Economic Review - First 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.

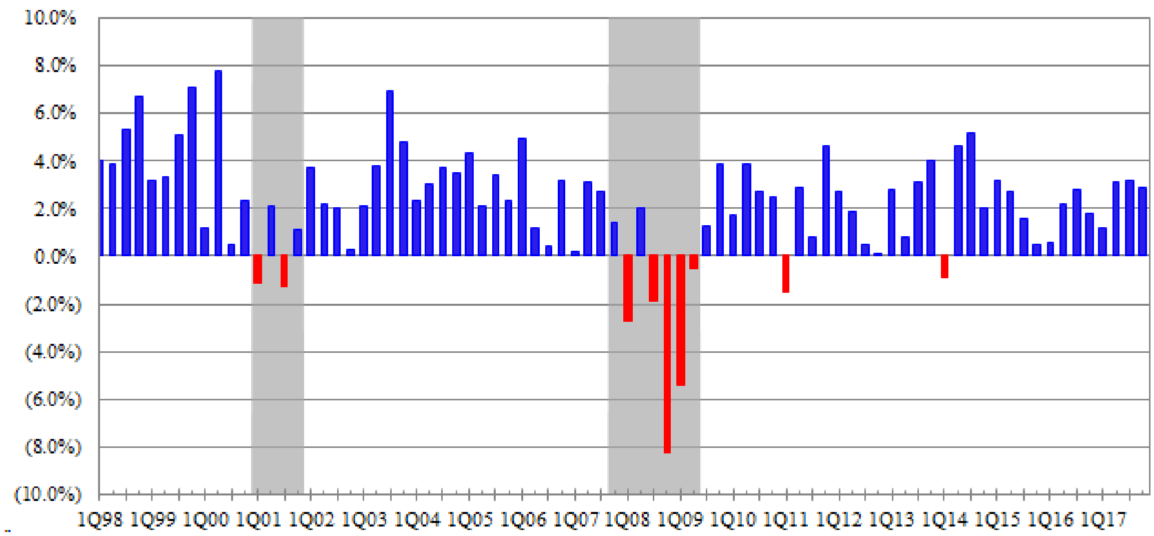
Following the March 20-21, 2018, meeting of the Federal Open Market Committee (the "Committee") of the Federal Reserve, the Committee issued a statement that economic activity increased at a solid rate in the first quarter of 2018. Labor market conditions continued to strengthen in the first quarter as non-farm payroll employment expanded, average earnings grew modestly, the unemployment rate remained at 4.1 percent since October 2017, the labor force participation rate increased, and the rate of private sector job openings increased by over 6 percent from the previous quarter.[2] 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 continued to steadily increase in the first quarter of 2018 after slumping midway through 2016. Household spending grew modestly in the first quarter, with gains in employment, real disposable income, and household net worth supporting spending. Recent data on housing activity indicated that spending moderated in the first quarter, after improving in the fourth quarter. Starts on single-family homes increased, although building permit issuances slowed. Multi-family housing starts were modest, while sales on new and existing homes declined. Growth in real private expenditures for business equipment moderated in the first quarter. Nominal shipments and new orders of non-defense capital goods excluding aircraft decreased in January, although, forward-looking indicators appear to be optimistic. Additionally, spending on commercial structures—excluding those related to mining and drilling—declined in January; however, the number of crude oil and natural gas rigs in operation increased throughout the first 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 2.9 percent in the fourth 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

