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Andrew Kohl
Chief Investment Officer

Economic Update
February 2018

By Andrew Kohl

Commentary

Last year could have easily been coined the "year of complacency" for stock investors. The market's measure of expected volatility (aka the "VIX") hit an all-time low and the S&P 500 hit a record number of days without a 3% or more correction. That trend continued at the start of 2018 as the market stormed ahead by 7% in a little over three weeks. Then, as we entered February, market nervousness awakened. After a strong labor report, the stock market started to fear higher interest rates. In dollar terms, the Dow experienced its largest one-day loss ever. (Although, in percentage terms, the drop wasn't even in the top twenty all-time.) The VIX rose sharply and placed pressure on investment vehicles that bet against higher volatility. Over the past few weeks, markets have calmed down, but remain on edge. The stock market currently stands up 2% so far this year.

We think the big lesson from the sell-off is how fast sentiment can change. The fear of higher rates should not have been a surprise since the Fed hiked rates three times last year and has indicated that it expects to hike six more times over the next two years. What seemed to change was the market's focus, which shifted from earnings growth to the reduced value of future earnings when interest rates are higher. Sentiment is a powerful force and it is nearly impossible to predict when it will change – just ask the investors who bet against a rise in volatility and lost 80-100% of their investments in one day.

Amidst all the market turmoil, Congress agreed to a budget deal that covers the next two fiscal years. In addition, they suspended the debt ceiling until March 1, 2019. This takes away some near-term risk and added more fiscal stimulus to the economy. The budget deal adds almost $300 billion in new spending authority over the next two years. With the increase, the federal deficit will likely exceed $1 trillion in 2019 and stand at 5.2% of GDP. (For comparison, the deficit was 3.2% of GDP last year.) When combined with the tax cuts passed at the end of last year, this is the largest fiscal stimulus ever during a non-recessionary/non-wartime period.

The increased government spending will add to GDP this year and next. Assuming the fiscal multiplier (aka the measure of how much government spending will impact GDP) is one, GDP will be 0.2% higher in 2018 and 2019 due to the recently passed budget increase. Of course, the key to the actual impact on the economy will be the accuracy of the fiscal multiplier. The fiscal multiplier is greater than one if the spending leads to greater economic productivity. It is less than one if the government spending simply "crowds out" spending that would have occurred in the private sector anyway. Typically, "crowding out" is less of a problem in a recessionary period when the private sector is reluctant to make new investments. Since that is not the case today, we believe the multiplier is less than one and, therefore, the economic impact will be more muted.

We believe the economy is likely to grow by 2.7% to 3.0% in 2018. Absent the fiscal stimulus from the tax cuts and the budget deal, the economy would have continued to grow in the low-to-mid 2.0% range in 2018. The fiscal stimulus will add to growth this year and next. But, we believe the risk of a hard landing is now increased when this expansion eventually comes to an end, given the reduced ability for the government to respond.

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Fixed Income Outlook

Bond market yields continued to move higher in February. Rates moved 10 to 15 basis points higher across the curve due to stronger labor market and inflation data. The market is now pricing in three hikes in 2018, which matches the Fed's current forecast. The risk of seeing more than three hikes this year moved higher following the passage of the stimulating budget plan. Many economists now believe that four hikes are likely.

We continue to believe the Fed will hike three times in 2018. The quick change in sentiment that occurred in the stock market will serve as a wake-up call for the Fed not to hike too fast. The Fed is still operating in an environment with little room to provide a stimulus if a significantly negative economic event occurs. Therefore, the Fed will remain cautious. We believe inflation will remain subdued given structural factors in the economy.

