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VIEWPOINT

A Stephens Inc. Economic and Financial Commentary
by Thomas Goho, Ph.D., Chief Economic Consultant

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Victory in a major bowl game by one's favorite football team can often lighten mid-winter blues. Likewise, positive economic news may alleviate winter gloom for investors and economists. Let's hope the good economic reports in late 2015 were just the kickoff for this winter's economy. These upbeat reports include:

- Positive economic growth in the third quarter even though the headline number looked a little weak
- Strong consumer spending
- Optimistic housing industry reports
- Strong employment conditions with multi-decade lows in initial jobless claims
- Muted inflation aided by low commodity prices
- Hesitancy by the Federal Reserve to raise short term interest rates—merely a quarter percent in late December
- A two-year budget agreement in Congress , which should postpone government funding issues

These reports provide a clear indication of the **potential** for the U.S. economy in 2016.

Economic Growth

The headline Gross Domestic Product (GDP) in the third quarter of 2015 grew at what appeared to be an anemic 2.0%. (*See Figure 1.*) But the real story is more positive. The real growth in the economy was close to 2.7%, but a one-time subtraction of .71% for inventory reduction occurred in the third quarter. Most economists would ignore the ephemeral change in inventories.

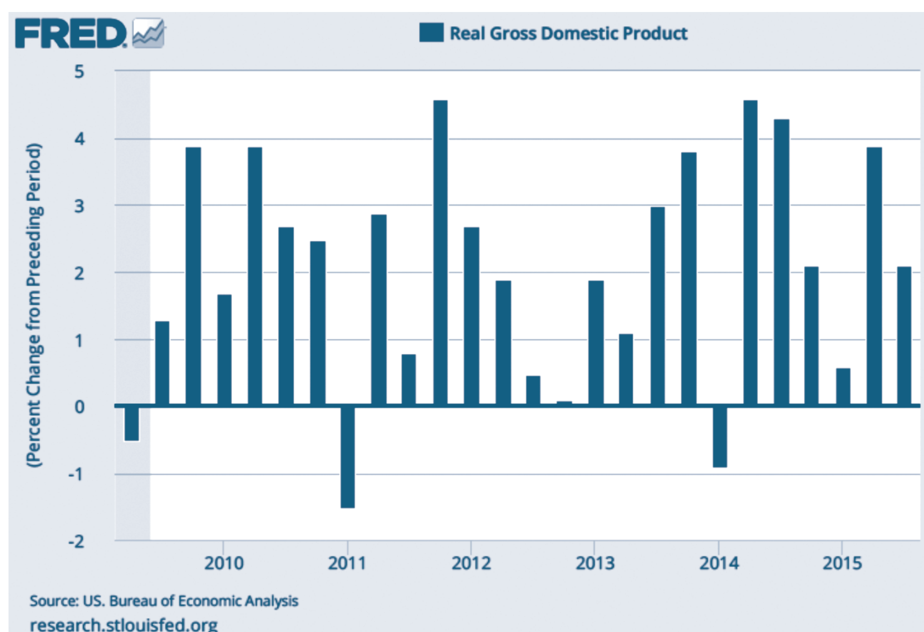
Figure 1:
Change in Real Gross Domestic Product (2013 to Present)

	2013	2014				2015		
	4th	1st	2nd	3rd	4th	1st	2nd	3rd
Final Sales	3.96	0.40	3.46	4.34	2.13	-0.23	3.94	2.73
Consumption	2.36	0.85	2.60	2.34	2.86	1.19	2.42	2.04
Fixed Investment	0.79	0.91	0.87	1.23	0.39	0.52	0.83	0.60
Nonresidential	1.05	1.00	0.56	1.12	0.09	0.20	0.53	0.33
Residential	-0.26	-0.09	0.31	0.11	0.31	0.32	0.30	0.27
Government	-0.51	0.00	0.21	0.33	-0.26	-0.01	0.46	0.32
Federal	-0.49	0.02	-0.08	0.26	-0.41	0.08	0.00	0.02
State and Local	-0.01	-0.03	0.29	0.07	0.15	-0.09	0.46	0.30
Net Exports	1.26	-1.39	-0.24	0.39	-0.89	-1.92	0.18	-0.26
Changes in Inventory	-0.08	-1.29	1.12	-0.01	-0.03	0.87	0.02	-0.71
Real GDP Growth	3.82	-0.92	4.57	4.28	2.07	0.64	3.92	1.98