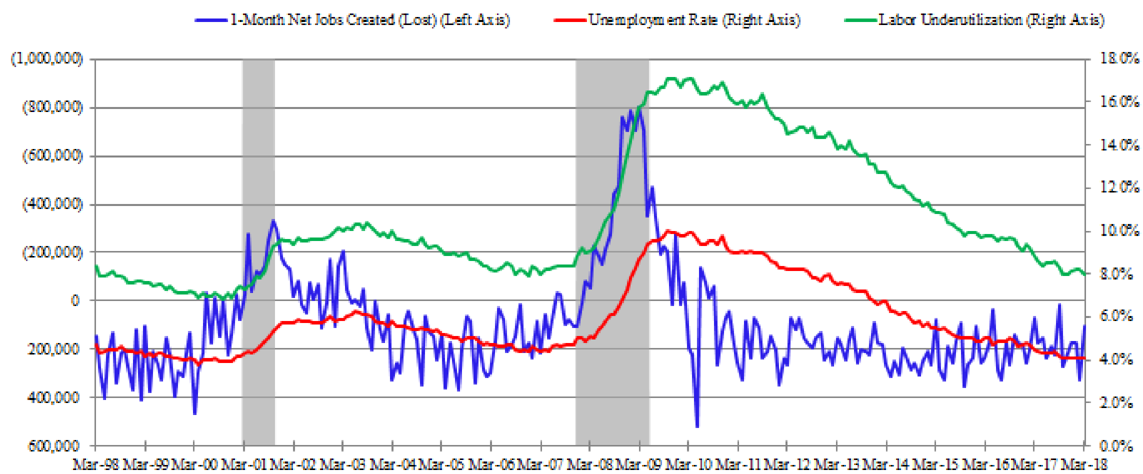


Sources: U.S. Bureau of Economic Analysis and National Bureau of Economic Research.
GDP percent change is based on chained 2009 dollars.

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 97 consecutive months from March 2010 to March 2018, 18.5 million non-farm jobs (net) were created.[3] The unemployment rate peaked at 10.0 percent in October 2009 and reached a low of 4.1 percent in October 2017 (continuing into March 2018), the lowest unemployment rate since December 2000.[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 8.0 percent as of March 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



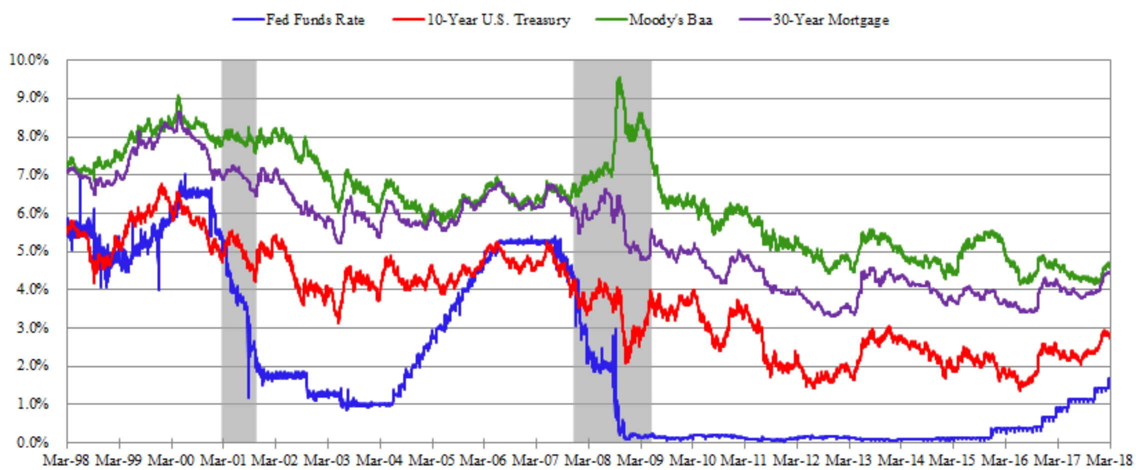
Sources: Department of Labor, Bureau of Labor Statistics, and National Bureau of Economic Research. Data represents non-farm payrolls.

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 March 20-21, 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 1.25-to-1.50 percent to a range of 1.50-to-1.75 percent.

United States financial markets were supportive of economic growth and employment in the first quarter of 2018. Both corporate bond spreads and 30-year mortgage rates have increased over the quarter, but corporate bond spreads remain near the lower end of their historical range. Additionally, both short-term and long-term Treasury yields increased during the quarter. Measures of inflation based on Treasury-inflation-protected securities were fairly stable in the first quarter. Conditions within the financial and municipal bond markets remained accommodative in the first quarter; however, the issuance of investment-grade and speculative bonds lessened. The issuance of institutional leveraged loans was robust; however, growth in bank-intermediated credit to nonfinancial firms decreased. Financing for consumers remained accommodative, as consumer loan balances increased at a moderate pace following rapid expansion in the fourth quarter. However, borrowing was higher for sub-prime lenders, with credit limits and balances still low by historical standards. The issuance of commercial real estate loans shrank in the first quarter, growing at a consistent pace over the past few years. 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

After generally unhindered growth in recent years, the U.S. stock market posted its first negative quarter since 2015. Despite the Dow Jones Industrial Average Index posting over an 11 percent loss during its "correction" in February, the index made up ground to end the quarter with only a 2.0 percent loss. As the fourth quarter of 2017 ended on a positive note, with the passage of new tax cuts for businesses, the S&P 500 Index and Dow Jones Industrial Average Index reached record highs early into January. Strong earnings reports also helped propel stock indices to double-digit growth in January.

