Economic Review - Third 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 September 19–20, 2017, meeting of the Federal Open Market Committee (the "Committee") of the Federal Reserve, the Committee issued a statement that economic activity increased moderately in the third quarter of 2017 before the impact of Hurricanes Harvey and Irma. Data pertaining to the economic effects of these hurricanes was limited as of the September 19–20, 2017, meeting; however, it appears that economic activity will be restrained only in the near term. Labor market conditions continue to strengthen as non-farm payroll employment expanded, the unemployment rate decreased to 4.2 percent in September, the labor force participation rate increased, and the rate of private sector job openings increased. 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.

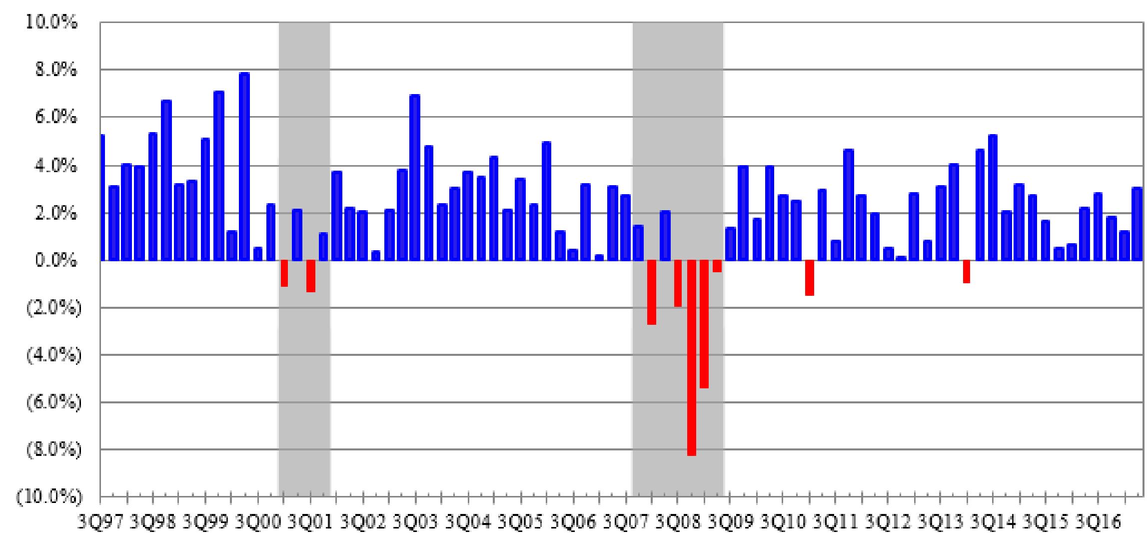
Industrial production increased for a sixth consecutive month in July before declining sharply in August. The hurricanes contributed to the decline in industrial production in August, as the storms impacted the drilling, servicing, and extraction activities of oil and natural gas operations in the Gulf Coast region. The negative impact on industrial production from the storms continued into September; however, certain data indicate that production has already started to recover. Data indicate that household spending increased at a slower rate in the third quarter than the second quarter, as retail sales data used in the U.S. Bureau of Economic Analysis' estimate of the personal consumption expenditures declined, light motor vehicle sales fell, and the hurricanes likely temporarily affected consumer spending. However, continued gains in employment, real disposable personal income, and households' net worth, were supportive of solid growth in household spending.

Housing activity continued to decline in the third quarter, as starts on single-family and multi-family homes, sales on new and existing homes, and building permit issuances for new single-family homes decreased. Private expenditures for business equipment and intellectual property increased in the third quarter, as nominal shipments and new orders of non-defense capital goods excluding aircraft increased. In contrast, spending on commercial structures—excluding those related to mining and drilling—fell in June and July, and the number of crude oil and natural gas rigs in operation leveled out after increasing for the past year.

