Written on 5/23/16

Corporate Federal Credit Union

ECONOMIC UPDATE
May 2016

By Andrew Kohl

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Commentary

The Fed put the market on notice that it is still contemplating a hike in rates at their upcoming meeting on June 15. The market had been pricing in decreasing odds that the Fed would take action in June and less than a 50/50 chance that they would hike at all in 2016. Last week, almost every Fed speaker made an effort to remind the market that June is a “live” meeting and that rate hikes are not that far away. The minutes from the April meeting (released on May 18) confirmed what the speakers were saying.

Those in favor of a hike in the near term have two main arguments. They believe that the labor market is operating at full capacity and that wage inflation will soon pick up. When coupled with the increase in oil prices (+16% year-to-date), they are concerned that inflation could overshoot. This could create a scenario where the Fed would need to hike rates much faster and higher than market expectations. This could choke off the economic recovery. Their other argument is that holding rates excessively low for so long encourages risky behavior. This could lay the foundation for another financial crisis.

Those that favor a more cautious approach to hiking rates make the following counterpoints. They point out that inflation is still tracking well below the Fed’s target and that it has remained below that target for more than four years. Across the globe, countries are having more trouble sustaining inflation than dealing with prices overheating.

The other main argument against a near term rate hike is the asymmetry of risks. There is plenty of room to move rates higher if inflation starts to pick up, but there is little the Fed can do if economic growth sputters and deflationary forces set in. The results from non-traditional central bank action (quantitative easing and negative interest rates) have been mixed at best. Therefore, the Fed should be willing to risk an overshoot on inflation in order to be more confident that the economy can handle higher rates.

We side with the more cautious approach. The Fed should be willing to allow a modest overshoot of inflation given the economic risks in the rest of the world. That being said, it is hard to ignore the recent Fedspeak. It is also important to note that back in March a majority of Fed participants anticipated hiking rates twice in 2016. To get in two rate hikes this year, they will want to get the first one done relatively soon.

We still believe that July is more likely than June as the meeting for the first hike. There just isn’t enough economic data that is released from now until the June meeting to confirm that economic growth and inflation will continue on the path that the Fed expects. In addition, the UK vote to exit the European Union occurs shortly after the Fed meeting. This is an added uncertainty that the Fed will want to clear before hiking. We believe that the Fed will use the June statement to more clearly lay out the case for a hike in July.

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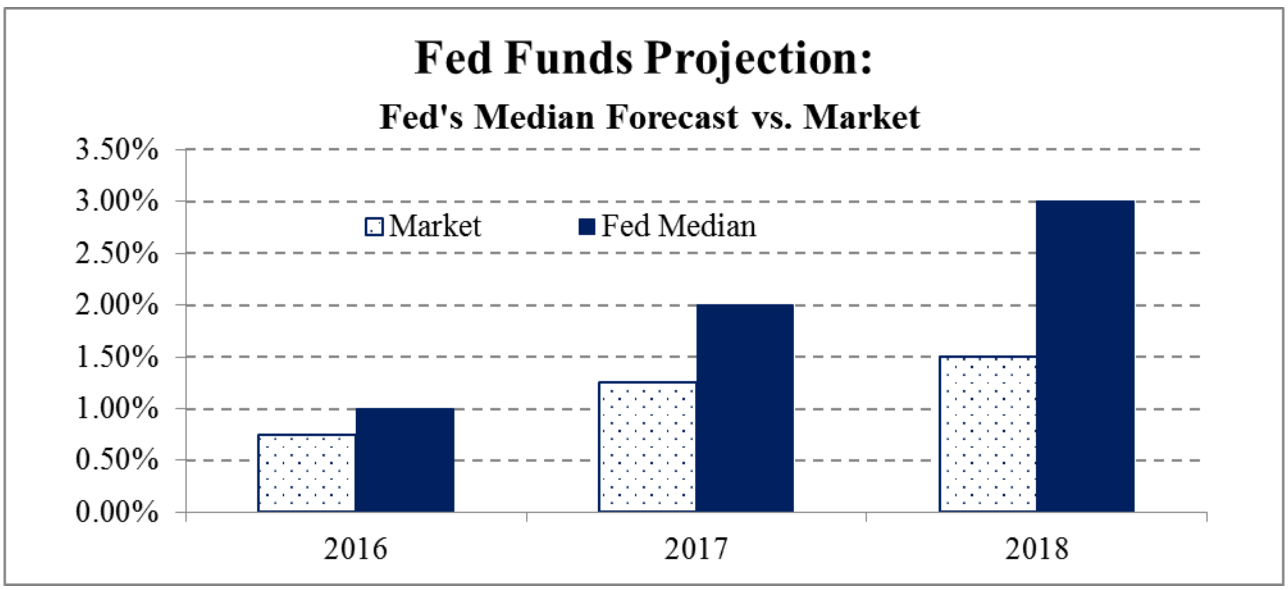
Fixed Income Outlook

Short-term interest rates spiked higher after various Fed speeches and the Fed minutes pointed to a potential June hike. The market is pricing in approximately a one in three chance of a hike in June (up from a 5% chance the week before). Interestingly, the long-end of the curve did not move much. The market is pricing in a significant chance that the Fed makes a policy mistake by hiking too soon and will have to reverse course at some point in the not too distant future. We believe that current market pricing represents fair value.



