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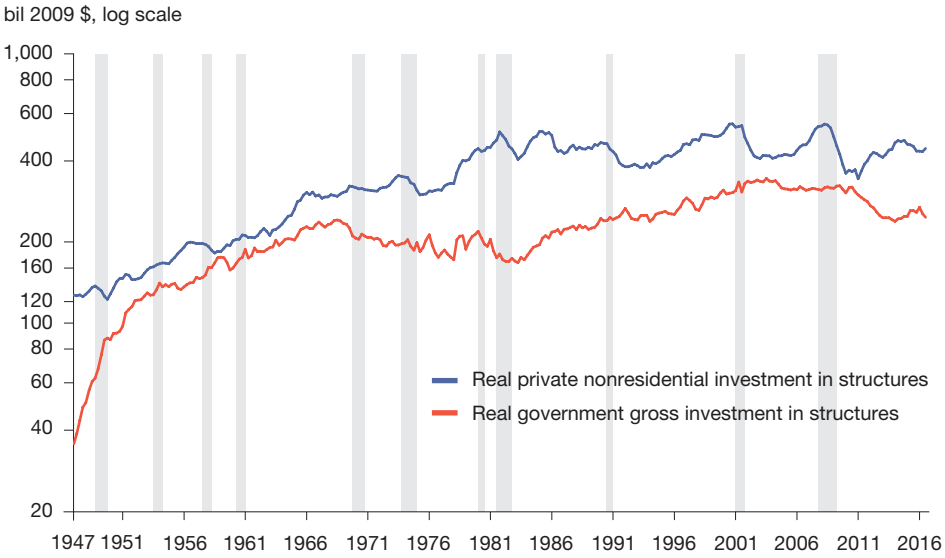
An improving economy and new fiscal policies may boost spending on structures.

The outlook for the U.S. economy continues to improve. Our index of Primary Leading Indicators rose again in the latest month, the labor market continues to show strength, financial conditions remain favorable, and business and consumer confidence are broadly upbeat.

This month we examine the outlook for spending on structures, one of three major categories of business investment, aside from equipment and intellectual property (see the December BCM for our analysis of spending on equipment, www.aier.org/bcmoverview2016december). Neither private nor public-sector spending on structures has recovered to pre-Great Recession levels (Chart 1). However, increasing economic activity and improved profits should provide a solid foundation for more private investment. For the public sector, promises of greater infrastructure spending were supported by both presidential candidates and many members of both political parties. While governing is very different from campaigning, it would seem likely that politicians could agree on some areas of infrastructure spending policy in coming years.

Chart 1. Real investment in structures remains below prior peaks.



Note: Shaded areas denote recessions.
Source: Bureau of Economic Analysis (Haver Analytics).

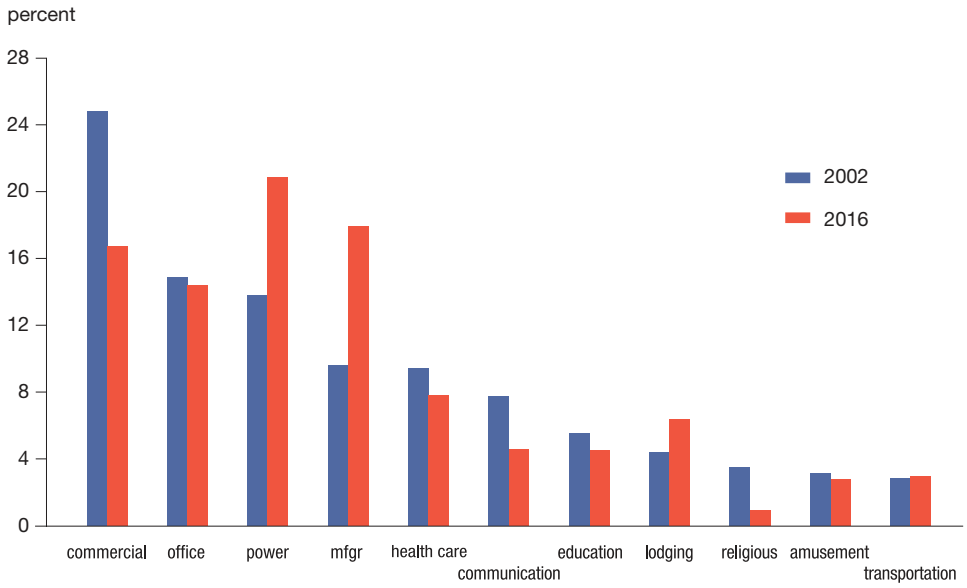
INSIDE THIS ISSUE

Stronger economic growth could lead to greater private investment in structures.

Private investment Private investment in nonresidential structures covers a wide range of building types. The U.S. Census Bureau reports monthly on spending for 11 categories of nonresidential structures such as hotels, hospitals, airports, and schools. Among those 11 categories, four dominate: commercial (primarily retail), office buildings, power structures (gas, oil, and electric), and manufacturing plants (Chart 2). Combined, these four accounted for about 70 percent of private-structure spending in 2016.

