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Economic Update
February 2017

By Andrew Kohl

Commentary

Riskier assets continue to price higher despite the lack of clear economic plans from the Trump administration (the S&P 500 has advanced almost 6% this year, and 11% since Trump was elected). The markets have also grown complacent with stock market implied volatility close to an all-time low. It will be difficult for the equity markets to continue to forge ahead based on promises of a "phenomenal" tax plan and higher economic growth. This increases the importance of Trump's speech to Congress on February 28. It is time to turn the campaign rhetoric into substantive plans or the market is likely to falter.

To date, Congress and the Trump administration have placed the repeal of the Affordable Care Act (aka "Obamacare") and immigration policy ahead of pro-growth strategies. This makes it unlikely that any stimulus will impact the economy in 2017. We think that the markets continue to underestimate how long it will take to get tax reform and expansionary fiscal spending enacted.

We see major hurdles to tax reform despite the Republican control of both the executive and legislative branches of the government. People forget how long it took to get tax reform completed in 1986 and we believe that tax reform this time will be even more difficult. The 1986 tax reform was essentially a tradeoff between lower tax rates (which Republicans wanted) and reduced tax loopholes (which Democrats wanted). This made it relatively easy for each party member to get behind. This time, the changes being discussed (border adjustment, expensing of capital, elimination of interest deduction, repatriation tax) will create clear winners and losers. The winners and losers will vary state by state and not along political lines. Therefore, it is easy to envision that support for tax reform could be split within the Republican party. When you throw in the likelihood that the tax reform will add to the deficit (the 1986 reform was deficit neutral), it makes agreement of major reform even more unlikely. Ultimately, we believe that some reform will get enacted, but it will be watered down substantially from many of the plans that have been bandied about.

Even though our baseline assumption does not include economic stimulus impacting 2017, we believe that the economy will continue to grow at the pace that we've grown accustomed to over this lengthy expansionary period (2% real GDP growth) this year. The labor market continues to tighten, which should help keep consumer spending on track. Risks from abroad have diminished to some extent, and it seems unlikely that the Fed would need to move rates up quickly and significantly to snuff out inflationary threats.

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Fixed Income Outlook
The Treasury curve has flattened with the long-end of the curve moving slightly down since the end of January. Economic data continues to come in at or near expectations thus far in 2017. The odds of a hike at the March 15 Fed meeting has been increasing over the last several weeks. The market-based odds currently stand at a 40% chance of a Fed hike in March.

We think that a hike in March is unlikely given the clear lack of direction from the Fed to date. The minutes from the February meeting did not signal an imminent Fed hike and neither did Janet Yellen at her Congressional testimony a few weeks back. Yellen will have one more chance to signal a hike as she has a speech scheduled on March 3 (the blackout period for Fed communications starts the following day), but given her dovish tilt, we think it's very unlikely that she will signal a March move in rates. The current Fed makeup leans dovish and we believe that they will remain patient. If upcoming data continues to meet or beat expectations, we see a hike in June as the most likely outcome.

