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ECONOMIC UPDATE
April 2016

By Andrew Kohl

Commentary

The stress in the financial markets has continued to abate over the past few months. This has led to a rally in risky assets. The U.S. stock market (as measured by the S&P 500) is up 2% year-to-date and has rallied by almost 15% from the lows in mid-February. The rally has been spurred on by a less aggressive stance by the Fed and some better than expected data from China.

The Fed meets next week for the third time this year. At their last meeting, they cut their expected hikes in 2016 in half (from 100 basis points to 50 basis points) mainly due to financial stress from abroad. As they enter this meeting, economic data in the U.S. has been sluggish. It appears that first quarter GDP is tracking under 1% and inflation pressures are easing. This means that the decision to keep rates unchanged is not in doubt, but it will be interesting to see if the Fed attempts to prep the market for a hike in June.

Since there is not a press conference at the conclusion of the meeting, there will be even more scrutiny on the official post-meeting statement. In particular, the statement related to the balance of risks in the economy will be the key. Given the financial turmoil experienced during or near their last two meetings, the Fed refrained from making a judgement on the balance of risks. With the recent calm, they should be more comfortable making a judgement one way or the other. If the Fed continues to refrain to make an assessment, it would send a strong signal to the market that a June hike is unlikely.

We believe that the Fed will remain very cautious with this hiking cycle for several reasons. First and foremost, the global economy remains relatively weak and we are just a few short months away from the markets pricing in a meltdown. The easing of the dollar has helped to calm those fears (especially the fears of a devaluation of China's currency). The lower dollar has also helped to increase the price of oil. The Fed will be leery about sparking another round of fear in the markets.

We also believe that the Fed must be pleased with the progress being made with the labor force participation rate. The participation rate has increased to its highest level in over two years as many people have re-entered the workforce. One of the goals of easy monetary policy that was stressed by the Fed's chair, Janet Yellen, was to help get people back to work. There was great debate to whether the labor force participation rate would be able to increase again so soon given the demographic trends and loss of job skills for those out of work for a long period of time. The recent trend has been encouraging and with wage inflation still low, the Fed is likely to give this trend more room to run.

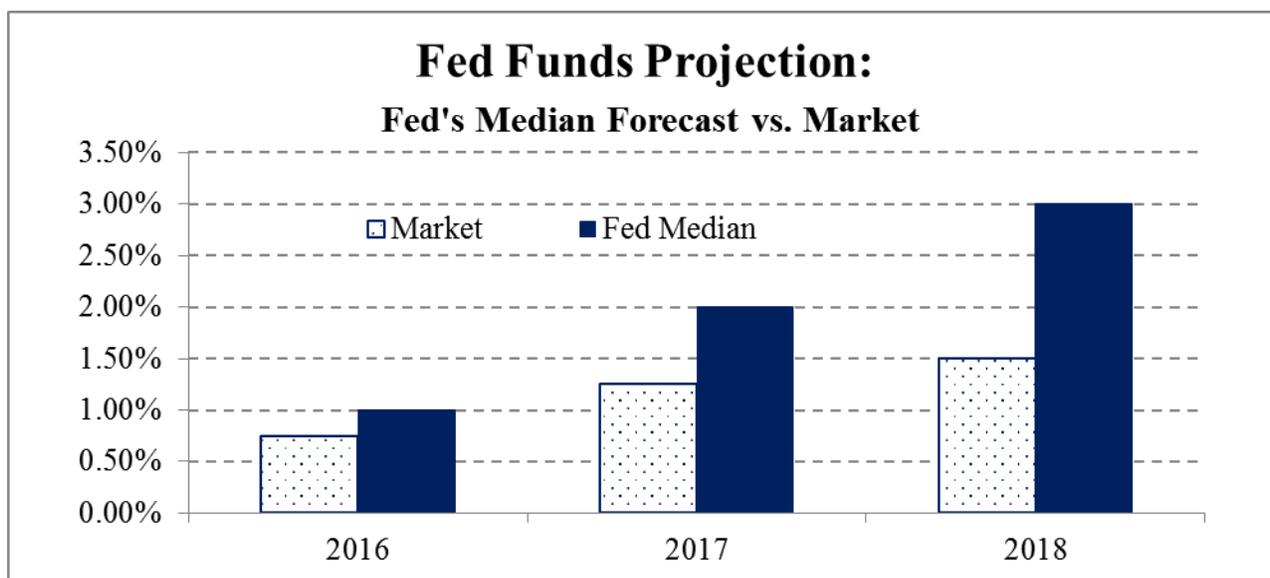
We still believe that the Fed is likely to hike rates in 2016, but see July as the earliest they would make a move. Besides the reasons given above, the U.K. votes on its exit from the European Union ("EU") just eight days after the Fed's meeting in June. The vote looks close at this time. A vote to leave the EU could cause further concerns for the global economy. The Fed would not want to add to those concerns.



