# D.J.'s Economix

A mix of economics and markets from Dwight Johnston

# Longer-term Commentary

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California Credit Union League

Nevada Credit Union League

# 2018 — Is that all there is?

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It's time for the annual review of the last year and outlook for the year ahead. So, without further ado, here are my year-end reflections and year-ahead musings.

## 2017 — Turbulent but tranquil

To borrow from Charles Dickens, "It was the best of times, it was the worst of times." At least that is the way it seemed in 2017. Hurricanes, floods, fires, and political discord dominated the headlines. But somehow the economy and the markets rose above it all to record a terrific year.

### *The year in Trump*

You must start any year-end review with a review of the first year of Trump. For those of you who had a date of one-year or less in your Trump survival pool, you lose. Trump did survive his first year in office and took most people on a wild ride of emotions. Some of you might have been thrilled with his tweets and bravado, some of you might have been appalled and disheartened, but everyone was fascinated. It was quite a trip.

But the thing is, Trump had little impact on the economy this year. The only piece of legislative accomplishment was the tax bill, which only came at the end of the year. Ironically, the delay in the tax bill from the stated goal of May until December worked in favor of the stock market. Traders had a full year to anticipate and hype the tax bill. No wall was built, some regulations bit the dust but no dramatic changes were realized, and his campaign bluster on trade failed to be converted into real action. The lack of action on trade was one of the biggest positives of Trump's first year.

But Trump does deserve credit for at least part of the stock rally, though not as much as he would have you believe, because he did launch a year-long surge in business optimism on the anticipation of tax and regulatory relief.

Without getting into the politics of the first year of Trump, let's just say that he and the American public survived.

### *The year in the markets*

Obviously, it was a great year for stocks, with the Dow up 25%, the S&P +20%, and the NASDAQ +29%. But perhaps the most surprising development in the stock market was the lack of volatility. Despite the Trump tempest stirred up from time to time, 2017 was the least volatile year on record in terms of daily changes.

The year 2017 was not a good year for the bond market, but it wasn't a disaster. The Fed did as economists forecasted by raising the funds rate three times in 2017, and shorter-term rates rose accordingly. The 2-year yield rose 70 basis points, and the 5-year yield was 28 basis points higher. The "roll-down-the-yield curve" trade did not work this year, either. Rolling down the curve simply means you could buy a 2-year note for instance, and a year later it would be a 1-year note that would be priced to lower yields. But the Fed's push higher of the funds rate and the flattening yield curve pushed that trade into the losing column.

The 10-year yield was almost unchanged on the year, falling only 5 basis points. But looking at the yearly average, the 10-year yield in 2017 was significantly above that of 2016. The 10-year yield averaged 2.33% in 2017 vs. 1.75% in 2016. The 30-year bond was the only issue on the yield curve to post a gain on the year, as the yield declined from 3.06% to 2.74%.

The bond market was also notable for its lack of volatility. Daily moves were very limited. Yields in the short-end of the curve rose steadily, but longer-term yields moved little as yield curve flattening trades were all the rage in bondland. The trading range for the 10-year note for the entire year was 2.04% to 2.61%, and those two extremes were short-lived.

Despite what felt like turbulent times, the markets were positively tranquil.

***The year in the economy***

The economy in 2017 did well to very well by almost all measures. We were treated to multiple headlines this year that began with "Best (fill in the blank) in 15 years!" In some cases, the time frame was forever. There were no real lowlights in 2017, several highlights, and a few so-so lights. Let's recap some of the top economic developments in 2017:

- Nonfarm Payrolls averaged 171k on a monthly basis, down only 12k from the 2016 average. That might not sound like a particular highlight, but it is when you consider that came with a very tight labor pool. Along with the payroll gains, the Unemployment Rate fell to a sixteen-year low of 4.1%.
- Auto sales fell from 17.5 million in 2016 to 17.2 million in 2017. This one also doesn't sound like a highlight, but it was still a very good year for automakers from a couple of perspectives. First, after two consecutive record-setting years, capping off a seven-year recovery cycle, the pullback to 17.2 million was above most expectations. It is also worth noting 2017 was the fourth best year for car sales on record. Second, the lower sales rate was partially intentional by the automakers as they consciously pared back sales to rental companies who offer only small profit margins and damage used car prices.
- Home prices rose 6.5% on a national basis according to the Case-Shiller home price index. The gains were not spread evenly, but all regions reported price increases. But the story of the year was the lack of supply, and that was a common thread throughout the country.

