ECONOMIC OUTLOOK

Economic Summary

The U.S. economy continues to perform well. Economic growth has picked up in recent quarters and job gains remain strong enough to pull down the unemployment rate even as more individuals are looking for a job. More importantly the near-term prospects for economic growth are good. The business cycle is not yet waning. The tight labor market drives wage growth higher. And as the economy approaches capacity, inflation is set to rise after five years running below target. From this relatively strong cyclical vantage point, the recently passed Tax Cut and Jobs Act by the federal government will boost near-term growth even further. However, longer-run forecasts remain relatively unchanged, in part due to the temporary and expiring provisions in the legislation.

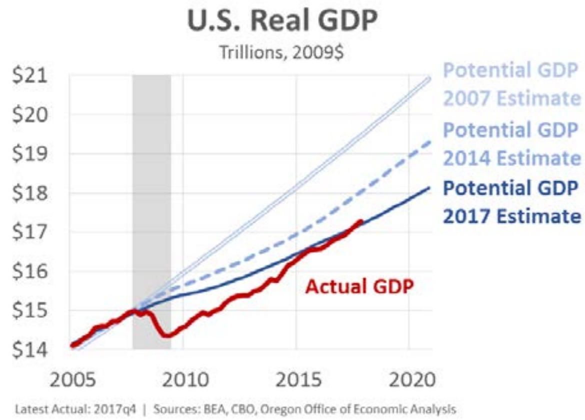
In Oregon, the outlook remains bright as the economy continues to hit the sweet spot. Employment growth is more than enough to meet population gains and to absorb the workers coming back into the labor market. Wages are rising faster than in the typical state, as are household incomes. That said, employment and measures of economic wages have come in below expectations in the second half of 2017. From this somewhat lower starting point, the modest economic boosts provided by federal tax changes results in a relatively unchanged forecast overall.

U.S. Economy

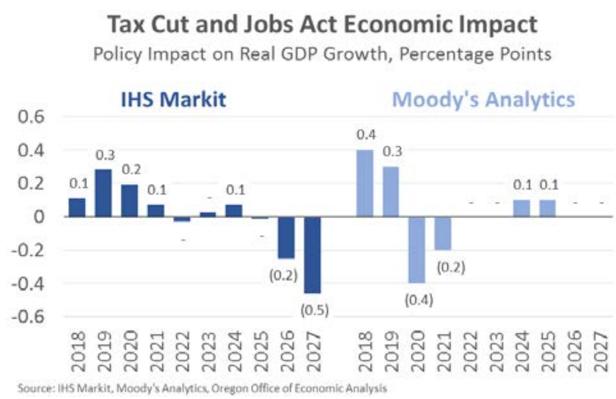
The U.S. economy continues to see a healthy data flow. Real GDP growth has been above potential for the past three quarters, marking the best stretch since 2014. Given employment gains continue to outpace labor force growth, the unemployment rate is set to decline further. The combination of record-setting job openings, and faster wage gains due to a tighter labor market are pulling more individuals off the sidelines. Some of these improvements are masked due to the wave of Baby Boomer retirements in recent years, however progress is being made. That said, the economy is likely not quite at full employment, as some economic measures continue to show slack. In particular, the share of prime working-age Americans with a job remains about one full percentage point below where it stood prior to the Great Recession, and two and a half percentage points below its late 1990s readings. As such, wage growth, while improving and set to march higher, remains relatively tame compared with past business cycles. Similarly, inflation has picked up in recent months, following five years of running below target.

The combination of healthy U.S. data and better-than-expected growth from around the world reveals an economy that is finally is a strong cyclical position. The International Monetary Fund recently revised up their estimates for global GDP in 2017 and raised their forecasts for this year and next. Additionally, Moody's Analytics finds that no major economy around the world is currently in recession for the first time since the financial crisis a decade ago. The business cycle has clearly not waned yet. And it is from this position that the U.S. is set to run a fiscal experiment, given the recently passed Tax Cut and Jobs Act and the federal budget negotiations.

While the conventional case for fiscal stimulus is typically countercyclical, undergoing stimulus today may prove productive and at the same time also have relatively limited risks in the near term. Or at least risks that are skewed toward the upside and not the downside. Today, U.S. GDP is at potential, or at least the most recent estimate of potential from the Congressional Budget Office. However, GDP remains four percent below the CBO's 2014 estimate and eleven percent below their 2007 estimate. To the extent that this fiscal experiment of providing stimulus in a relatively strong economy can wring out those last few percentage points of prime-age employment, or increase business investment and raise potential GDP further, then it may be worth taking the opportunity to try. These benefits, should they be realized, would be very valuable. Full employment and a tight labor market do work wonders, even if they cannot cure all ills.



Even so, while all of the major studies of the Tax Cut and Jobs Act find the legislation to be stimulative, the impacts on economic growth are very much on the margin. IHS Markit, formerly IHS Global Insight, estimates the impact on GDP in 2018, 2019 and 2020 to average 0.3 percentage points. Moody's Analytics is a bit more optimistic in 2018 and 2019, however their estimated impacts turns negative sooner, and more severe in 2020 and 2021 as the tax cuts begin to shrink and eventually phase out, at least on the personal side. Over the longer-term, no major study finds that GDP increases substantially due to the legislation, at least in part due to the temporary provisions, in part due to the strength of the business cycle, and in part due to the nature of the tax cuts. Some of the tax windfall for both individuals and corporations will be saved and not spent or invested in growth enhancing endeavors.



