Written on 3/23/16

Corporate Federal Credit Union

Andrew Kohl
Chief Investment Officer

ECONOMIC UPDATE

March 2016

By Andrew Kohl

Commentary

The market continued its turnaround over the past month as fears of a hard landing for the global economy have subsided. The U.S. stock market is back where it ended last year after being down over 10% a little over a month ago. The story is even more dramatic with oil prices, where after being down almost 25%, prices have fully recovered and now stand higher than year-end levels. What was the impetus for such a dramatic move in a relatively short timeframe?

Ideally, the recovery in asset prices would have been based on improving economic fundamentals. Unfortunately, evidence of a substantial improvement in the worldwide economic outlook does not appear in the data. The best that can be said is that things don't seem to be getting much worse. Importantly, the U.S. economy appears to be holding its own. The economy has continued to produce jobs at a pace of over 200,000 a month. This has led to an improvement in broader measures of employment. Wage growth continues to be anemic, but other inputs to inflation have ticked up lately. The rate of growth for the U.S. economy in the first quarter should be an improvement over the prior quarter. But, it is still likely to be near a somewhat modest 2% growth rate.

Since economic fundamentals haven't changed much, there must have been another factor to explain the dramatic risk repricing. The obvious place to look has been the risky assets' best friend over the last several years; the central banks. Once again, in the face of turmoil, central banks responded by taking aggressive action. China cut the reserve ratio for its banks. The European Central Bank (ECB) took a variety of measures to spur growth. Those measures included going deeper into negative rate territory and paying European banks to increase lending (via a negative interest rate four-year loan from the ECB). In the U.S., the Fed cut its expected hikes in half this year.

Given that the Fed's actions have the most direct impact on the U.S., let's take a deeper dive into their thought process. The decision not to move rates in March was never really in doubt since the Fed gave little to no indication that they were going to act. With the market still somewhat skittish, this was not going to be a time where the Fed created a negative surprise. The surprise from the meeting was the reduction in the inflation projections and the magnitude of the reduction in expected rate hikes over the next two years.

Recent inflation data has surprised to the upside and the year-over-year core inflation rate (as measured by Consumer Price Index) is now at its highest level since May 2012. In addition, two of the main factors that have held headline inflation down lately (oil price depreciation and dollar appreciation) reversed over the past month. This would seem like an odd time to lower inflation projections.

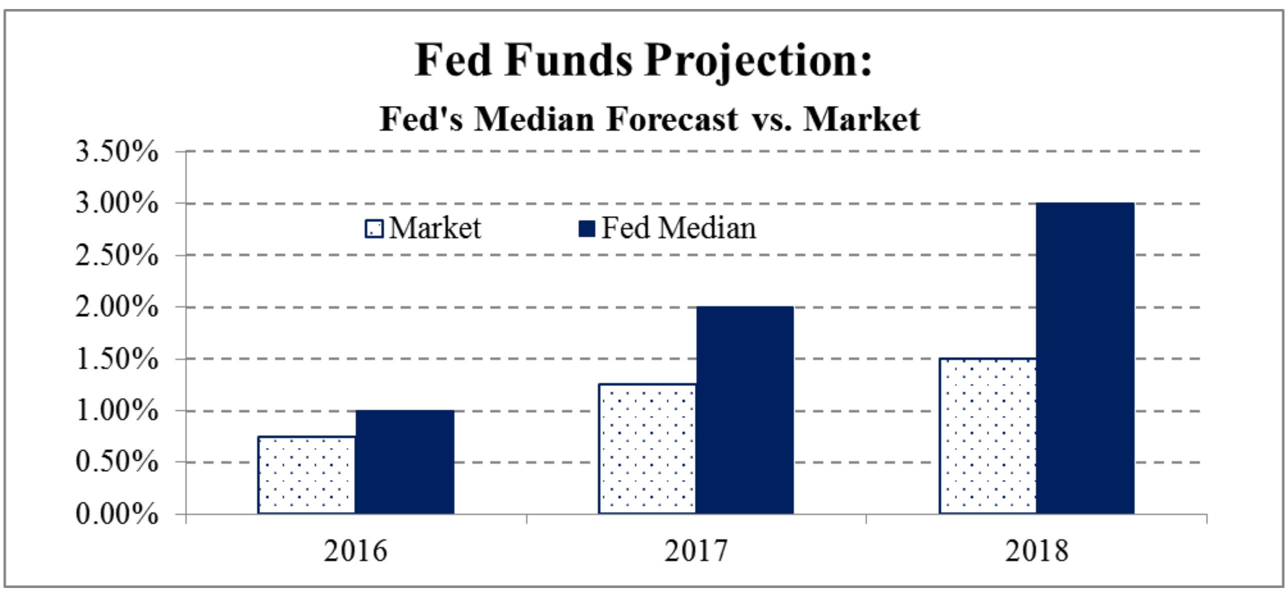
Therefore, what is evident is that the Fed has become increasingly concerned about the global environment. The reality is that the divergence between short-term rates in the U.S. and other countries is more of a factor that the Fed may have originally believed. It is important to note that since China's exchange rate is closely linked to the dollar, when the dollar appreciates (likely due to actual and expected

