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Economic Update
March 2017

By Andrew Kohl

Commentary

The Fed took center stage last week and raised rates for the second time in the last three months. There was little doubt with the outcome as the market was pricing in 100% probability of a hike. The unknown was whether the Fed would indicate a more aggressive hiking cycle. Treasury yields had climbed 30 basis points since late February in anticipation of a more hawkish shift in the Fed's sentiment.

Ultimately, the Fed changed very little in its updated quarterly economic forecast. The median projection for the number of rate hikes remained at a total of three in 2017 and 2018. The longer run projection for the fed funds rate remained at 3%. At her post-statement press conference, Chairman Janet Yellen reiterated that the Fed did not change its collective economic outlook. In addition, she stated that the Fed has "time to react" if anticipated fiscal expansionary policy gets enacted.

The Fed clearly does not believe that it is falling "behind the curve" when it comes to hiking interest rates. Others in the market disagree. Many of those that disagree point to the Taylor rule (a proposed guideline for where the fed funds rate should be given certain economic conditions). On an unadjusted basis, the rule indicates that rates should be three percentage points higher than where they stand today. When adjusting for a lower terminal Fed funds rate, the Taylor rule still shows that rates should be one percentage point higher. Some people look at history as a guide to why the Fed should hike rates at a quicker pace. The 1960's also saw a period of low unemployment and low inflation. When inflation started to rise, it rose at a much quicker pace than many expected. Due to political pressure, the Fed was very slow to respond and erred on the side of higher employment. That ultimately helped to contribute to the extremely high inflation rate seen in the early 1970's.

We are on the side of the Fed and believe that the gradualist approach is the better path. The Fed should not respond to proposed fiscal policy changes given that they may never come to fruition. The Fed still has limited tools to react if the economy hits a significant bump. This augurs well for keeping rates lower than normal. Still, we do recognize that the Fed should and will hike faster than they have over the past few years. Worldwide risks have dissipated and the global economy appears to be reflating. In addition, financial markets continue to climb.

Our baseline expectation is for two percent real GDP growth in 2017. Yet again, it appears that the first quarter will be relatively weak (Atlanta Fed's GDP model shows .9% growth), but we believe that growth will bounce back later in the year. The Republican proposal to change Obamacare will likely go through several iterations before it gets passed. This will keep Congress bogged down and therefore it's unlikely there will be any fiscal stimulus in 2017.

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Fixed Income Outlook

The Treasury curve from two years and longer in maturity is virtually unchanged from the end of February, but rates are down 15-20 basis points from their peak a week ago. The Fed statement and subsequent press conference was more dovish than many expected. The Fed is expecting to hike two more times in 2017, but the market only has 1.5 hikes priced in. The short-end of the Treasury curve seems very rich. The two-year Treasury rate stands at just 25 basis points higher than Fed funds and the Fed is in hiking mode. There are certainly risks to the financial markets, but many of the short-term risks appear to be receding.

It is important not to lose sight at the impending changes at the Fed. It appears likely that President Trump will appoint five Fed Governors over the next eighteen months. Most importantly, Chairman Yellen's term expires in February 2018. Despite Trump's bashing of her policies during his campaign, we think that there's a chance that he asks her to serve for another term. Many in the market believe that he will choose more hawkish Fed Governors, but we believe that he'd rather choose more pro-growth candidates.

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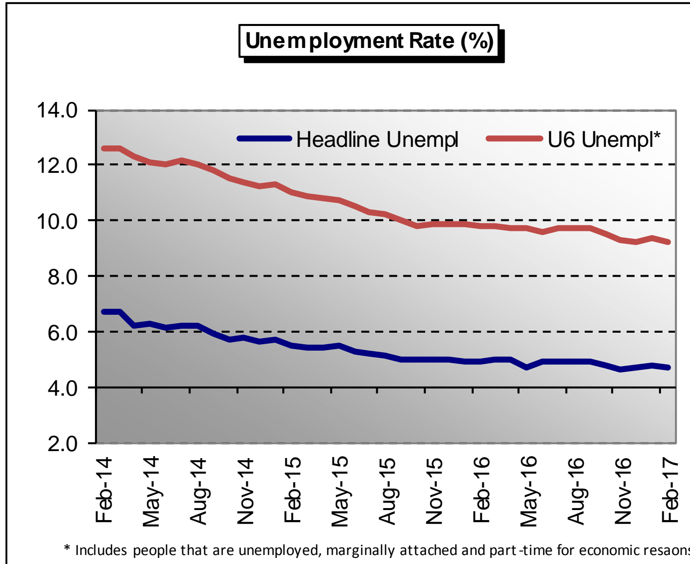
Labor Readings

