Economic Review - Second 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.

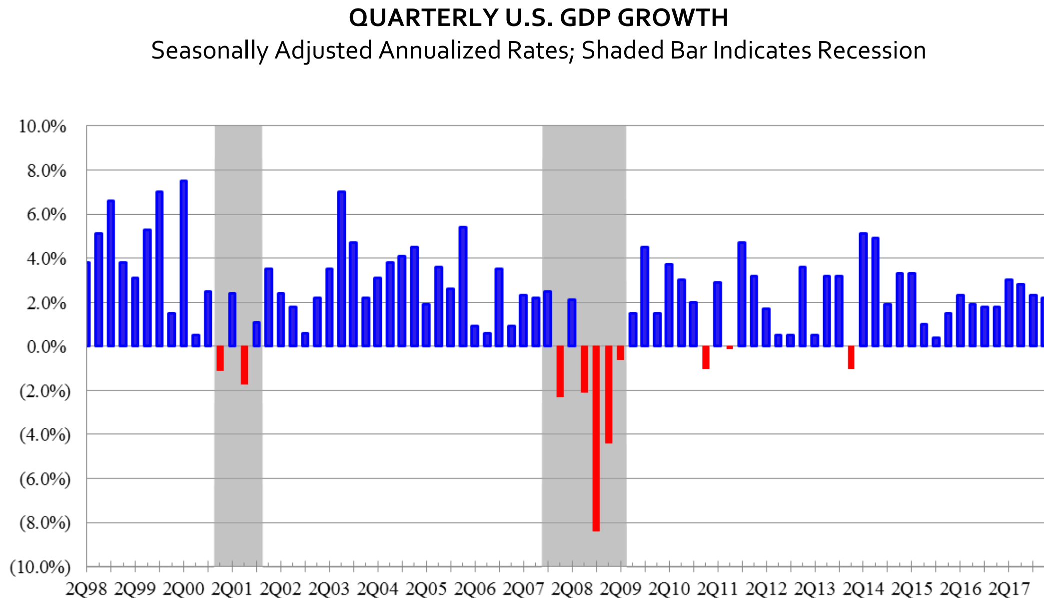
Following the June 12-13, 2018, meeting of the Federal Open Market Committee (the "Committee") of the Federal Reserve, the Committee issued a statement that economic activity increased at a solid rate in the second quarter of 2018. Labor market conditions continued to strengthen in the second quarter as non-farm payroll employment expanded, the unemployment rate decreased to a low of 3.8 percent in May, and the labor force participation rate declined, although the rate remained similar to a year earlier. Additionally, the rate of private sector job openings grew steadily with the expanding economy, and average hourly earnings continued to increase over the past year.[2] U.S. consumer price inflation and core price inflation, which excludes consumer food and energy prices, have approached the Committee's long-run objective of 2.0 percent.

Industrial production continued to increase in the second quarter of 2018. Household spending continued to grow in the second quarter, supported by gains in employment, real disposable income, and the tax cuts in December 2017. Housing activity was poor, with starts on single-family homes maintaining pace with first quarter growth, and starts on multi-family home sales and sales of new and existing homes declining. Real private expenditures increased moderately in the second quarter after robust growth in the first quarter. Nominal shipments and new orders of non-defense capital goods excluding aircraft increased in April, and forward-looking indicators show near-term optimism. Additionally, real business spending for nonresidential buildings and the number of crude oil and natural gas rigs in operation have expanded in the second 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 2.2 percent in the first quarter of 2018. 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

