Economic Review - Third Quarter 2016

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Summary

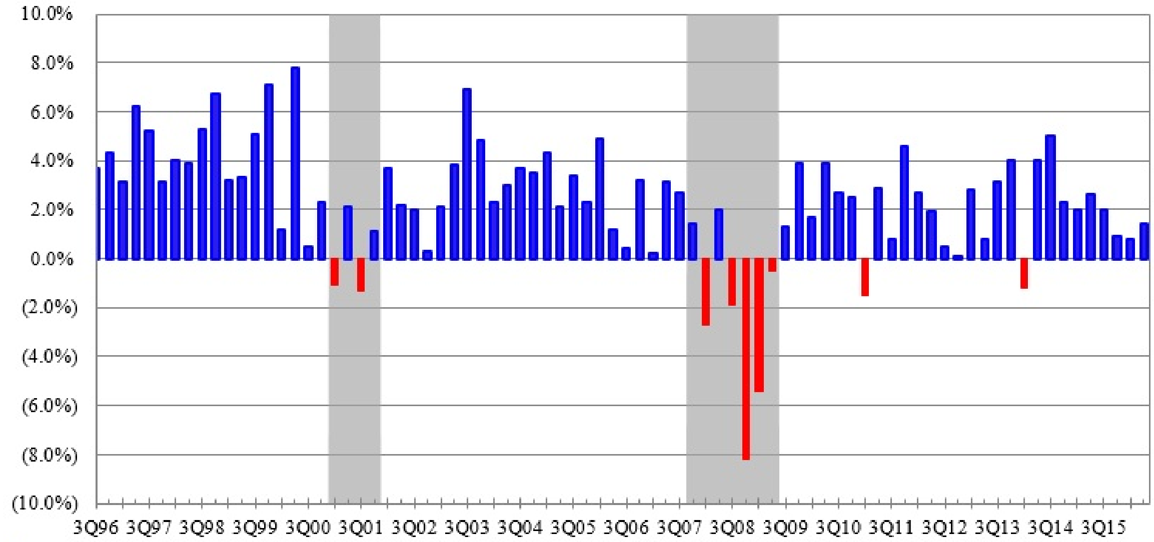
The state of the general economy can help or hinder a business' prospects by influencing the demand for its goods and services and the availability and price of inputs such as capital and labor. The prevailing economic conditions therefore directly impact the value of a business at a specific point in time. The economic recovery following the recession of 2007–2009 continues, but modestly. Following the September 20–21, 2016, meeting of the Federal Open Market Committee (the "Committee") of the Federal Reserve, the Committee issued a statement that economic activity was increasing at a faster pace in the third quarter of 2016 than in the first half of 2016. Although the unemployment rate has not materially changed since the second quarter, labor market conditions have strengthened as total non-farm payroll employment expanded and both the labor force participation rate and the employment-to-population ratio have improved. Industrial production increased slightly in July and August, reflecting improvement in the mining sector. Spending on commercial structures, excluding those related to mining and drilling, increased in June and July. Business spending continued to slowly increase in the third quarter, despite a decline in shipments of non-defense capital goods excluding aircraft in July. Household spending increased as gains in employment, real disposable personal income, and households' net worth continued.

Offsetting these positive developments, however, manufacturing production remained unchanged since June, as weak export demand and spillovers from the decline in crude oil and natural gas drilling weighed on industrial activity. 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 first quarter. The housing sector recovery was modest in the third quarter, as starts on single-family and multi-family homes decreased in July and August, and building permit issuance for new single-family homes has been flat since late 2015.

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 second 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



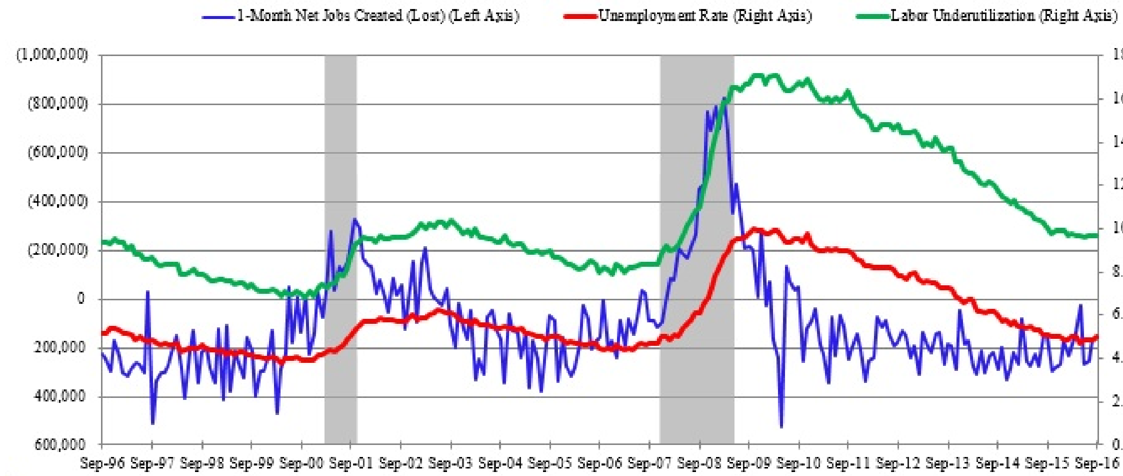
Sources: U.S. Bureau of Economic Analysis and National Bureau of Economic Research.
GDP percent change is based on chained 2009 dollars.