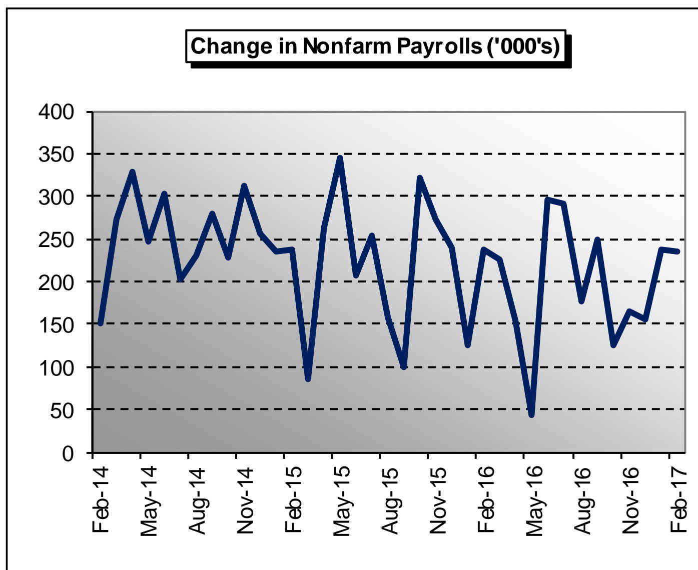
(Data source: Bloomberg)



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

Labor Market Remains Strong

The unemployment rate in February decreased to 4.7% from 4.8% the prior month. The underlying details of the report were relatively strong. The labor force experienced a sharp increase and job growth was more than sufficient to absorb the new workers. The labor force participation rate hit its highest level in almost a year. Wage growth largely met expectations and bounced back from the weak January data.



Solid Job Growth Continues

Payroll growth in February surprised to the upside. Net jobs increased by 235,000 versus an estimate of 200,000. Non-government jobs increased by the largest amount since July and stretched across more industries. Job gains remain well-above the 100,000 per month level that many economists believe is consistent with a stable job market.

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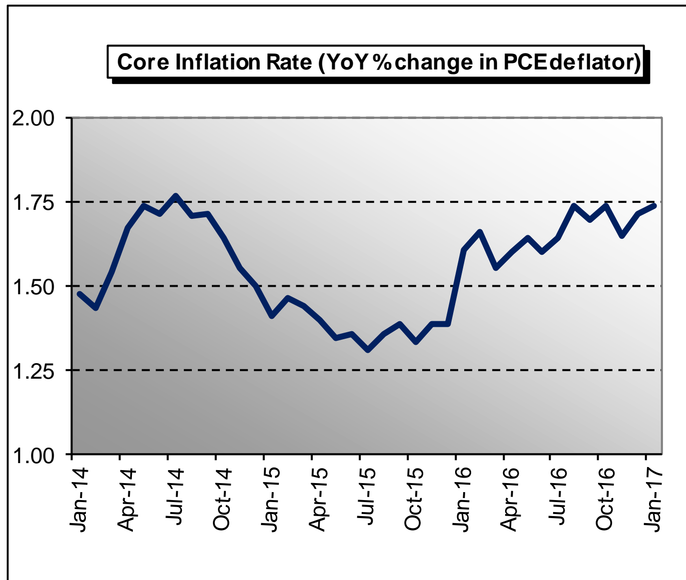
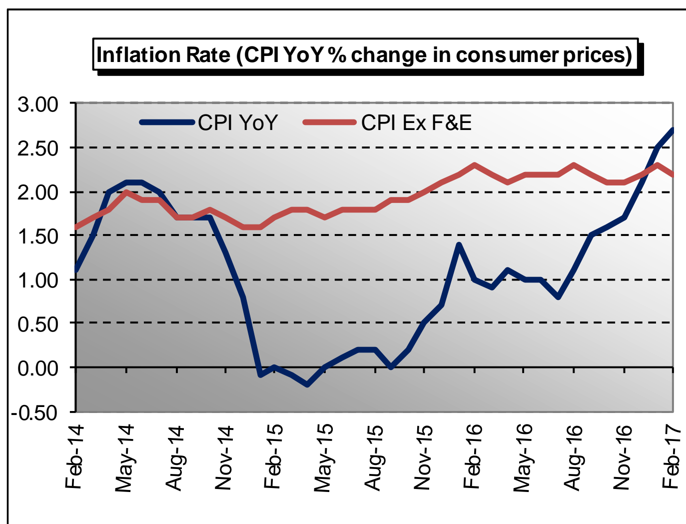
Inflation Readings
(Data source: Bloomberg)