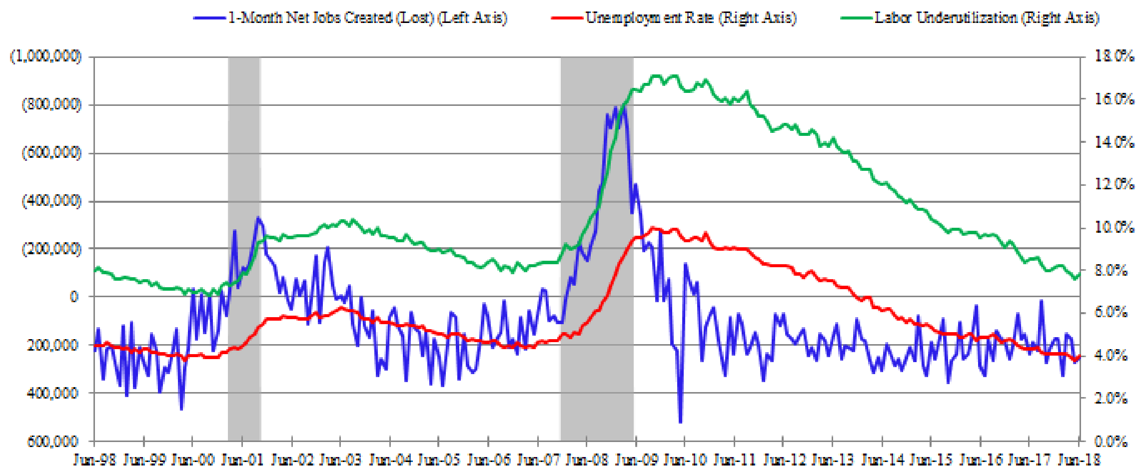


Sources: U.S. Bureau of Economic Analysis and National Bureau of Economic Research.
GDP percent change is based on chained 2012 dollars.

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 100 consecutive months from March 2010 to June 2018, 19.2 million non-farm jobs (net) were created.[3] The unemployment rate peaked at 10.0 percent in October 2009, and has since reached 3.8 percent in May, the lowest unemployment rate since April 2000,[4] and finished the second quarter at 4.0 percent. 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 7.8 percent as of June 2018, its lowest level since 2001.[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



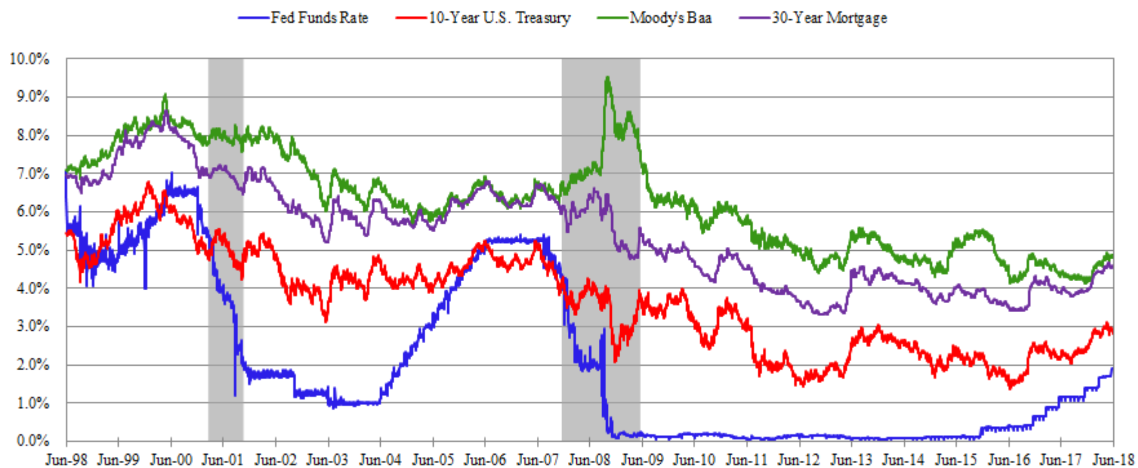
Sources: Department of Labor, Bureau of Labor Statistics, and National Bureau of Economic Research. Data represents non-farm payrolls.

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 June 12-13, 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 1.50-to-1.75 percent to a range of 1.75-to-2.0 percent. The Committee expects that gradual increases in the target range for the federal funds rate to be consistent with the sustained growth of economic activity, labor conditions, and inflation near the Committee's symmetric 2 percent objective over the medium term.