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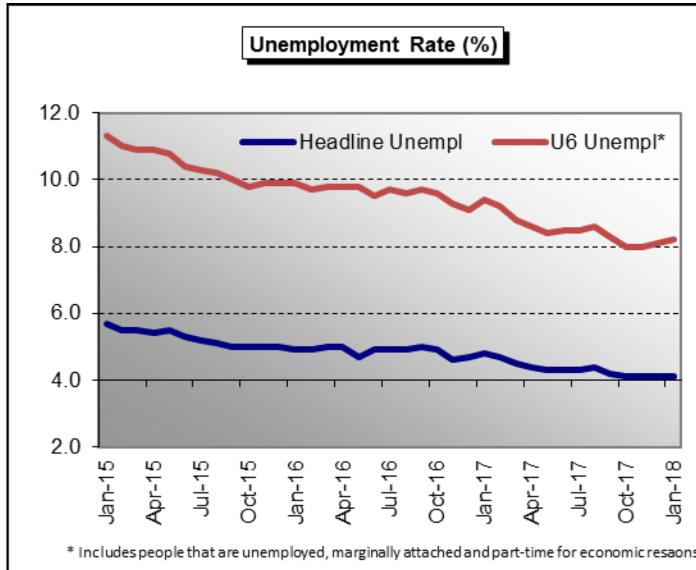
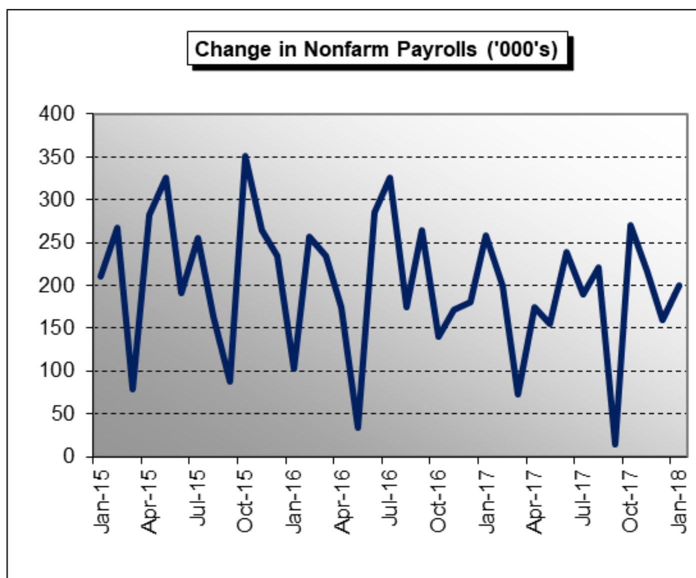
Labor Readings
(Data source: Bloomberg)



Unemployment Rate Holds Steady
The unemployment rate remained at 4.1% for the fourth consecutive month in January. The underlying details of the report were strong, as both the number of people employed, and the labor force experienced gains. Wages rose more than expected on a year-over-year basis, hitting the fastest growth rate since June 2009.



Payroll Growth Exceeds Expectations
Payrolls in January increased by 200,000 jobs; 20,000 higher than expectations. Three-month average payroll growth is now at its highest level in six months. Most economists believe that it takes 100,000 jobs/month to hold the unemployment rate steady. Therefore, job growth at its current pace should continue to push the unemployment rate lower.

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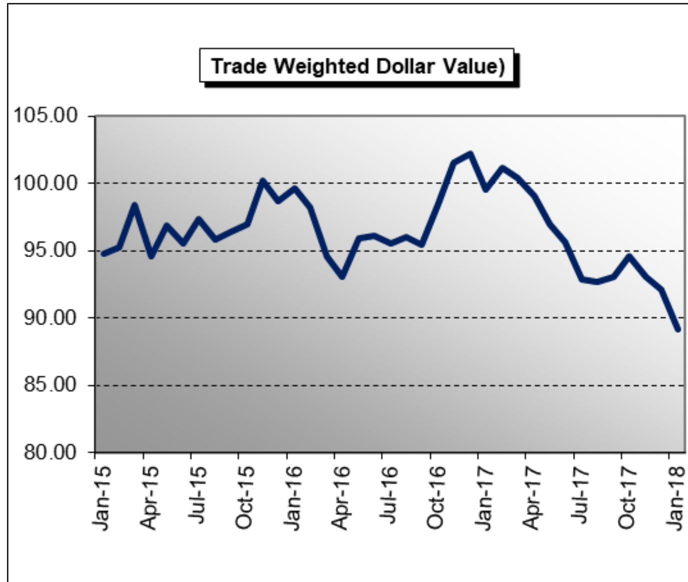
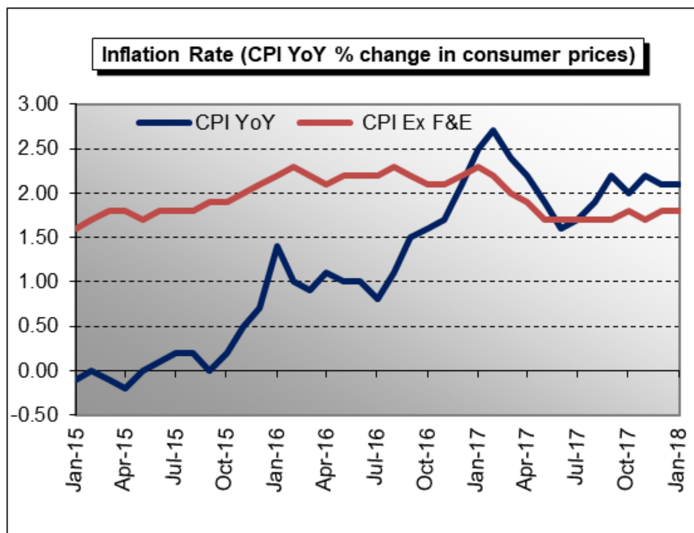
Inflation Readings