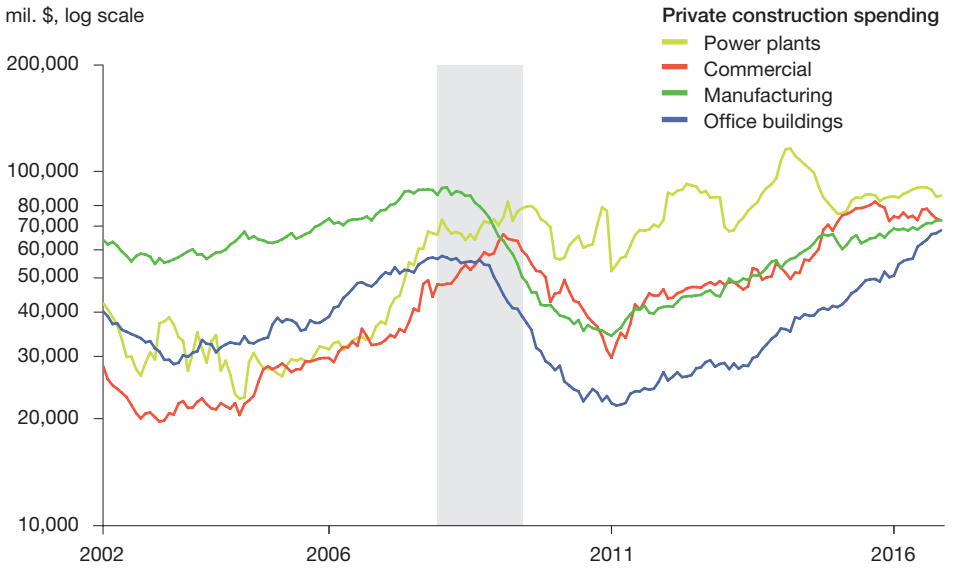
Among these four, spending on commercial, office, and manufacturing facilities fell following the Great Recession. Power structures showed some smaller declines but generally trended upward (Chart 3). The three categories that suffered big declines have already posted solid rebounds. All four, as well as many lesser categories, should benefit from an improving economy and better profit growth.

Chart 2. Commercial, office, power, and manufacturing facilities dominate private investment in structures.



Source: U.S. Census Bureau (FactSet).

Chart 3. Three of the four structure categories suffered spending declines following the Great Recession but have since rebounded.



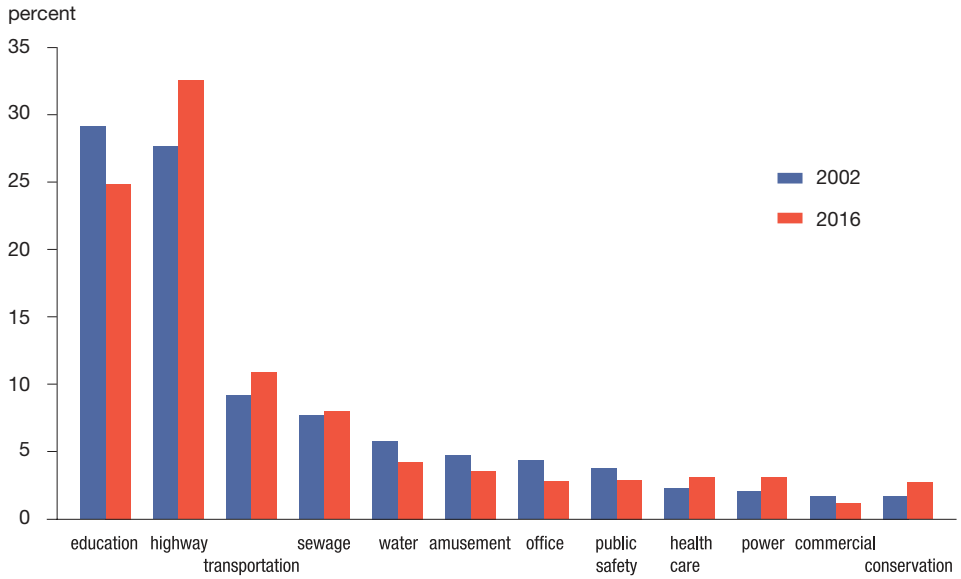
Note: Shaded area denotes recession.
Source: U.S. Census Bureau (FactSet).

More infrastructure spending is likely to be a public priority.

Public investment Infrastructure spending, an important part of overall investment in structures, is dominated by capital spending on education (classrooms, dorms, and athletic facilities, for example) and highway spending. Combined, education and highways account for about 57 percent of infrastructure spending. Adding transportation facilities (such as terminals, runways, and railroad tracks) and sewage treatment plants brings the total to about 76 percent of total public spending on structures (Chart 4). Highway and transportation spending are primarily federal programs, while education structures and sewage plants are typically paid for by state and local governments.