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 79 consecutive months from March 2010 to September 2016, 15.0 million non-farm jobs (net) were created.[1] The unemployment rate peaked at 10.0 percent in October 2009 and reached a low of 4.7 percent in May 2016, the lowest unemployment rate since November 2007.[2] The unemployment rate was 5.0 percent as of September 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 9.7 percent as of September 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.

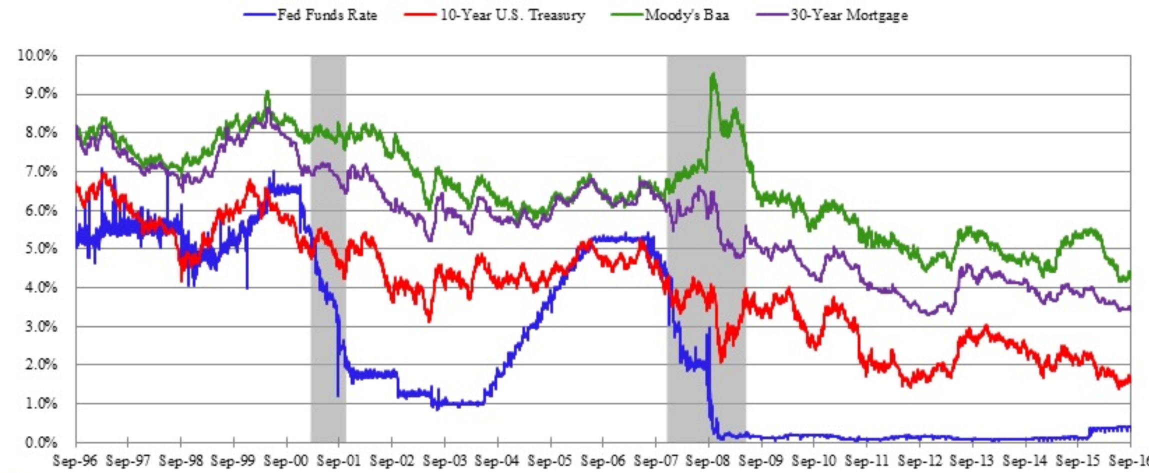
Interest Rates

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 September 20–21, 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 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 third quarter of 2016. Corporate bond spreads narrowed to historical norms and 30-year mortgage rates declined slightly. The Treasury yield curve flattened (shorter-term yields increased more than longer-term yields), as investors sold short-term bills in anticipation of an increase in the federal funds rate. The issuance of commercial and industrial loans declined in the third quarter, but corporate bond issuance was robust. Financing for consumers remained accommodative, as consumer loan balances expanded. There was continued growth in the issuance of commercial real estate loans, although market conditions for residential mortgages remain constrained for borrowers with low credit scores. Mortgage refinancing activity was high in August, reflecting low mortgage rates in June and July. 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 third quarter, with gains early in the quarter on favorable economic data, including payroll reports, consumer confidence readings, retail sales, and housing starts and permits. However, markets dropped towards the end of the quarter, as fears over an interest rate hike at the September 20–21, 2016, meeting unnerved investors, and economic data for the second half of the quarter was modest. All of the major stock market benchmarks recorded gains in the third quarter; the technology-focused NASDAQ Composite Index and Russell 2000 Index grew by more than 9 percent, while the S&P 500 Index rose less as certain sectors underperformed. The information technology sector gained nearly 13 percent in the third quarter, while higher dividend-yielding sectors, including telecommunications and utilities fell nearly 6 percent as expectations grew for competition from higher bond yields. Total returns for U.S. stock indices during the third quarter of 2016 are shown in the following figure.

TOTAL RETURNS OF MAJOR U.S. STOCK INDICES

Index	Third Quarter 2016	Year To Date
S&P 500	3.85%	7.84%
Dow Jones Industrial Average	2.78%	7.21%
NASDAQ Composite (1)	9.69%	6.08%
S&P MidCap 400	4.14%	12.40%
Russell 2000	9.05%	11.46%

Note:
(1) Return represents principal only.

Initial public offering (IPO) activity continued to improve in the third quarter of 2016 with 33 offerings raising $6.1 billion, on par with activity in the third quarter of 2015 (34 offerings raising $5.1 billion) and the median quarterly level of the past decade (32 offerings raising $6.2 billion). The third quarter had the largest IPO of 2016, Japanese messaging app LINE, which raised $1.1 billion and experienced a re-emergence of technology IPOs with 10 offerings (compared to 4 IPOs in the second quarter of 2016 and 1 IPO in the third quarter of 2015). Healthcare IPOs remained the most active sector for IPOs with 11 offerings, while there were 6 offerings from the financial sector, 3 offerings from the consumer sector, and 1 offering each from the materials, energy, and capital goods sectors. Although several private-equity-backed and venture capital-backed companies continue to wait for more favorable public market valuations, the third quarter included 10 private-equity-backed offerings and 13 venture capital-backed offerings. Nevertheless, private equity and venture capital activity still remains below historical levels. Activity for the IPO market for the remainder of 2016 is expected to be tied to certain key events, including the U.S. presidential election, the holiday slowdown, and a potential interest rate increase.

