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VIEWPOINT

A Stephens Inc. Economic and Financial Commentary

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The new year is highlighted by the departure of one president and the inauguration of a new president. The departing President touts his economic achievements, while the President-elect promises improved economic growth as he makes "America great again." Political rhetoric aside, what is the condition of the American economy as we enter 2017?

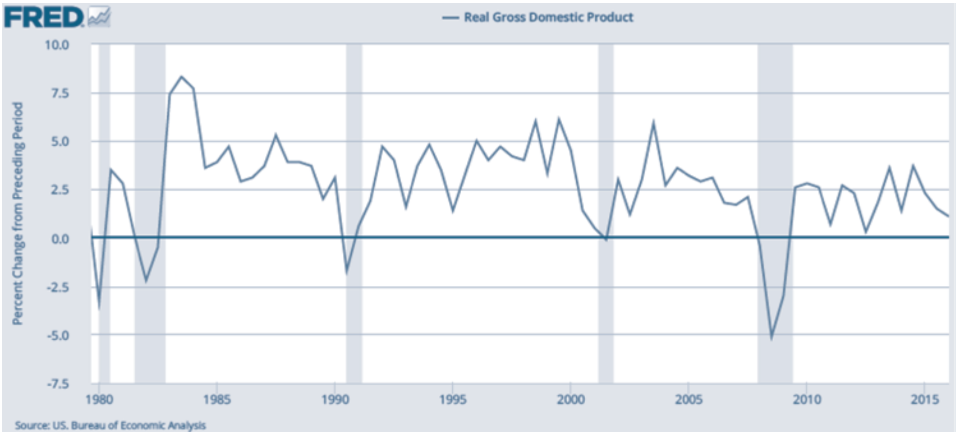
This issue of *Viewpoint* focuses on the broad conditions of the economy at year end 2016.

- What are the strengths and weaknesses of the American economy in late 2016?
- What, if anything, can be done to improve performance of the economy in the next 12 or 24 months?
- Is it likely that the economy will experience a recession in the early years of the next presidency?

American Economic Growth

The American economy continues to experience positive but sub-par growth. At least that growth is sub-par compared to the recoveries in the latter part of the 20th century. It has been a world of 2% growth, a little more than half the rate of Reagan and Bill Clinton presidencies. (*See Figure 1.*) However, Americans did have a glimmer of hope for higher growth as the economy expanded by 3.2% in the most recent quarter — very good news after two quarters of a lackluster economy at the beginning of 2016.

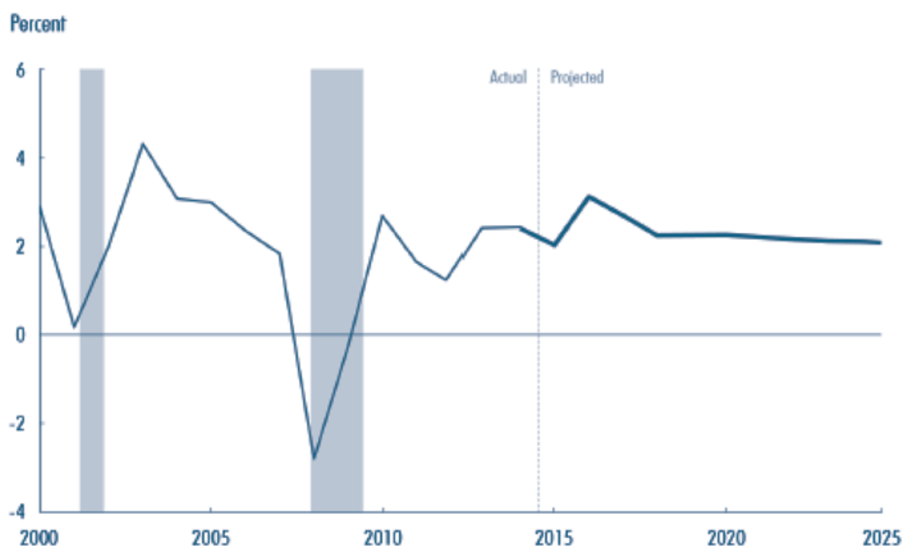
Figure 1:
Change in Real Gross Domestic Product (1980 to 2016)



Source: Federal Reserve Bank of St. Louis. Extracted from the Federal Reserve Economics Database (FRED) on December 4, 2016.