- Housing Starts managed to hit 1.3 million units on an annualized basis. This was the best level since October 2007. This, as well as big gains in commercial construction, led to a strong add of 210k jobs to the construction sector.
- Manufacturing had a bit of a resurgence in 2017. The National ISM index hit a 14-year high, and the U.S. added 196k manufacturing jobs to the payroll count.
- It looks like GDP will come in around 2.6% for the year. That is not a fantastic number, but it is better than the consistent 2.0-2.2% the last five years.

Perhaps the biggest and best economic surprise of the year was how well the global economy performed, especially Europe. Europe survived critical elections in France and Germany, and the economy exceeded all expectations.

Yes, it was a very good year for the economy and the markets in general, and that set-up will provide a good launching pad for 2018. But a good launch doesn't guarantee a smooth landing.

**2018 — A turning point?**

In 2011 and 2012 I was cautiously optimistic on the economy. From 2013 through 2017 I was very optimistic on the economy. I as we enter 2018, I find that old caution creeping back into my outlook. There is no hard data now to suggest that we will see anything other than an improved economy. I can't point to numbers. It's more of a feeling I get after observing the economy, the markets, and human behavior for many years. So, you can take this outlook with a grain of salt, but I hope this will cause you to think beyond the standard Wall Street forecasts and come to conclusions of your own. The following is what I think the big factors will be in 2018 and how those factors will impact the economy and your credit union.

***The best or worst tax bill ever!***

Naturally, we must start any discussion on the outlook for 2018 with the implications of the tax bill and an understanding of what this tax bill truly is. The analyses given by the creators of the tax bill and critics of the bill were miles apart in all areas but one. They were both hyperbolic by a factor of one hundred. I don't see this bill as bringing in Boom City, nor do I see it as destructive. It has something for everyone, just maybe not enough in the right places. This will be the longest part of this commentary, and I'll break it down in bite-size chunks without going into laborious detail.

***For the people*** — Trump and Congress tried to sell the bill as the greatest middle-class tax cut of all time, but the American public didn't buy that. A more honest sales pitch from Congress would have been "Hey! It's better than nothing!" But truth in advertising does not apply in politics. A true middle-class tax cut and a reformation of the tax system would have started with something like this:  much lower tax rates for those making less that $100,000 or perhaps up to $150,000, and no change at all for those in higher incomes. That would have had a much more positive impact on spending, as those in the lower brackets tend to spend any increase in take home pay, while it makes little difference in the spending patterns of the wealthy.

This simple plan would also help toward narrowing the income inequality gap that politicians and others claim to be so concerned about. The income gap first started really showing up after the Reagan tax cut. Just a coincidence? I don't think so. There are certainly other factors impacting income inequality, but this must be at the top of the list. But this sort of plan would never see the light of day under *any* political party. Money talks, and it talks the loudest in Washington D.C.

There is something for the middle class, just not a lot. According to the Wall Street Journal, those making between $20,000 and $100,000 will realize a cut of somewhere between $800 and $1200 per year. The total piece of the tax cut pie for that group, which represents 50% of all taxpayers, comes to 10% of the total tax bill or $140 billion over ten years. That is $14 billion per year. That is not nearly enough to move the needle on the economy.

The rich do come out on top. That is just math. They pay the most and, since they got a cut, they get the most. But there will be some of the wealthy that will pay more in high-tax states like California, with the caps on state and local taxes. But I am not concerned about a max exodus from California et al. Those states have been the highest taxed states for decades. This is not new. A lot of people, especially retirees, have moved already moved from California and will continue to do so, but the tax bill will not accelerate that trend. There are many reasons why Californians have chosen for years to remain Californians and pay the freight, and those reasons aren't going away.

