ECONOMIC OUTLOOK

Economic Summary

The economic expansion continues and the outlook remains bright. For the first time since the financial crisis, the U.S. economy lacks a major headwind. Expectations are not for a substantial pick-up in growth rates themselves, but for the expansion to endure, possibly becoming the nation's longest on record. If anything, the current macroeconomy is a conundrum for the Federal Reserve given low unemployment and low inflation. Even so, there do remain significant risks to the outlook, particularly the uncertainty of federal policy.

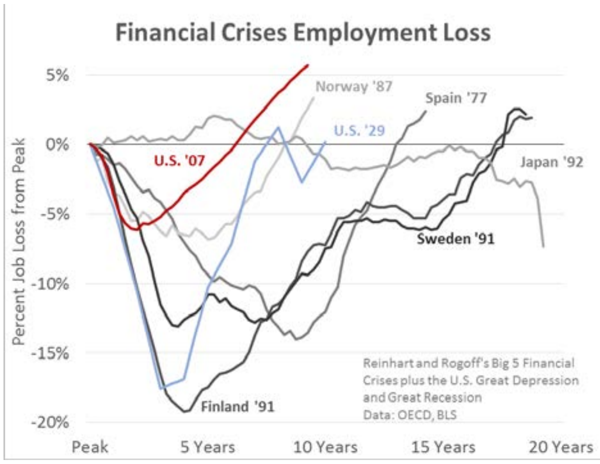
Oregon's economy is largely tracking expectations of slower growth in a mature expansion. The state continues to see healthy job gains that are enough to keep pace with a growing population and hold down the unemployment rate. However recent, preliminary employment reports, and stabilizing growth in withholdings out of Oregonian paychecks indicate that risks may be tilted toward the upside over the next year.

To maintain stronger labor market gains Oregon will need to see either stronger population growth overall or higher labor force participation rates among current residents. To date Oregon has experienced a very strong, and needed labor force response. Participation rates have increased considerably in recent years as more Oregonians have come back to the workforce in search of the more-plentiful and better-paying jobs. Further participation gains, particularly among the prime-age population is not unreasonable to expect in a strong economy. Oregon continues to hit the sweet spot as the economy approaches full employment.

U.S. Economy

The current economic expansion is now eight years old making it the third longest expansion in the U.S. since World War II. Even as the economy is closer to the next the recession than it is to the last, the outlook remains bright. Maybe not so much in terms of growth rates, but in terms of sustainability and duration of the cycle. For the first time since the financial crisis, the U.S. economy lacks a major economic headwind or cyclical issue.

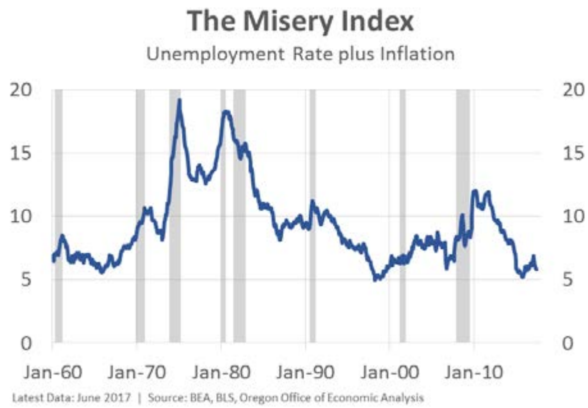
In years past the U.S. faced the financial crisis itself, the household debt overhang from the housing bubble, the Greek debt crisis, a federal government shutdown, and an oil bust to name a few. The good news is that today none of those impediments remain. The U.S. has weathered each storm and overall has outperformed the other major financial crisis in history. To quote Mark Zandi, Moody Analytics' chief economist, the macroeconomic outlook looks to be, if anything, boring. Even so, risks remain as do long-term structural challenges.