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 3.0 percent in the second 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

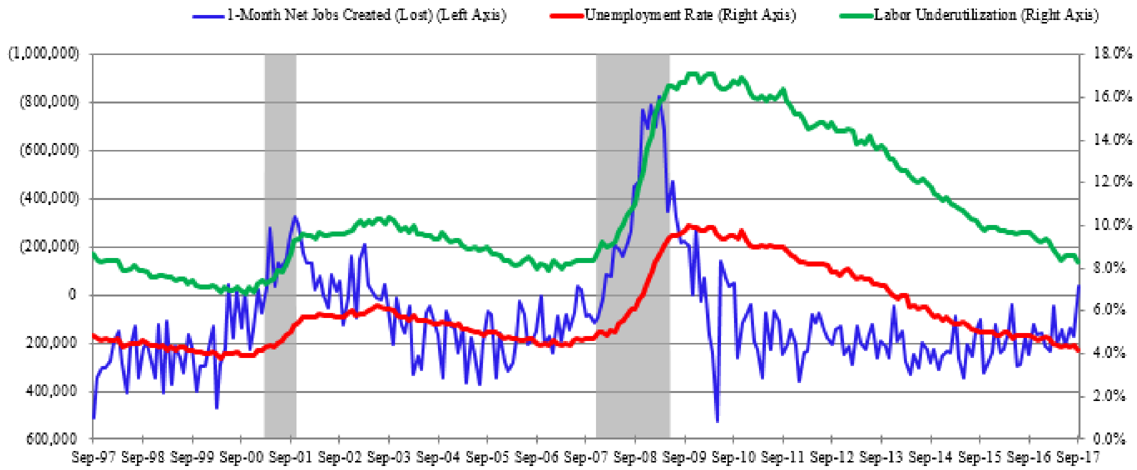


Sources: U.S. Bureau of Economic Analysis and National Bureau of Economic Research.
GDP percent change is based on chained 2009 dollars.

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 91 consecutive months from March 2010 to September 2017, 16.9 million non-farm jobs (net) were created.[2] The unemployment rate peaked at 10.0 percent in October 2009 and reached a low of 4.2 percent in September 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 8.3 percent as of September 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



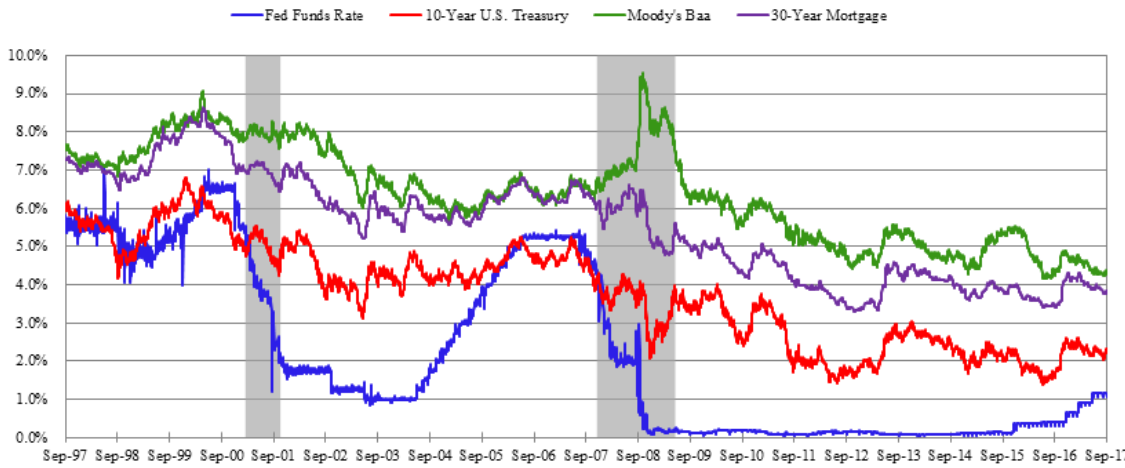
Sources: Department of Labor, Bureau of Labor Statistics, and National Bureau of Economic Research. Data represents non-farm payrolls.

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 September 19–20, 2017, meeting, the Committee considered the outlook for economic activity, the labor market, and inflation. Recent hurricanes were considered by the Committee, as the storm-related disruptions and rebuilding will affect economic activity in the near term; however, past experience indicates that the hurricanes are unlikely to affect economic activity in the medium term. Accordingly, the Committee weighed the uncertainties associated with the outlook and kept the federal funds rate at a range of 1.00-to-1.25 percent. The Committee is continuing its policy of reinvesting proceeds from maturing bonds that it purchased in previous rounds of "quantitative easing."

