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Corporate Federal Credit Union

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# Economic Update
## January 2018

By Andrew Kohl

## Commentary

Political bickering certainly shows no signs of tapering off in the new year. In the past week, the government experienced a shutdown for the first time in over four years. Since the shutdown was short-lived (lasting only three days), the economic impact was negligible. Unfortunately, however, only a short-term agreement was reached between the parties. Therefore, there is a threat of another shutdown if consensus is not reached on the federal budget in roughly three weeks. Despite the negative political news, the equity markets continue to reach new highs.

The market's reaction to the government shutdown was not surprising given that shutdowns have not been all that rare; several shutdowns have occurred over the past four decades since the current budget process took effect in 1976. In fact, there have been 18 previous episodes, with the last one occurring in October 2013 and lasting 17 days. The term "shutdown" is a bit of a misnomer since more than 80% of federal outlays still occur (importantly, Social Security and Medicare benefits still get paid). In addition, federal employees who were furloughed in previous episodes have always received back-pay for the time they missed. Therefore, there is clear evidence that short-term shutdowns have little impact on economic growth. Notably, the longest government shutdown on record lasted 32 days.

Due to the strong divide between the political parties, the bigger risk is failure to raise the debt ceiling. Separate from the budget process, there is a law that limits the total amount of debt the Treasury can issue to meet its obligations. It is likely that the federal government will need additional borrowing in March. Therefore, if it fails to raise the debt ceiling, the U.S. government would be forced to miss a payment on one of its outstanding bonds. This would be considered a "technical default" and could have far-reaching effects. (This is a "technical" default since the markets likely would not question the solvency of the U.S. government, and would believe the obligations would be paid relatively soon.)

If a technical default occurs, the federal government would be forced to operate under a balanced budget. Given that federal government revenues only cover about 80% of outlays (as was the case in 2017), it is likely that Social Security, Medicare and other federal income support payments would be cut immediately. In turn, the recipients of those payment would cut spending, which would hurt economic growth. A technical default would also bring into question the reserve currency status that the dollar holds. U.S. interest rates are held down by the strong demand from foreign investors, who own almost 50% of outstanding U.S. debt.

The U.S. government has never defaulted on its debt, but it came close in 2011 when party bickering pushed the debt limit agreement right up to the drop-dead date. During that period, the stock market fell by 20%. Presently, the two political parties are even further apart than where they stood in 2011. We hope that calmer heads prevail, and an agreement can be reached well before the deadline. Our baseline expectation is that an agreement will be reached, but the risk of failure to reach an agreement in time is higher than it has been in previous years.

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### Fixed Income Outlook
The bond market has shifted higher and steepened thus far in 2018. Treasury rates from two years in maturity and longer have all moved upwards by at least 20 basis points. The market has caught up with the Fed's forecast, and now expects three interest rate hikes in 2018. Several economists now believe four rate hikes are the most likely outcome.

We still believe the Fed will continue its gradualist approach for raising rates, and that three rate hikes will occur this year. Inflation should rise in 2018, but remain relatively tame and below the Fed's 2% target. The tax changes will pull growth forward the next two years, but it will be difficult to sustain 3% real GDP growth for more than a few quarters. We think the bond market is fairly valued at these levels.