February, however, represented a reversal in stock prices after a Labor Department report sparked fears of inflation after noting a 2.9 percent annual increase in average hourly earnings and with the potential for a trade war with China and other countries.[6] Despite declines late in March due to regulatory concerns, technology stocks helped limit the damage from the major loss seen during February.

Even after recovering a good portion of their initial losses in February, stock market indices remained volatile and failed to find any positive momentum as most indices posted a negative return in the first quarter. Increased discretionary spending coupled with the tax cuts in the fourth quarter also boosted negativity in the market as speculation grew over the United States' persistent and growing debt problem, as it has already ran a $375 billion deficit just in the first quarter of 2018.[7] The U.S.'s implementation of tariffs on selected Chinese goods, along with the Chinese pledge for retaliation on $3 billion worth of U.S. goods further fueled skepticism of the U.S.'s economic relationship with the rest of the world.

The main stock market indices reported either losses or very modest gains in the first quarter of 2018. Volatility in the stock market spiked in the first quarter after being relatively flat throughout 2017. The Chicago Board Options Exchange Volatility Index (VIX) reached its highest level since 2011. The NASDAQ Composite was the only index to report a positive return, due to its heavy compilation of technology stocks. Small and mid-cap stocks outperformed large cap stocks, and value stocks outperformed growth stocks across all market capitalizations. Technology stocks performed best within the S&P 500 Index, as did consumer discretionary stocks, due to strong performances by internet-related media and retail stocks. Telecommunications, consumer staples, energy, materials, and real estate stocks were among the weakest performers. Total returns for U.S. stock indices during the first quarter of 2018 are shown in the following figure.

TOTAL RETURNS OF MAJOR U.S. STOCK INDICES

Index	First Quarter 2018
S&P 500	(0.76%)
Dow Jones Industrial Average	(1.96%)
NASDAQ Composite (1)	2.32%
S&P MidCap 400	(0.77%)
Russell 2000	(0.08%)

Note:
(1) Return represents principal only.

The first quarter of 2018 was solid for initial public offerings (IPOs), with 44 IPOs raising $15.6 billion, posting the highest quarterly proceeds in over three years. Four billion-dollar IPOs accounted for 46 percent of all capital raised. IPOs averaged an 8.6 percent return, outperforming major stock market benchmarks, and IPOs were driven by gains in technology, health care, and energy. Health care topped IPO activity for the sixth consecutive year, accounting for 32 percent of all IPOs throughout the first quarter. Despite a sluggish performance by the overall market in the first quarter, IPOs still maintained positive returns and the high levels of capital raised suggest confidence in the U.S. IPO market going into the second quarter.[8]

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.[9] However, enacting the tax law would lead to an increase in the federal budget deficit of $1.455 trillion from 2018 to 2027.[10] 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.[11]

Trade

On January 22, President Trump announced the U.S.'s first round of tariffs on China for imported residential washing machines and solar cells and modules, based on investigations, findings, and recommendations of the independent U.S. International Trade Commission (ITC), in an effort to provide relief to U.S. manufacturers and combat loss of market share. Under this round of tariffs, President Trump approved a 30 percent tariff on imported solar cells and modules in the first year, followed by 5 percentage point reductions in years 2 through 4. The first 1.2 million units of imported finished washers in years 1, 2, and 3 will have a tariff of 20 percent, 18 percent, and 16 percent, respectively. All imported washers beyond 1.2 million washers will have a tariff imposed equal to 50 percent, 45 percent, and 40 percent in years 1, 2, and 3, respectively. Additionally, a tariff was approved on covered parts for washing machines equal to 50 percent, 45 percent, and 40 percent in years 1, 2, and 3, respectively.[12]