Fed's Key Inflation Measure Remains Below Target

The rate of inflation, as measured by the core personal consumption expenditure ("PCE") index, has increased since the middle of 2016, but remains below the Fed's target of 2.0%. The Fed prefers to use the PCE index rather than CPI since it has a broader scope. With inflation still below 2%, the Fed will likely remain comfortable with a gradual approach to adjust interest rates.



Headline CPI Inflation Rate Increases

The headline inflation rate continues to climb and stands at its highest level (as measured by year-over-year change) since March 2012. Higher inflation rates are being driven by higher energy prices and housing costs. The core inflation rate, which the Fed uses as a leading indicator to the headline inflation rate, has stabilized. This likely means that the Fed is not fearful of a large inflation breakout.

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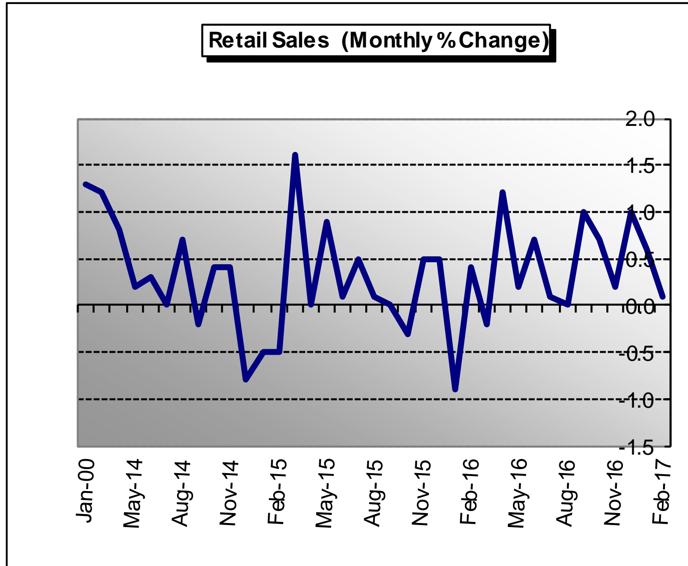
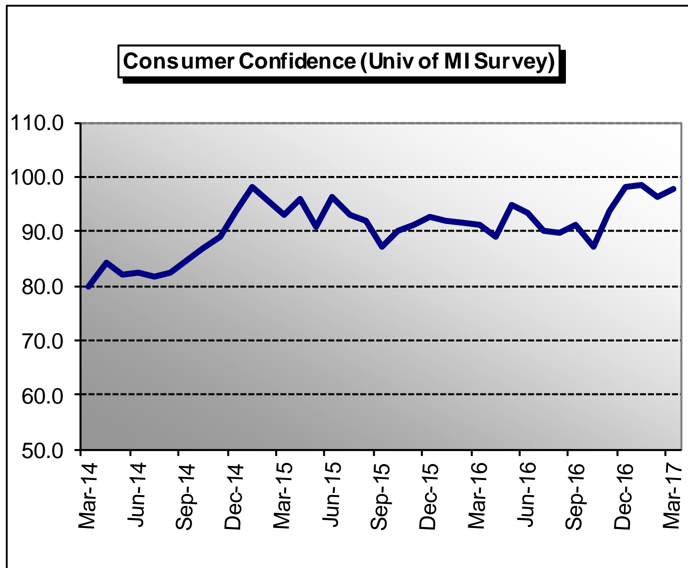
Consumer Readings
(Data source: Bloomberg)



Retail Sales Drop
Retail sales in February were the weakest in six months, but largely met expectations. On a positive note, January sales were revised significantly higher and the two-month trend is solid. Overall, consumption in the first quarter of 2017 will likely be muted due to lower consumer spending on utilities given the mild winter. Current estimates for first quarter GDP are around 1%.



Consumer Confidence Still Elevated
Consumer confidence beat estimates and bounced back near a 13-year high, according to the preliminary March results. The current conditions section of the survey hit a 16-year high. Long-term inflation expectations hit the lowest level since the survey began in 1979.