VIEWPOINT

A Stephens Inc. Economic and Financial Commentary

by Thomas Goho, Ph.D.

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Many challenging events are changing the American and global economic landscapes. Some are positive, such as the new U.S. tax plan, others are negative, such as the possible tariff wars with U.S. global trading partners. These factors and others are impacting the U.S economic outlook. And certainly the economic landscape is energizing. Times like these warrant perspective, therefore, Stephens is relaunching Viewpoint. A well-timed move, as I found in retirement that I am not content to be just a distant observer of the economy.

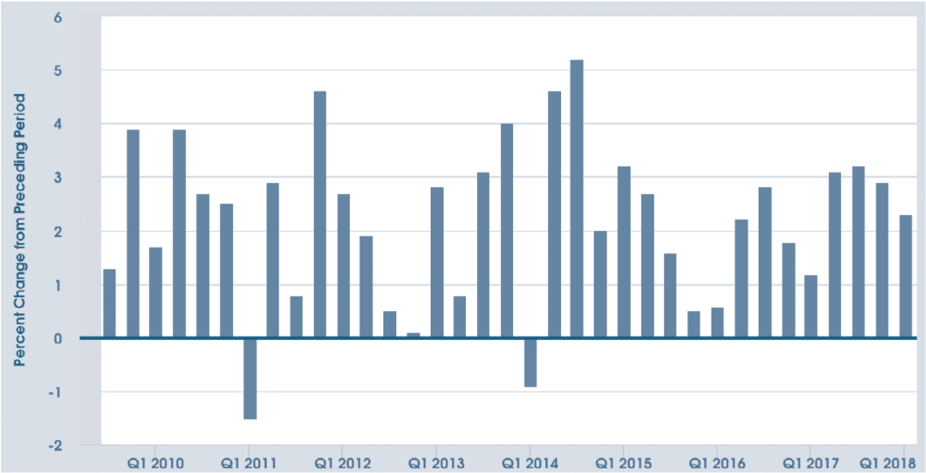
In the “final” Viewpoint one year ago, I indicated my expectation that the U.S. economy would continue growing at a rate similar to that of the Obama years—2% to 2.25%. President Trump’s economic growth goal of 3% to 4%, I believed, was unrealistic because too many factors in the American economy were and are impeding such strong growth.

Let’s assess how the U.S. economy has been performing under the Trump presidency. What is going well, and what is hindering strong economic growth?

Economic Growth

Growth in real gross domestic product (real GDP) has accelerated since the beginning of the Trump administration. From the end of the financial crisis in 2010 to the end of the Obama presidency, economic growth averaged about 2.1%. In the five quarters of the Trump presidency economic growth has averaged 2.5%. (*See Figure 1.*)

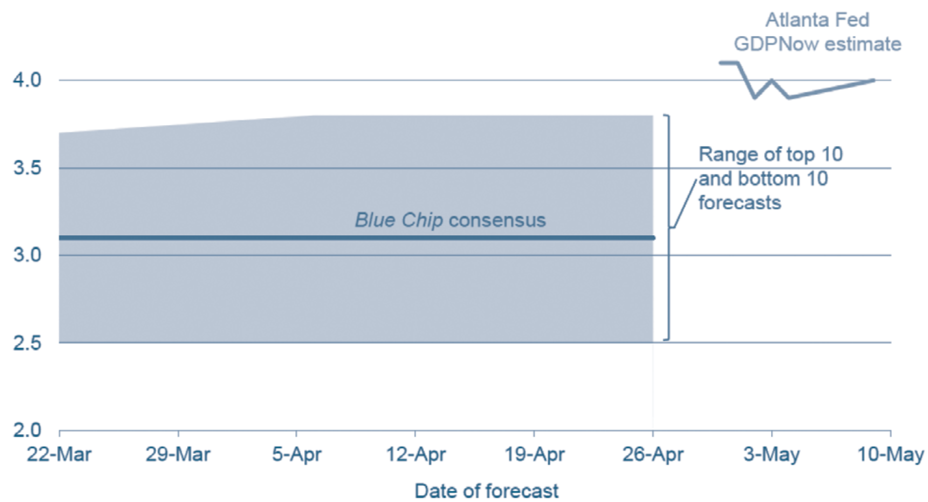
Figure 1:
Real Gross Domestic Product 2010 to the Present (Q1 2018).



Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database on June 2, 2018.

This modest acceleration in growth occurred before the full impact of the Trump tax cuts had rippled through the economy. Forecasts for second quarter growth in 2018 by most economic organizations including the Federal Reserve Bank of Atlanta expect real GDP to continue accelerating. The Atlanta Fed's second quarter real time growth estimate is 4%, well in excess of most forecasters' expectations of slightly more than 3%. (*See Figure 2.*)

Figure 2:
Federal Reserve Bank of Atlanta's Forecast of Q2 2018 Real GDP in Real Time.



Source: Federal Reserve Bank of Atlanta. Atlanta Fed GDPNow Estimate for 2018 Q2. May 9, 2018.

Full-year 2018 estimates of most economists are about 3.0% with a range between 2.8% to 3.2%. Collectively these forecasts tend to the low side of the 3% to 4% range President Trump foresaw during his administration. Trump's goal is higher than any rate recorded during the G. W. Bush and Obama presidencies.

Best Guess on Economic Growth

The Republican-controlled Congress delivered a tax package that I did not expect would pass in 2017 or 2018. The tax bill is a complicated piece of legislation, but it should deliver increased growth over and above that which occurred in the past decade. It has and will stimulate business investment, and its provisions will induce multinational firms to relocate at least some of their operations to the United States.

The tax legislation is not a long-term panacea for the slow growth of the American economy, but in the short run it should bump economic growth to about 3% for the next 12 to 18 months.

Labor Employment

Labor market conditions were tight when President Trump entered office in January 2017 and are now even tighter. The unemployment rate dropped from 4.8% in early 2017 to 3.8% in May 2018. (*See Figure 3.*)

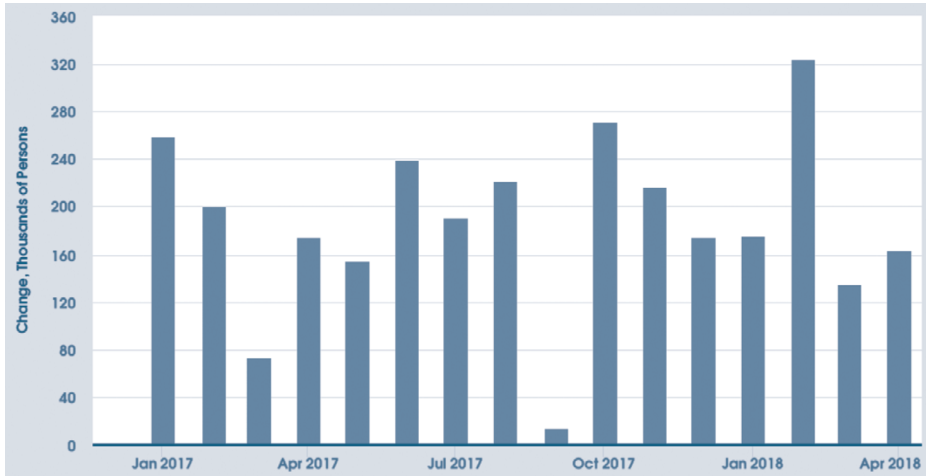
Most economists expect that the unemployment rate will not fall much lower than 3.7% by the end of 2018. The current rate of 3.8% reflects full or near full employment. Any rate much lower could be a harbinger of significant wage inflation, a condition absent in most sectors of the economy during the current recovery.

Figure 3:
Unemployment Rate (Q1 2010 to Present).

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database on June 2, 2018.

