertainty about the how these trade disputes will escalate, but also to what extent the current tariffs will cause friction among domestic producers and consumer activity. Producers that use inputs from targeted Chinese sectors will face higher production prices; therefore, consumers will be faced with higher prices for a wide range of goods.

As discussed, all the major stock market benchmarks posted solid gains in the third quarter. The Chicago Board Options Exchange Volatility Index (VIX) subsided from multi-year highs in past quarters, maintaining a consistent level throughout the third quarter. The Dow Jones Industrial Average Index outperformed the S&P 500 Index and NASDAQ Composite Index, led by returns from large-cap industrial and health care companies. The Russell 2000 Index trailed the major indices as small-cap companies were muted behind the strong earnings of large-cap firms. Health care stocks were the best performers throughout the third quarter, while materials and energy stocks were the weakest performing sectors. Total returns for U.S. stock indices during the third quarter of 2018 are shown in the following figure.



TOTAL RETURNS OF MAJOR U.S. STOCK INDICES

Index	Third Quarter 2018	Year To Date
S&P 500	7.7%	10.6%
Dow Jones Industrial Average	9.6%	8.8%
NASDAQ Composite (1)	7.1%	16.6%
S&P MidCap 400	3.9%	7.5%
Russell 2000	3.6%	11.5%

Note:

(1) Return represents principal only.

The third quarter of 2018 was another strong quarter for initial public offerings (IPOs), with 52 IPOs raising \$11.2 billion, continuing the trend of strong growth in the IPO market since the fourth quarter of 2017. IPOs averaged a 34 percent return, outperforming major stock market benchmarks, driven predominantly by technology and small-cap healthcare companies, along with a 700 percent gain by the U.S.'s first cannabis stock. Health care, mostly biotech companies, continued the recent trend of representing a major share of IPO activity. The 2018 IPO market, through three quarters, is on pace for more growth in the fourth quarter and set to finish the year with over 200 IPOs.⁶

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 the elimination 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.⁷ However, enacting the tax law would lead to an increase in the federal budget deficit of \$1.455 trillion from 2018 to 2027.⁸ 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.⁹ While the tax bill was passed late in the fourth quarter of 2017, its effects were still relevant in this year's third quarter, which was most evident from strong corporate earnings reports and increases in real disposable income.

Trade

The trade dispute between the U.S. and China continued in the third quarter of 2018, with both countries failing to develop any form of a free trade agreement or mutually-agreed policy. The United States has continued to focus on Chinese technology imports, while China has its their aim on U.S. agricultural goods. The U.S. implemented a new round of tariffs that went into effect on September 24, which targeted over 5,000 Chinese products valued at approximately \$200 billion. The U.S. Trade Representative cited an investigation into China's violation of trade practices as the main reason for the implementation of additional tariffs.¹⁰ The U.S. Trade Representative made China aware of its findings, but reported that China indicated it will not take any actions at this time and are prepared to apply additional tariffs on the U.S. in response.



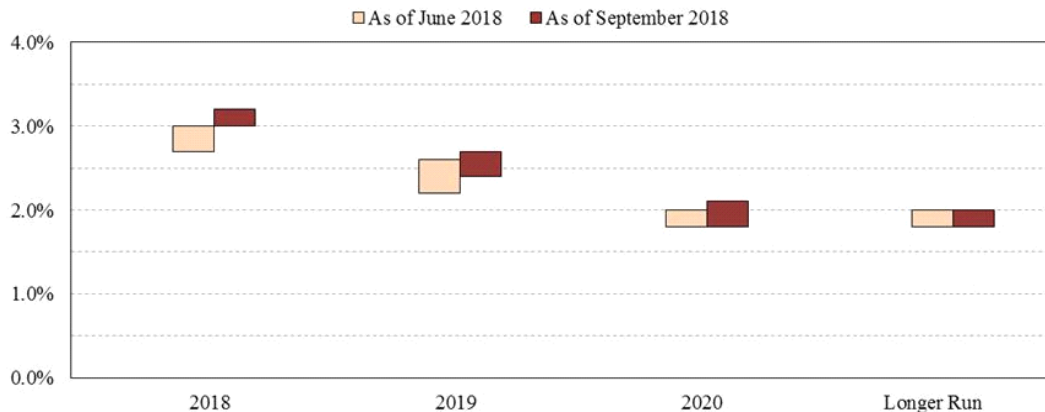
The third quarter ended on a positive note in terms of trade, with the United States, Canada, and Mexico agreeing to a new trade deal, the United States-Mexico-Canada Agreement (USMCA). The new deal was drafted on September 30, 2018. The deal is viewed as an update to rather than a replacement of NAFTA, with a focus on agriculture, auto manufacturing, and wider protection to intellectual property rights.