Most economists think that the growth of about 2% per year over the past six years is likely to continue for the foreseeable future. This growth rate is reinforced by recent projections of the Congressional Budget Office. (*See Figure 2.*)

Figure 2:
Actual and Projected Growth in Real Gross Domestic Product (2000 to 2025)



Source: Congressional Budget Office. "An Update to the Budget and Economic Outlook: 2015 to 2025. August 25, 2016. Page 10.

Best Guess on Economic Growth

We expect that annual economic growth will be about 2% over the coming 12 to 18 months. The prospects for a recession during that time period seem remote. Yet, as noted recently in *The Wall Street Journal*, "the U.S. must face one of two scenarios: Either the next president will face a recession in office, or the U.S. will have the longest economic expansion in its history." A survey of economists put the likelihood of a recession within the next four years at nearly 60%.

We agree with the economists who forecast a recession within next four years — but not in 2017. Given the intrinsic softness of the two most recent economic recoveries during the George W. Bush and the Barack Obama presidencies, it seems likely that the economy will have at least two quarters of negative GDP (in other words a recession) during Trump's term in the White House. America's tepid growth is a breeding ground for short periods of negative growth.

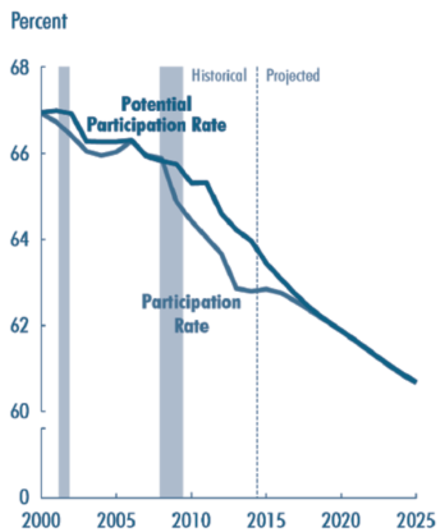
U.S. Labor Participation and Worker Productivity

America's weak economic growth has two sources:

- Decline in labor participation.
- Low growth in labor productivity.

A country achieves economic growth from either a rising labor participation rate and/or increases in labor productivity. Both of those growth factors are working against the United States. Labor participation rates in the United States are falling and will continue to fall for at least a decade as baby boomers continue to retire. (*See Figure 3.*)

Figure 3:
Actual and Projected American Labor Participation Rates (2000 to 2025)



Source: Congressional Budget Office. "An Update to the Budget and Economic Outlook: 2015 to 2025. August 25, 2016. Page 10.

Best Guess About Labor Participation

It is unlikely that any policy changes in the next two to four years will significantly alter the labor participation rate trend. Boomers are retiring, and policies out of Washington, D.C. are unlikely to alter boomers' retirement plans. Participation rates will drop from the current level of 62% in 2016 to about 60.5% in 2025. Improved growth in the U.S. will not come from higher labor participation rates. We will have to look elsewhere for growth prospects.

American Labor Productivity

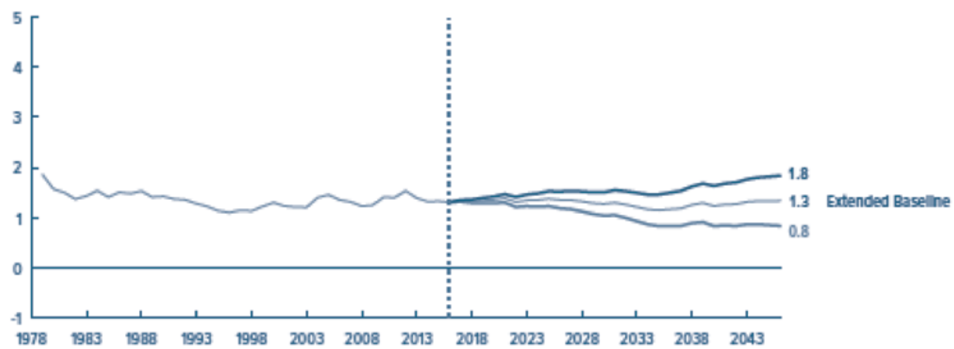
Unlike the labor participation rate, governmental policy can influence labor productivity. Changes in tax and labor law have the potential to either improve or degrade labor output per hour. The one fact is clear. Labor productivity gains have trended downward since the start of the new millennium. (*See Figure 4.*)

Figure 4:
Output Per Worker Hour in All Industries (2000 to Present)

Source: Federal Reserve Bank of St. Louis. Extracted from the Federal Reserve Economics Database (FRED) on December 4, 2016.