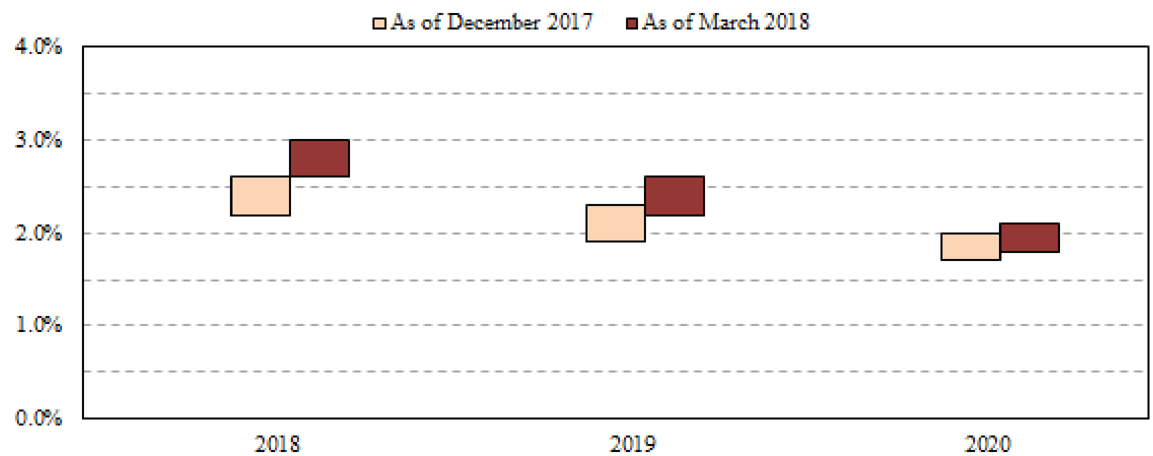
After this round of tariffs was enacted, the equity markets responded with large losses across all major indices due to fears of developing trade wars. Although the market began to rebound from those losses by the end of the first quarter, it is unclear what impact these tariffs will have on the economy.

On March 8, the U.S. Trade Representative acknowledged President Trump's desire to place another round of tariffs on Chinese steel and aluminum. These additional tariffs have yet to go into effect but are likely in the second quarter.

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 from December to March. 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 28, 2018, Treasury Statement of Receipts and Outlays of the United States Government states that the federal budget deficit for the first five months of 2018 was $391 billion, in comparison to $666 billion for fiscal year 2017.[13] 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.[14] Real GDP is projected to grow 2.2 percent in calendar year 2017 and 2.0 percent in calendar year 2018.[15] 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.[16] 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.[17]

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.[18]

Endnotes:

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

2. Federal Reserve Bank of St. Louis. <https://fred.stlouisfed.org/series/LMJVPRUVUSQ175S>.

3. 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>.

4. 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>.

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. Bureau of Labor Statistics, "The Employment Situation - January 2018," February 2, 2018. <https://www.bls.gov/news.release/archives/empsit_02022018.pdf>.

7. Bureau of The Fiscal Service, "Monthly Treasury Statement: of Receipts and Outlays of the United States Government," March 31, 2018. <https://www.fiscal.treasury.gov/fsreports/rpt/mthTreasStmt/mts0318.pdf>.

8. Renaissance Capital, "US IPO Market: 1Q 2018 Quarterly Review," March, 28 2018. <https://www.renaissancecapital.com/review/RenCap1Q18_US_IPO_Review.pdf>.

9. U.S. CBO, "Cost Estimate for the Conference Agreement on H.R. 1," December 15, 2017. <https://www.cbo.gov/system/files/115th-congress-2017-2018/costestimate/53415-hr1conferenceagreement.pdf>.

10. Ibid.

11. U.S. CBO, "Repealing the Individual Health Insurance Mandate: An Updated Estimate," November 2017. <https://www.cbo.gov/system/files/115th-congress-2017-2018/reports/53300-individualmandate.pdf>.

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13. U.S. Department of Treasury, "February 2018 Monthly Treasury Statement of Receipts and Outlays of the United States Government," February 2018. <https://www.fiscal.treasury.gov/fsreports/rpt/mthTreasStmt/mts0218.pdf>.

14. U.S. CBO, "An Update to the Budget and Economic Outlook: 2017–2027," June 2017. <https://www.cbo.gov/system/files/115th-congress-2017-2018/reports/52801-june2017outlook.pdf>.

15. Ibid.

16. Ibid.

17. Ibid.

18. Ibid.