Puerto Rico continues to struggle with its ongoing debt crisis, owing more than $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. The Puerto Rican government signed an emergency moratorium bill in April 2016 that allows it to halt payments on debt owed by the Government Development Bank. On May 2, 2016, Puerto Rico defaulted on $399 million of a $422 million debt payment, paying only $23 million of interest payments. On June 30, 2016, President Obama signed into law a bill that would help Puerto Rico restructure its debt. The bill, named the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), is intended to help address the country's financial problems by providing access to a bankruptcy-like debt restructuring process and creating a seven-member fiscal control board with complete autonomy to control Puerto Rico's budget, laws, financial plans, and regulations. On July 1, 2016, Puerto Rico defaulted on $800 million of general obligation bonds. On August 31, 2016, President Obama named the seven-member board, which met for the first time on September 30, 2016, and appointed Jose Carrion III as chairman. As of September 30, 2016, the economic impact of the Puerto Rican debt crisis remains uncertain.

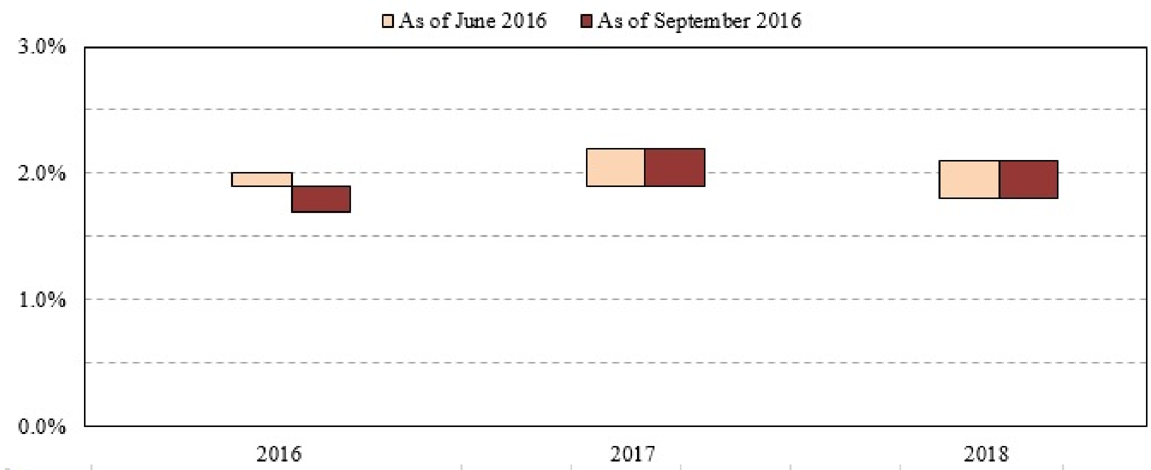
At its August 3, 2016, meeting, the Bank of England's Monetary Policy Committee (MPC) announced a 25 basis point cut in the Bank of England's base interest rate to 0.25 percent, a resumption of its asset purchase program (corporate bond purchases of up to £10 billion and government bond purchases of £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. The Bank of England maintained its policy stance at its September meeting, in line with market expectations. Following the September meeting, a majority of policymakers appeared open to an additional bank rate cut before the end of the year, depending on the forecasts for the economy from the Bank of England's next inflation report in early November.

According to a preliminary estimate by the U.K's Office of National Statistics, the U.K. economy grew by 0.5 percent in the third quarter, compared with 0.7 percent growth in the second quarter. The U.K's GDP was 2.3 percent higher in the third quarter of 2016 than the third quarter of 2015. This release of GDP reflects a full quarter of data following the June referendum. 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, agriculture, and production decreased by 1.4 percent, 0.7 percent, and 0.4 percent, respectively. Once Britain invokes Article 50 of the European Union's Lisbon Treaty, which prime minister Theresa May is expected to do by March 2017, the U.K. has 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. In September, the Federal Reserve lowered its projected growth rates for the U.S. economy for 2016, while 2017 and 2018 remains unchanged. Factors contributing to the lowering of projected growth in 2016 include weaker than expected GDP growth in the first half of this year. 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 August 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 11 months of fiscal year 2016, the federal budget deficit was $621 billion.[4] The CBO's 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.[5] 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.[6] 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.[7] 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.[8]

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.[9]

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, "August 2016 Monthly Treasury Statement of Receipts and Outlays of the United States Government," September 2016. <https://www.fiscal.treasury.gov/fsreports/rpt/mthTreasStmt/mts0816.pdf>.

5. 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>.

6. Ibid.

7. Ibid.

8. Ibid.

9. Ibid.