4/18/18

Corporate Federal Credit Union

Andrew Kohl
Chief Investment Officer

Economic Update
April 2018

By Andrew Kohl

Commentary

Global tensions have eased this week. Russia did not retaliate to the U.S.-led strikes in Syria over the weekend (as it threatened it would), and it was revealed that the U.S. has already held some high-level talks with North Korea. The risk of a trade war has also ebbed. Both China and the U.S. have indicated that they are willing to negotiate rather than play the tit-for-tat tariff game. Combined with a strong start to the corporate earnings season, the stock market has rallied almost 5% since the beginning of the month and now stands in positive territory for the year. Despite the recent gains, the market has shown a much greater sensitivity to the news than it has in recent years. The VIX, a measure of stock market volatility, is almost 60% higher than its 2017 average.

The economic news has been mixed. The year-over-year core inflation data climbed the most in over 13 years and stands above 2% for the first time in a year. Much of this was anticipated, as the drag from lower wireless phone services from a year ago dropped from the calculation. The current inflation trend is relatively strong, but still shows little sign of breaking out to the upside.

The jobs data disappointed this month after a very strong February. Given the large standard error for this statistic, it is unlikely to impact the Fed’s view on the underlying economic trends. The three-month moving average is a better indicator, and it shows job creation at a solid pace of 202,000 per month. It is estimated that it only takes approximately 100,000 new jobs a month to offset the pace of growth in the labor force. Therefore, the current pace of job creation should continue to exert downward force on the unemployment rate.

The minutes from the March Federal Open Market Committee meeting showed confidence that the economy has strengthened. The Fed expects a boost from the recent tax changes and the increased spending levels in the federal budget. A majority of the Fed members increased their estimates for economic growth for the next two years and lowered their estimates for the unemployment rate. The median Fed projection now has 175 basis points in Fed hikes from now until the end of 2020.

We agree that the economy will benefit in the near-term from the fiscal stimulus, but worry about the long-term implications. The increased debt burden will take away from other important government outlays in the future and/or taxes will need to significantly increase at some point down the road. As for the current economy, we look for the first quarter to show its typical weakness and come in below a 2% growth rate. The economy should quickly bounce back and post growth for the full year of 2018 near 2.5%.

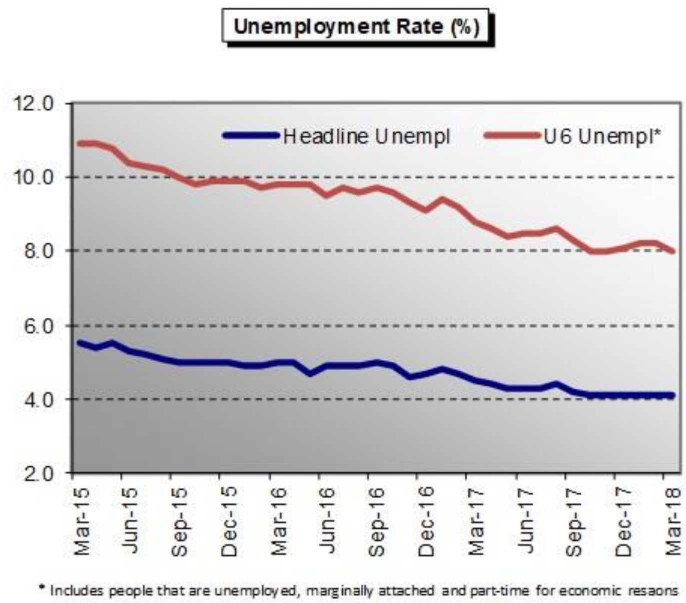
Economic Update
April 2018

Fixed Income Outlook
Since the end of March, bond market yields have moved higher across the curve by 10 to 15 basis points. This mainly reflects the easing trade tensions and a move towards riskier assets. The front and intermediate parts of the Treasury curve (two to five years in maturity) are at eight-year plus highs. The longer part of the curve has not moved to the same degree and the slope of the curve (as measured by the spread between 10-year yields and two-year yields) is at the lowest level in over 10 years.