Source: Federal Reserve Bank of St. Louis. *National Economic Trends*. November 2015.

The quarterly changes in GDP over the past five years (*See Figure 2.*) are very similar to the two-year changes shown above—quarters of strong growth followed by weak or negative growth. This erratic change is a characteristic of this current recovery.

Figure 2:
Change in Gross Domestic Product (2009 Q4 to Present)



Source: Federal Reserve of St. Louis. Extracted from the Federal Reserve Economic Database (FRED) on December 18, 2015.

In simplest terms, the current recovery is characterized by growth in GDP of about 2.2%. This growth rate is weaker than most post-World War II recoveries but comparable to several of the recent ones. (*See Figure 3.*)

Figure 3:
GDP Growth Rates During Post-World War II Presidencies

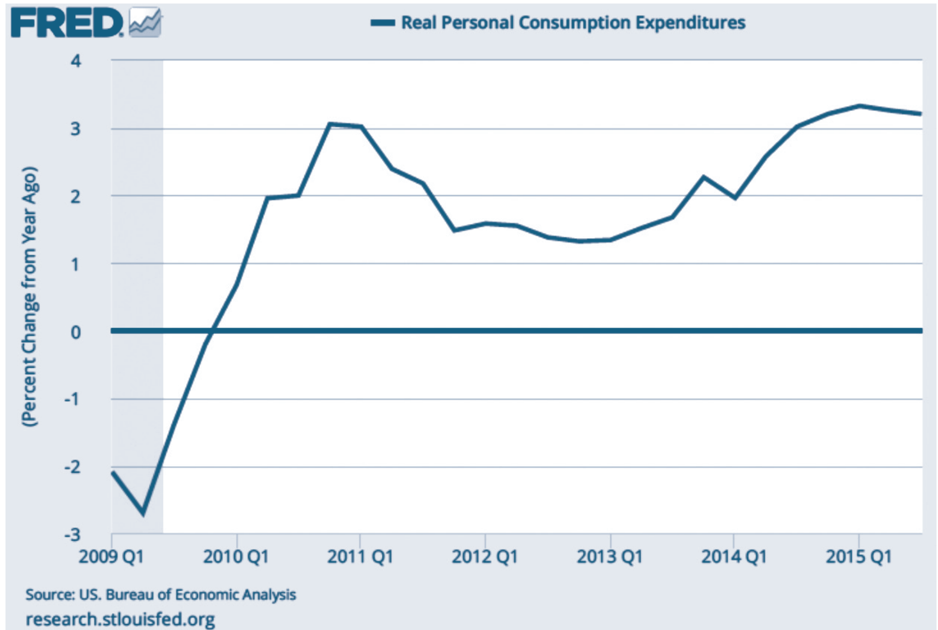
President	Average GDP Growth
Truman	4.8%
Eisenhower	2.4
Kennedy	5.2
Johnson	5.1
Nixon	3.1
Ford	2.2
Carter	3.3
Reagan	3.5
Bush (GHWB)	2.2
Clinton	3.8
Bush (GWB)	1.7
Obama	2.2

Source: The Washington Post.com. “The Clinton economy, in charts.” (by Dylan Matthews). September 6, 2012. And author’s calculations.

Notwithstanding the weak growth during both the George W. Bush and the Barack Obama presidencies, hopeful signs for additional growth are present in recent government reports.