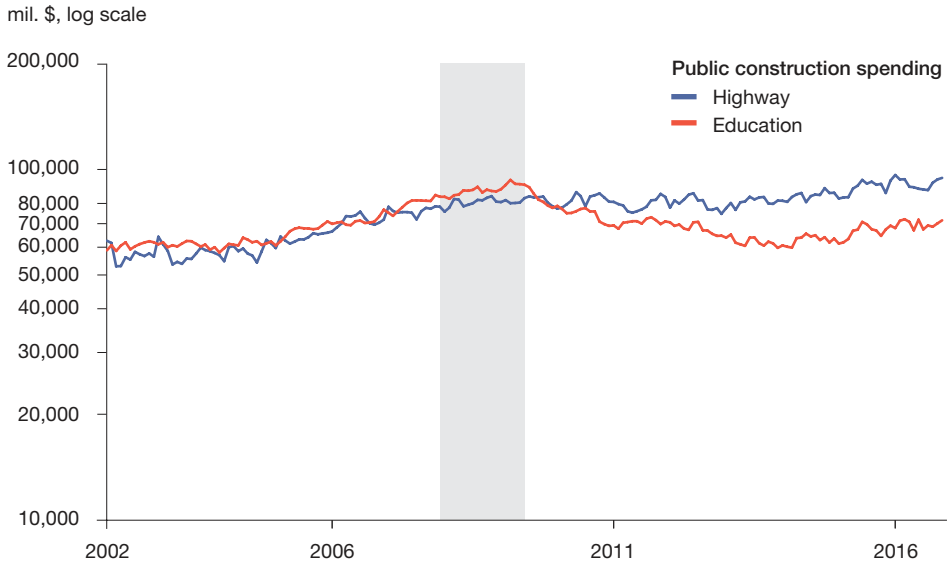
Several challenges face public infrastructure spending: politics perhaps not yielding optimal allocation among projects; improper bidding; waste and cost overruns; and long lead times. Those issues aside, increased public infrastructure spending is likely to be a priority in coming quarters.

Chart 4. Highways and education dominate public spending on structures, followed by transportation and sewage facilities.



Source: U.S. Census Bureau (FactSet).

Chart 5. Highway spending is above its prior peak, while spending on education structures is well below its high mark.



Note: Shaded area denotes recession.
Source: U.S. Census Bureau (FactSet).

ECONOMIC OUTLOOK

Our Business-Cycle Conditions Leaders index increased again in the latest month, rising to 75 in December, the highest level since 2014 and up from 67 in November (Chart 6). December also marks the first four-month stretch above the neutral 50 level for the Leaders since the end of 2015.

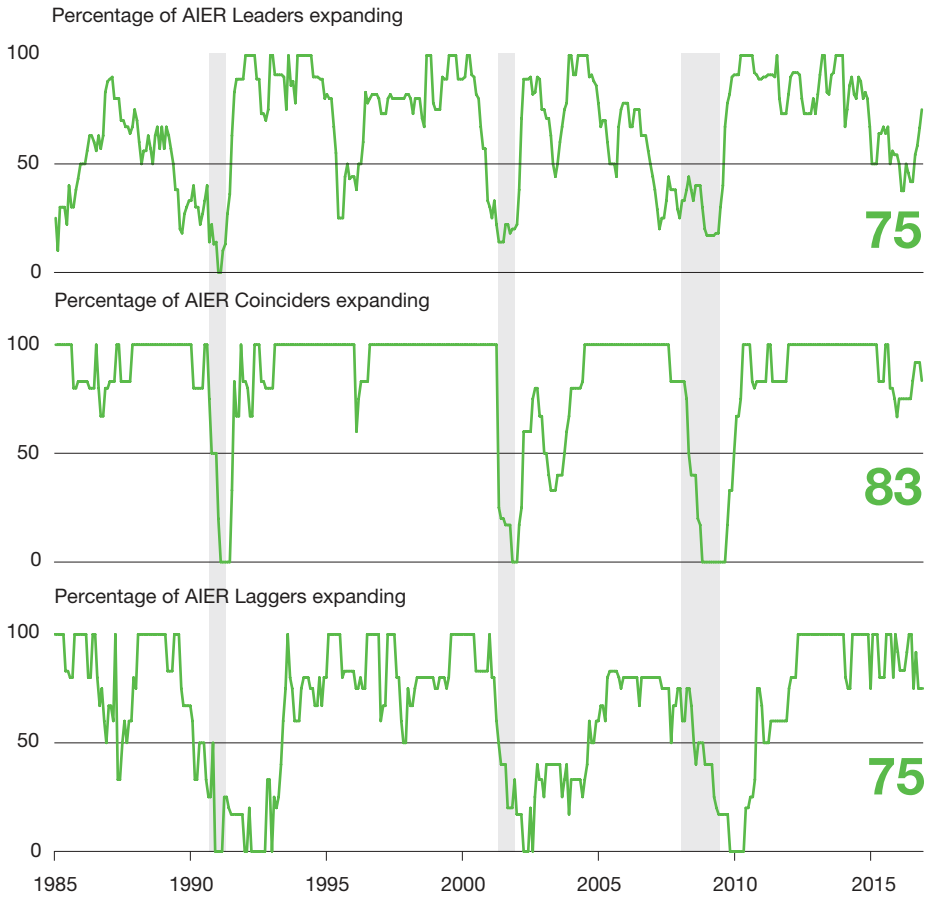
Among our 12 Leaders, seven are trending higher, four are trending flat, and just one is trending lower. Those trending higher are: initial claims for unemployment insurance, real retail sales, manufacturing and trade sales to inventories, consumer expectations, residential housing permits, real stock prices, and real debit balances in margin accounts. Flat trends have been identified in real new orders for consumer goods, real new orders for capital goods, the Treasury-yield spread, and the average workweek in manufacturing (hours). The lone decliner is real heavy-truck unit sales.