The Congressional Budget Office (CBO), using a slightly different measure than FRED, thinks that American labor productivity will remain anemic for the foreseeable future. CBO's projections are for productivity growth to remain somewhere in the range of .8% to 1.8% per year. (*See Figure 5.*) Keep in mind that those projections are based on existing laws and policies.

Figure 5:
Actual and Projected American Productivity Growth Rate



Source: Congressional Budget Office. The *2016 Long-term Budget Outlook*. July 2016. Figure 7-1.

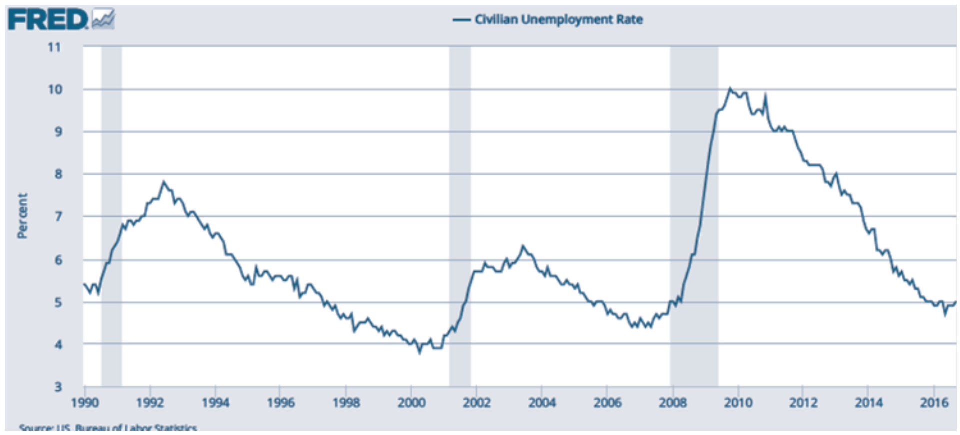
Best Guess About Labor Productivity

If the current laws and policies remain intact, the CBO's forecasts of productivity gains seem quite reasonable. When one combines the falling labor participation with weak productivity gains, the result will be American economic growth of no more than 2% per year. With a new administration, policy changes could have a positive or negative impact on these forecasts.

Employment and Unemployment

The combination of slow but steady growth combined with demographic shifts in the labor force has led rather unexpectedly to a healthy headline employment rate. The rate is within striking distance of full employment, currently at 4.6%. (*See Figure 6.*)

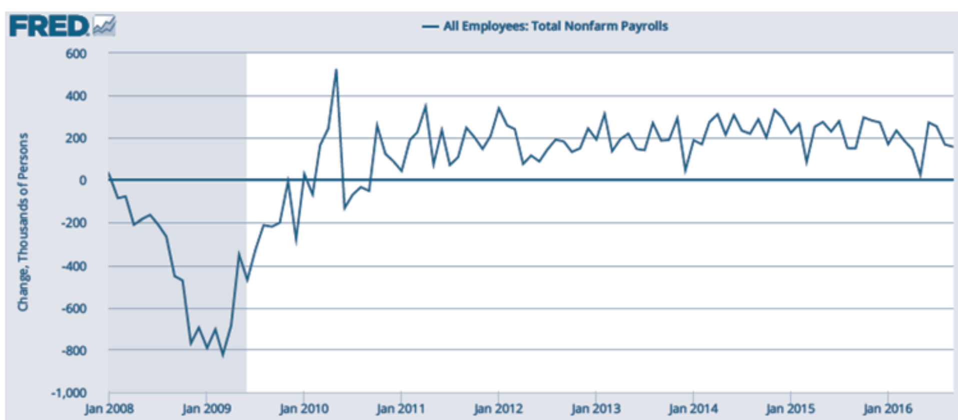
Figure 6:
U.S. Civilian Unemployment Rate, 1990 to Present



Source: Federal Reserve Bank of St. Louis. Extracted from the Federal Reserve Economics Database (FRED) on December 14, 2016.

American jobs are being created at a reasonably healthy rate of about 200,000 per month. (*See Figure 7.*) Such a rate is adequate to absorb new entrants into the labor market as well as providing a modest reduction in the rate of unemployment.

Figure 7:
Monthly Change in Nonfarm Payrolls, 2008 to Present



Source: Federal Reserve Bank of St. Louis. Extracted from the Federal Reserve Economics Database (FRED) on December 14, 2016.