Real personal consumption, the largest component of GDP, is strong. (*See Figure 4.*) For the last 12 months real personal consumption has grown in excess of 2%, and for the past two quarters the economy has grown at a rate of over 3%. These rates are measured after removing the effects of inflation.

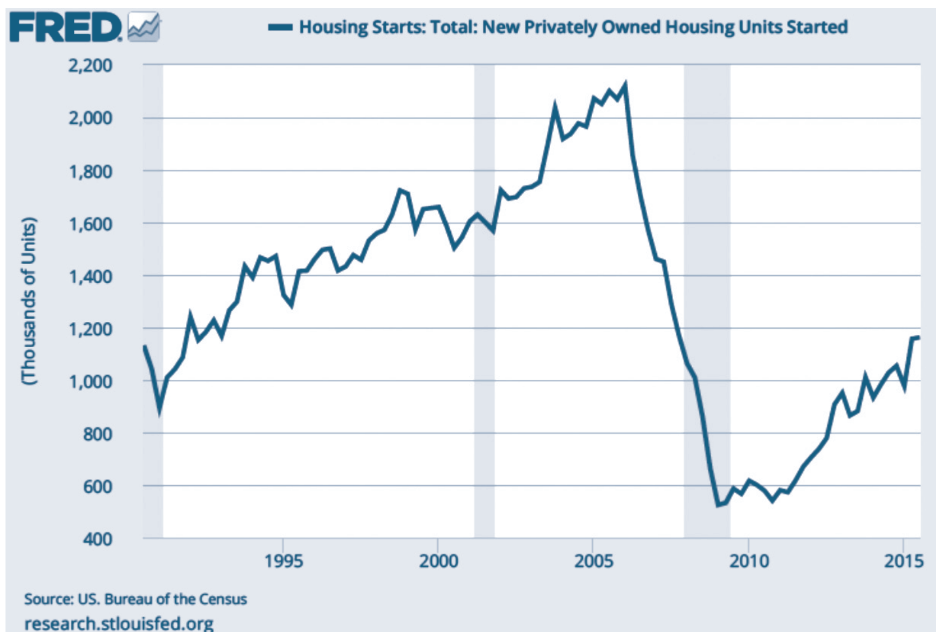
Figure 4:
Change in Real Personal Consumption Expenditures. (2009 to Present)



Source: Federal Reserve of St. Louis. Extracted from the Federal Reserve Economic Database (FRED) on December 18, 2015.

Residential investment strength is also contributing to GDP. U.S. housing starts have more than doubled since the depths of the recession in 2009. (*See Figure 5.*) However, the number of starts is far below those in the peak of the housing bubble in 2005-7.

Figure 5:
Housing Starts Seasonally Adjusted (1990 to Present)