But first some good news. The one major drag on growth in recent years has been the fallout of the oil bust that began in late 2014. As oil prices have stabilized and increased some since then, mining activity has revived. The declines seen in nationwide industrial production have reversed. Hard hit sectors like mining and related activities and metal manufacturing are growing again. Manufacturing is once again adding jobs, reaching new post-Great Recession highs in each recent month. Overall business investment has picked up as well, at least in part due to new mines and wells.

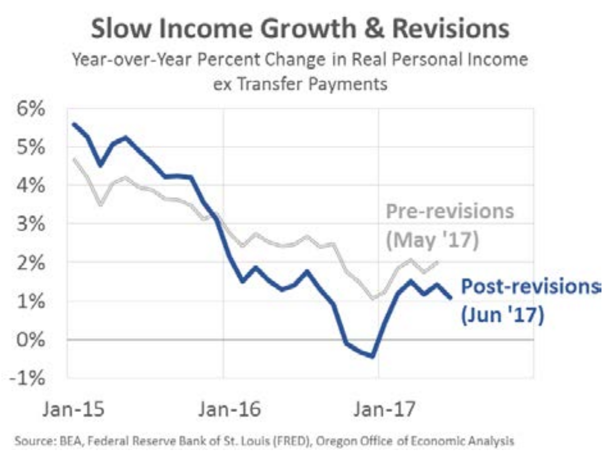
While job growth nationwide, and here in Oregon, has slowed over the past 18 months, it remains strong enough to both pull workers back into the labor force and bring down the unemployment rate. Wage growth continues to improve at the U.S. level, however in fits and starts and at a slower pace than the unemployment rate alone would suggest. This indicates some economic slack remains, particularly among the prime working-age population (25-54 years old) where the share of such Americans with a job remains a couple percentage points lower today than a decade ago. Inflation remains well-anchored, however consistently below the Federal Reserve's target for the past five years.

In fact, the U.S. economy is near a multi-decade low for the so-called Misery Index. Coined by economist Arthur Okun in the 1960s, the index is the combination of the unemployment rate and the rate of inflation. The index stands near 6 percent in recent months given unemployment is near 4.5 percent and inflation is around 1.5 percent.



A low Misery Index is generally good news as it means most people who want a job, have a job and prices are stable. However it can create challenges for the Federal Reserve. Good challenges, but challenges nonetheless. Today, the unemployment rate is below the Fed's estimate of the natural rate of unemployment and, again, inflation remains below target. Therefore, the current economy is somewhat of a conundrum for the Fed. As such, many economists are looking for potential monetary policy mistakes that may be the catalyst for the next recession.

While nearly all economic news in recent months continues to be positive, there is one persistent and on-going issue plus significant risks to the outlook. Total U.S. personal income continues to grow at a slow pace. Additionally the annual revisions undertaken by the Bureau of Economic Analysis shows that there is less personal income than estimates initially thought and the growth rates have been slower as well. This is concerning in its own right, however the downward revisions are also problematic from an economic and revenue forecasting perspective. Even though the revisions are to historical data, estimates of Oregon's personal income in early 2017 have been revised down nearly one percent, with wages down nearly two percent. While these slower income trends may overstate any economic weakness given the plethora of other data points, they still flow through to the underlying economic and revenue outlook.

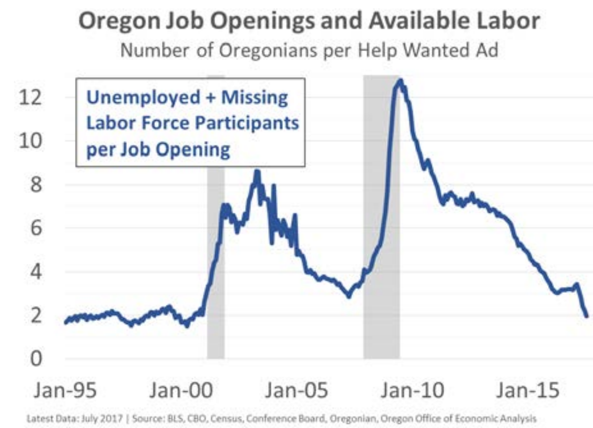


Additionally, federal policy uncertainty looms large, however there has yet to be any real impact on what economic forecasters are predicting. Forecasters' rhetoric about how potential policies may play out has ebbed and flowed with the political winds, however forecasters' actual predictions for economic growth, jobs, personal income and the like have held steady throughout the turbulent first few months of the Trump administration and unified Republican government.