Is the labor market fully recovered from the financial crisis of 2008–9? No. There remains a large segment of workers who are working part-time but would like to work full-time. (*See Figure 8.*)

Figure 8:
Full Time Workers Versus Part-Time Workers in the Labor Force (2008 to 2016)

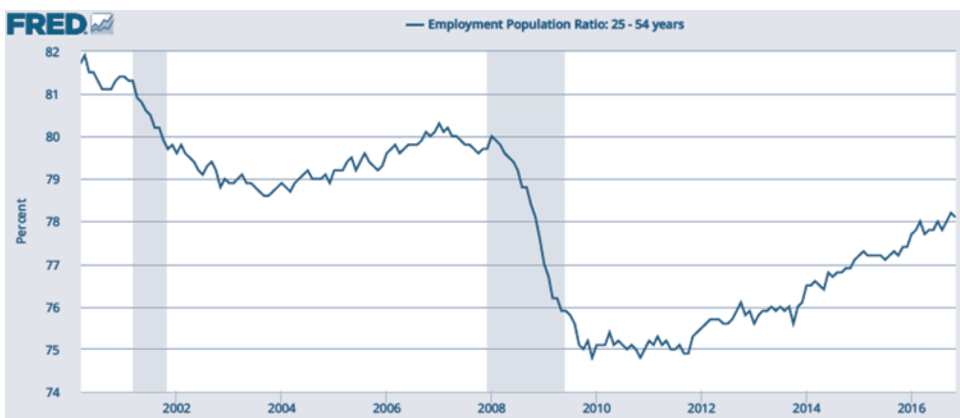
Period	Full Time	Part Time	Total
2008	83.1%	16.9%	100%
2016	81.7	18.3	100

Source: Bureau of Labor Statistics. BLS Database. Extracted December 10, 2016.

Another manifestation of labor market weakness is the unusually high rate of unemployment among workers in their prime working years, age 25–54. In the pre-recession economy before 2008, the unemployment rate was 2.9% for those workers. It is now 4.0% for that same segment of workers.

Not only is the unemployment rate higher among prime working age persons, but also their overall involvement in labor markets is diminished compared to the start of the new millennium. (*See Figure 9.*) In 2000 almost 82% of prime working age individuals were in the workforce. Today the rate is approximately 78%. To match the 2000 peak, an additional 4.7 million prime age workers would need to be employed.

Figure 9:
Employment to Population Ratio, Workers Age 25 to 54 (2000 to 2016)



Source: Federal Reserve Bank of St. Louis. Extracted from the Federal Reserve Economics Database (FRED) on December 14, 2016.

These conditions are disturbing given that the headline number for the unemployment rate is so robust. Despite these sub-optimal numbers, the economy and labor markets are moving in the right direction—albeit rather slowly.

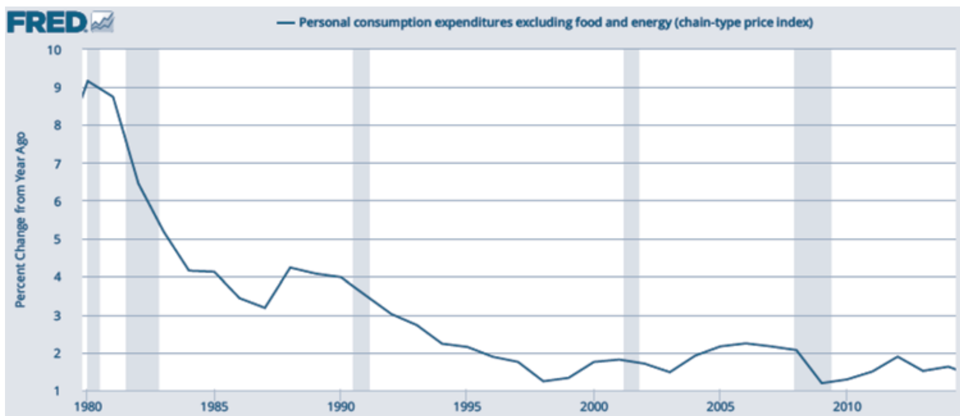
Best Guess About Labor Market Conditions

The pre-conditions for a stronger labor market are in place. The economy continues to grow and generate employment at or near the full employment rate. American businesses are capable of generating about 175,000 to 225,000 new jobs per month, a rate supportive of an unemployment rate of 4.5% to 5.0% in 2017.