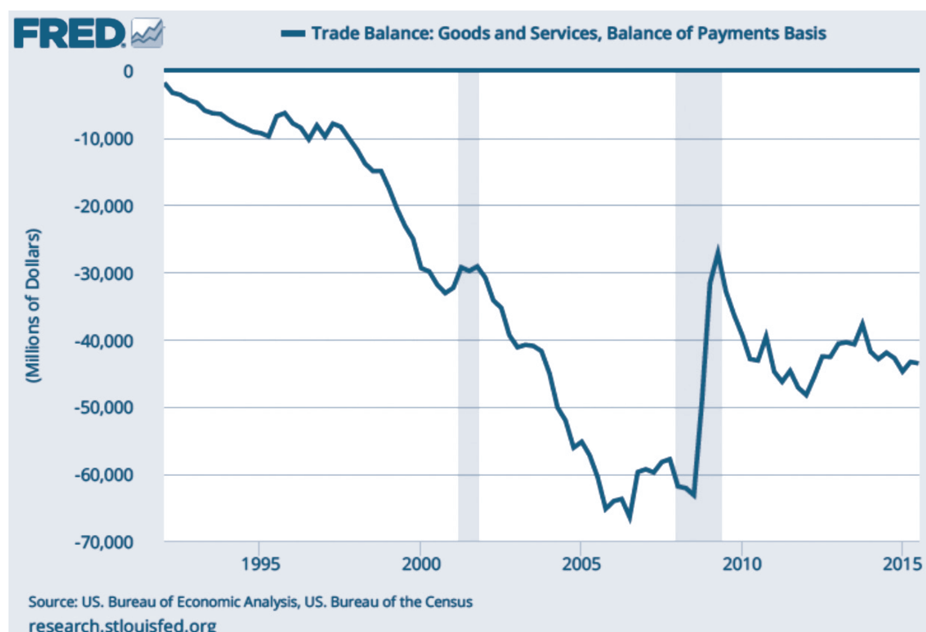


Source: Federal Reserve of St. Louis. Extracted from the Federal Reserve Economic Database (FRED) on December 20, 2015.

The current level of housing starts is probably more indicative of a healthy housing market than the conditions that prevailed during the housing bubble when far too many houses were built and sold to financially less-qualified buyers.

A third component of strength in the recent GDP is the **modest** negative impact of trade on domestic GDP. In a normal business cycle as the economy improves, the U.S. trade balance deteriorates because consumers purchase larger amounts of imported goods. This deterioration has not occurred in the current recovery. (*See Figure 6*.)

Figure 6:
Trade Balance: Goods and Service (1990 to Present), Seasonally Adjusted



Source: Federal Reserve of St. Louis. Extracted from the Federal Reserve Economic Database (FRED) on December 20, 2015.

Figure 6 shows a significant deterioration in America's trade balance as recoveries progressed during the Clinton and G.W. Bush presidencies. In the current recovery, the trade balance stabilized at a deficit of about $45 billion per month or about $.5 trillion on an annual basis. Almost all of that improvement is attributable to the drop in energy imports as the U.S. ramped up oil and gas production via fracking in places like North Dakota and Texas.

Is a trade deficit of $.5 trillion per year an optimal situation? Absolutely not. But it is far better than the $.75 trillion trade deficit the U.S. was experiencing during the last decade. That difference of $250 billion per year is being spent domestically instead of seeping out of the U.S. economy. This improvement in the trade deficit is another positive factor in the U.S. GDP story.

Best Guess on U.S. Economic Growth

The combination of strong housing, solid consumer spending, and stabilized trade will support economic growth in 2016. Economic growth as measured by real GDP will be about 2.5%. In other words, the economy will experience growth in line with rates that have prevailed through the current recovery. The economy will score a field goal but no touchdown.

U.S. Labor Markets

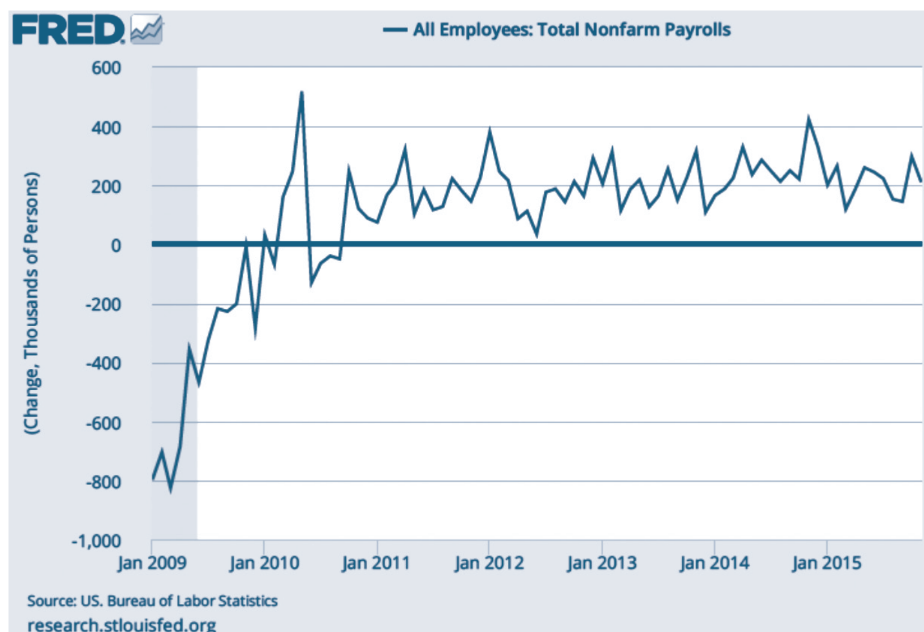
American labor markets are brimming with positive news.