Should there be less economic slack than believed, or the supply side constraints harder to overcome, then the fiscal stimulus will likely manifest itself into higher inflation. From here, the Federal Reserve would step in and raise interest rates faster than they otherwise would to slow economic growth. This plausible scenario could also signal the end of the expansion and the onset of the next recession. Engineering the so-called soft landing, where the Fed slows growth to head off inflation but not tipping the economy into recession, is difficult to achieve in reality. Just like the economy overall, the newly reconfigured Fed and FOMC faces considerably different challenges in 2018 and beyond than what has happened in recent years.

In fact, as stock markets have repriced their expectations of interest rates, due at least in part to the healthy flow of economic data and the Federal Reserve signaling their future path of hikes, there has been a correction in valuations in recent weeks. To date this correction, if anything, works in the Fed's favor, or their baseline outlook. Longer-term interest rates have crept up slightly as economic growth and inflation have firmed, and concerns about excessive financial market growth are gone, for now.

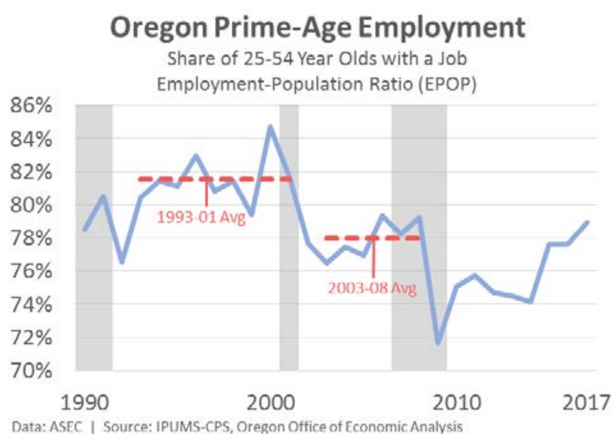
Finally, the economy is beginning to run into supply side constraints. The biggest and most pressing issue today is labor. The fiscal stimulus may lead to higher participation rates as workers are pulled back into the strong economy and tight labor market, and to higher wages in the long run. However, the classic economic case for lower corporate taxes leading to higher wages is not for a company to take their savings and immediately turn around and hand some of it to their workforce. This may occur, but the economic literature, as laid out by

President Trump's Council of Economic Advisors[1], shows the typical channel is through investment and productivity gains. As businesses invest a portion of their tax savings in new, better, or more capital, their workers become more productive, and earn higher wages. This is very much a multi-year process. As such, recent media reports and corporate press releases noting worker bonuses and pay raises may better reflect the current tight labor market, rather than compensation increases solely due to the tax legislation.

U.S. Bottom Line: The economic expansion marches on and the flow of economic data remains healthy. The U.S. is about to embark on a fiscal experiment of stimulating a relatively strong economy. Expectations are for somewhat stronger growth in the near-term. However, even as the probability of recession remains low – just 14 percent based on the latest Wall Street Journal consensus – a plausible recession scenario has now come into focus. Should the economy truly be at full employment, then the stimulus will manifest itself in higher inflation, leading to interest rates rising faster than currently expected, and potentially choking off economic growth entirely. However, this is far from a foregone conclusion at this date and economists and the Federal Reserve are watching for signs of better employment gains, wage growth, inflation, and pushing through supply side constraints.

Oregon Economy

The Oregon economy continues to hit the sweet spot. Job growth is strong enough to keep up with population gains and absorb the workers coming back into the labor market. The state's participation gap is effectively gone, following the rising labor force participation rate in recent years. The tight labor market is resulting in faster wage gains here in Oregon than in the typical state. While Oregon's average wage remains lower than the U.S. average, it is now at its highest relative point since the mills closed in the 1980s. And Oregon's per capital personal income is now at its highest relative point since the dotcom crash. All told, Oregon's expansion remains intact. However, both job growth and measures of economic wages, like those from the Bureau of Economic Analysis, have come in below forecast in recent quarters. Oregon is still seeing growth, however a bit below our office's expectations. Combining this relatively lower starting point, with the modest expansionary gains from federal tax reform results in a relatively unchanged forecast overall.



Like the U.S., Oregon's labor market is tight. Difficulty finding and retaining workers[2] is the biggest challenge many businesses face today. This tight labor market is expected to remain in place until the next recession for two different reasons that are coming to a head today: the business cycle and demographics.

First, the unemployment rate is flirting with record lows even as Oregon has seen the labor force response one

[1] https://www.whitehouse.gov/sites/whitehouse.gov/files/documents/Tax%20Reform%20and%20Wages.pdf
[2] https://www.qualityinfo.org/documents/10182/90519/A+Lack+of+Applicants+in+a+Growing+Economy?version=1.2