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 2018–2020 improved moderately from June to September, mirroring the Federal Reserve's statement that economic conditions appear positive. The projected growth rates for the longer run remain unchanged from June's report. The estimates for U.S. GDP growth are presented in the following figure.

U.S. GDP GROWTH ESTIMATES

Source: Federal Reserve.



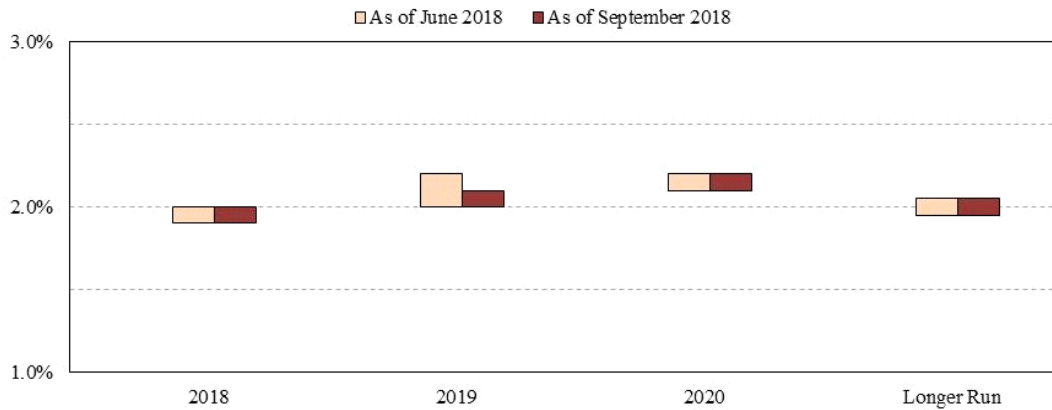
Source: Federal Reserve.

The U.S. Department of the Treasury's September 30, 2018, Treasury Statement of Receipts and Outlays of the United States Government states that the federal budget deficit for fiscal year 2018 was \$779 billion, in comparison to \$666 billion for fiscal year 2017.¹¹ The CBO August 2018 report expects that the growth in real GDP for 2018 will be driven by business investment and government purchases; growth in 2019 will be primarily supported by consumer spending.¹² Real GDP is projected to grow 3.1 percent in calendar year 2018, 2.4 percent in calendar year 2019, and 1.7 percent in calendar year 2020.¹³ The CBO estimates excess demand to push inflation above the Federal Reserve's 2.0 percent target for a brief period this year, then stabilize near 2.0 percent in the following years. Interest rates are expected to increase as the Federal Reserve has indicated further rate hikes to the Federal Funds Rate, which will exert upward pressure on the unemployment rate, which has been below the natural rate since late 2017. Higher interest rates are expected to slow the output growth, and excess demand is expected to begin to diminish after 2019.¹⁴ Real GDP is expected to grow, on average, at an annual rate of 1.7 percent in 2020, 1.6 percent from 2021 through 2022, and 1.7 percent from 2023–2028.¹⁵



Inflation, as measured by the core personal consumption expenditure (PCE), which excludes the effects of food and energy, is forecast to be 2.0 percent in 2018, 2.1 percent in 2019 and 2020, and average 2.0 percent per year in the longer run.¹⁶ The estimates for core PCE inflation rates are presented in the following figure.

U.S. CORE PCE INFLATION ESTIMATES



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. Federal Reserve Bank of St. Louis. <<https://fred.stlouisfed.org/series/LMJVPRUVUSQ175S>>.
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5. "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.
6. Renaissance Capital, "US IPO Market: 3Q 2018 Quarterly Review," September 28, 2018. <https://www.renaissancecapital.com/review/3Q18_US_Review_IPO_Pro.pdf>.
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13. Ibid.
14. Ibid.
15. Ibid.
16. Ibid.