- Drop in unemployment
- Strong job creation
- Higher real wages
- Lower initial jobless claims

For the first time since 2007, unemployment has fallen as low as 5% as it did in November 2015. We saw very strong job creation of 211,000 in that month.

Since the beginning of 2011, the economy has created on average 205,000 jobs per month. (*See Figure 7.*) The economy needs to create at least 100,000 jobs to absorb new entrants into the labor market from increases in U.S. population as well as new immigrants. The extra 105,000 jobs help to bring individuals who were on the unemployment rolls back into the job market.

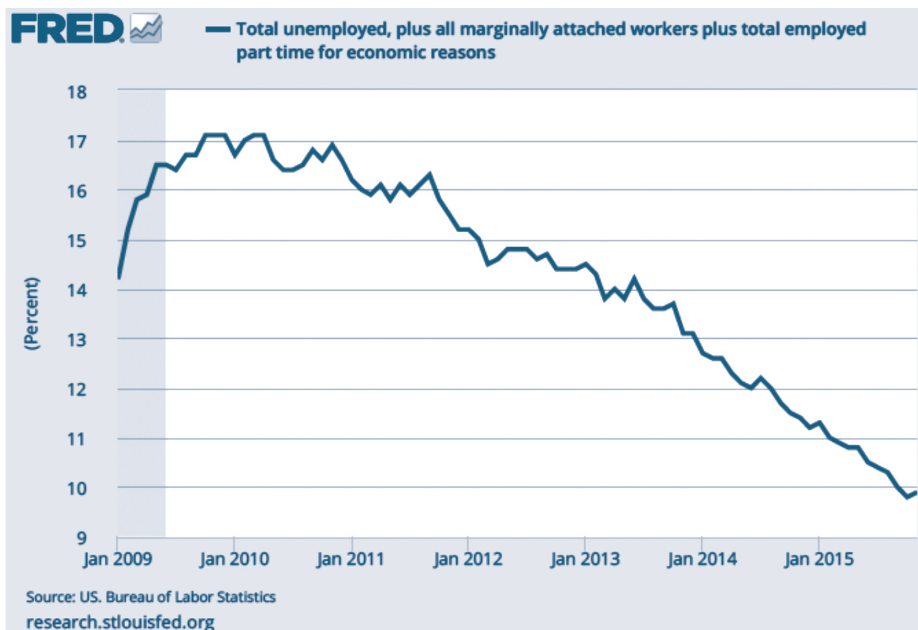
Figure 7:
Change in Nonfarm Payrolls (2009 to Present)



Source: Federal Reserve of St. Louis. Extracted from the Federal Reserve Economic Database (FRED) on December 20, 2015.

Strength in labor markets is also apparent in the drop in the U-6 rate, the broadest measure of unemployment. (*See Figure 8.*) This measure includes a range of unemployed and underemployed workers, especially those who are employed part-time but would like full-time employment.

Figure 8:
The U-6 Measure of U.S. Unemployment (2009-to Present), seasonally adjusted



Source: Federal Reserve of St. Louis. Extracted from the Federal Reserve Economic Database (FRED) on December 20, 2015.