But let's look at the upside. Despite polls showing that only 22% of Americans believe their taxes will be lower, the fact is more than 90% will see some sort of cut. Currently, 71% already take the standard deduction, and that group will grow. They are guaranteed lower taxes. Once that is realized, consumers might be willing to spend a little more. For those in California and other high tax states, the new tax law will leave many of them uncertain about what they will pay. Is it a tax cut or a tax increase? Most, but not all, will end up slightly better off.

Clearly, I am not a fan of this bill as it applies to individuals. It is a lost opportunity. But the bottom line is that the vast majority of Americans will be seeing fatter paychecks to varying degrees, and that can't be bad.

***For businesses*** —I have no argument with the provisions in the tax bill for businesses. Reform was long overdue. The ultimate success or failure of the total tax bill rests with corporations, because this bill is really a corporate tax reform bill. Businesses need to provide the "trickle down" effect for this bill to be successful for everyone. And, I am somewhat optimistic that businesses will spend more in at least the first half the year.

Capital spending by businesses rose sharply in 2017 as businesses acted on that renewed sense of optimism. The tax law changes should keep that trend intact, at least in the first few months of the year. Not only will they enjoy a lower tax rate, they will also benefit from the immediate write-off for capital expenses.

Many analysts are worried that businesses will do what they have always done with tax windfalls — financial engineering. Businesses were allowed a one-time tax break on bringing foreign earnings home in 2004. But instead of spending to grow, they paid dividends and bought back shares. With this tax break I'm sure we'll see some that again, but I think this time businesses will at least start going down the spending-to-grow road, and we have Wall Street traders and investors to thank for that.

For years Wall Street rewarded companies based on earnings per share (EPS), and that rewarded companies that bought back shares and reduced shares outstanding. Fewer shares meant higher EPS. The businesses could be stagnant, but the stocks could soar based on EPS. But the picture started to change about two years ago. Now Wall Street analysts look at revenue growth first and EPS second.

I expect the first half of the year will be the best part of the year for spending and hiring. After that splurge is when I start to get concerned. If revenue growth doesn't come quickly, Wall Street will turn on businesses and businesses will retreat.  I hope I am wrong and revenues rise and justify higher stock prices and business spending, but I expect an unwelcome slowing in the second half of 2018.

***For housing*** — Changes in the mortgage interest deduction caused as much uproar as anything in the tax bill but will have the least impact of all. First, the cap is $750,000, which is only $250,000 lower than the current cap. Existing home mortgages of $1,000,000 will be left as is. CoreLogic estimates that nationally, only 3.9% of future buyers will be hit with reduced deductions, though that rises to 11% in California.

The limit on property taxes will be more problematic for California and other states with high real estate prices, but the problem is not what you think. The problem is this will discourage homeowners form selling to move up. They will have more incentive than ever to stay put in their existing home with a lower tax rate.

The biggest problem for real estate in California and many, many other states is lack of supply, and this bill will exacerbate that problem. That's positive for home prices but not for real estate activity.

Despite these arguments and more, I still hear a lot of concern that home prices will suffer because of the tax bill. But if you think tax benefits of buying a house are at the top of the list of reasons people buy homes, you are wrong. The following list is a summary of the top 5 reasons people buy homes according to three separate surveys from real estate and consumer groups:

- More space
- Family reasons— safe place, schools, etc.
- Opportunity to build equity and freedom to make changes
- Near family
- Prestige

You will note that missing from this list are tax benefits. If you want to worry about home prices, your only source of worry might be rising mortgage rates, not the new tax bill.

***More to come***

I feel like I have just scratched the surface of this tax bill. What about the deficit? That's a worry for another day, and isn't that always the case? Ultimately, this could be a very big deal, but we have a few years to face that. How about health care? How many people will see a tax cut but see their health insurance bills skyrocket thanks to the stealth dismantling of Obamacare with no adequate replacement? How about funding for deficit financing costs if interest rates rise? We're just getting started, but now let's turn to interest rates

**A brand-new Fed and maybe a brand-new bond market for 2018**

In the December commentary I wrote about the brand new Fed in 2018 with five of the seven members of the Federal Reserve Board, including the Chairman and Vice Chairman, being Trump appointees. Politics should not matter, as once a board member takes his/her chair the Administration has no control. But I think politics might matter this time with such a complete upheaval in the board make-up.

