Economic Review - Second Quarter 2016

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.

Summary

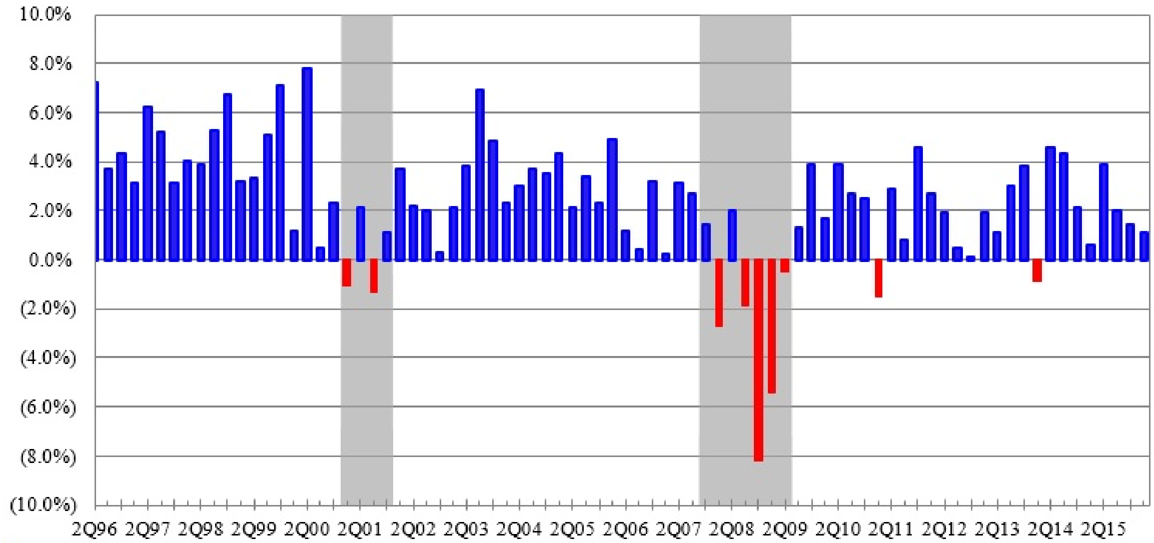
Following the June 14–15, 2016, meeting of the Federal Open Market Committee (the "Committee") of the Federal Reserve, the Committee issued a statement that economic activity improved modestly in the second quarter of 2016. Industrial production increased in April, reflecting an improvement in the output of utilities and a moderate increase in manufacturing production. The housing sector has continued its gradual recovery as single-family and multi-family home starts increased. Household spending increased as real disposable income grew in March and April, and household net worth was bolstered by an increase in home values. After declining sharply in the first quarter, business spending stabilized early in the second quarter.

Offsetting these positive developments, however, mining output continued to contract as drilling activity, crude oil extraction, and coal production declined. Shipments of non-defense capital goods excluding aircraft increased modestly in April although spending on commercial structures excluding mining and drilling was flat in March and April. 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. Although labor market conditions improved slightly, this improvement was partially due to a decrease in the labor force. Total non-farm payroll employment gains also slowed in April and May.

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 1.1 percent in the first 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



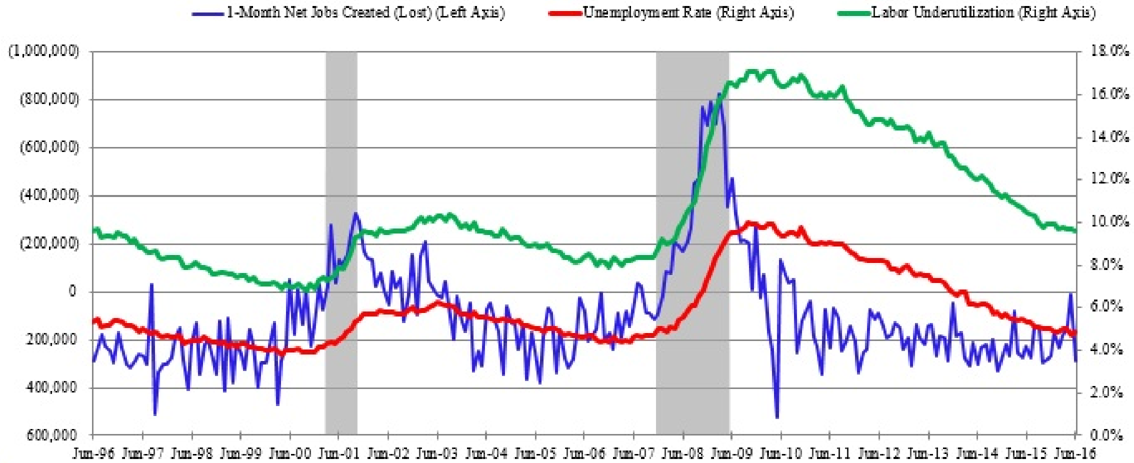
Sources: U.S. Bureau of Economic Analysis and National Bureau of Economic Research.
GDP percent change is based on chained 2009 dollars.