The U-6 unemployment rate is now at the lowest level (9.9%) since the beginning of the financial crisis in 2008. The rate is still higher than the 7.9% during the George W. Bush presidency, but it is slowly approaching an historically normal rate during a typical recovery.

Not only has employment improved, but also average hourly earnings have begun to trend slightly upward in the past few months. (*See Figure 9.*) The hourly earnings are now increasing at a rate above core inflation, which means that **real** hourly earnings are increasing for the first time in several years.

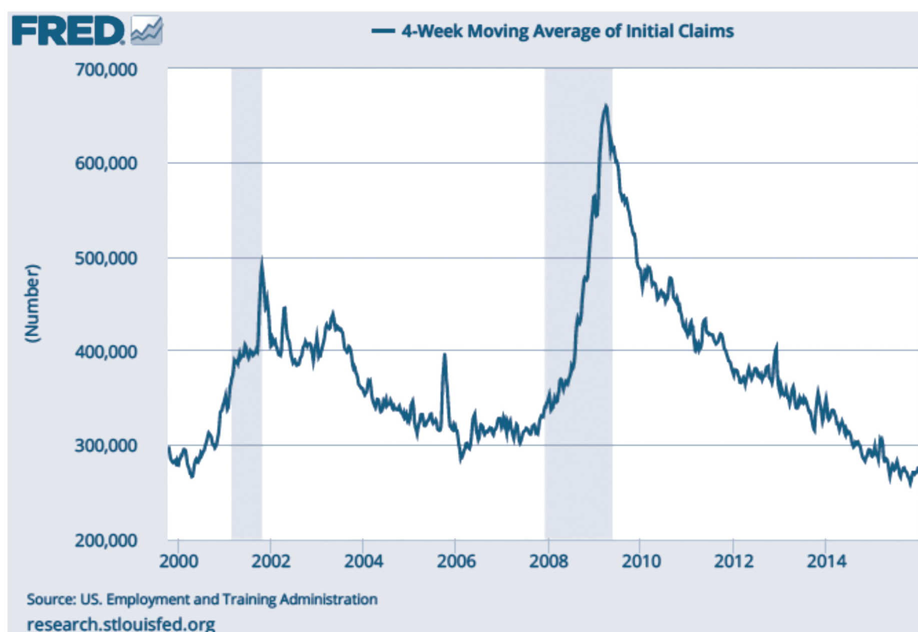
Figure 9:
Average Hourly Earnings of All Employees (2007 to Present)

Source: Bureau of Labor Statistics. Database for Earnings, Hours and Earnings from the Current Survey Statistics. Extracted from the database on December 5, 2015.

Although the increase in real hourly earnings is modest, it is an important step toward sustained growth in consumer spending and real GDP growth. Hourly compensation increased faster in November than in any month during the last five years. Again, the increase is not spectacular, but it is headed in a positive direction.

A fourth positive indicator of labor market strength is the ongoing drop in initial jobless claims. (*See Figure 10.*) Initial jobless claims are now at the lowest level since the start of the new millennium. In fact, jobless claims are at a four decade low.

Figure 10:
Four-Week Moving Average of Initial Jobless Claims (2000 to Present)



Source: Federal Reserve of St. Louis. Extracted from the Federal Reserve Economic Database (FRED) on January 1, 2016.

