Economic Review - First Quarter 2016

The state of the general economy can help or hinder a business' prospects and therefore has a direct impact on the value of a business. The economic recovery following the recession of 2007–2009 continues, but modestly.

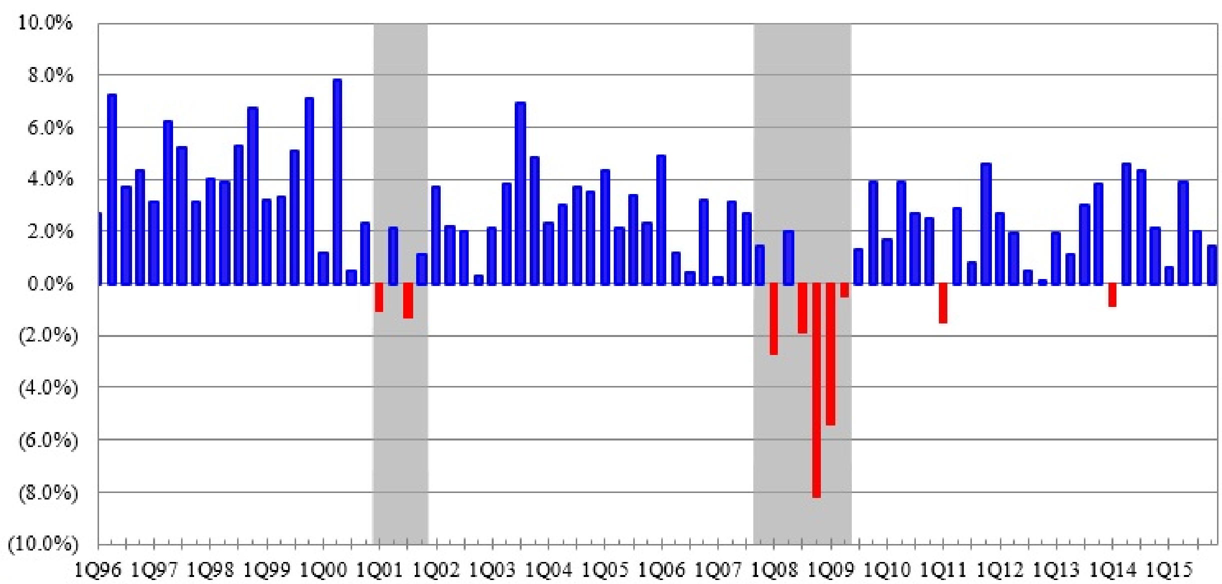
Summary

Following the March 15–16, 2016, meeting of the Federal Open Market Committee (the "Committee") of the Federal Reserve, the Committee issued a statement that economic activity expanded moderately in the first quarter of 2016. Labor market conditions continued to improve, with total non-farm payroll employment increasing in January and February. Consumer price inflation continued to run below the Committee's long-run objective of 2 percent, as consumer energy prices and non-energy import prices have decreased. Manufacturing production increased in January, despite decreased mining sector output. Business spending only grew modestly, as shipments of non-defense capital goods excluding aircraft declined in January. Spending on commercial structures excluding mining and drilling increased in January, after declining in November and December. The gradual recovery of the housing sector has been driven by an increase in starts on single-family homes and sales of existing homes, despite a decrease in starts on multi-family units and sales of new homes. Household spending increased as real disposable income grew in January and February, and household net worth was bolstered by recent gains in equity prices and home values.

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 1.4 percent in the fourth quarter of 2015. 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