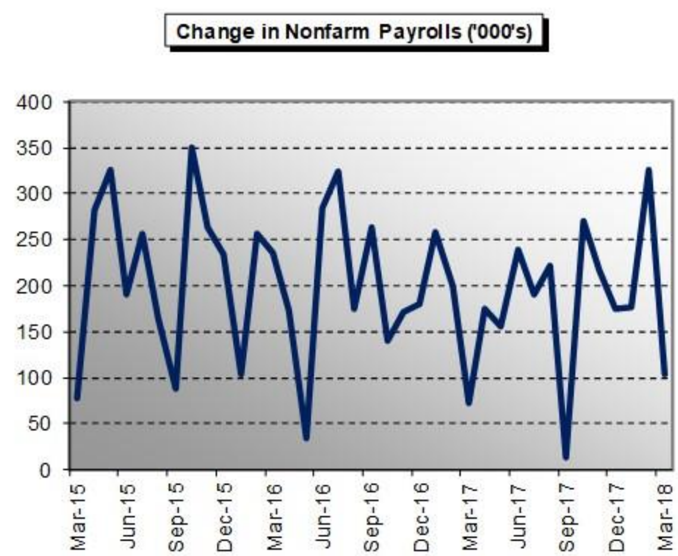
The market is pricing in 90% odds that the Fed will hike again in June. This seems appropriate given all the recent communication from members of the Fed. We think it would take an extreme event for the Fed not to hike in June. After that, the market expects one more hike this year (three cumulative hikes in 2018). We also agree with the market on this view and therefore believe the short-end of the curve seems fairly priced. The market does not believe the Fed will be able to hike much after 2018. There are only 50 basis points of additional hikes priced in after this year versus the Fed's median forecast of 125 basis points. Therefore, the longer-term part of the curve seems rich at this time.

Economic Update
April 2018

Labor Readings
(Data source: Bloomberg)



Unemployment Rate Remains at 4.1%
The unemployment rate held at 4.1% for the sixth consecutive month in March. In the household labor report, both employment and the labor force shrank in March. This was likely a payback from the outsized gains seen in February. Wage growth came in as expected at a 2.7% year-over-year pace.



Payroll Growth Misses Estimates
Payrolls in March increased by the smallest amount since September and were well below estimates. Payrolls increased by 103,000 versus an estimated 185,000 gain. At least some of the miss was likely due to inclement weather as construction employment was down and missed hours due to bad weather were much higher than normal. Despite the weaker-than-expected report, the three-month moving average is 202,000 per month. This is more than enough job creation to push the unemployment rate lower.