Inflation and Inflationary Pressures

Against this backdrop of near full employment, the economy is experiencing a quiescent inflation environment, with inflation at a rate of under 2%. (*See Figure 6.*) For comparison, President Reagan inherited a core inflation rate (excluding food and energy) in excess of 9% the day he entered the Oval Office. (*See Figure 10.*) The headline Consumer Price Index (CPI) was increasing at an annual rate of over 10%. President Obama is handing over an economy with core CPI inflation running at a rate of about 1.5%. The incoming President should have a positive start in maintaining and controlling inflationary pressures.

Figure 10:
Personal Consumption Expenditures Price Index (Excluding Food and Energy) From 1980 to Present



Source: Federal Reserve Bank of St. Louis. Extracted from the Federal Reserve Economics Database (FRED) on December 13, 2016.

Best Guess About Inflation

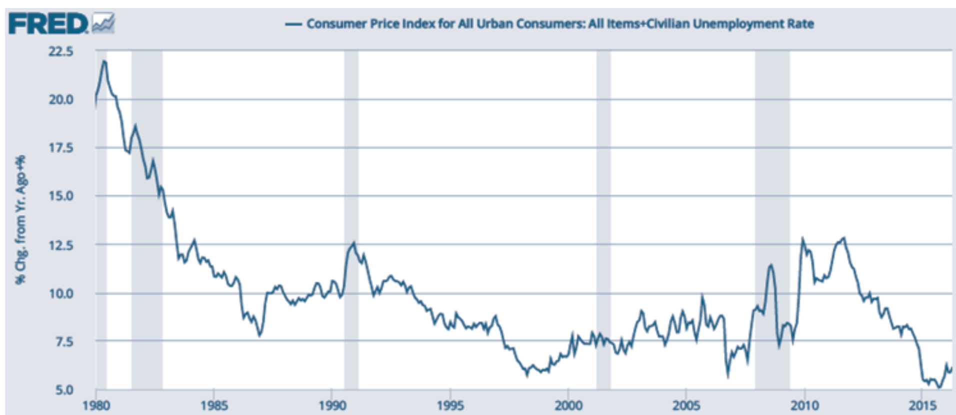
Slackness in global demand along with excess global labor and capital should keep inflation muted in 2017. We expect annual inflation (excluding food and energy prices) to be between 1.75% and 2.25%. However, wage pressures are increasing in the United States which likely will move inflation toward the upper end of that range.

Misery Index

Economists sometimes look at a slightly broader picture of the economy – the Misery Index. Arthur Okun, President Johnson's chairman for the Council of Economic Advisors, created the Misery Index, which is the sum of the annual inflation rate and the unemployment rate. It provides a crude, but useful, gauge of the conditions in the economy. The lower the index the better the economy is for American households. For example, President Reagan inherited an economy that was suffering from both high inflation and high unemployment. The Misery Index then was in excess of 20%.

Today the American economy is experiencing both low inflation and a low unemployment rate. The economy has a Misery Index at a multi-generational low. (*See Figure 11.*) The index does not get much better than our current 6%, which is a combination of 1.5% inflation and 4.6% unemployment.

Figure 11:
U.S. Misery Index (Inflation Rate as Measured by the CPI Plus the Unemployment Rate), 1981 to Present



Source: Federal Reserve Bank of St. Louis. Extracted from the Federal Reserve Economics Database (FRED) on December 13, 2016.

Many factors, including presidential policies, affect fluctuations in the country's level of misery. But neither Democratic nor Republican presidents seem to have the answer for lowering the Misery Index. External factors such as soaring oil prices increase consumer prices and can greatly affect the Misery Index, such as in the Carter administration.

It is instructive to see how the index has changed during recent presidencies. (*See Figure 12.*)

Figure 12:
Percentage Point Change in the Misery Index During Recent Presidencies, 1977 to Present, Rounded to the Nearest Whole Percentage Point

Presidency	Percentage Change in Misery Index From Start to Finish of Presidency
J. Carter	+7%
R. Reagan	-10
George H.W. Bush	0
W. Clinton	- 3
George W. Bush	-1
B. Obama (through Nov. 2016)	-2

Source: Federal Reserve Bank of St. Louis. Extracted from the Federal Reserve Economics Database (FRED) on December 13, 2016.