While the improvement in our Leaders index provides further evidence that the risk of recession in the near term has diminished significantly, we do not expect a sharply different pace of growth. Growth during the current recovery has been below its historical average. While new fiscal policy such as tax cuts and/or higher spending has the potential to boost growth in the short term, headwinds persist, such as unfavorable demographics, low productivity growth, and weak global growth.

Among our other indexes, the Coinciders retreated a bit to 83 in December from 92 in November while the Laggers held steady at 75 in the latest month.

Chart 6. Indicators at a glance

Shaded areas denote recessions.
A score above 50 indicates expansion.



Source: AIER.

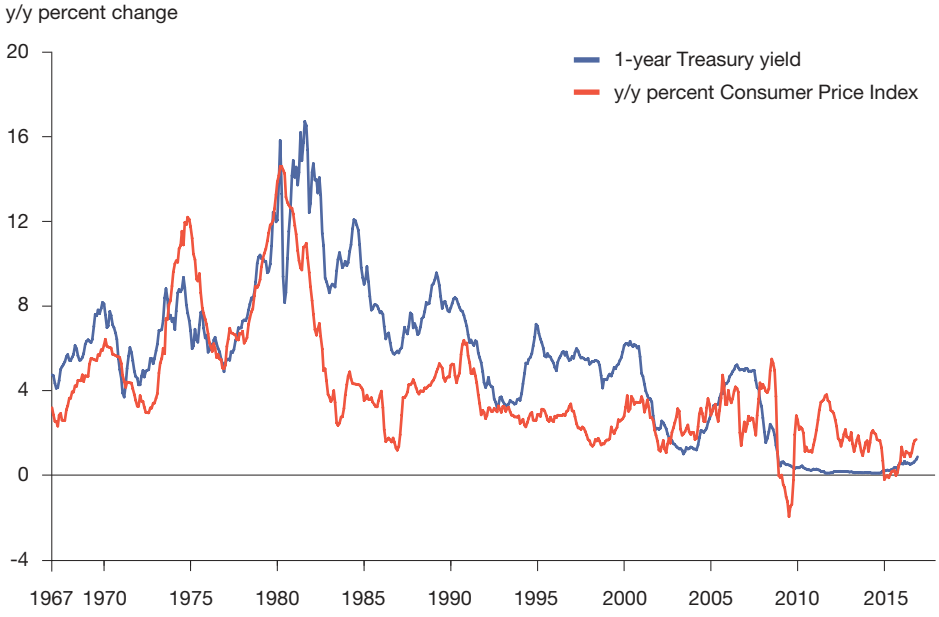
Interest on savings has not kept pace with inflation.

The Federal Reserve has kept interest rates extremely low in response to the 2007–2009 Great Recession and subsequent slow economic recovery. Since mid-2016 economic activity has been expanding at a moderate pace, and the labor market continues to strengthen. With the improvements in the economy, the Fed raised the federal funds target rate in December by a quarter point, from a range of 0.25–0.50 to 0.50–0.75. Looking ahead, the latest projections predict three more quarter-point increases in 2017. However, the Fed is data dependent, and the path of future rate increases is not locked in. The Fed's decision to raise the federal-funds target rate in December marks the second increase in two years, after a decade of keeping interest rates at historic lows.

Low interest rates on conservative savings accounts have not kept pace with inflation. Since the Great Recession, personal income from interest on assets has increased at an average annual rate of 1.5 percent. Over the past two decades, interest income has increased at an average annual rate of 2 percent. In December, the yield on the one-year Treasury note was 0.8 percent. The national average interest rate on a one-year bank certificate of deposit, another traditionally low risk investment, was 0.5 percent in December. In comparison, inflation as measured by the year-over-year change in the Consumer Price Index was 1.7 percent in the latest month.

A decade of low interest rates has helped borrowers, on the other hand. Important consumer finance rates, such as mortgages and auto loans, are lower today compared with their 10-year averages. According to BankRate, the national average in December for a 30-year, fixed-rate mortgage was 3.6 percent, compared with a 10-year average of 4.1 percent. Today, the interest rate on a new auto loan is 4.3 percent, compared with a 10-year average of 5.7 percent. Lower interest rates have spurred growth in consumer credit. Both revolving and non-revolving consumer credit outstanding have grown 6 percent over the past year, faster than in recent years. Debt service and principal payments as a share of income are near all-time lows.

Chart 7. Treasury yields have not kept pace with inflation.



Source: Bureau of Labor Statistics (FRED).

Simplifying the tax code introduces new complexities.

The complexity of the U.S. tax code, with its maze of deductions, exemptions, and different rates, imposes significant costs and burdens on households and businesses every year in the form of time spent preparing returns and money paid to tax preparers. A report by the nonpartisan Tax Foundation found that in 2016 Americans spent almost 9 billion hours complying with IRS tax filing requirements.

In addition, such complexity may distort economic decisions, making our economy less efficient. For example, if individuals do not know their marginal tax rates—there are currently seven brackets—they may make saving and spending decisions based on an incorrect amount of take-home pay.

It is not surprising, then, that politicians have long promised to simplify or reform the tax code.