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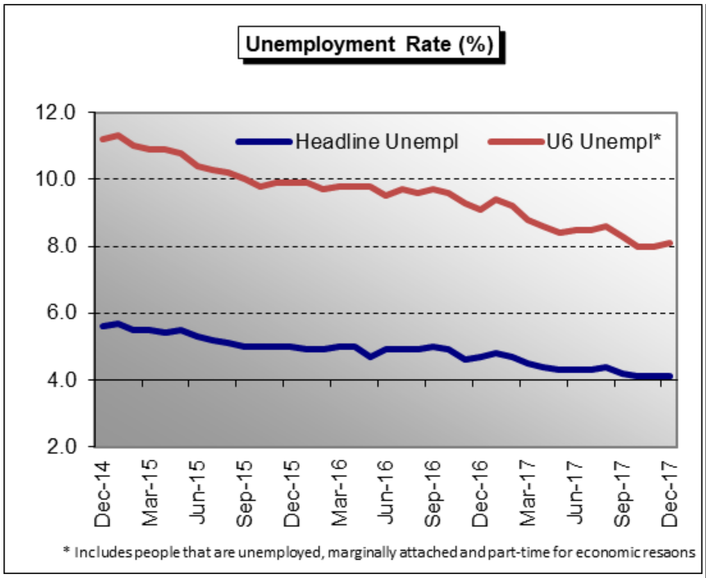
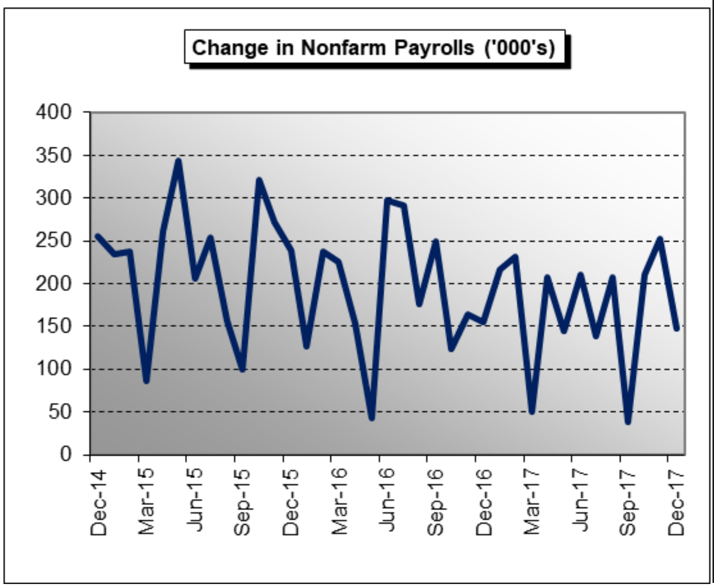
## Labor Readings
*(Data source: Bloomberg)*




### Unemployment Rate Holds Steady
The unemployment rate remained at 4.1% (a 17-year low) in December. The underlying details of the report were relatively strong as both the number of people employed and the labor force experienced gains. In 2017, the unemployment rate dropped from 4.7% to 4.1%. Despite the drop, wage inflation is running at 2.5% per annum. This is well below the wage inflation rate seen during past economic recoveries.




### Payrolls Come in Weaker than Expected
Payrolls grew by 148,000 jobs in December compared to an expected gain of 190,000. For the full year of 2017, payroll growth averaged 15,000/month lower than 2016. Still, the current pace is more than enough to offset the growth in the working age population and should continue to lead the unemployment rate lower.

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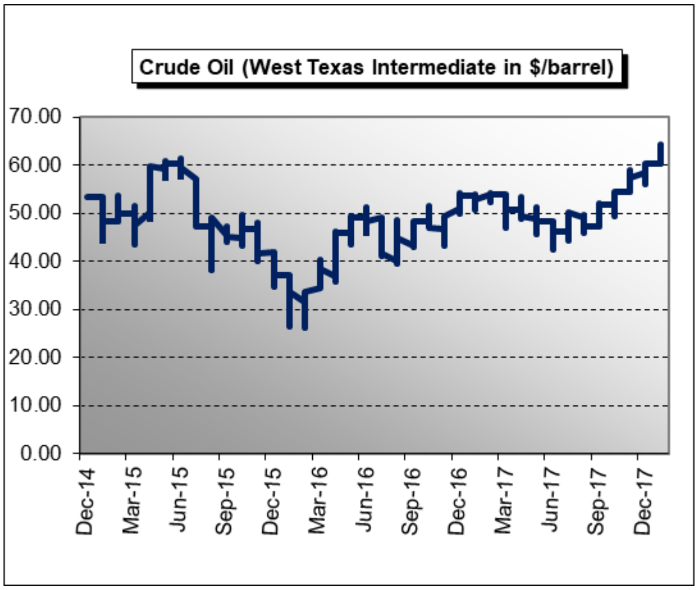
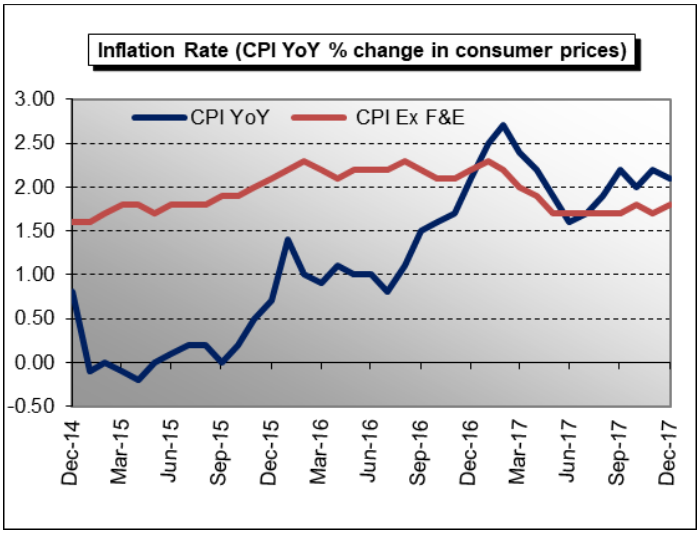
### Inflation Readings