Best Guess About the Misery Index

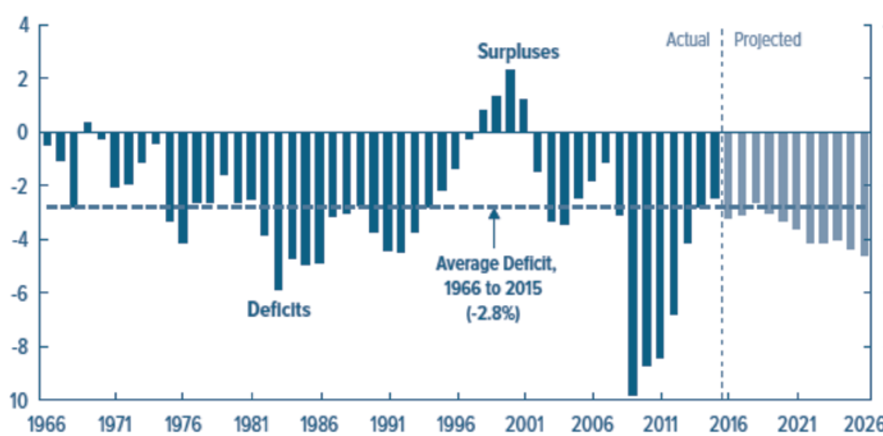
It is reasonable to expect that the Misery Index should remain near the current level of 6%. Job creation is adequate, wage pressures are contained, and food and energy prices are tame, thereby restraining the price of goods and services. I expect that the Misery Index will remain near its current level of 6% over the next 12 months.

Fiscal Conditions of the United States Government

The fiscal conditions of the government in 2016 are vastly better than they were in the early years of the Obama administration when the government was responding to the financial crisis of 2008–9. The budget at that time had a deficit of almost 10% of GDP. (*See Figure 13.*) Recently the federal deficit is close to its long-term average of slightly under 3% of GDP.

Does that 3% warm the hearts of fiscal conservatives? Absolutely not. However, a deficit of 3% of GDP is manageable in the short run mainly because of the current low interest rates for new government debt.

Figure 13:
U.S. Federal Deficits and Surpluses as a Percentage of U.S. Gross Domestic Product, 1966 to 2026



Source: Congressional Budget Office. *An Update to the Budget and Economic Outlook: 2016 to 2016.* August 2016. Figure 1-1.

Best Guess on America's Fiscal Condition

The federal deficit should remain manageable over the next 12 to 24 months, assuming that no new major spending programs are implemented. The one concern for fiscal stability is the upward movement in most Treasury interest rates since the election. Higher rates put a strain on the deficit because of the large amount of federal debt—$20 trillion. It is not alarming at this point, but conditions could change fairly rapidly.

Final Thoughts

The United States economy is headed in the right direction as 2017 begins. Notwithstanding some of the issues in the American labor market, conditions are positive for continued economic strength.

Moderate economic growth: 2% per year.

- Reasonable job creation: 150,000 to 200,000 new jobs per month.
- Acceptable inflation: about 2% but trending upward.
- A manageable federal deficit for the next several years: about 3% of real GDP.
- An absence of recessionary signs: *The Wall Street Journal* Survey of Economists puts the odds of a recession at 17% in the next year.

Some of President Trump's proposed policies could enhance these current economic conditions:

- Less government regulation of key industries such as energy and finance.
- Lower and restructured corporate taxes to encourage greater investment by American enterprises on American soil instead of abroad.
- Investment in needed infrastructure.

President-elect Trump sees clearly that less government regulation of key industries combined with thoughtful corporate tax reduction are key components in a plan to accelerate productivity gains. These strategies could increase economic growth to a rate of between 3 and 4%.

Yet, some of Mr. Trump's proposed policies are minefields for economic disruption, higher inflation and heightened economic uncertainty including:

- Threats of withdrawal from NAFTA and other trade agreements.
- Tariff threats against China and other supposed currency manipulators.
- Rejection of free trade agreements such as the Trans Pacific Partnership (TPP).
- Deportation of large numbers of illegal (but vital) immigrant workers.
- Reluctance to expand visa programs for skilled international workers.

Individually these policies, if implemented, may not damage the economy, but collectively I think these proposals would cause much higher federal budget deficits, increased inflation, higher interest rates, and weakening long-term growth. I hope I am wrong, but President Trump's statements are not encouraging for sustained economic growth over the next four years.

As investors make decisions over the coming months, they would be wise to consider the various actions of our new President. Some of his proposals lead to higher growth and greater American prosperity. Other proposals are in direct opposition to those outcomes. We will just have to wait and see what the new year brings.

We wish you a happy, healthy and prosperous New Year.

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.

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