These promises, along with tax cuts, were echoed this year both by President-elect Donald Trump and Republican congressional candidates. So with the GOP now controlling Congress and the White House, it might appear that major tax code reform is on the horizon. However, the president-elect and House Republicans have put forward very different plans. While Trump has promised to simplify the code, his proposed plan does little of the sort. The House GOP's "Better Way for Tax Reform" plan actually takes steps to simplify, however. Democrats, who control 45 seats in the new Senate (above the threshold of 40 needed to sustain a filibuster) may have some leverage here in helping tip the scales between either plan.

How the Republican plans compare

The greatest area of overlap between the two Republican plans is in tax brackets. Both propose reducing the number of brackets from the current seven, which range from 10 percent to 39.6 percent, to three—12 percent, 25 percent, and 33 percent. However, this is the only area where the Trump tax plan actually simplifies anything.

The two plans disagree markedly on tax deductions, which are generally considered the greatest source of complexity in the tax code. The GOP plan would eliminate almost all deductions other than for home mortgages and charitable contributions, while folding everything else into a new larger standard deduction ($12,000 for individuals, $18,000 for individuals with a child, and $24,000 for married couples). The Trump plan would consolidate personal exemptions into an even larger standard deduction ($15,000 for individuals and $30,000 for married couples). But it would not eliminate the deductions targeted for cuts by the House GOP, and it would add new deductions for dependents (both children and elderly), leaving the current system largely intact.

The trade-off in any tax simplification is that the tax code is one of government officials' most effective tools to subsidize or discourage certain behaviors. The GOP plan retains a child credit, an earned-income credit, and a higher-education credit, but it boils down what is currently a wide range of credits and exemptions to one simple calculation in each category. The Trump plan retains more itemized deductions and offers a new rebate on child-care expenses as part of the earned- income tax credit. It proposes, for those with children and certain income levels, dependent-care savings accounts that are eligible for government matching. The Trump plan retains much of the current capital-gains tax structure (but under its proposed new tax brackets), while the GOP plan proposes effectively exempting half of investment income but treating the other half as ordinary income. The Trump plan retains more precision and flexibility in setting tax rates, but the GOP plan is more streamlined and may be easier for households to understand.

Higher education tax policies could be simplified

One area where tax simplification could have significant benefits is in higher education. In a March 2016 working paper for the National Bureau of Economic Research, Susan Dynarski and Judith Scott-Clayton reviewed the impact and structure of tax benefits for higher education (www.nber.org/papers/w22127). The current tax system subsidizes college expenses throughout a student's lifetime, with benefits for college savings programs, deductions for tuition costs, income exclusions of scholarships or tuition reductions, and deductions for interest on student loans. Possibly because of the complexity and dispersion of these benefits, empirical analyses have found little impact of these tax benefits on educational achievement. A consolidation of these many programs into one simple and transparent credit could simultaneously affect students' behavior and drastically reduce administrative costs.

The nonpartisan Tax Policy Center writes that the GOP plan "would boost incentives to work, save, and invest if interest rates do not change." The plan would substantially reduce federal revenue, and it cannot be thoroughly evaluated without seeing what cuts in spending and the federal deficit would be made concurrently. But the TPC's analysis is a sign that that the tax code could be significantly streamlined without adversely affecting taxpayer incentives. This is a worthy goal given the billions of tax-return preparation hours that could be saved with even a modest reduction in tax complexity.

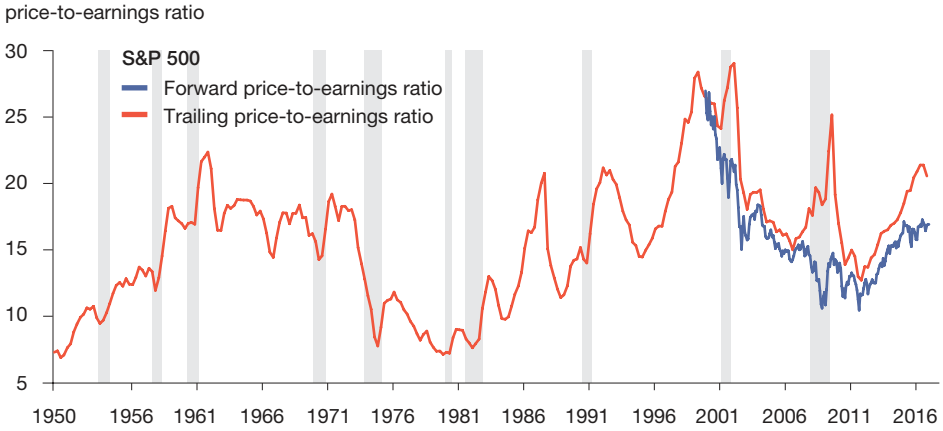
Recent stock gains reflect high expectations for the year ahead.

The Standard & Poor's Composite Index of 500 Stocks rose 9.5 percent in 2016, with about half the gain coming after the Nov. 8 presidential election. That relatively strong performance has raised concerns that the U.S. equity market may be overvalued. While there are numerous ways to measure valuations, by two of the more commonly accepted metrics, the U.S. equity market looks to be near the high end of normal historical ranges, neither excessively overvalued nor excessively undervalued.

The first valuation metric we examine is the S&P 500 price-to-forward-earnings ratio. It compares the current S&P 500 price index to the expectation for S&P 500 earnings 12 months from now. At a ratio of 16.9, the valuation is at the middle of the range for the past 20 years (Chart 8). The second metric is the S&P 500 12-month forward-earnings yield (earnings divided by price, the inverse of the price-to-earnings ratio). The earnings yield is compared with the yield on corporate bonds (Chart 9). By this metric, equities with a forward-earnings yield of 5.9 percent look to be a better value than corporate bonds, which have a current yield of 4.8 percent.