United States financial markets were supportive of economic growth and employment in the second quarter of 2018. Both corporate bond spreads and 30-year mortgage rates increased moderately over the quarter, but corporate bond spreads remained near the lower end of their historical range. Additionally, both short-term and long-term Treasury yields increased slightly during the quarter. Measures of inflation compensation based on treasury-inflation-protected securities remained relatively unchanged. Municipal bond issuance was solid in the second quarter, recovering from a slower pace in the first quarter. The issuance of institutional leveraged loans was strong; however, corporate bond issuance slowed, likely reflecting seasonal patterns. Financing conditions for consumers supported growth in household spending; however, consumer credit slowed and financing for consumers with sub-prime credit scores continued to tighten. Conditions for commercial real estate loans remained accommodative, although the growth in loans held by banks declined in the second quarter. Conditions for residential mortgage financing remained accommodative for most borrowers, except for borrowers with low credit scores. 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

Some of the momentum from March carried into the second quarter as all the major benchmarks reported gains. Optimism in the market was fueled by corporate earnings exceeding expectations following the December 2017 tax cuts; however, volatility in the market in the first quarter speculation of further trade disputes increased.

The stock market became more stable as volatility lessened during the second quarter, especially when compared to the first quarter. Strong corporate earnings reports in the second quarter raised expectations; however, the retaliatory tariffs placed on U.S. goods by China fueled fear of an escalating trade war. Not only is there general uncertainty about how these trade disputes will escalate, but also in terms of how current tariffs will impact domestic producers and consumer activity. Producers that use inputs from targeted Chinese sectors will face higher production prices; therefore, consumers will be faced with higher prices for a wide range of goods.

The major stock market benchmarks posted modest gains in the second quarter, although performance varied. The Chicago Board Options Exchange Volatility Index (VIX) subsided from multi-year highs in past quarters, although the market continued to have large price swings. The NASDAQ Composite Index outperformed the S&P 500 Index and Dow Jones Industrial Average Index, led by returns from "mega-cap" technology companies. The Russell 2000 Index led the major benchmarks in the second quarter, while escalating trade tensions weighed on the Dow Jones Industrial Average Index, especially on general export-focused stocks. Energy stocks performed best as oil prices continued to rise amid multi-year highs, while industrials and business services, financials, and consumer staples stocks were among the weakest performers in the second quarter. Total returns for U.S. stock indices during the second quarter of 2018 are shown in the following figure.

TOTAL RETURNS OF MAJOR U.S. STOCK INDICES

Index	Second Quarter 2018	Year To Date
S&P 500	3.4%	2.6%
Dow Jones Industrial Average	1.3%	(0.7%)
NASDAQ Composite (1)	6.3%	8.8%
S&P MidCap 400	4.3%	3.5%
Russell 2000	7.8%	7.7%

Note:
(1) Return represents principal only.

The second quarter of 2018 had exceptional growth for initial public offerings (IPOs), with 60 IPOs raising $13.1 billion, making the second quarter the most active quarter for IPOs since the second quarter of 2015. IPOs averaged a 29 percent return, outperforming major stock market benchmarks, driven predominantly by an average return of 61 percent for technology IPOs. Health care continued to dominate IPO activity, accounting for over 40 percent of all IPOs in the second quarter. The second quarter finished strong, with June 2018 being the busiest month in three years. The IPO market, now halfway through 2018, is outpacing 2017 by about 40 percent in both issuance and capital raised.[6]

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 the elimination 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.[7] However, enacting the tax law would lead to an increase in the federal budget deficit of $1.455 trillion from 2018 to 2027.[8] 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.[9] While the tax bill was passed late in the fourth quarter of 2017, its effects were still relevant in this year's second quarter, which was most evident from strong corporate earnings reports and increases in real disposable income.

Trade

Following the tariffs imposed on residential washing machines and solar cells and modules imposed by the United States, China responded with retaliatory tariffs on April 2. China placed tariffs equal to $2.4 billion of mainly agricultural goods from the United States. The Trump administration responded in June by providing a list of Chinese technology imports worth $50 billion that will receive a 25 percent tariff. China responded again by providing a similar list of U.S. imports worth $50 billion that could face up to 25 percent tariffs starting in July 2018.[10] The United States' tariffs targeted China's industrial sector, while China focused on many agricultural products, including soybeans, pork, and wheat. The second