Fed hikes), financial conditions tighten in China. This leads to increased fears that China will experience a hard landing and further dollar strengthening (a negative feedback loop). Dollar appreciation hurts U.S. exporters and lowers the price of imported goods. In essence, the magnitude of a rate hike on the U.S. economy gets amplified when other countries are standing pat or lowering their rates. In rosier times, this may not be a large concern. In today's environment of low growth and near zero interest rates, this factor can't be discounted. We continue to believe that a cautious approach to Fed hikes is the best course and the Fed's current rate projection for 2016 seems reasonable.

Fixed Income Outlook

Interest rates climbed by 30 basis points across most of the curve as the equity market healed in the weeks leading up to the Fed meeting. With the Fed's more dovish than expected meeting, rates ratcheted down about 10 basis points. The market is pricing in a 40% chance of a hike in June and 75% chance of at least one hike by the end of the year. This seems reasonable to us.

Market expectations continue to track below the Fed's projections. The median Fed projection is 1.00% at year-end 2016 versus 0.75% for the market. The divergence gets greater in 2017 and 2018 (see graph below).



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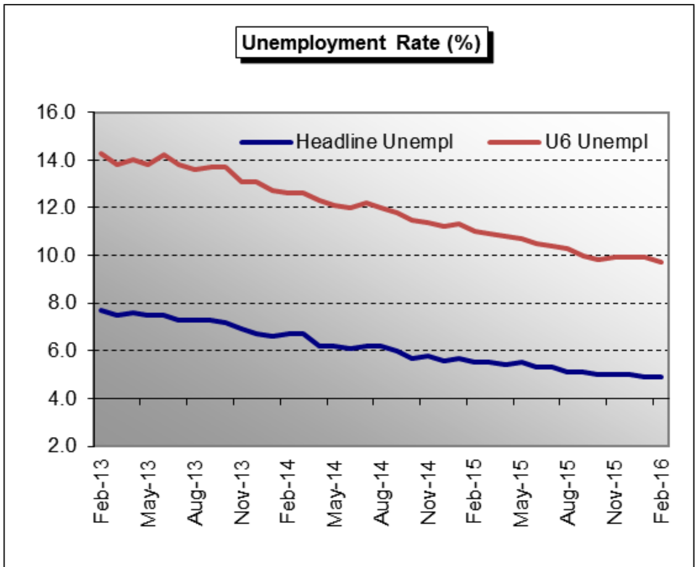
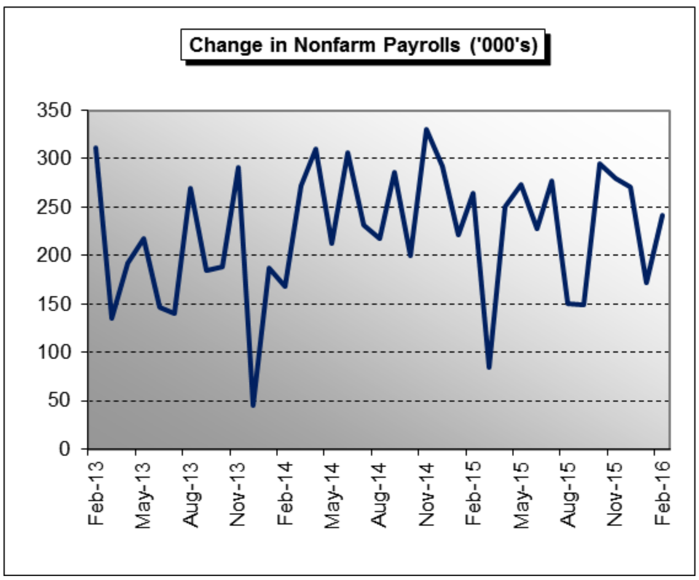
Labor Readings
(Data source: Bloomberg)