A second characteristic of this current recovery is solid job creation. Since the start of the Trump administration monthly job creation has averaged 187,000 jobs for first 16 months in office. (*See Figure 4.*) This job creation rate is similar to that of the last 16 months of the Obama administration when 205,000 jobs were created per month. Over the years from the end of the financial crisis until the end of Obama administration, the monthly job creation rate was 188,000.

Figure 4:
Monthly Change in Nonfarm Payrolls (January 2017 to April 2018).

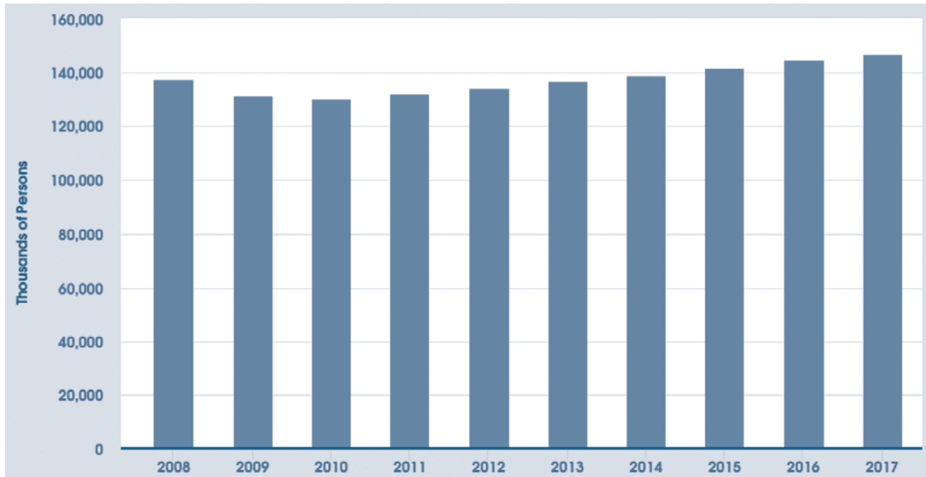


Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database on May 12, 2018.

Month after month the headline employment numbers look quite encouraging. Job creation of close to 200,000 jobs per month would translate into over 2 million new jobs per year, which should expand the labor force over a decade by more than 20 million jobs. But that didn't happen. Many of the 20 million jobs that were created merely replaced positions that were eliminated during the financial crisis in 2009 and 2010.

From the beginning of 2008 to the end of 2017, the labor force has grown by only 10 million, from 138 million to 148 million workers. (*See Figure 5.*) Between 2008 and 2017 the labor force grew at an anemic .6% per year compared to growth of .8% during the G.W. Bush years, and 1.2% during the Clinton years.

Figure 5:
Total Nonfarm Payroll (2008 to 2017).



Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database on June 11, 2018.

Businesses are having difficulty finding qualified individuals to fill available positions. There are currently 6.7 million job openings and only 6.3 million unemployed workers. Many of the unemployed lack the requisite skills to fill the available positions. This mismatch between the skills required for the available jobs and the skills of unemployed workers will require a long-term solution—better education for young workers and reeducation of older unemployed workers.

Best Guess About Unemployment

The unemployment rate is likely to tick lower to possibly 3.7% by the end of 2018. However, it seems unlikely the rate will drop below that level. The economy is already pushing the limits of full employment.