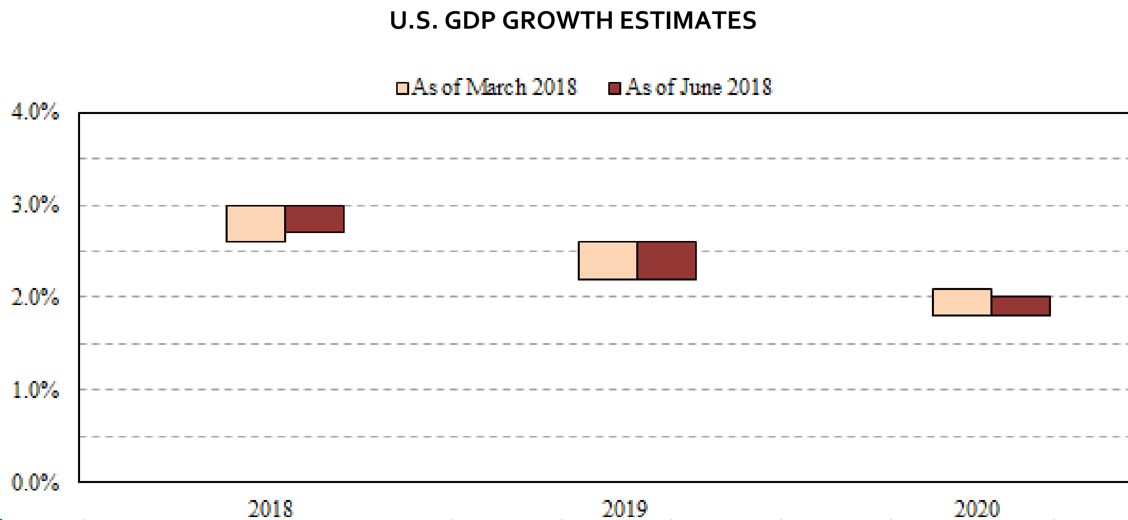
quarter ended with the Trump Administration outlining additional goods from China worth $200 billion that could receive 10 percent tariffs.

The escalating trade tensions have led to a chain of retaliatory tariffs from both countries and there is no indication of returning to a free trade environment anytime soon.

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 remained relatively unchanged from March to June. 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 31, 2018, Treasury Statement of Receipts and Outlays of the United States Government states that the federal budget deficit for the first eight months of 2018 was $32 billion, in comparison to $666 billion for fiscal year 2017.[11] The CBO April 2018 report expects that the growth in real GDP for 2018 and 2019 will be driven by consumer spending and business investment, which will also be supported by federal spending.[12] Real GDP is projected to grow 3.3 percent in calendar year 2018, 2.4 percent in calendar year 2019, and 1.8 percent in calendar year 2020.[13] The CBO estimates excess demand that is expected to occur over the next few years will push up inflation and interest rates which will, in effect, exert downward pressure on the unemployment rate, which was already below the natural rate in 2017. Higher interest rates are expected to slow the growth of output, and excess demand is expected to begin to diminish after 2019.[14] Real GDP is expected to grow, on average, at an annual rate of 1.8 percent in 2020, 1.5 percent from 2021 through 2022, and 1.7 percent from 2023-2028.[15]

Inflation, as measured by the Core Consumer Price Index, which excludes the effects of food and energy, is forecasted to be 2.3 percent in 2018, 2.5 percent in 2019, 2.6 percent in 2020, and average 2.5 percent per year from 2021 to 2022, and remain at an average of 2.4 percent in the 2023-2028 period. [16]

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. 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. Renaissance Capital, "US IPO Market: 2Q 2018 Quarterly Review," June 28, 2018. <https://www.renaissancecapital.com/review/2Q18_US_Review_IPO_Pro.pdf>.

7. 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>.

8. Ibid.

9. 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>.

10. Office of United States Trade Representative, "USTR Issues Tariffs on Chinese Products in Response to Unfair Trade Practices," June 15, 2018. <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2018/june/ustr-issues-tariffs-chinese-products>.

11. U.S. Department of the Treasury, "Monthly Treasury Statement," May 31, 2018. <Departmenthttps://www.fiscal.treasury.gov/fsreports/rpt/mthTreasStmt/mts0518.pdf>.

12. U.S. CBO, "The Budget and Economic Outlook: 2018 to 2028," April 2018. <https://www.cbo.gov/system/files/115th-congress-2017-2018/reports/53651-outlook.pdf>.

13. Ibid.

14. Ibid.

15. Ibid.

16. Ibid.