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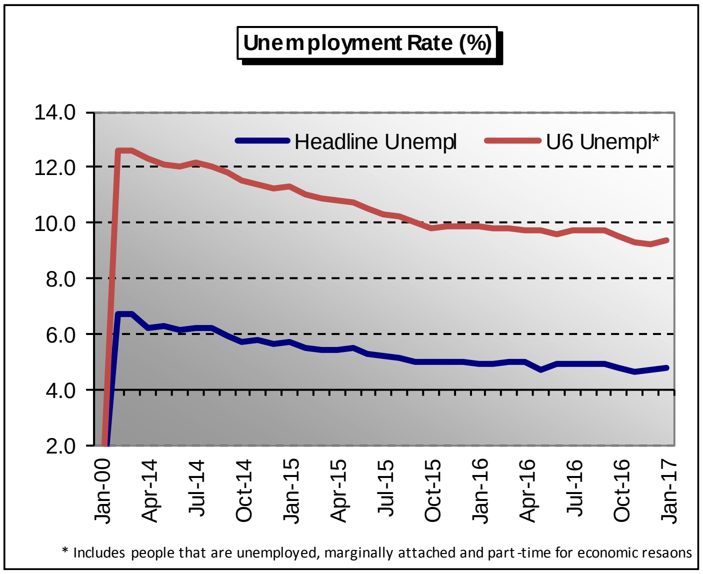
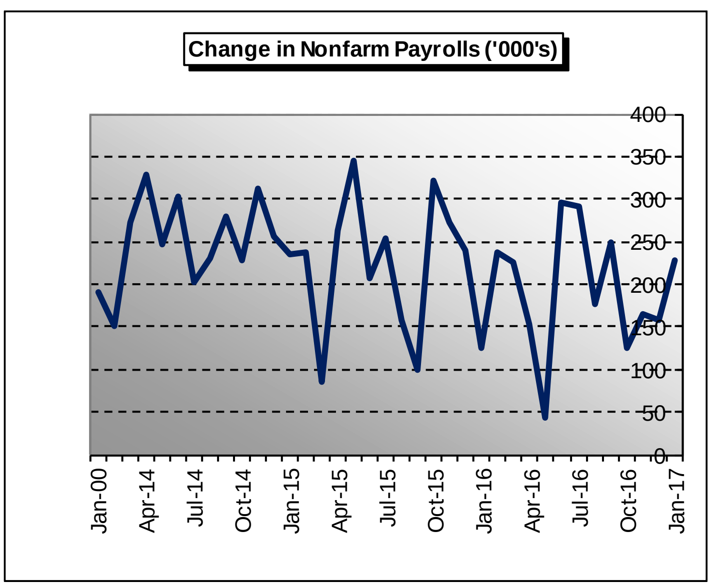
Labor Readings
(Data source: Bloomberg)



Unemployment Rate Moves Higher
The unemployment rate in January rose to 4.8% from 4.7% the prior month. This was the second consecutive uptick after the unemployment rate hit a nine year low of 4.6% in November. The biggest surprise from the report was the relatively large downturn in wage growth. The market was expecting year-over-year wage growth of 2.7% and it only came in at 2.5%. Wage growth continues to be much slower than previous expansions, which indicates that there is still slack in the labor market.



Job Growth Beats Estimates
Payroll growth in January came in well above estimates. Payrolls increased by 227,000 jobs versus an expected gain of 180,000 jobs. This was the largest gain in four months and higher than the 2016 average gain of 186,000 jobs. Overall, the Fed is likely pleased with the January jobs data, which showed healthy job creation, improved labor force participation and tepid wage growth. This type of report fits well with their stated strategy to gradually raise rates.

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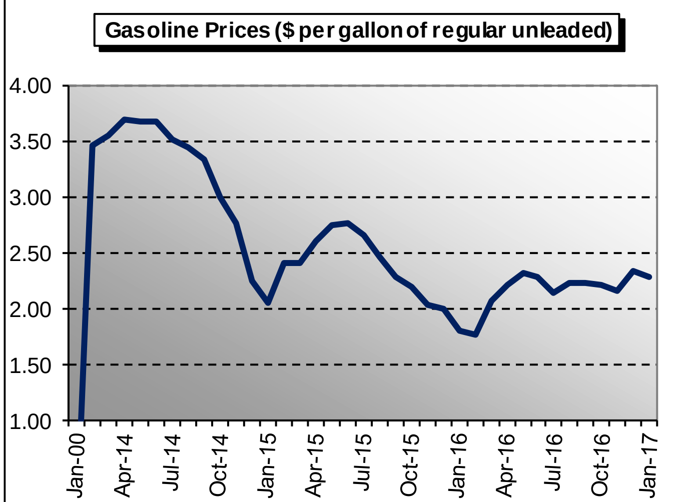
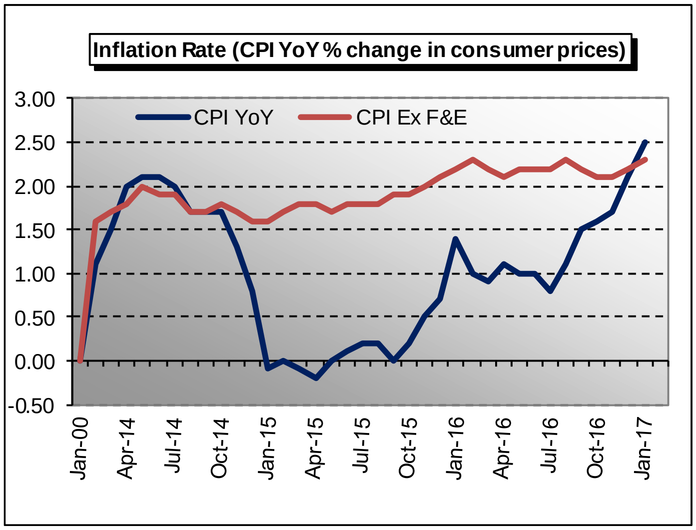
Inflation Readings