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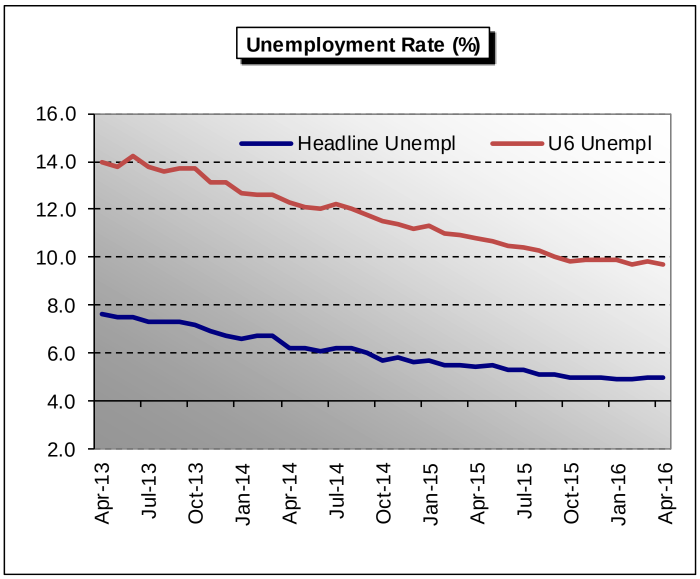
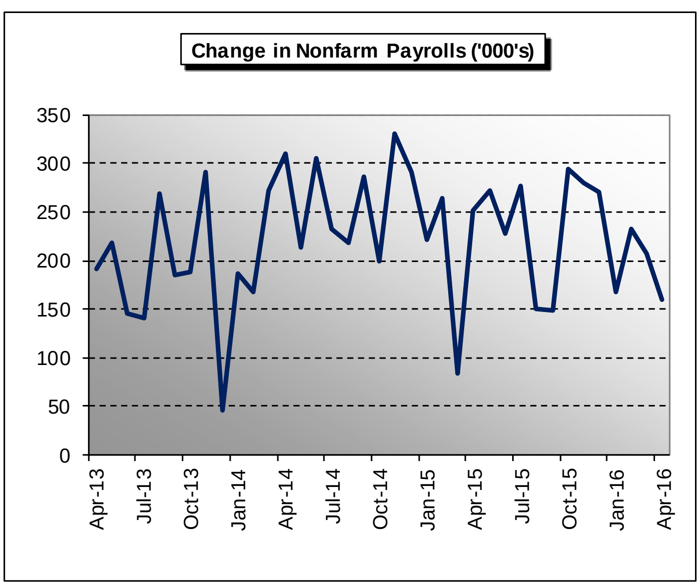
Labor Readings
(Data source: Bloomberg)



Unemployment Rate Holds Steady
The unemployment rate in April held at 5.0%. The underlying details of the labor market were mixed. On the negative side, the labor force shrank for the first time since September, 2015. On the positive side, wage inflation showed some signs of life and surprised to the upside.



Job Gains Disappoint
Payrolls increased by 160,000 versus an estimated 200,000 gain. It was the smallest gain in jobs in seven months. Retailing and construction jobs were the main sources of weakness. Despite the miss to the downside, the result was still within the standard margin of error for the index of 100,000 jobs. Therefore, it will likely take several months of below trend growth to impact the Fed's decision making.

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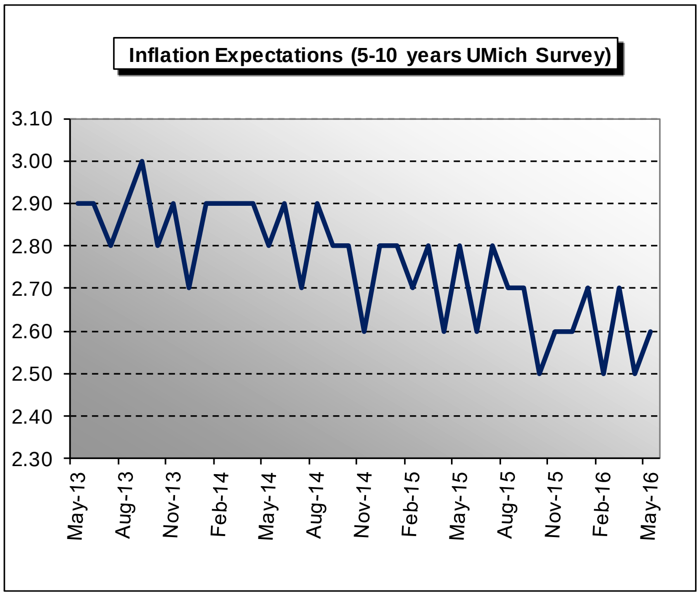
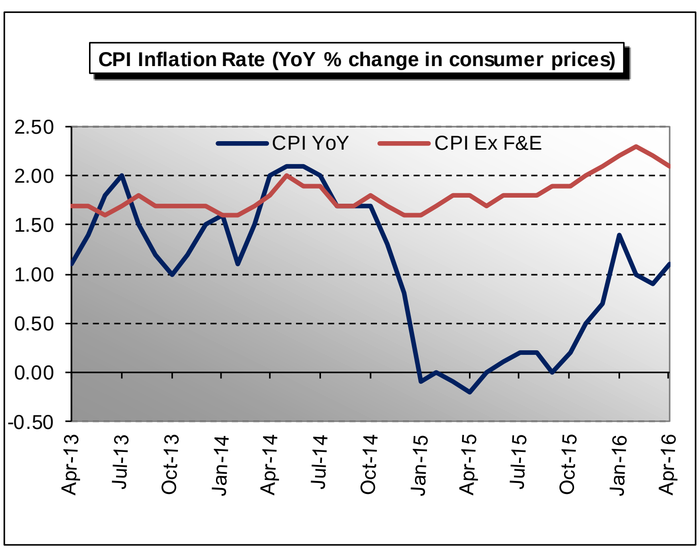
Inflation Readings
(Data source: Bloomberg)