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Fixed Income Outlook

Interest rates are largely unchanged from where they stood last month. The market is balancing the impacts of sluggish economic data in the U.S. and reduced odds of financial turmoil from abroad. The market is placing almost zero chance of a hike at April's meeting and a 20% chance of a hike in June. Odds of a hike don't exceed 50% until the September meeting and only one hike is priced in for all of 2016.

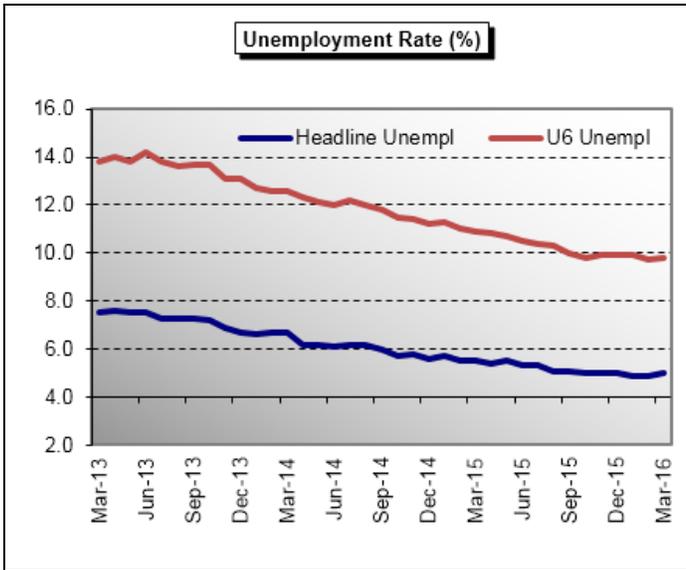




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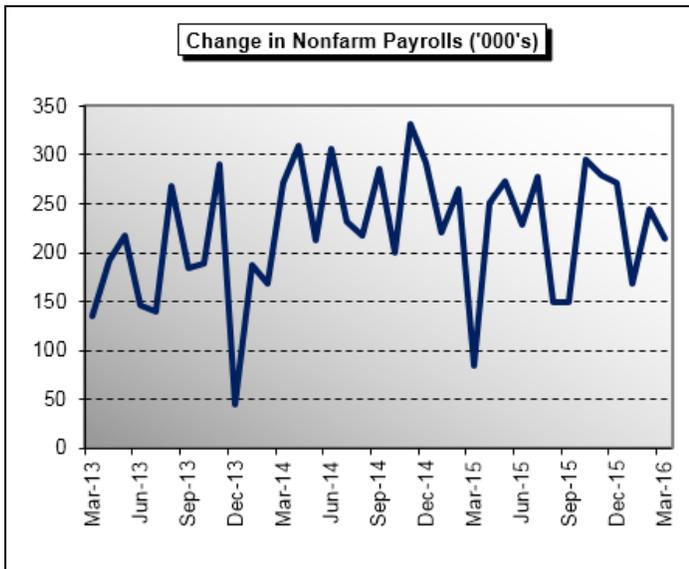
Labor Readings

(Data source: Bloomberg)



Unemployment Rate Ticks Up

The unemployment rate in March ticked up slightly from 4.9% to 5.0%. It was the first time that the rate has increased in almost a year. The underlying details of the labor market were generally positive. The increase in the unemployment rate was due to another relatively large increase in the labor force rather than a decline in employment. In addition, wage increases came in slightly higher than expectations.



Job Gains Meet Estimates

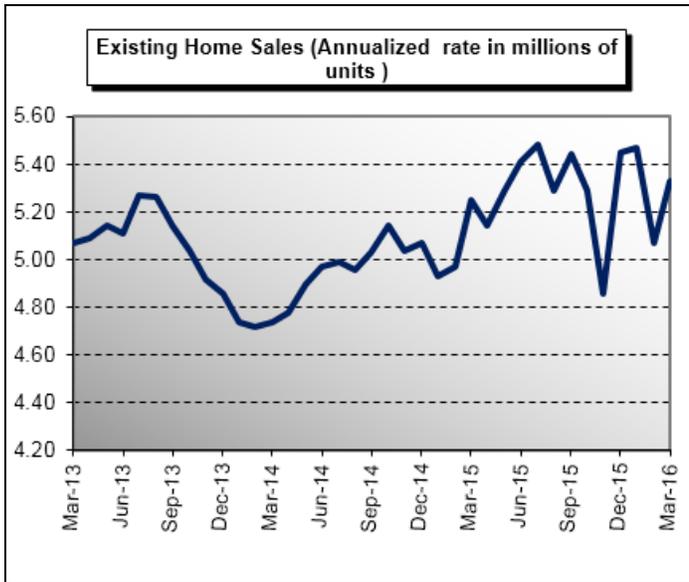
Payrolls increased by 215,000 versus an estimated 205,000 gain. Construction payrolls grew at a rapid pace, likely due to the warm winter across the country. Manufacturing employment slumped by the most in six years as the strong dollar and weak oil has hurt growth in that sector.