*(Data source: Bloomberg)*




### Crude Oil Hits Three-Year High

Crude oil prices continue to move higher due to higher global demand. A broad majority of global economies are experiencing economic expansion. Oil prices are up almost 20% in a year, and over 140% since the low reached on February 11, 2016. Higher oil prices should push up headline inflation in the coming months.




### Core Inflation Increases

"Core inflation" (minus food and energy prices) came in higher than expected in December. On a year-over-year basis, core inflation rose by 1.8% in December (versus an expected increase of 1.7%). Despite the higher-than-expected results in December, nothing in the report points to an approaching breakout in inflation in the near term.

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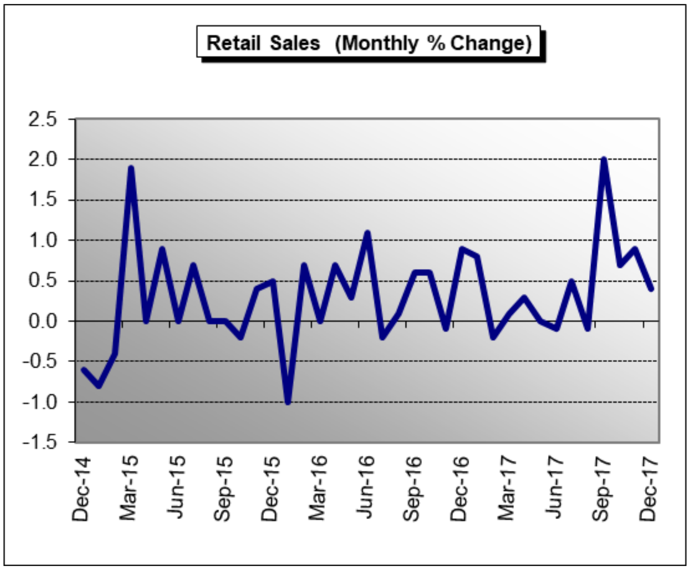
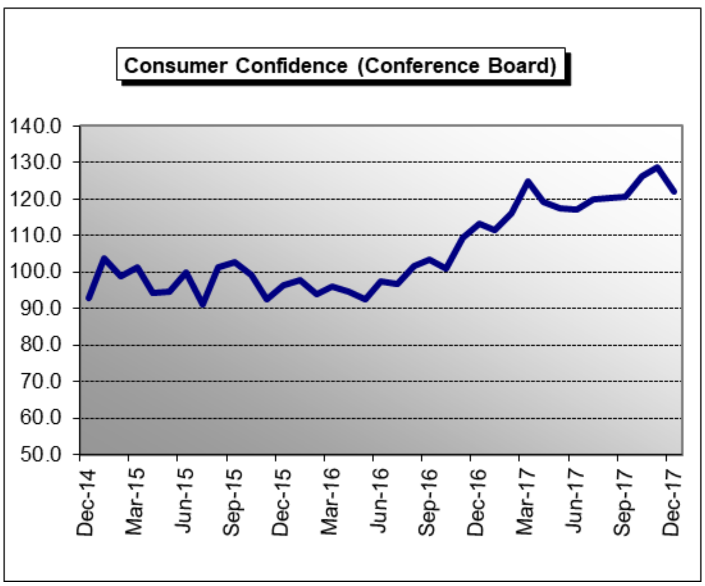
### Consumer Readings
*(Data source: Bloomberg)*




### Retail Sales Remain Strong
Retail sales in December were higher than expectations, and the previous month's data was revised upwards. The average gain in sales for the last two months of the year were the strongest in seven years. In 2017, retail sales rose by 4.2% over the previous year – the biggest increase since 2014.




### Consumer Confidence Drops
Consumer confidence came in lower than expectations in December, but remains at a historically elevated level. Despite the fall, this is the highest December reading in 17 years. This bodes well for consumer spending in 2018. In addition, an increasing number of consumers see their incomes rising over the next six months.