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Corporate Federal Credit Union

Economic Update
March 2018

By Andrew Kohl

Commentary

The Trump administration has largely pursued pro-growth strategies since coming to office a little more than a year ago. Fulfilling some of its campaign promises, the administration has lowered taxes and reduced regulations. This has helped to propel equity markets to all-time highs. Unfortunately, the administration now has turned to another one of its promises: trade protectionism. In the past week, tariffs have been placed on imported steel and aluminum, and a basket of imports from China. This has spooked the equity markets and pushed the Dow into correction territory (down over 10% from its all-time high).

At the present time, fears of an all-out trade war appear overblown. Typical of President Trump's tactics, he initially took an extreme view that grabbed headlines, but eventually comprised and moved more towards the middle. Since the trade tariffs were announced, some countries have been exempted, and others may follow. The planned tariffs only impact approximately 3% of total imports. If measures stop here, the economy will feel almost no effect.

Despite recent presidents' pro-trade policies, it is not uncommon for presidents to impose trade tariffs. With that said, this time, the tariffs are a bit scarier because Trump often espouses anti-trade sentiment. He appears to view any country with whom we have had a trade deficit as an unfair trading partner. This makes the risk of a trade war higher than it has been in the recent past.

Global trade helps to improve all economies and allows countries to specialize in products where they have a comparative advantage. On an aggregate basis, this lifts the worldwide growth rate and raises the standard of living. Unfortunately, it also creates winners and losers across various industries. When production moves overseas to a more efficient region, jobs are lost at home. This creates a human toll as some skills are not easily transferable to new industries. The natural reaction is to attempt to protect the jobs at home, but this can lead to poor economic decisions.

Using the Chinese tire tariff in 2009 as an example, studies have shown that for each manufacturing job the tariffs saved, three times as many retail jobs were lost in tire-related sales. In addition, the increased cost of tires hurt U.S. consumers. The Peterson Institute (a non-profit, non-partisan research company) estimated that each saved manufacturing job ultimately cost consumers $900,000 due to the increased cost of tires that consumers had to pay for.

From an economic standpoint, the ideal response to the reduction/loss of an industry due to trade is to retrain the employees whose jobs are affected. Sadly, the U.S. has had a poor history of assisting with job retraining. Rather than using tariffs to delay the loss of jobs, the government should use funds to subsidize job training and help to revitalize the negatively impacted areas of the country.

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Fixed Income Outlook

Bond market yields have moved slightly lower for the first time in several months. As expected, the Fed hiked rates last week, but didn't move off their three-hike expectation in 2018. (The market feared the Fed would move to four hikes this year.) Still, the Fed did increase the number of expected rate hikes in 2019 and 2020. The market still does not believe the Fed will be able to implement that many rate hikes; it has three fewer hikes priced in than the Fed by the end of 2020.

We continue to believe that the Fed will hike three times in 2018. Current market pricing seems appropriate as we are skeptical that there will be a noticeable bounce in the inflation data. We think the Fed will remain cautious.

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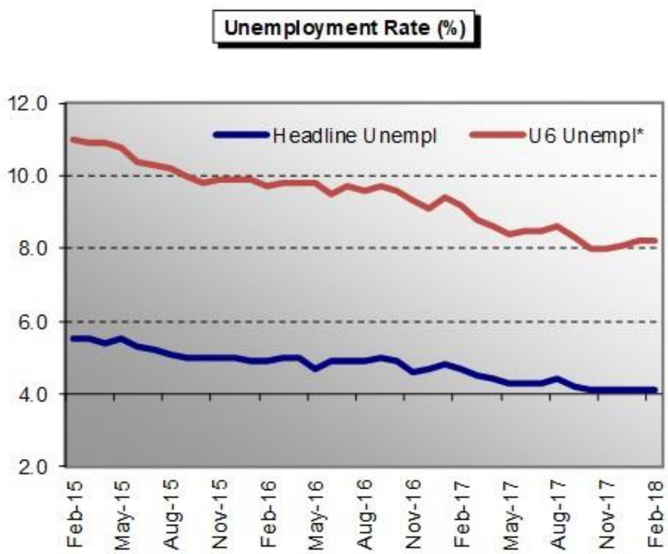
Labor Readings

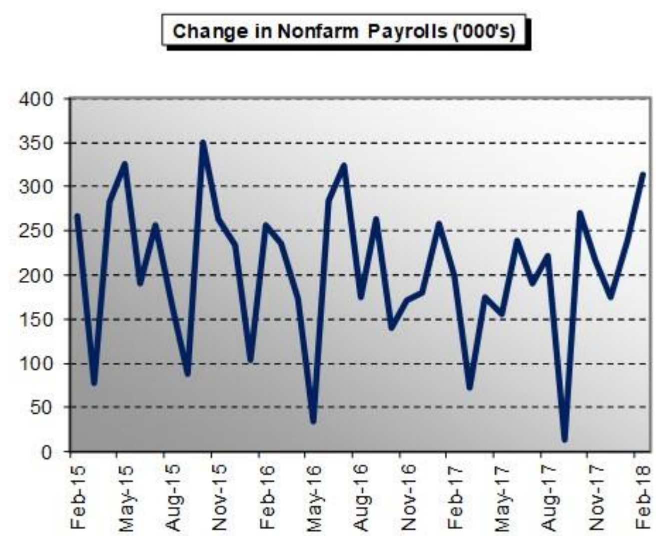
(Data source: Bloomberg)



* Includes people that are unemployed, marginally attached and part-time for economic resaons

Unemployment Rate Holds Steady

The unemployment rate continued to hold at 4.1% in February. The underlying details of the household labor report were very strong. Both the labor force and the number of people employed experienced large gains. The labor force participation rate jumped to its highest level in five months. The participation rate for men aged 25 to 54 hit the highest level since 2010.