Now I am really delving into what I think might happen that has no data to support my theory. Currently, the market is pricing in a funds rate increase in March, with two more to follow in 2018. This was the current Fed's plan, and economists are expecting that plan to remain unchanged with the new regime. If inflation ticks up, the consensus forecast for the Fed will be realized, as it was last year. The year-end funds rate will be 2.00-2.25%, and 10-year rate will only reluctantly near 3%. The yield curve will continue to flatten.

But I expect this Fed to act differently. I believe this Fed, while independent, will be reluctant to raise rates and risk appearing to try to blunt the positive impact of the tax cut. If inflation is stable or rises only slightly, they will have the excuse to go slowly. In fact, they can point to the path of inflation in 2017 to justify taking more time to raise rates. The Core CPI was 2.3% beginning in 2017 but then fell to 1.7%. This year the core rate will begin at 1.8%. Even if the economy is humming, the Fed could stand aside and point to sluggish inflation.

Based on that, I am looking for one funds rate increase at most, and that would not come until June at the earliest. That is a new forecast for me. Of course, I will give myself an out. If inflation surges or wages bolt higher, the Fed's hand will be forced, and we will get those three rate increases, and I will resurrect my old forecast.

A slower Fed does not mean good times for the long-end of the bond market. If I am right, I think the bond market might rebel and begin to worry the Fed is being too loose, too long. That could put upward pressure on longer-term rates. But there will be a far bigger force at work in bonds than the Fed, and it's called supply and demand. By the 4th quarter of 2018, the Fed will be completely out of the securities buying business, and the European Central Bank will also either be out of the business or have a much smaller presence. I don't think that has sunk in to traders . . . or they are living in a state of denial.

That's the demand side. On the supply side, thanks to the growing deficit (locked in before the tax bill) and the maturities of notes, *net* new issuance of notes and bonds will be over $200 billion. This is according to Goldman Sachs. There will be another $400 billion in net new demand that the Treasury will likely add to maturing treasury bills.

This combination of events will result in a steepening of the yield curve as we approach the latter part of 2018. Major bond trading accounts are all-in on the yield curve flattening trade for 2018, but I think the bond market is in for a reset.

**Just for credit unions**

Credit unions should continue to do well in 2018, but I would expect loan growth rates to decline slightly. Part of the reason is math. Percentage gains in growth will be harder to match because the base for the growth rate is larger. Auto lending should be solid, but I expect mortgage business to slow as higher rates limit refi activity and the housing shortage crimps the purchase mortgage business.

If the Fed does raise rates three times this year, some high loan/share credit unions will be facing growing competition for shares and c.d.s. If I am right on either longer-term rates or a go-slow Fed, the steepening yield cure will offset some of the upward pressure on share rates.

I think this will be another good year for credit unions, but I might lower my expectations later in the year.

**The recap**

Everyone loves bullet points, so here are my final thoughts in bullet point form:

- The easy prediction is the stock and bond markets will be more volatile this year. The year 2017 will be an easy year to beat for that prediction to be realized.
- The Fed will raise the funds rate only once but the 10-year yield will rise to 3.50-3.75%. If inflation surges, I'll have to issue a mid-course correction forecast for this one.
- Job growth will be good again, but the monthly job gains will slow because of the tightening labor pool. Wage growth will take a step forward.
- The economy will do better the first half of the year than in the latter half. But we won't have to worry about a recession just yet.

The classic Peggy Lee song, "Is that all there is?" keeps popping up in my thoughts. My concern is that consumers will be singing that when it comes to realizing what the tax cut has meant to them, and businesses will be singing the same tune later in the year when business fails to grow as strongly as expected. When revenues disappoint Wall Street, you can bet traders and investors will have "Is that all there is?" playing on a loop. If this song is the song of 2018, let's not forget the way the song ends. *"If that's all there is my friend, then let's keep dancing. Let's break out the booze and have a ball if that's all there is."* Maybe that's good advice no matter what happens this year.