Unemployment Rate Remains at 4.9%
The unemployment rate remained at 4.9% in February. The underlying details of the labor market were mixed. On the positive side, there was another large increase in the labor force and almost all found work. This helped to improve broader measures of labor market health (the U6 unemployment rate is at the lowest level in almost eight years). On the negative side, wage growth took a step backwards and workweek hours fell. This dampens the hope that January signaled a return to the higher pre-recessionary wage growth levels.



Job Gains Beat Estimates
Payrolls increased by 242,000 versus an estimated 195,000 gain. In addition, the prior two months were revised upwards by 30,000 jobs. Payrolls have increased for 65 consecutive months and the three month average payroll growth rate remains strong.

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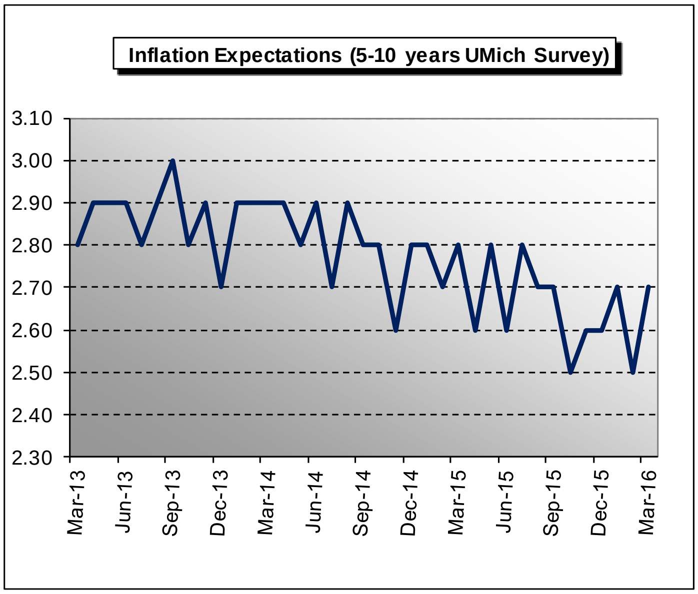
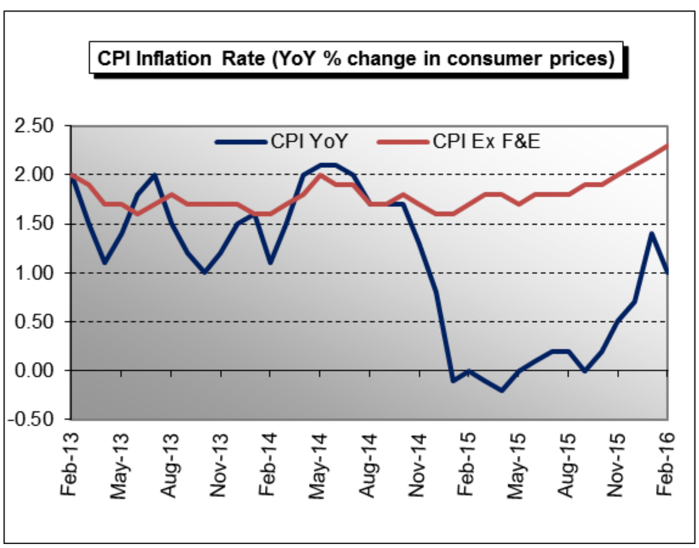
Inflation Readings
(Data source: Bloomberg)



Medium Term Inflation Expectations Bounce Back

Medium term inflation expectations bounced back from an all-time low last month. This should provide some comfort to the Fed, as many Fed officials cited the unusually large decline in this survey as cause for concern. In addition to this survey, market-based levels of inflation expectations have also bounced back over the past month.