Medium Term Inflation Expectations Increase
Medium term inflation expectations increased marginally from April to May, but still remain below the long-term average. Inflation expectations for the next year fell from 2.8% to 2.5%, but seem to be largely driven by expectations for gasoline prices. The Fed continues to closely watch survey measures of inflation as they are wary of deflationary risks.



Inflation Readings Higher than Expected
Consumer prices in April rose by the most since February 2013 on a month-over-month basis. The jump in the headline index was mainly due to the rebound in fuel costs. The core index remained in the vicinity of the Fed's long-term inflation goal of 2.0%.

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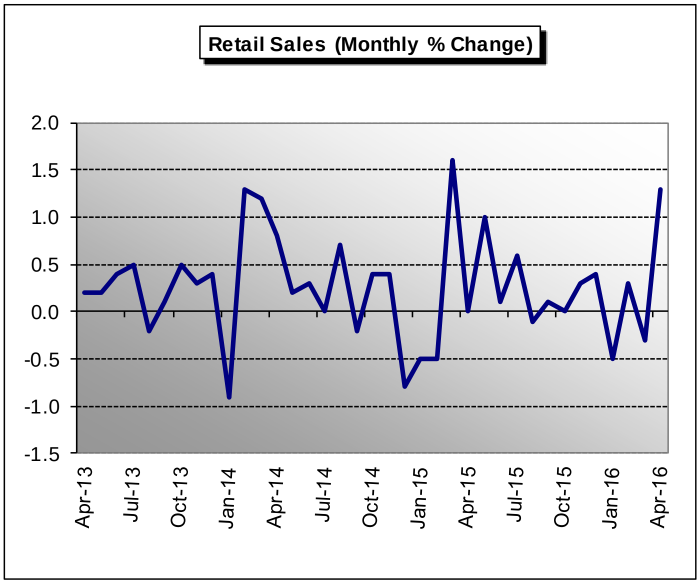
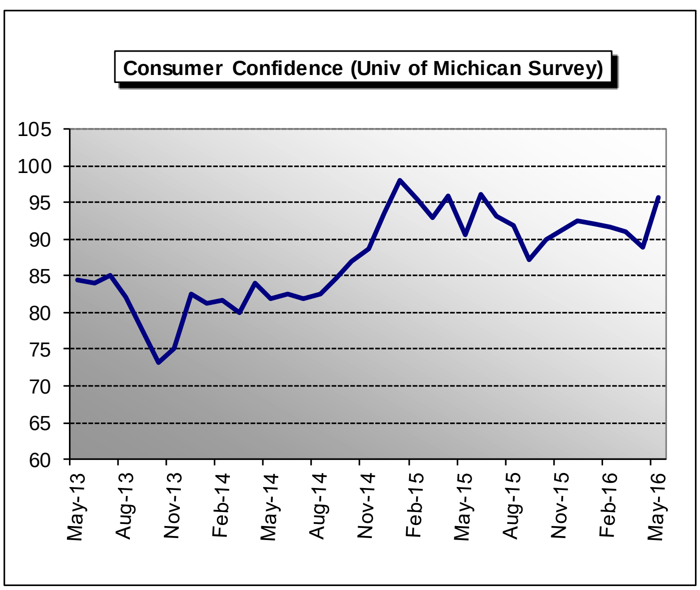
Consumer Readings

(Data source: Bloomberg)



Retail Sales Soar

Retail sales in April rose by the largest amount in over a year. The gains were broad-based as 11 of the 13 major categories increased. The large increase will likely cause many economists to upgrade their growth estimates for the second quarter as consumer spending makes up roughly 70% GDP.



Consumer Confidence Gains

Consumer confidence surged to its highest level in a year. There were broad-based advances in the expectations section of the survey. In addition, real income expectations rose to the highest level in 10 years.