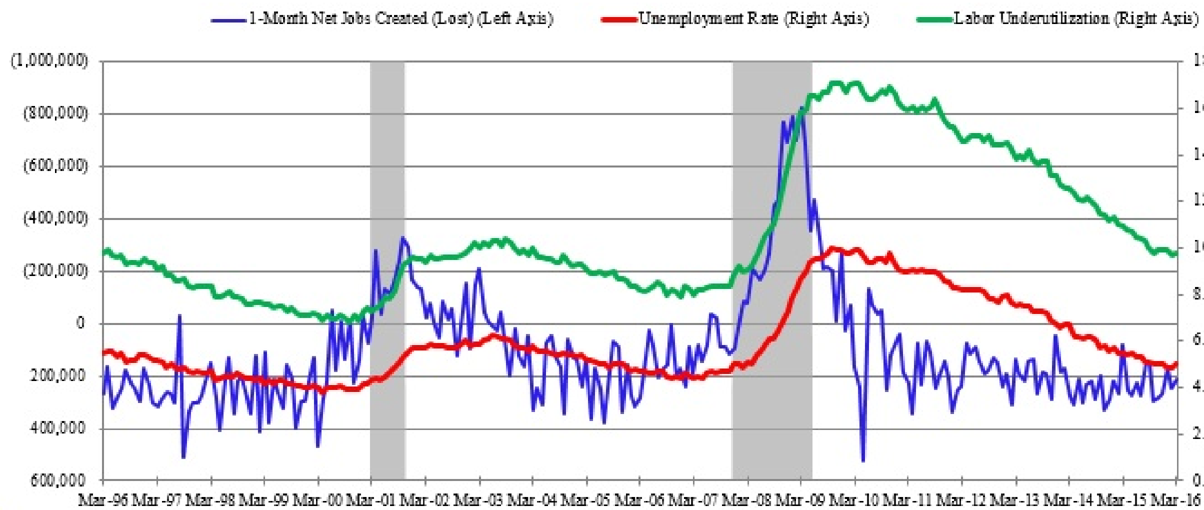
Sources: U.S. Bureau of Economic Analysis and National Bureau of Economic Research.
GDP percent change is based on chained 2009 dollars.

Employment

Employment conditions in the United States are improving. In the 25 consecutive months from February 2008 to February 2010, 8.7 million non-farm jobs (net) were lost. In the 70 consecutive months from March 2010 to March 2016, 14.0 million non-farm jobs (net) were created.[1] The unemployment rate peaked at 10.0 percent in October 2009 and reached a low of 4.9 percent in January 2016, the lowest unemployment rate since February 2008.[2] The unemployment rate was 5.0 percent as of March 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 9.8 percent as of March 2016.[3] 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.

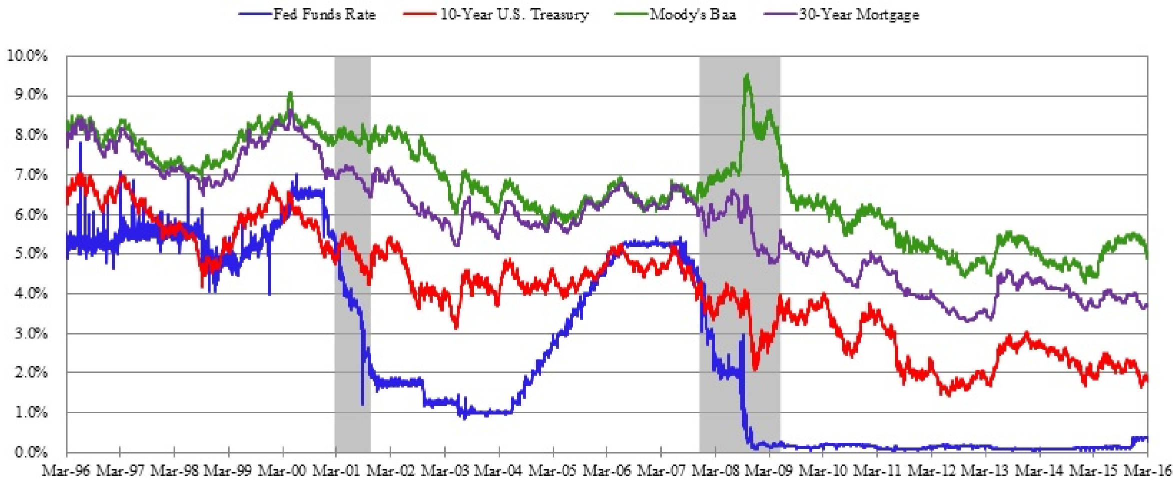
Interest Rates

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 15–16, 2016, meeting the Committee considered the outlook for economic activity, the labor market, and inflation and weighed the uncertainties associated with the outlook, and maintained the range for the federal funds rate at 0.25-to-0.50 percent. In determining the timing and magnitude of future adjustments to the target range, the Committee will assess realized and expected economic conditions relative to its objective of maximum employment and 2 percent inflation. The Committee is continuing its policy of reinvesting proceeds from maturing bonds.