(Data source: Bloomberg)



Dollar Value Continues to Fall

The value of the dollar has declined by 10% in the past year and stands at a three-year low. A weaker dollar can lead to an increase in inflation since it makes imported goods more expensive in the U.S. The dollar has declined mainly due to the improved growth prospects of many foreign countries.



Consumer Inflation Data Surprises to the Upside

Both the headline and core (minus food & energy prices) Consumer Price Index inflation data came in higher than expected in January. The month-over-month increase in core inflation hit the highest level in a year. The three-month annualized gain in core inflation is 2.9%, the highest since 2011.

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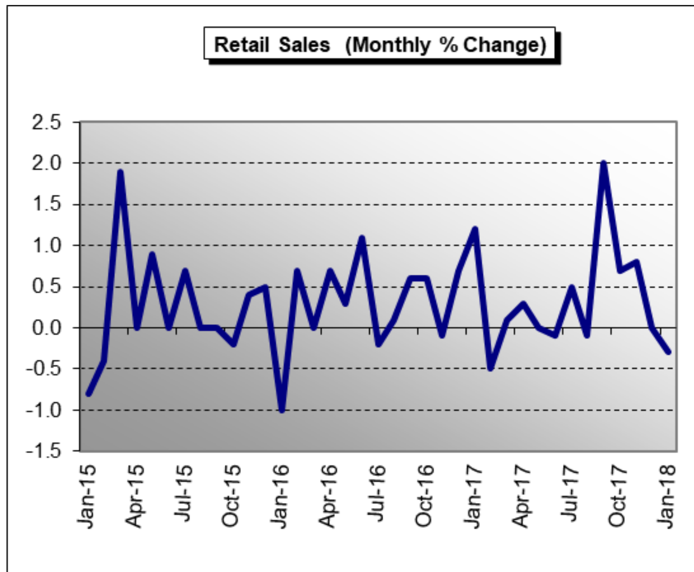
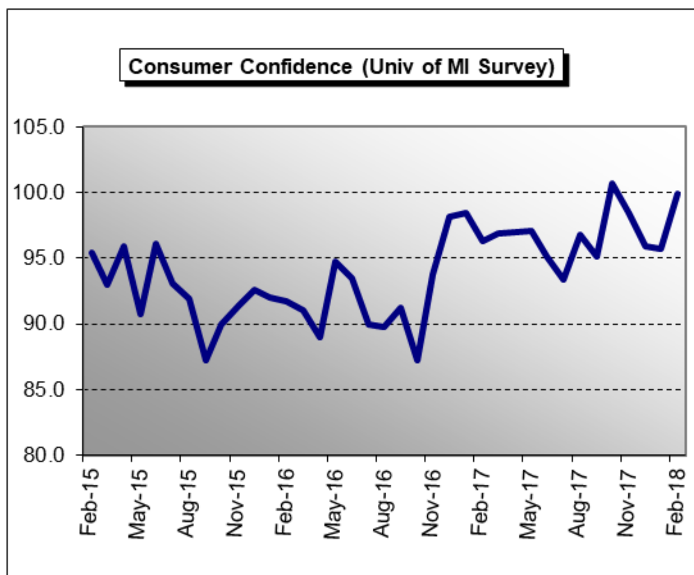


Retail Sales Show Weakness
Retail sales in January were much lower than expectations and had the largest monthly decline in almost a year. In addition, the December sales data were revised downward. The decrease in sales was broad-based and indicates that consumer spending in the first quarter will likely not be able to meet or exceed the growth rate from the fourth quarter.



Consumer Confidence Bounces Higher
The preliminary confidence data for February showed a significant bounce-back from the prior month. The measure was higher than expected and the second highest reading since 2004. Optimism about current and future incomes helped to push the index higher.