Labor Participation Rate

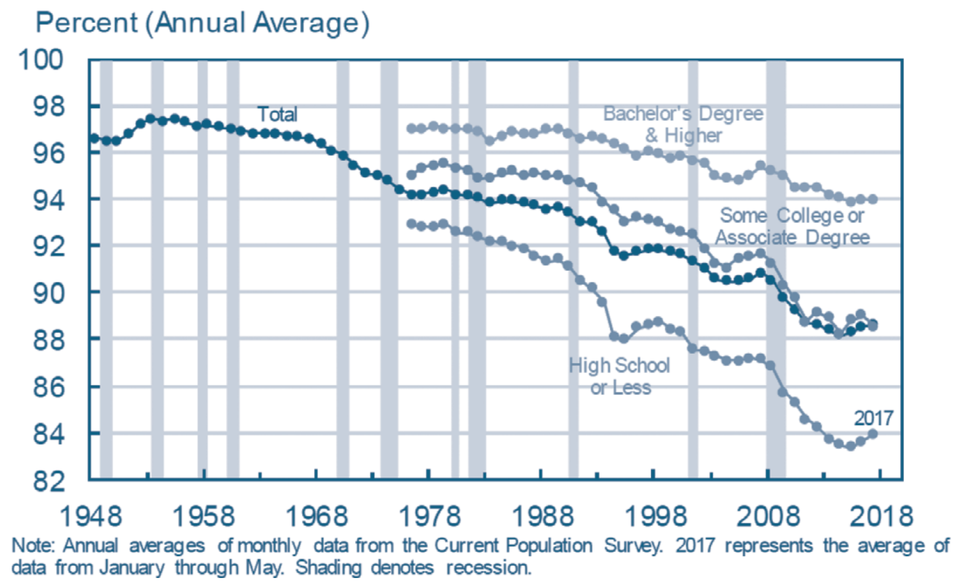
Labor participation rate measures the percent of workers age 16 – 64 that are employed or are actively seeking employment. With an unemployment rate of 3.8% you would expect the labor participation rate to be climbing, yet it is moving in the wrong direction. From the beginning of 2000 to April 2018 the participation rate dropped from 67.3% to 62.8%. (*See Figure 6.*) The drop after the financial crisis of 2008 was especially dramatic. In a labor force of almost 150 million workers that means that more than 6 million workers exited the labor force.

Figure 6:
Labor Participation Rates for Civilian Workforce (2000 to Present).

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database on June 11, 2018.

Many who exited the workforce were older people who retired. The real story is the significant drop in the participation rate among workers age 25 to 54, workers in their prime years. (*See Figure 7.*) This rate has fallen for decades, but it has accelerated for the least educated workers in the new millennium. America now has the lowest labor participation rate of prime age workers of any industrialized country except Italy.

Figure 7:
Labor Force Participation Rates for Men Ages 25 – 54 by Educational Attainment (1948 to 2017).



Source: Brookings Papers on Economic Activity. "Where Have All the Workers Gone? An Inquiry into the Decline of the U.S. Labor Force Participation Rate." (By Alan Krueger.) September 7 – 8, 2017. Figure 5.

In the past several quarters these negative trends have abated somewhat as labor markets have tightened. Employers seem to be willing to take a chance on marginally qualified workers. In addition, economic necessity is increasing the labor participation rate of older workers, those 55 and above.

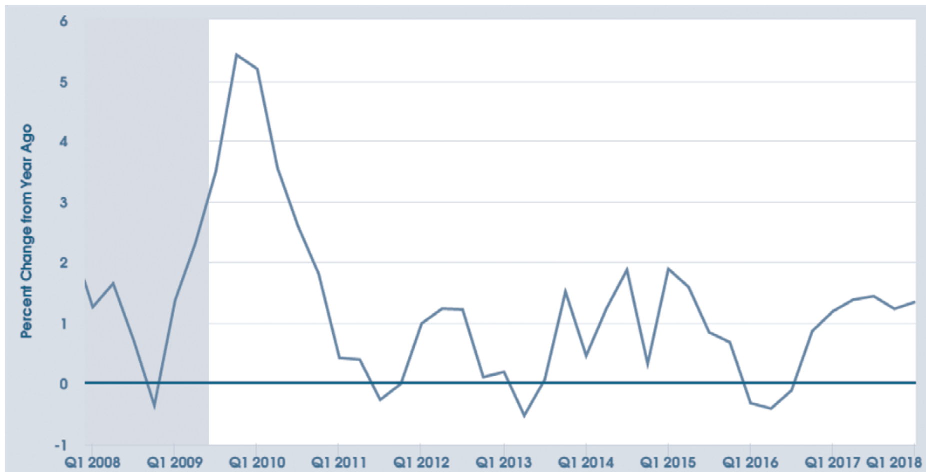
Best Guess About Labor Participation

Given the strong labor market conditions the participation rate is likely to stabilize for the remainder of the year, but heading into 2020s that rate will slide again. As the workforce ages the labor participation will continue to shrink such that by 2024 the United States Bureau of Labor Statistics projects that the participation will decrease almost 2 percentage points to 61% of the labor force. This projection presages a growth in the total labor force of just .5% per year, a rate not very supportive of strong economic growth.