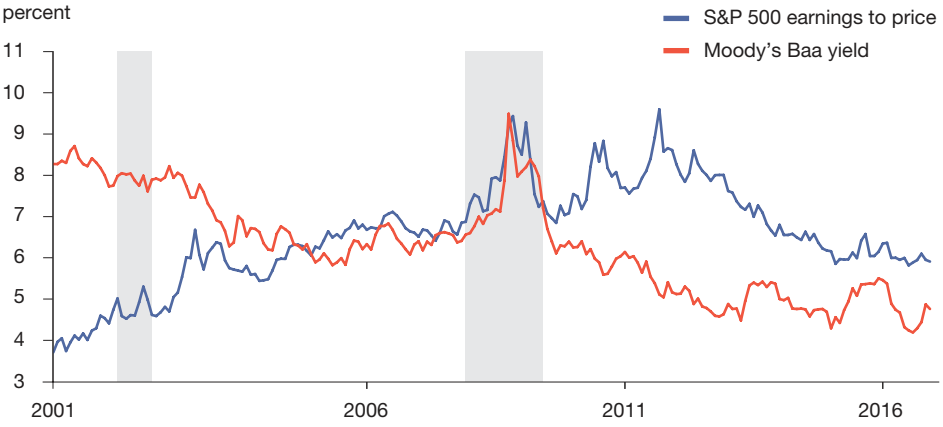
No valuation metric is perfect, but analyzing and monitoring a variety of valuation metrics can give some reassurance to investors.

Chart 8. The projected S&P 500 price-to-earnings ratio for 12 months forward is toward the middle of its recent range and not in bubble territory.



Note: Shaded areas denote recesssions.
Source: Standard & Poor's, FactSet.

Chart 9. The 12-months-forward earnings yield on stocks looks favorable compared with corporate bond yields.



Note: Shaded areas denote recesssions.
Source: Standard & Poor's, Moody's, FactSet.

CAPITAL MARKET PERFORMANCE

(Percent change)

	Dec. 2016	Latest 3M	Latest 12M	Calendar Year 2016	2015	2014	Annualized 3-year	5-year	10-year
Equity Markets									
S&P 1500	1.9	3.8	10.6	10.6	-1.0	10.9	6.6	12.4	5.0
S&P 500 - total return	2.0	3.8	12.0	12.0	1.4	13.7	8.8	14.7	6.9
S&P 500 - price only	1.8	3.3	9.5	9.5	-0.7	11.4	6.5	12.2	4.7
S&P 400	2.0	7.0	18.7	18.7	-3.7	8.2	7.3	13.6	7.5
Russell 2000	2.6	8.4	19.5	19.5	-5.7	3.5	5.2	12.9	5.6
Dow Jones Global Index	2.0	0.8	5.9	5.9	-4.0	2.1	1.2	7.3	1.6
Dow Jones Global ex. U.S. Index	2.3	-1.9	1.8	1.8	-6.6	-5.5	-3.5	2.9	-1.3
STOXX Europe 600 Index	5.7	5.4	-1.2	-1.2	6.8	4.4	3.2	8.1	-0.1
Bond Markets									
iShares 20+ year Treasury bond	-0.9	-13.4	-1.2	-1.2	-4.2	23.6	17.0	-0.4	3.0
Dow Jones corporate bond index total return	0.7	-3.0	5.8	5.8	-0.2	7.7	13.8	4.4	6.3
Commodity Markets									
Gold	-1.4	-13.4	8.1	8.1	-12.1	0.1	-1.6	-5.6	6.1
Silver	-0.4	-16.1	17.5	17.5	-13.5	-18.1	-5.9	-10.4	2.3
CRB all commodities	0.8	5.1	12.9	12.9	-14.4	-3.8	-2.5	-2.6	1.6