That said, as detailed earlier this year[1], many of the big policy ideas being discussed generally fall into two camps when it comes to their impact here in Oregon. The first camp consists of policies like tax rate reductions, infrastructure spending, deregulation, and immigration reform, that will likely impact Oregon to the same degree as the typical state. The second camp consists of policies like tax base broadening, health care reform, federal land policies including Canadian lumber tariffs, and international trade wars that are expected to have a larger impact on Oregon than seen in the typical state. Campaign promises rarely turn word for word into legislation and the devil is always in the detail. As such, until actual legislation is drafted and passed, it can be hard to predict the economic impact of these broad and wide-ranging topics.

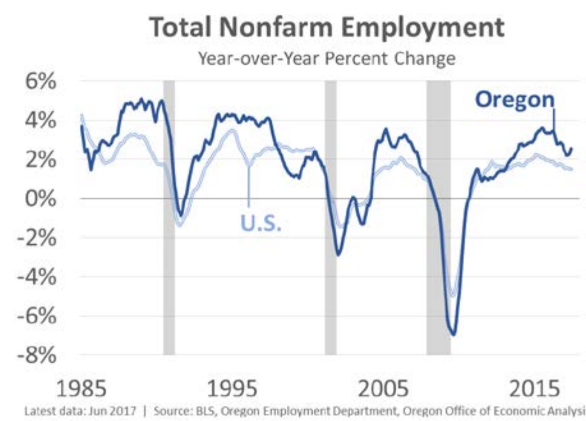
Oregon Economy

As always, Oregon's expansion is outperforming the typical state due to our industrial structure and ability to attract and retain young, working-age households. Today is no different. While job growth here in Oregon has slowed since the full-throttle rates seen in 2014 and 2015, Oregon is still outpacing the nation overall. The state's labor market is relatively tight. The number of available Oregonians per job opening is nearly all the way back down to levels not seen since the 1990s. Businesses across the state are reporting more positions are difficult to fill today than a few years ago. As the Oregon Employment Department reports[2], many are hard to fill for job-specific reasons like low wages, odd hours, geographic location and so forth, however some are hard to fill due to a lack of applicants in general.



Oregon's relatively tight labor market is now driving a virtuous cycle of stronger wage gains, businesses hiring candidates with a gap in their resume or an incomplete skill set, and pulling more Oregonians back into the workforce in search of the more-plentiful and better-paying jobs. Furthermore the tight market is leading to slower growth as the economy transitions down to a more sustainable rate. An economy digging out from a recession behaves considerably different than once approaching full employment.

That said, there still remains upside risk to the Oregon outlook in the near-term. Job growth has picked up in recent months, at least in the unrevised data, and withholdings out of Oregonian paychecks have stabilized at relatively strong rates of growth. While it remains unlikely Oregon will grow at full-throttle rates at this point in a mature expansion, job and income gains can certainly be better than expected. In order to see such gains, the labor force will need to continue to increase.



Labor force growth can be due to stronger population gains. However as the economy slows overall, population growth will as well. In fact, one good leading indicator – surrendered drivers' licenses at Oregon DMVs – has come off its

[1] See the March 2017 forecast document for details http://library.state.or.us/repository/2009/200908311536431/
[2] https://www.qualityinfo.org/documents/10182/90519/A+Lack+of+Applicants+in+a+Growing+Economy?version=1.2