Labor Productivity

Along with sliding labor participation, declining labor productivity is adding to slow economic growth in the new millennium. Weak real output growth per hour in American business is a serious problem. (*See Figure 8.*) In the last 11 years the average annual growth in hourly output was 1.2%. In the 5 quarters of the Trump administration, hourly output was 1.3%. Labor productivity growth in the Clinton and the G. W. Bush administrations averaged between 1.5% and 3%.

Figure 8:
Nonfarm Business Sector: Real Output Per Hour of All Persons (Q1 2008 to Q1 2018).



Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database on June 12, 2018.

The bump in labor productivity after the last recession is really more of an anomaly as a result of massive worker layoffs. After workers were rehired in the post-recession period the productivity levels returned to the normal level of only slightly more than 1.25%.

The combination of low productivity growth and small increases in the size of the labor force will constrain the American economy to an overall growth of about 2% per year. That is, unless some "shocks" like changes in tax laws and/or the regulatory environment can alter the intrinsic dynamics of the economy.

Best Guess About Labor Productivity

Two countervailing forces will be operating on labor productivity for the remainder of 2018 and into 2019. On the one hand, businesses are hiring new employees, including marginally qualified workers, to fill positions. These marginally qualified employees impede already low labor productivity. On the other hand, the 2017 Tax Cut and Jobs Act legislation is encouraging businesses to invest in new plant and equipment, which should enhance the capital stock and improve labor productivity. The Tax Act is significant and will have a palpable impact on labor productivity such that it will increase at least 1.5% to 1.75% per year for the next two years.

Inflation and the Price Levels

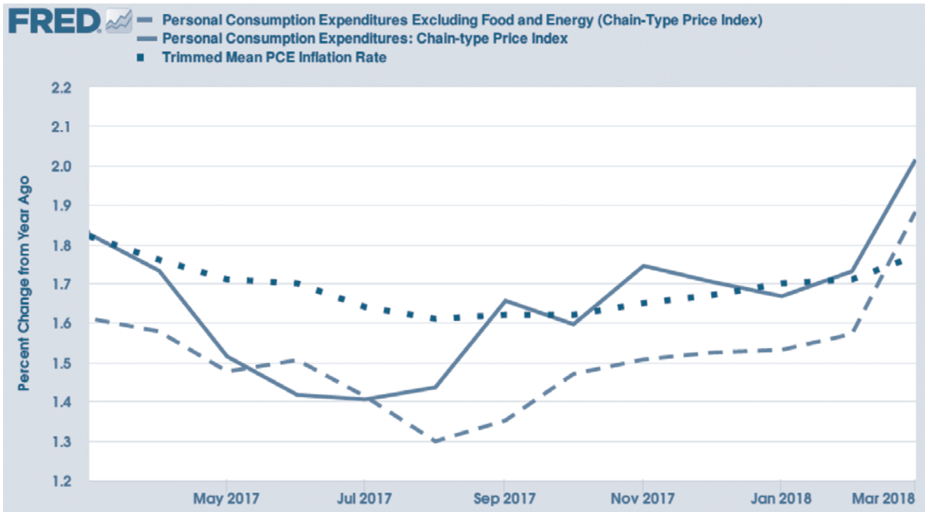
Inflation has remained relatively quiescent so far in this recovery. In an economy with accelerating economic growth and tight labor markets, economists expect that inflation will accelerate. (*See Figure 9.*) The Federal Reserve's preferred price index, the Personal Consumption Expenditures Price Index (core PCE) excluding food and energy, is increasing at a rate of about 1.9%, below the Fed's target rate of 2%.