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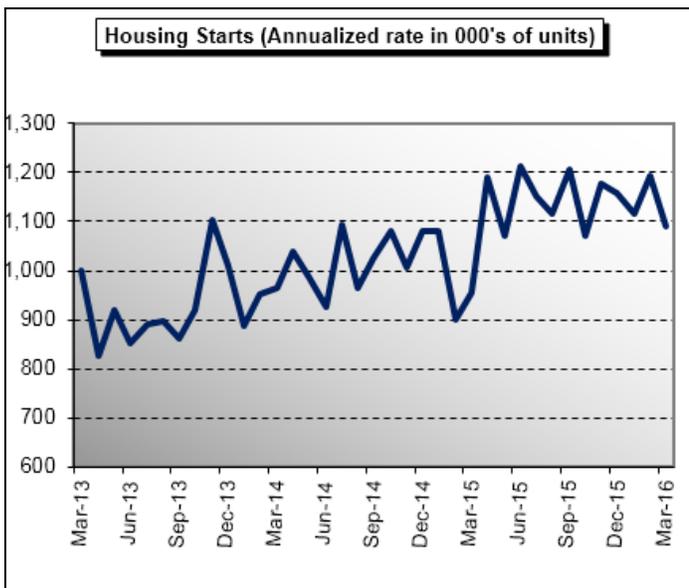
Housing Readings

(Data source: Bloomberg)



Existing Homes Sales Bounce Back

Sales of existing homes increased in March and beat estimates for the month. Home sales increased by 5% from the prior month after experiencing a large decline in February. Inventories remain tight, which has helped push housing prices higher.



Housing Starts Decline

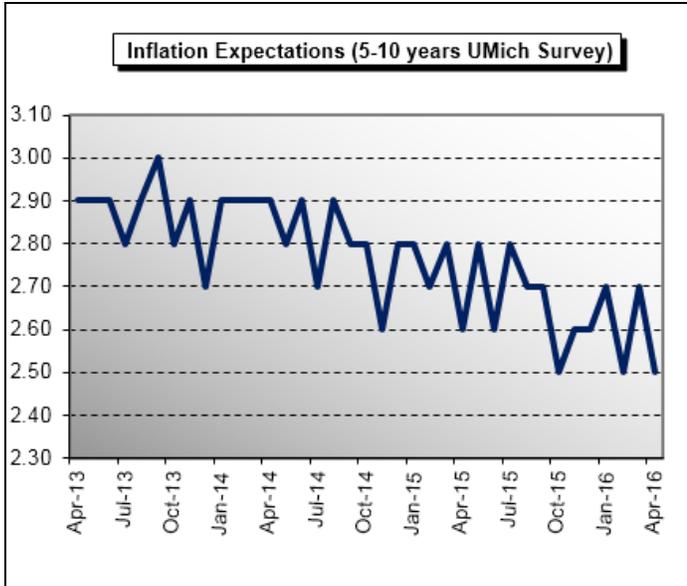
New home construction fell by almost 9% on a month-over-month basis in March. This was well below the expectations of only a slight decrease from the prior month. It was also the weakest reading since October. Building permits, a proxy for future construction, also were much weaker than expected.



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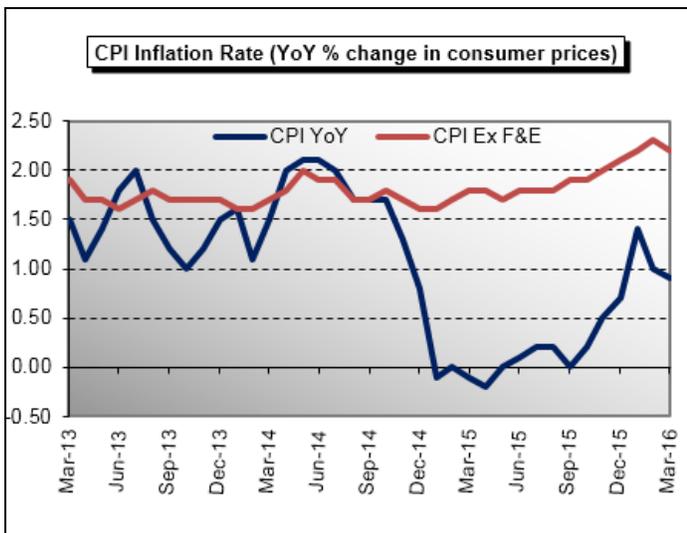
Inflation Readings

(Data source: Bloomberg)



Medium Term Inflation Expectations Fall

Medium term inflation expectations fell back to its all-time low in April. The Fed is closely watching inflation expectations since the market-based measures of inflation have dropped substantially over the past few years. Low inflation expectations will keep the Fed on hold longer.



Inflation Readings Ease

Both the headline and core inflation rates fell from the previous month in March. It was the first decline in the core inflation rate in almost a year. Apparel and food prices dropped while energy and housing increased less than in the previous month. The drop in the inflation readings this month supports the Fed's view that the recent increases were due to transitory factors and that inflation remains tame.