Best Guess on American Labor Market Conditions

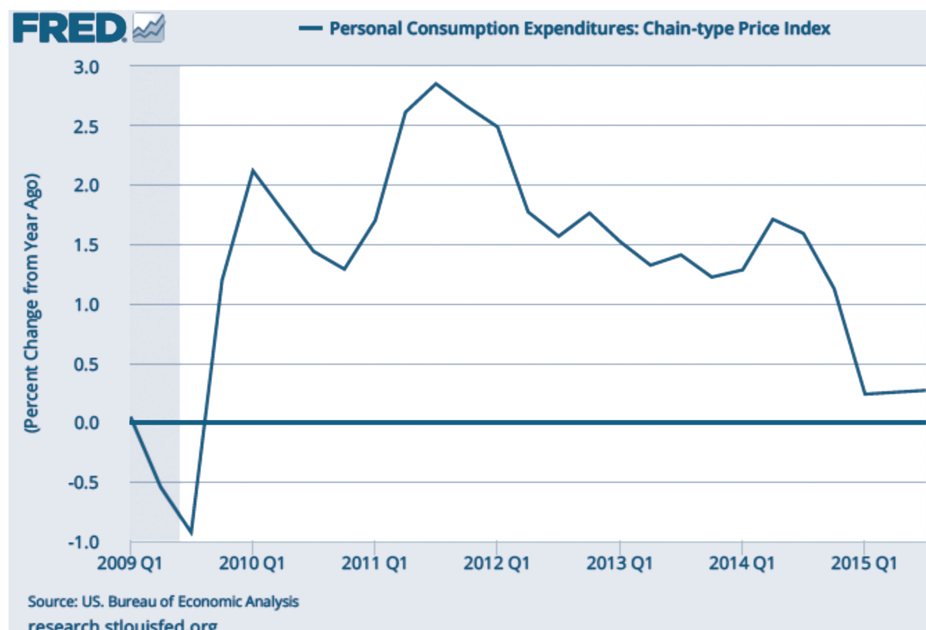
The brightest spot in the U.S. economy is its almost full-employment. This situation will continue in 2016 with unemployment at or near 5% for the whole year. In addition, workers will experience **wage increases of 3%, or about 1% after inflation.**

The tightening of labor markets and the general improvement in U.S. wage growth usually means that inflationary pressures are building in the economy. Surprisingly inflation does not seem to be on the horizon.

Inflation and Price Levels

Consumers may observe an increase in the price of some goods and services. That is normal. At any one time some items may become more expensive than in the past. Nevertheless, the broad measures of inflation are tame. The inflation measure used by the Federal Reserve for policy making decisions, the Personal Consumption Expenditures Price Index (PCE), is increasing at a modest rate. (*See Figure 11.*)

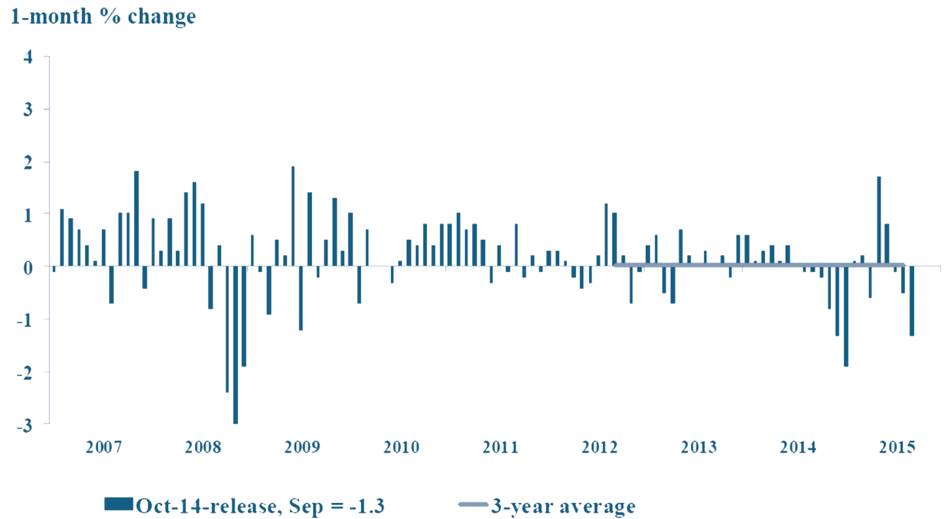
Figure 11:
Personal Consumptions Expenditures Price Level (2009 to Present), seasonally adjusted



Source: Federal Reserve of St. Louis. Extracted from the Federal Reserve Economic Database (FRED) on December 21, 2015.