Payroll Growth Much Higher than Expected

Payrolls in February rose by 313,000 jobs versus an expected 205,000 increase. In addition, the previous two months were revised up by 54,000 jobs. Employers added the most workers in a month since July 2016. Hiring was strong in almost every sector.

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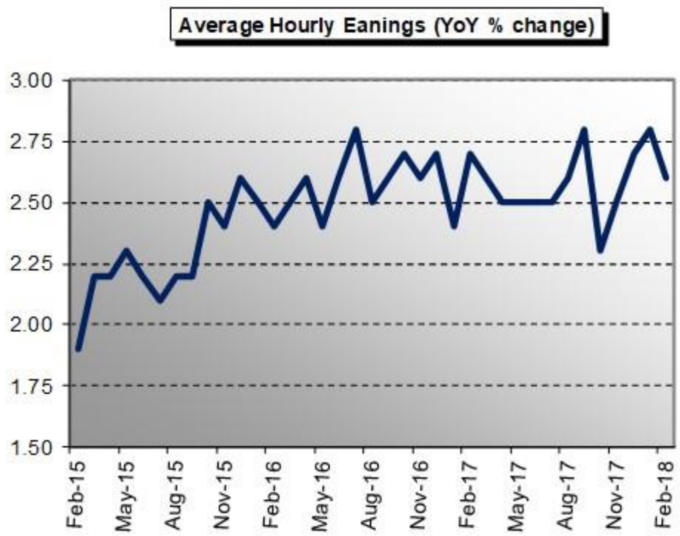
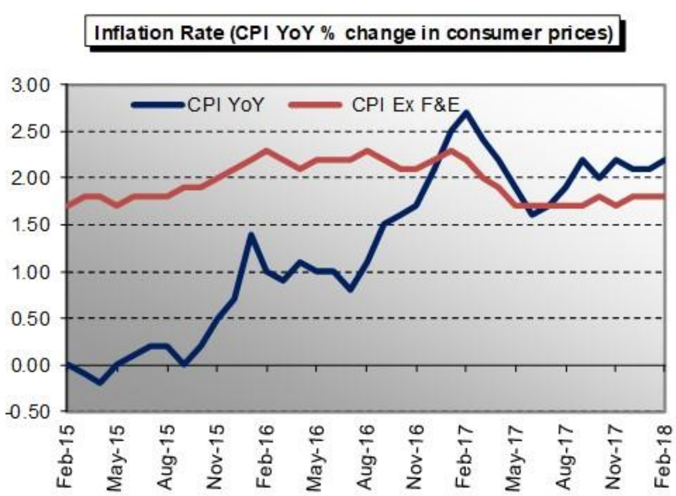
Inflation Readings

(Data source: Bloomberg)



Wage Inflation Cools

Wage inflation (as measured by average hourly earnings) came in below estimates in February. The market was expecting a 2.8% year-over-year increase and the actual result was 2.6%. In addition, the prior month was revised downwards. The Fed will not look to increase its pace of hiking unless they see a sustained uptick in wage inflation.



Inflation Data Meets Estimates

Both the headline and "core" (minus food and energy prices) Consumer Price Index inflation data met market expectations in February. Prior to the February report, the market was more concerned than normal after the January data was higher than expected. This report indicates that inflation is gradually picking up, but showing little sign of breaking out to the upside.

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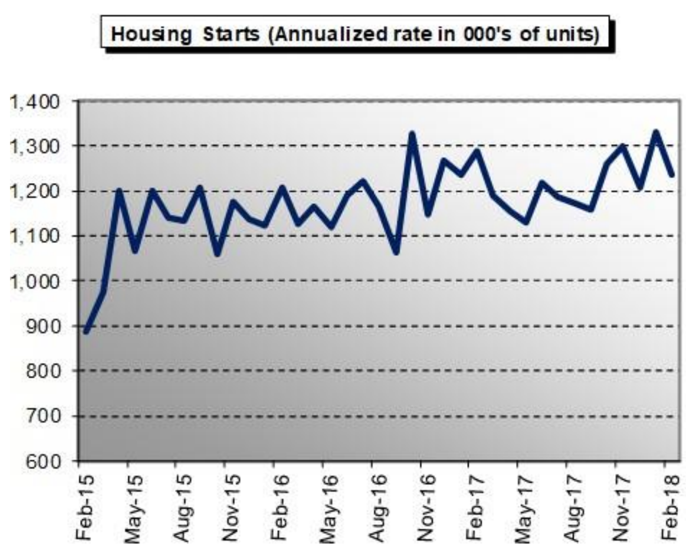
Housing Readings
(Data source: Bloomberg)

Housing Prices Continue to Climb
Largely due to the scarcity of inventory, housing prices continue to move higher. Year-over-year prices have climbed for over five consecutive years. Overall, housing prices are just slightly below the peak reached in 2006. Each of the twenty major cities that were analyzed experienced year-over gains in 2017. The largest gain was Seattle, with a 12.7% increase.



Housing Starts Weaker than Expected
New home construction came in lower than expectations in February. The weakness was solely in the multifamily housing sector as the momentum in that part of the housing market has started to fade. Single-family housing starts climbed for the second month in a row.