Figure 9:
Personal Consumption Expenditures Excluding Food and Energy (Chain-Type Price Index) From 2008 to 2018.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database on June 14, 2018.

However, other statistical measures of inflation suggest that inflation has breached the 2% level which worries the Federal Reserve. One such measure is the overall PCE index that includes food and energy price. (See the solid line in Figure 10.) In addition, most economists expect the headline number, the Consumer Price Index (CPI) to exceed 2% for the remainder of the year.

Figure 10:
Three Measures of PCE Inflation (2017 to 2018).



Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from the database on June 14, 2018.

Prices are increasing at a controllable rate, and combined with tightening labor markets the Federal Reserve will continue the measured process of monetary tightening with higher short-term interest rates in the second half of 2018 and 2019, as demonstrated by its quarter-point rate hike in June 2018.

Best Guess About Inflation

The core PCE index will continue increasing during the remainder of the year. The core inflation rate for the second half of the year will be about 2.25%, which is not yet alarming, but high enough to have the Federal Reserve and financial markets on alert.

Final Thoughts

Modest gains in labor productivity and the size of the labor force have produced historically sub-par economic growth of about 2%. Several factors under the guidance of the Trump administration are improving the economic outlook for 2018 and 2019.

- 2017 Tax Cut and Jobs Act: This legislation should encourage incremental investment which will improve American productivity and competitiveness.
- Economic Growth, Regulatory Relief, and Consumer Protection Act: This legislation has the potential to free smaller community-oriented financial institutions from the onerous regulatory requirements of the Dodd-Frank Act. As a result, a greater flow of financial resources to small and middle-market businesses should enhance domestic growth. Small business formation has suffered since the passage of Dodd-Frank. This condition should be improving.

These two pieces of legislation combined with other regulatory reforms are giant steps forward in moving the economy from 2% to 3% annual growth. One year ago I doubted that these tax and regulatory changes would be passed and implemented so quickly. Americans can now expect the economy to grow at 3% for the next 12 months. What is the evidence of that strong growth potential?

- Adequate job creation per month
- Significant job openings versus job seekers
- Manageable inflationary pressure
- High consumer confidence
- Record household wealth
- Strong corporate profits

Unfortunately the Trump administration is undermining these favorable economic conditions by taking a giant step backward with his misguided tariff initiatives that may be directed at NAFTA (Mexico and Canada), the European Union, China, Japan and other trading partners.

Tariffs generate two certain outcomes. First, they disrupt complex supply chains that were developed over many years. Tariffs are costly business disruptions and fraught with uncertain consequences.

Second, tariffs are inflation accelerants for American businesses and consumers, with the greatest impact on low-income consumers. The United States economy is on the brink of inflationary pressures without the imposition of these ill-conceived tariffs.

Tariffs will set off additional inflation alarm bells at the Federal Reserve. The Fed will act decisively to control inflation, which could mean faster rather than slower interest rate increases in late 2018 and 2019.

One Final Guess About This Economy

The currently robust economic expansion should have several more years of life. It is always difficult to identify the factor or factors that will end an expansion. But my best guess is that if the President follows through on broad-based tariffs and/or abandonment of NAFTA, he will create inflationary conditions and business uncertainty that could kick off the next recession. Most forecasters place the likelihood of a recession in the next 12 months at no more 20%. Several rounds of tariffs against major trading partners, especially NAFTA, will very quickly raise that recession probability to 40%.

In the new millennium this economy seemed to operate on the conservative football philosophy of Ohio State coaching legend Woody Hayes, "three yards and a cloud of dust." Regrettably the American economy has not acquired the trophies that Hayes amassed with his strategy. We now have a president who seems to espouse a philosophy of "ten yards and a cloud of tariffs." His bold game plan has real potential to support solid 3% growth, but his philosophy of tariffs and other protectionist actions could court a major economic fumble, not a trophy.

Thomas Goho, Ph.D. is formerly the Chief Economic Consultant for Stephens Inc. He also served 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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