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 76 consecutive months from March 2010 to June 2016, 14.4 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 4.9 percent as of June 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 9.6 percent as of June 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.

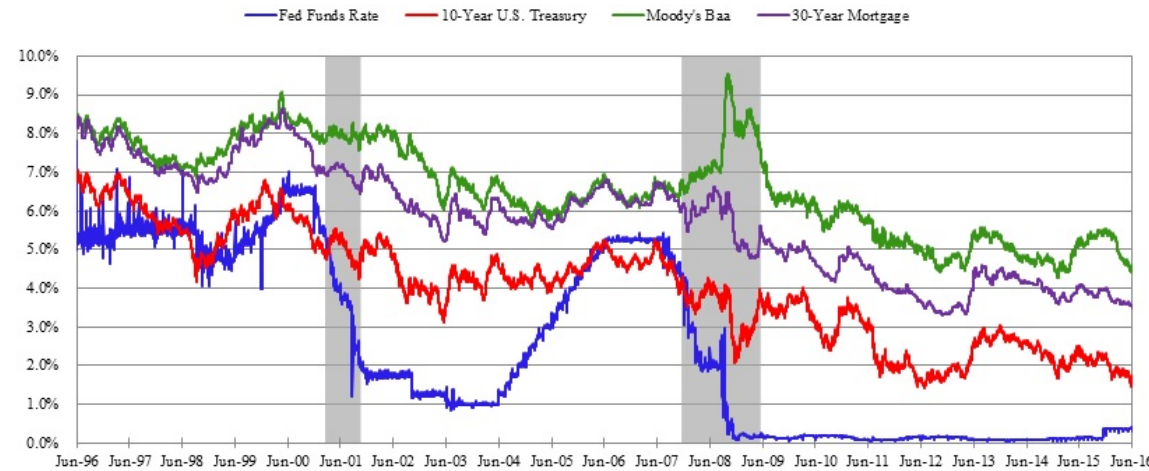
Interest Rates

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 June 14–15, 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 second quarter of 2016. Corporate bond spreads narrowed and 30-year mortgage rates declined. The Treasury yield curve flattened as yields on long-term nominal Treasury securities have declined, reflecting a deterioration in global risk sentiment following the release of mixed employment data. Growth in the issuance of commercial and industrial loans was solid, and corporate bond issuance was robust. Financing for consumers remained accommodative, as consumer loan balances expanded. Financing for commercial real estate was also supportive of economic growth, with loans increasing during April and May, 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 showed modest gains in the second quarter, with considerable volatility at the end of the quarter due to Britain's vote to exit the European Union ("Brexit"). The energy sector gained nearly 12 percent in the second quarter amid a partial rebound in oil prices. Amid falling bond yields, higher dividend-yielding sectors, including telecommunications, utilities, REITs, and consumer staples improved; however, more cyclical sectors, including technology and consumer discretionary recorded losses. Most of the major stock market benchmarks recorded gains in the second quarter; however, the technology-focused NASDAQ Composite declined. Total returns for U.S. stock indices during the second quarter of 2016 are shown in the following figure.

TOTAL RETURNS OF MAJOR U.S. STOCK INDICES

Index	Second Quarter 2016	Year To Date
S&P 500	2.46%	3.84%
Dow Jones Industrial Average	2.07%	4.31%
NASDAQ Composite (1)	-0.56%	-3.29%
S&P MidCap 400	3.99%	7.93%
Russell 2000	3.79%	2.22%

Note:
(1) Return represents principal only.