United States financial markets were supportive of economic growth and employment in the third quarter of 2017. Corporate bond spreads and 30-year mortgage rates were relatively unchanged during the third quarter. However, both short-term and long-term treasury yields increased during the quarter. Treasury-inflation-protected securities increased in the third quarter, in part reflecting the above-expectations inflation data in August. The issuance of commercial and industrial loans increased in the third quarter and corporate bond and equity issuance was strong. Financing for consumers remained accommodative, as consumer loan balances increased at a moderate pace. The issuance of commercial real estate loans moderated in July and August, showing a slowdown in lending to both non-farm non-residential units and construction and land development. However, growth in mortgage lending for home purchases picked up in July and August compared with the second quarter. 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 early on in the third quarter, sparked by better than expected corporate earnings reports in July and early August. More specifically, improved profitability in the energy sector and strong earning gains in the technology sector led the early rise in stocks in the third quarter. However, these early gains were reduced by the middle of August as a result of a number of crucial events: (i) the ongoing conflict between the U.S. and North Korea came to its greatest height as President Trump vowed to meet North Korea's aggression with "fire and fury" and the firing of a missile over Japan; (ii) the President's response to the violence in Charlottesville, Virginia and the subsequent resignations of members from two CEO advisory councils and the ultimate disbanding of the councils; and (iii) rumors that the President's chief economic advisor was going to resign, which the White House quickly denied. Thereafter, in late August, stocks rallied following a report that Republican lawmakers were making progress on tax reform legislation. The GOP eventually released its tax reform proposal at the end of September, with details to lower the top individual tax rate, eliminate the alternative minimum tax, and treat corporate profits accumulated overseas as already repatriated. For the remainder of the quarter, the market seemed relatively unmoved by the hurricanes that made landfall in the U.S. and other natural disasters, as there was no clear understanding at that time to what extent these events would affect the economies of the affected regions in the long term.

The major stock market benchmarks recorded gains in the third quarter, bringing the returns of all of the benchmarks except the S&P MidCap 400 Index into the double digits for the year-to-date period. However, trading volumes were subdued in the third quarter, especially in the typically quiet month of August. Information technology stocks were the best performer within the S&P 500 Index, followed by energy, telecommunication services, and materials stocks. Consumer staples underperformed in the third quarter, the only sector to record a loss, followed up by the modest gains recorded by consumer discretionary and real estate stocks. Overall, small cap stocks edged out large cap stocks slightly, while mid cap stocks fell behind small and large cap stocks. Total returns for U.S. stock indices during the third quarter of 2017 are shown in the following figure.

TOTAL RETURNS OF MAJOR U.S. STOCK INDICES

Index	Third Quarter 2017	Year To Date
S&P 500	5.58%	15.45%
Dow Jones Industrial Average	4.48%	14.24%
NASDAQ Composite (1)	5.79%	20.67%
S&P MidCap 400	3.22%	9.40%
Russell 2000	5.67%	10.94%

Note:
(1) Return represents principal only.

The number of initial public offerings (IPOs) and the amount of capital raised in the third quarter of 2017 were less than the strong activity and proceeds seen in the first two quarters of 2017, with 29 IPOs raising $4.1 billion. In comparison, the IPO market had 25 IPOs raising $9.9 billion in the first quarter and 52 IPOs raising $10.6 billion in the second quarter. Additionally, the third quarter of 2017 was the slowest third quarter of the past five years, and below the 10-year average of 33 IPOs. Activity continued to be limited by weakness in the retail and energy sectors and the decision by technology companies to remain private until receiving higher valuations. Despite a slow third quarter, IPO returns averaged 36 percent, driven by biotechnology companies. Biotechnology companies represented one out of three IPOs this quarter, remaining active for two consecutive quarters. The third quarter's 10 biotechnology IPOs averaged a return of 69 percent.

The Trump administration and members of the Republican Party have continued to pursue the "repeal and replace" of the Affordable Care Act (ACA) in the third quarter of 2017. Before the beginning of the third quarter, the Senate introduced a revision to the American Health Care Act named the Better Care Reconciliation Act. On July 25, Senate Republicans introduced a stripped down version of the health care bill designed to pass the motion to proceed to floor debate. The motion was ultimately passed 51 to 50, with the tie broken by Vice President Mike Pence. On July 26, the Senate rejected a "clean repeal" bill without a replacement for the ACA, and on July 28, the Senate voted against a "skinny repeal" bill, with a crucial no vote from Senator John McCain. The "skinny repeal" bill, officially known as the Health Care Freedom Act, would have eliminated parts of the ACA, including the individual and employer mandates. On September 13, an amendment to the American Health Care Act was introduced by Senators Lindsey Graham and Bill Cassidy. Key provisions of the amendment include the repeal of the ACA, a return of control of the Medicaid program to the states, and a cap on Medicaid's funding. A vote on the Graham-Cassidy amendment has yet to happen as of the end of the third quarter, leaving the status of health care reform uncertain.