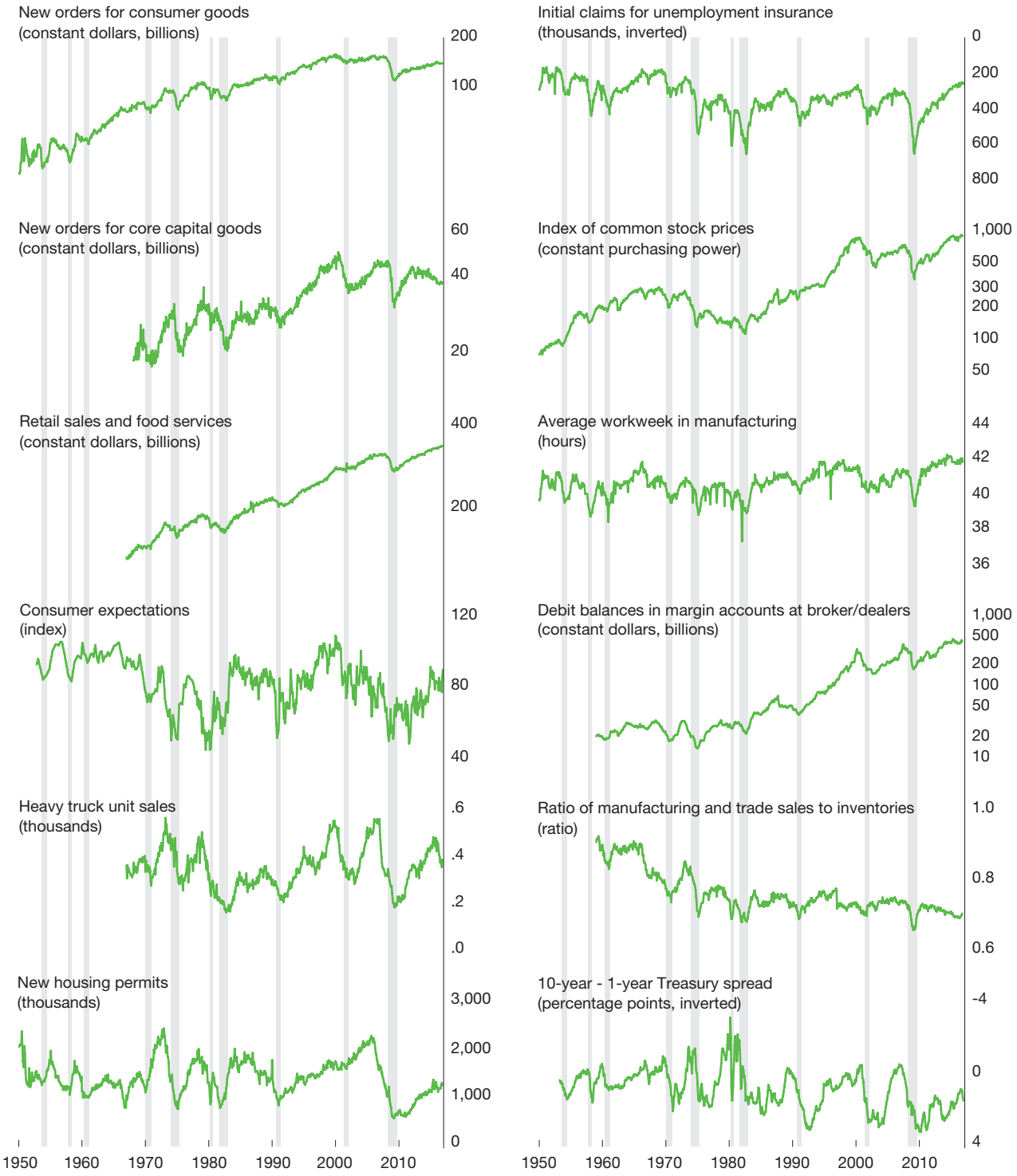
CONSUMER FINANCE RATES

(Percent)

	Dec. 2016	Latest 3M	Latest 12M	Average for Year 2016	2015	2014	Average over Period 3-year	5-year	10-year
30-yr. fixed mortgage	3.6	3.6	3.9	3.9	4.2	4.2	3.9	4.0	4.1
15-yr. fixed mortgage	2.8	2.8	3.0	3.0	3.2	3.2	3.0	3.1	3.2
5-yr. adjustable mortgage	3.0	3.0	3.2	3.2	3.4	3.4	3.2	3.2	3.2
Home-equity loan	4.5	4.5	4.8	4.8	5.4	5.4	4.9	5.2	5.4
48-month new car loan	4.3	4.3	4.2	4.3	4.2	4.2	4.2	4.4	5.7

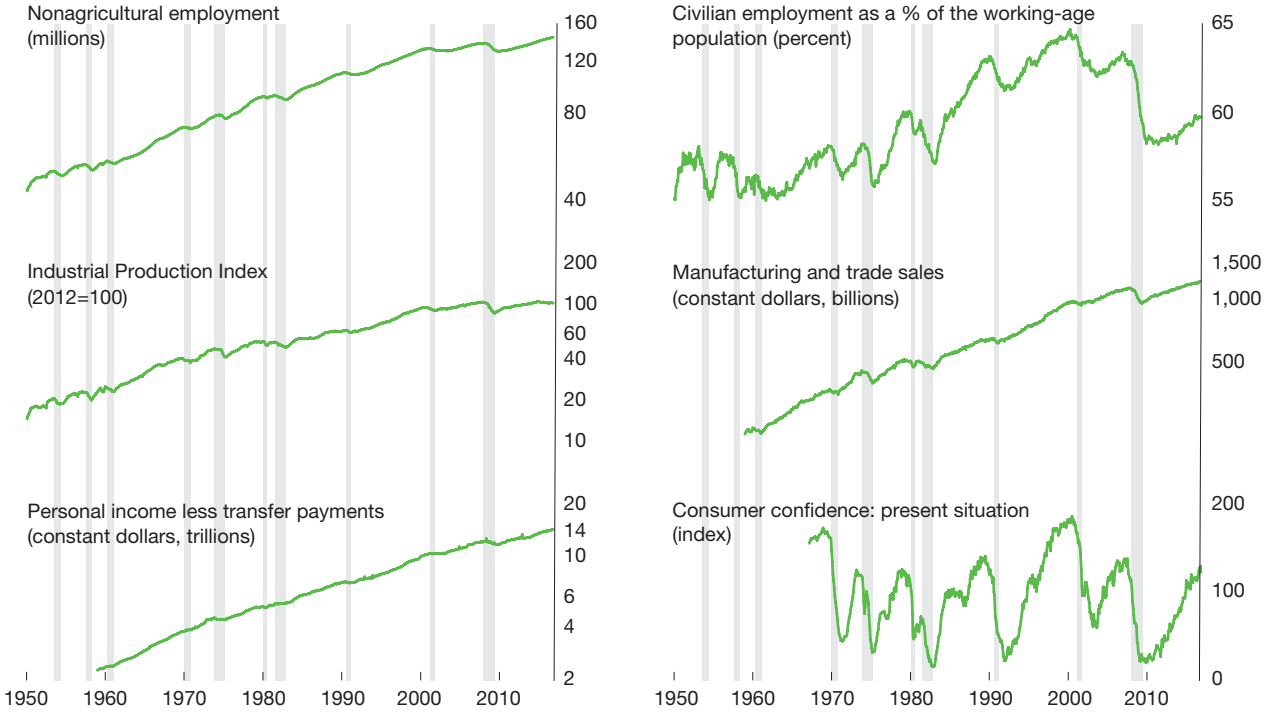
Sources for tables on this page: Bankrate, Barron's, Commodity Research Bureau, Dow Jones, Federal Reserve, Frank Russell, iShares, Standard & Poor's, STOXX Europe 600, FactSet.