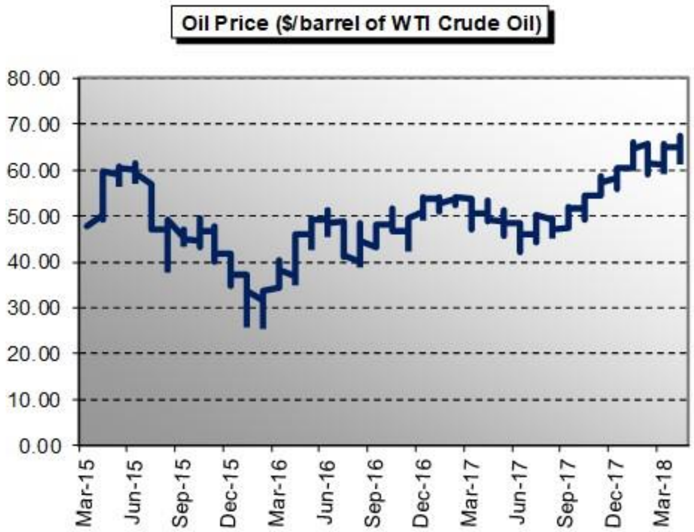
Corporate Federal Credit Union

Economic Update

April 2018

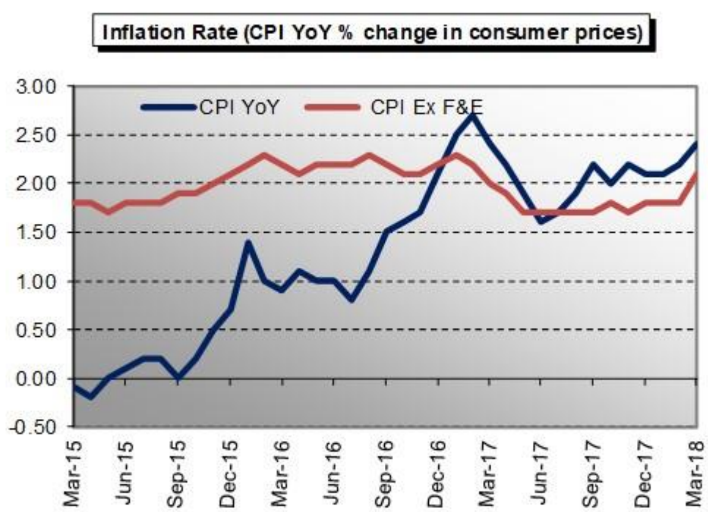
Inflation Readings

(Data source: Bloomberg)



Oil Prices Continue to Climb

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.



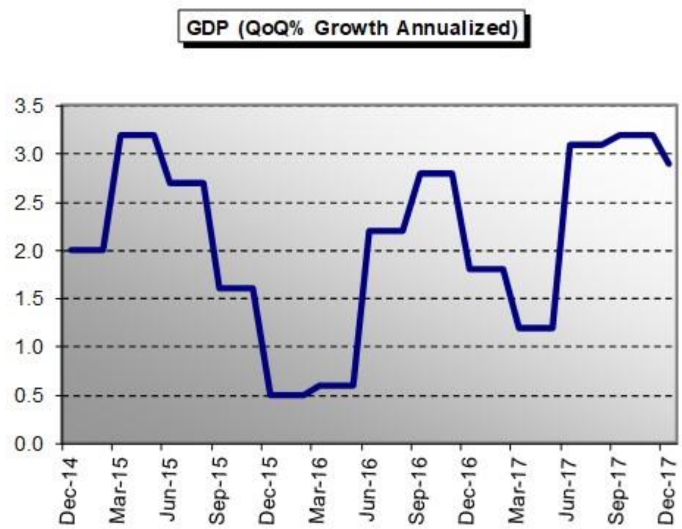
Inflation Rate Increases

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.

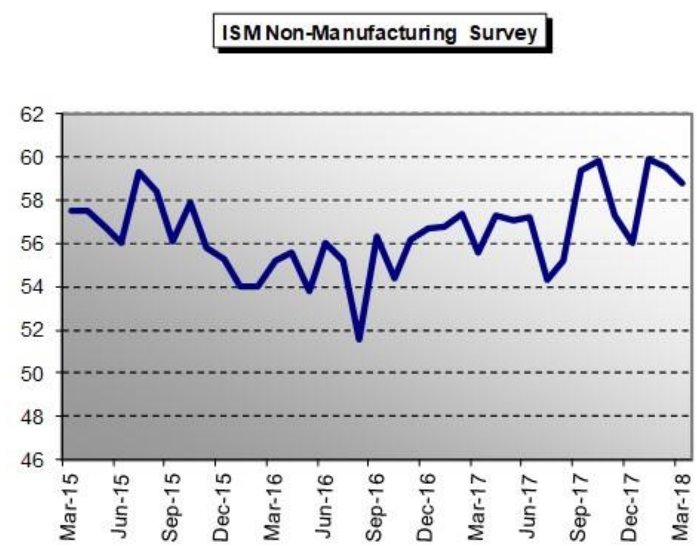
Corporate Federal Credit Union

Economic Update
April 2018

Economic Growth Readings
(Data source: Bloomberg)



Fourth Quarter GDP Growth Revised Upwards
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 20 major cities that were analyzed experienced year-over gains in 2017. The largest gain was Seattle, with a 12.7% increase.



Services Business Survey Remains Strong
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.