Core Inflation Rate Continues to Increase

The "core" (minus food and energy) inflation rate surprised to the upside for the second consecutive month. The annual rate of core inflation stands at the highest level since May 2012. The increases in inflation were broad-based. The headline inflation remains relatively low due to low energy prices. That rate may pick up soon as well. Oil prices have rebounded significantly since the bottom reached last month and now stand at higher levels than year-end.

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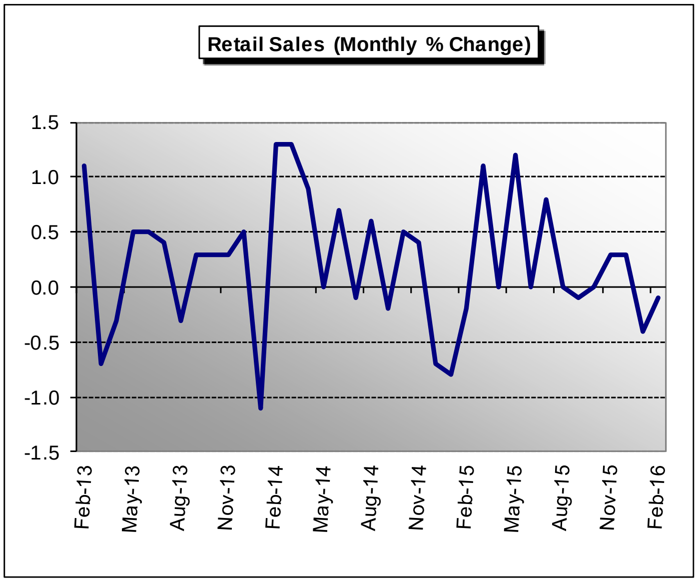
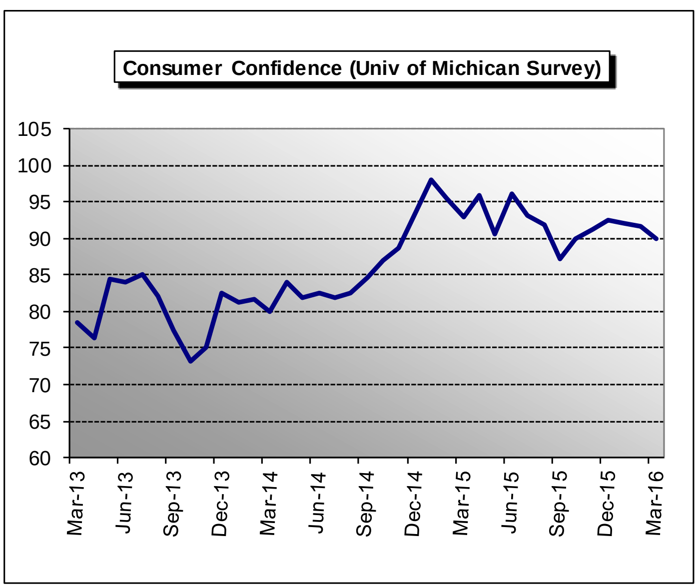
Consumer Readings
(Data source: Bloomberg)



Retail Sales Disappoint
Retail sales for February were slightly ahead of expectations, but that was overshadowed by the large negative revision to January's sales data. February's data showed that the decline in sales was broad-based. At current levels, personal consumption is running at 1% versus 1.6% last quarter.



Consumer Confidence Falls
Consumer confidence came in below expectations and fell to a five month low based on the preliminary March reading. Stagnant wages and recently increasing gasoline prices appear to be damping confidence.