LEADERS (1950–2016)

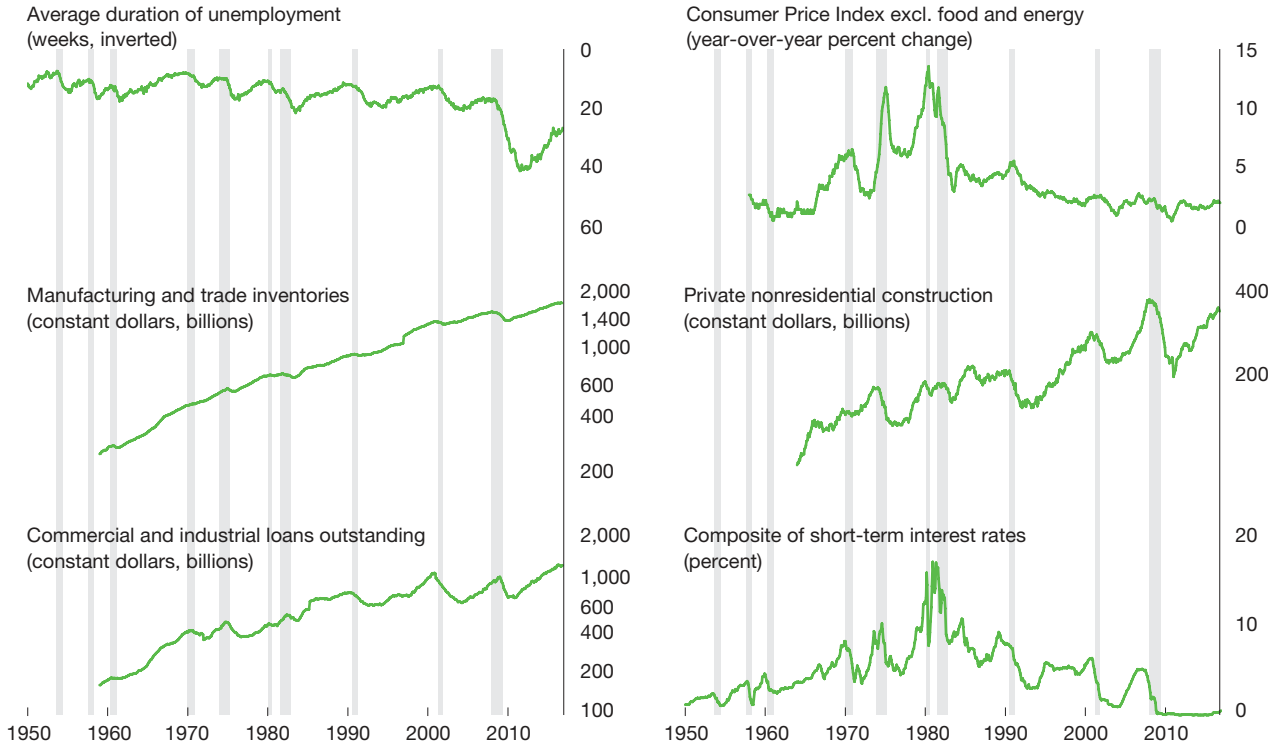


Sources for Appendix: Bureau of Economic Analysis, Bureau of Labor Statistics, Department of Labor, Federal Reserve, New York Stock Exchange, Standard & Poor's, The Conference Board, University of Michigan, U.S. Census Bureau.
Note: Shaded areas denote recessions (FactSet).

COINCIDERS (1950–2016)



LAGGERS (1950–2016)



AIER American Institute for Economic Research

250 Division Street
Great Barrington, MA 01230

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Research

Robert Hughes – Economy, Investing

Max Gulker and Patrick Coate – Policy

Theodore Cangero – Data Scientist, Inflation

Lucinda Weiss – Managing Editor

Rachel Shabani – Graphic Designer

To contact AIER by mail, write to:

American Institute for Economic Research
PO Box 1000
Great Barrington, MA 01230

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