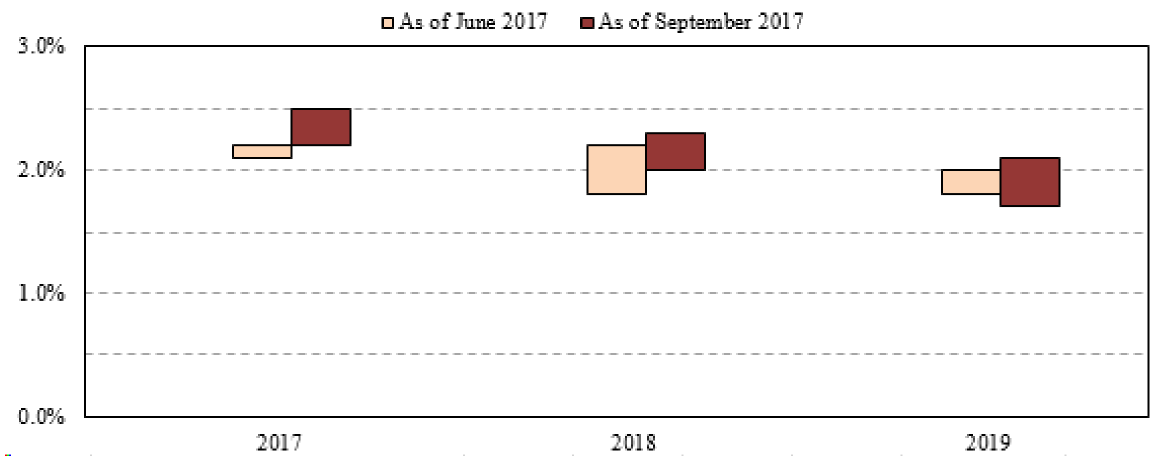
On September 22, newly elected President Emmanuel Macron signed five decrees overhauling France's labor rules, making it easier for companies to hire and fire employees, simplifying negotiations between employers and employees, and reducing the power of collective bargaining. These measures are an attempt to stimulate both economic growth and job creation. Among the decrees are some more contentious reforms, such as a cap on the financial penalties awarded by labor courts in the event of dismissals recognized as wrongful and an ease on regulations governing when and why companies can dismiss workers.

On September 24, Angela Merkel was re-elected to a fourth term as German Chancellor after the election for Germany's 19th Bundestag, the country's federal parliament. Merkel's party, the center-right Christian Democrat Union (CDU) and its Bavarian ally the Christian Social Union (CSU) won 33 percent of the vote, its worst result since 1949, while Merkel's junior "grand coalition" partner, the center-left Social Democratic party (SPD), took 21 percent of the vote. The SPD announced that it would not participate in a renewal of the "grand coalition," leaving a three-way coalition between the CDU/CSU party, the Free Democratic Party (FDP), and the Alliance 90/The Greens party as the only possible majority government. The far right, anti-immigration Alternative for Germany (AfD) party won 13 percent of the vote, becoming the first right wing nationalist party to sit in the Bundestag in 60 years.

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 August 2017 Monthly Treasury Statement of Receipts and Outlays of the United States Government states that the federal budget deficit for the first 11 months of fiscal year 2017 was $674 billion, in comparison to $586 billion for fiscal year 2016.[5] The Congressional Budget Office's (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.[6] Real GDP is projected to grow 2.2 percent in calendar year 2017 and 2.0 percent in calendar year 2018.[7] 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.[8] 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.[9]

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.[10]

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

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.

5. U.S. Department of Treasury, "August 2017 Monthly Treasury Statement of Receipts and Outlays of the United States Government," September 2017. <https://www.fiscal.treasury.gov/fsreports/rpt/mthTreasStmt/mts0817.pdf>.

6. 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>.

7. Ibid.

8. Ibid.

9. Ibid.

10. Ibid.