Consumer prices are increasing at a slow rate and producer prices are not increasing at all. (*See Figure 12.*) Producer prices in the past 3 years are flat as shown by the solid line in the graph. Such tame prices at the producer level suggest that negligible inflation is seeping into the economy as goods move from producers to retail stores.

Figure 12:
Monthly Change in the U.S. Producer Price Index (2007 to Present)



Source: Federal Reserve of Dallas. Dallas Fed Economic Data. October 2015.

Best Guess About Inflation

Stronger wage growth suggests that America is on the cusp of higher inflation. Yet, it will not happen in 2016. Soft commodity prices combined with weak import prices from the strong dollar will keep a lid on inflation. We think that core inflation will be about 1.5% to 1.8% in 2016. Such a moderate rate of inflation will give the Federal Reserve second thoughts about dramatic increases in short-term interest rates.

The Federal Reserve and Monetary Policy

Almost full employment and tame inflation create a quandary for the policy makers at the Federal Reserve because this outcome does not fit nicely into established economic theory. Under “normal” circumstances, full employment leads to inflationary pressures, which in turn leads to higher interest rates.

Even though the Fed’s models do not suggest significant discernable inflation in the near future, it decided to raise short-term interest rates in December 2015. Given that the Fed has not raised interest rates since the start of the financial crisis, a modest increase of a quarter percent is hardly a draconian move on its part.

This rate increase is likely to have a few negative (but small) impacts on the economy.

- A strengthening of the dollar caused by higher interest rates will hurt U.S. exports, especially manufactured goods in the ensuing quarters.
- A modest slowdown in the housing recovery caused by borrowers paying slightly higher mortgage rates
- A small increase in the size of the Federal deficit caused by the higher cost the government pays when it borrows money on a short-term basis in capital markets

On balance a single modest increase in interest rates will largely be a non-event for the American economy. However, if the Federal Reserve continues the rate increases for the remainder of 2016, it could perhaps have a negative consequence for the economy, especially for American manufacturers.

Best Guess on Fed Monetary and Interest Rates

We think that short-term interest rates will be no higher than 1.25% by the end of 2016. The Fed will be cautious in making rate changes given the lack of inflationary pressures in the U.S. and global economies.

Final Thoughts

The American economy is like a defense-minded football team. The team is keeping its opponent from scoring, but the home team is scoring only an occasional field goal.

For more than five years the U.S. economy was powered by fiscal policy (large budget deficits) as well as monetary policy (easy money and low interests). The positive, but modest, economic results so far are encouraging:

- Moderate growth fueled by a relatively strong housing market
- Almost full employment with modest real wage increases for many workers
- Little inflationary pressure
- A stable trade picture along with a strong dollar

Even with all this good news it's too early to declare a "victory" in this recovery. We need a touchdown in 2016.

Thomas Goho, Ph.D. is Chief Economic Consultant for Stephens Inc. He also serves as the Co-Director of Stephens University at Wake Forest University. Tom enjoys a successful career in both education and business. He served as a professor of finance, Wayne Calloway School of Business and Accountancy, Wake Forest University for 30 years. Before retiring in 2007, Tom was the first to hold the Thomas S. Goho Chair of Finance. Tom also served on the Board of Directors of the Wells Fargo Family of Mutual Funds for 20 years, and also was on the Board of Directors of Lifepath Funds of Barclay's Bank. A former Certified Financial Planner, Tom earned his BS and MBA from Pennsylvania State University and his Ph.D. from the University of North Carolina-Chapel Hill.

Stephens

111 Center Street
Little Rock, AR 72201
501-377-2000
800-643-9691
stephens.com

linkedin.com/company/stephens-inc.

@Stephens_Inc

facebook.com/about.stephens

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