Following the slowest quarter for initial public offerings (IPOs) since 2009 (eight IPOs collectively raising $700 million in the first quarter of 2016), IPO activity improved in the second quarter of 2016 with 34 offerings raising $5.5 billion. The healthcare sector accounted for 15 of the 34 IPOs (44 percent). Although IPO activity was in line with the third and fourth quarters of 2015, with 34 and 32 IPOs, respectively, this level is nevertheless below the second quarter's historical average of 40 to 50 IPOs. Venture capital-backed technology companies appear to be taking a "wait and see" approach due to lower-than-expected public market valuations, disappointing trading of 2015-vintage IPOs (68 percent of which are trading below their issue prices), and uncertainty surrounding Brexit and the path of future interest rates.

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. Additionally, 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 May 2, 2016, Puerto Rico defaulted on $399 million of a $422 million debt payment, paying only $23 million of interest payments. As of June 30, 2016, the economic impact of the Puerto Rican debt crisis remains uncertain.

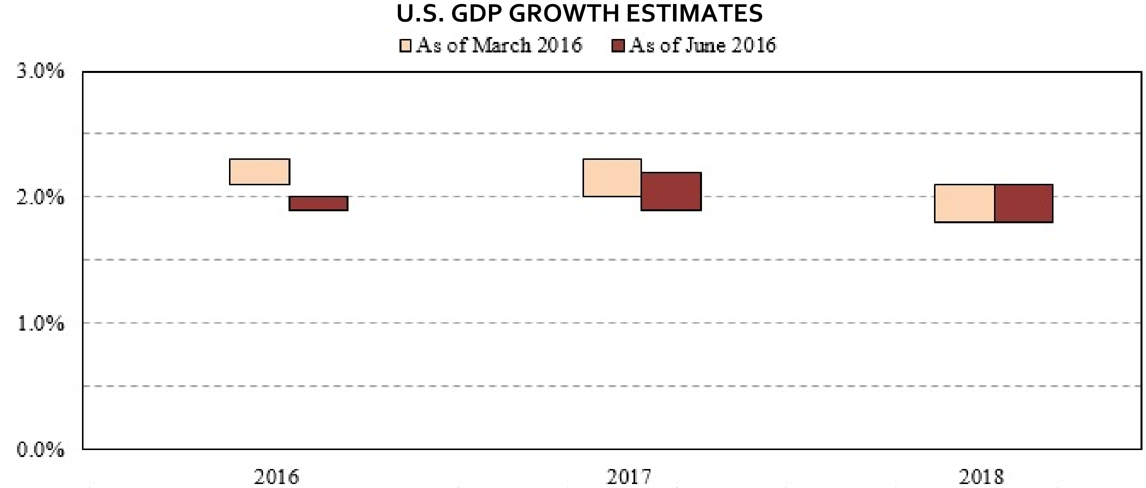
On June 23, 2016, Britain held a referendum whether to remain a member of the European Union or to leave. Ultimately, with 52 percent of the votes, the voters chose to leave. The result initially had a large impact on global markets. In the two trading days following the vote, the Dow Jones Industrial Average Index dropped nearly 900 points and major indices in London, Paris, and Frankfurt dropped between 2.5 percent and 3.0 percent. In total, about $3.6 trillion of global equity value was lost immediately after the referendum. The vote also led to a 31-year low value of the British pound.

After the initial two-day losses, markets began to stabilize. The British government has yet to begin the process of negotiating the terms of the country's exit, which can take up to two years. The decision to leave the European Union has investors questioning whether other countries will follow, and how banks will perform if central banks cut interest rates in the future.

Outlook

Various statistical reporting agencies provide estimates of the U.S. economy's near-term and longer-term growth rates. In June, the Federal Reserve lowered its projected growth rates for the U.S. economy for 2016 and 2017, while 2018 remains unchanged. Factors contributing to the lowering of projected growth in 2016 and 2017 include weaker than expected GDP growth in the first quarter and a poor outlook for business spending. 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 May 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 eight months of fiscal year 2016, the federal budget deficit was $407 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]

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, "May 2016 Monthly Treasury Statement of Receipts and Outlays of the United States Government," June 2016. <https://www.fiscal.treasury.gov/fsreports/rpt/mthTreasStmt/mts0516.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.