United States financial markets were supportive of economic growth and employment in the first quarter of 2016. Corporate bond spreads narrowed although 30-year mortgage rates continued to increase. Yields on short- and long-term nominal Treasury securities remained relatively unchanged. Growth in the issuance of commercial and industrial loans was solid, and corporate bond issuance was robust. Financing for consumers remained accommodative, as outstanding student and auto debt expanded. Financing for commercial real estate has tightened, while market conditions for residential mortgages remained relatively unchanged. 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 were volatile in the first quarter, declining through the middle of February before rising through the end of March. The gains in the second half of the quarter more than made up for the early losses for the Standard and Poor's (S&P) 500, Dow Jones Industrial Average (DJIA), and S&P MidCap 400 stock indices, while the technology-driven NASDAQ Composite and Russell 2000 stock indices ended the quarter with losses. The early losses for these indices can be attributed to worries about a slowing global economy (for example, weak manufacturing data in China and tensions in the Middle East), waning demand for U.S. exports, weakness in the domestic services sector, a slowdown in payroll growth, and a renewed decline in oil prices (domestic oil prices reached a 13-year low on February 11, 2016). Stock prices rebounded thereafter, as reports emerged that the Organization of the Petroleum Exporting Countries (OPEC) may agree to freeze or even cut oil output. However, even though oil prices fell late in the quarter, stock gains continued as U.S. economic data was favorable and the Federal Reserve announced that it would remain accommodative.

Sector performance was mixed during the first quarter. The utilities and telecommunication services sectors increased by more than 15 percent for the quarter, and consumer staples, industrials, business services, energy, and materials stocks also performed well. However, the health care and financial sectors performed poorly, decreasing by more than 5 percent. Total returns for U.S. stock indices during the first quarter of 2016 are shown in the following figure.

TOTAL RETURNS OF MAJOR U.S. STOCK INDICES

Index	**First Quarter 2016**
S&P 500	1.35%
DJIA	2.20%
NASDAQ Composite (1)	-2.75%
S&P MidCap 400	3.78%
Russell 2000	-1.52%

Note:
(1) Return represents principal only.

The number of initial public offerings (IPOs) and the amount of capital raised slowed in the first quarter of 2016, with only eight IPOs (the slowest start to a year since 2009) raising $700 million (the lowest total proceeds in a quarter for at least 20 years). IPO activity was down from 34 IPOs in the first quarter of 2015, a decrease of 76 percent, and total proceeds declined from $5.5 billion in the first quarter of 2015, a decrease of 87 percent. Nine companies postponed their IPOs in the first quarter that could have potentially raised $1.4 billion, twice the amount of capital actually raised. Additionally, there are a number of private companies that may be targeting a public offering in the near future.

The eight IPOs were all early-stage health care companies, all of which benefitted from the substantial buying of their stocks by existing shareholders. A number of factors led to the decline in IPO activity, including reduced valuations, increased global market volatility, low energy prices, a sell-off of technology and financial stocks, and weak retail sales.

In August 2015, China's central bank, the People's Bank of China (PBOC), allowed its currency, the yuan, to depreciate relative to the U.S. dollar, decreasing the yuan's value by over 3 percent in three days. The currency's devaluation on August 11, 2015, marked its largest single drop in 20 years. The PBOC stated that the midpoint for the value of the yuan relative to the U.S. dollar had diverged from market-determined rates and that the PBOC was allowing the market to determine the yuan's value. A shift towards a weaker currency – an approximately 3.6 percent decline in the yuan's value since August 11 – signals China's potential concern about slowing growth, as China reported economic growth of 6.9 percent in 2015, a 25-year low, and 6.7 percent in the first quarter of 2016. China's monthly industrial production and retail sales slowed to its lowest levels since November 2008 in January and February, with industrial production growing by 5.4 percent year-over-year and retail sales growing by 10.2 percent year-over-year. Chinese exports declined by 25.4 percent year-over-year and imports declined by 10.0 percent year-over-year. Financial markets have reacted negatively to the PBOC's move. However, recently, the yuan's value has appreciated against the U.S. dollar in February and March, which is expected to temper the capital outflows China has experienced since its currency devaluation.