(Data source: Bloomberg)



Gasoline Prices Continue to Drift Higher

The price that consumers pay for gasoline continues to increase. Prices are 27% higher than where they stood 12 months ago, and 8% higher than the 2016 average. This has caused headline inflation data to increase and quelled the fears of deflation.



Inflation Rate Jumps Higher

The rate of inflation continues its rapid climb since the middle of 2016. Much of the ascent has been due to increasing energy prices, but prices in other sectors are also starting to rise. The increase in January was larger than expected and the largest year-over-year increase in almost five years. The "core" inflation rate (which excludes the more volatile food and energy prices) also increased more than expected.

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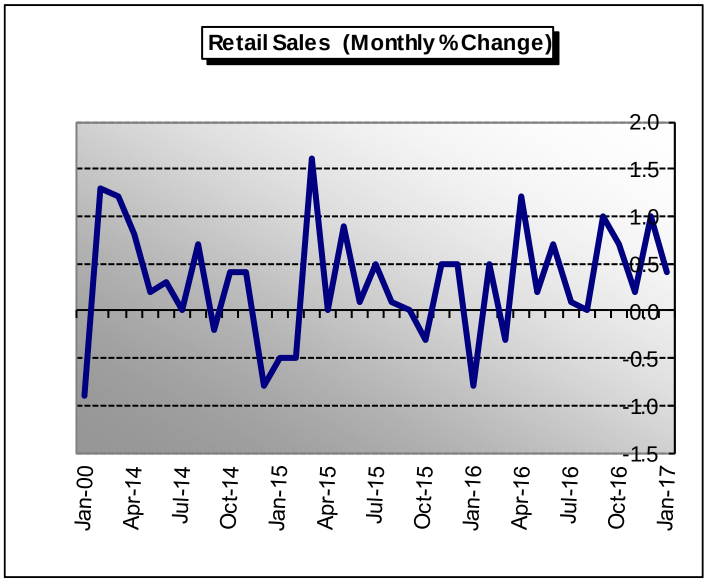
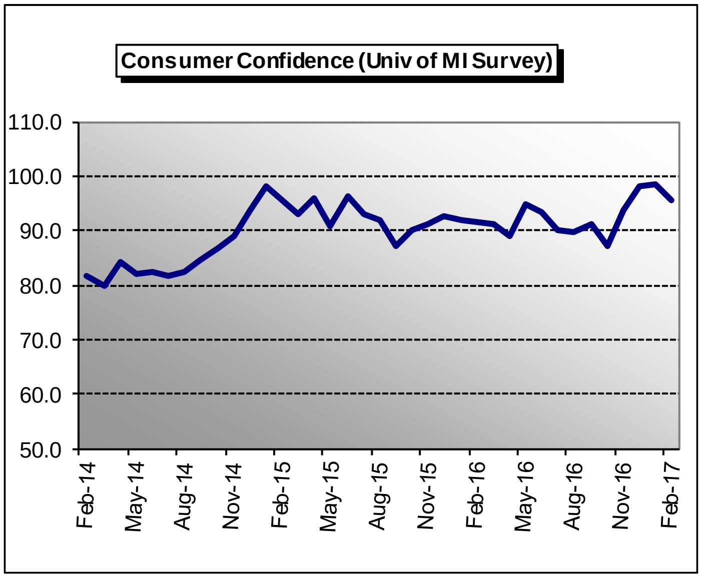
Consumer Readings
(Data source: Bloomberg)



Retail Sales Beat Estimates
Retail sales in January were stronger than expectations. Sales increased by .4% on a month-over-month basis versus an expected .1% gain. The gains were broad-based as 10 of the 13 major retail categories saw improvement. The only major weak spot was auto sales, but that followed a very strong auto sales month in December.



Consumer Confidence Declines
Consumer confidence retreated from a 13 year high according the preliminary February results. Confidence hit a three-month low and came in below estimates, but remains elevated compared to the pre-election data.