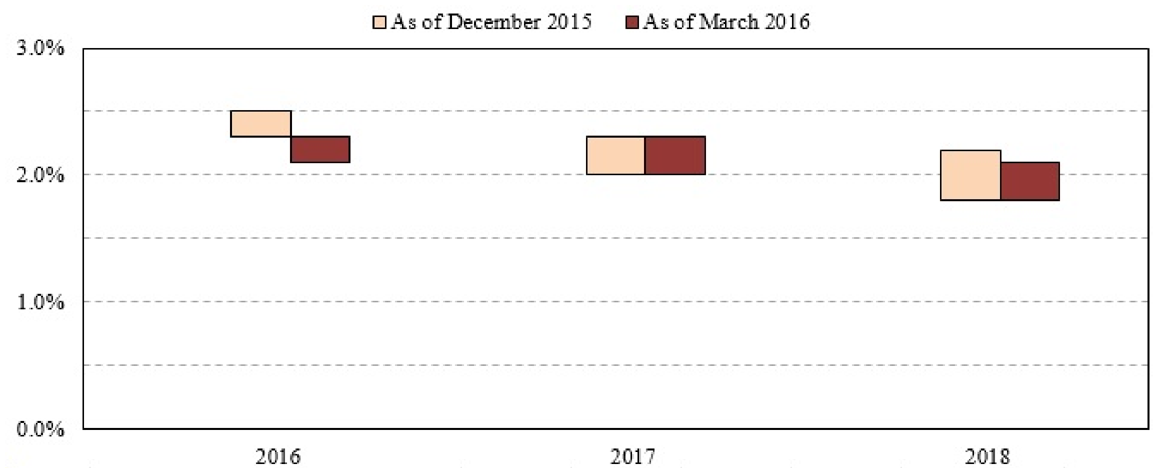
On August 3, 2015, Puerto Rico defaulted on a $58 million debt payment, only paying $628,000. In total, Puerto Rico owes about $70 billion of debt to various debtholders. As a commonwealth of the United States, Puerto Rico is unable to file for Chapter 9, Title 11 bankruptcy under the United States Bankruptcy Code, which is available exclusively to U.S. municipalities, to restructure its debts. Puerto Rico is instead seeking significant concessions from its creditors, which could include deferring some debt payments for as long as five years. However, the U.S. Congress is formulating a bill that would create a financial oversight board that would have the authority to initiate debt restructuring under a court-supervised process and approve budgets submitted by the Puerto Rican governor and passed by local legislature. On January 4, 2016, Puerto Rico defaulted on nearly $174 million in principal and interest payments, including $35.9 million due to holders of bonds issued by its Infrastructure Financing Authority and $1.4 million due to holders of bonds issued by its Public Finance Corporation. The Puerto Rican government diverted this $174 million amount from lower-grade bonds to pay holders of the legally protected general obligation bonds. As of March 31, 2016, the economic impact of the Puerto Rican debt crisis remains uncertain. Puerto Rico faces principal and interest payments in May and July, which include $422 million in May and $2 billion in July.

As of March 31, 2016, the future of the United Kingdom's membership in the European Union remains uncertain. The United Kingdom is scheduled to hold a referendum in June to decide whether the country will remain in the European Union. The uncertainty surrounding the referendum has caused volatility in the British pound. If the exit occurs, there may be negative economic impacts for both the United Kingdom and the European Union; however, the effect on the global economy is uncertain.

Outlook

Various statistical reporting agencies provide estimates of the U.S. economy's near-term and longer-term growth rates. In March, the Federal Reserve lowered its projected growth rates for the U.S. economy for 2016 and 2018, while 2017 remain unchanged. Domestic factors including improving labor conditions, stronger household and business balance sheets, lower consumer energy prices, and accommodative monetary policy are expected to support GDP, although the Federal Reserve projects the uncertainty regarding foreign conditions will negatively affect GDP growth in 2016 and 2018. 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 2016 Monthly Treasury Statement of Receipts and Outlays of the United States Government states that the federal budget deficit for fiscal year 2015 was $439 billion, a decrease of 9.1 percent from $483 billion in fiscal year 2014. For the first five months of fiscal year 2016, the federal budget deficit was $353 billion.[4] The CBO's March 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.[5] Real GDP is projected to grow 2.7 percent in calendar year 2016 and 2.5 percent in calendar year 2017. The CBO estimates that the gap between actual GDP and the economy's potential (that is, maximum sustainable) GDP will be eliminated by the middle of 2018.[6] Real GDP is expected to grow, on average, at an annual rate of 2.0 percent from 2018 through 2026.[7]

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 2016, 1.9 percent in 2017, and eventually increase to an average of 2.0 percent per year in the 2018–2026 period.[8]

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:

1. 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>.

2. 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>.

3. 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.

4. U.S. Department of Treasury, “February 2016 Monthly Treasury Statement of Receipts and Outlays of the United States Government,” March 2016. <https://www.fiscal.treasury.gov/fsreports/rpt/mthTreasStmt/mts0216.pdf>.

5. U.S. CBO, “An Update to the Budget and Economic Outlook: 2016–2026,” March 2016. <https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/51384-MarchBaseline.pdf>.

6. Ibid.

7. Ibid.

8. Ibid.