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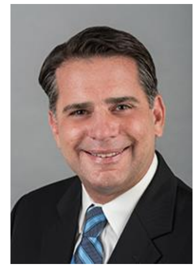

Andrew Kohl
Chief Investment Officer

Economic Update
May 2018

By Andrew Kohl

Commentary

It was smooth sailing for the markets for most of May. The stock market hit a two-month high and U.S. bond yields moved higher on relatively good economic news. Suddenly, news out of Italy sparked renewed concerns about the stability of the euro. Italian 10-year bond yields increased by 100 basis points in just two trading days, prompting global equity markets to experience a large sell-off and an ensuing flight to quality.

The two Italian anti-establishment parties were what rattled the markets. Combined, the parties hold the majority of the Parliamentary votes and are close to forming a coalition government. The proposed government may seek to break eurozone rules by drastically cutting taxes and increasing spending. They have also drafted a plan to leave the euro.

This may seem like a replay of the Greek crisis from roughly six years ago, but the stakes are larger this time. Italy's economy is ten times the size of Greece's economy, and is the third largest economy in the eurozone. In addition, Italy is not embroiled in a liquidity crisis and can play "hard ball" with the other eurozone members to gain concessions. If a coalition government cannot be formed, Italy is likely headed for another round of elections this summer. Our base case expectation is that the new Italian government will gain enough concessions to remain in the euro, but tensions are likely to remain high for an extended period.

The U.S. economic expansion keeps chugging along and, at nine years, is the second longest in post-World War II expansion. Given the length of the recovery, it's natural to look for clues for when it may end. Since the last recession was triggered by excessive leverage, the media tends to focus its attention there. This month, the Fed released its quarterly Household Debt and Credit Report. The report showed that the amount of household debt is now $500 billion higher than where it stood before the last recession. Not surprisingly, the media's headlines are focused on that fact. We think that data point should be taken with a grain of salt. Like other nominal (non-inflation adjusted) measures, the data will naturally move higher over time. A better way to look at consumer leverage is to scale it by another nominal measure, such as income. The debt-to-income ratio has been essentially flat since 2012 and is far below the peak reached in early 2009 (78% currently versus 104% peak).

The economic expansion could also end due to overheating (which subsequently leads to rapid Fed tightening). When looking at the most cyclical components of GDP (i.e. durable goods consumption, business investment, residential investment, etc.), all are subdued relative to where they stood before previous recessions. There appears to be little risk of the economy overheating in the near term.

Absent a large external shock, the economy recovery should continue at least through next year. Economic growth will get an assist from the fiscal stimulus over that timeframe. The stimulus will begin to fade in 2020 and thus, the risk of recession will increase.

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Fixed Income Outlook
Bond market yields have fallen by approximately 15 basis points across the curve in May. The largest move downwards came from concerns about Italy, but yields had already started moving lower after the release of the Federal Open Market Committee meeting minutes. The minutes continued to show that the Fed is willing to let inflation move above the 2% target without overreacting. The word “symmetric” was used multiple times in reference to the Fed’s inflation objective. In addition, the Fed seems increasingly concerned about the potential for an inverted yield curve due to moving rates too far too fast.

The minutes also discussed a “technical adjustment” to the interest on excess reserves (IOER) rate. For the last several years, the Fed has been setting rates by announcing a 25-basis-point range for the fed funds target. The IOER rate has always been set at the top of the range. With the next increase in rates (likely in June), the IOER rate is likely to move only 20 basis points and, therefore, be five basis points below the top of the range. The adjustment is meant to keep the effective fed funds rate from breaching the 25-basis-point range (the spread between effective fed funds and IOER has been declining over the last few months). We believe that this will be a one-time adjustment and the IOER will move in lockstep with the announced rate change going forward.

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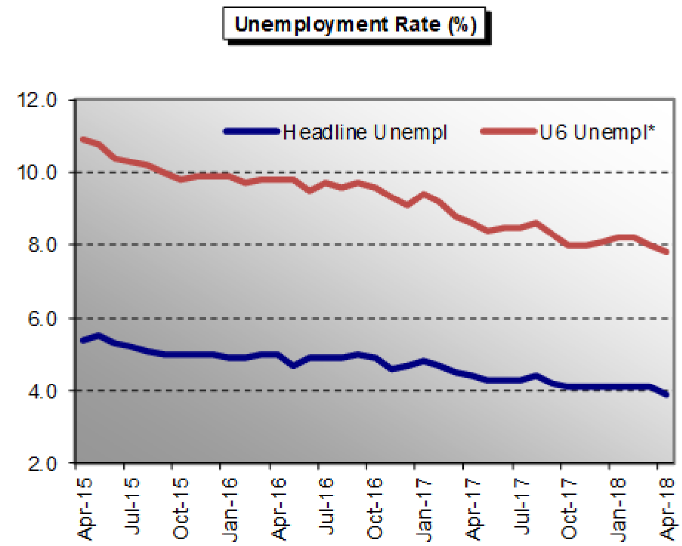
Labor Readings

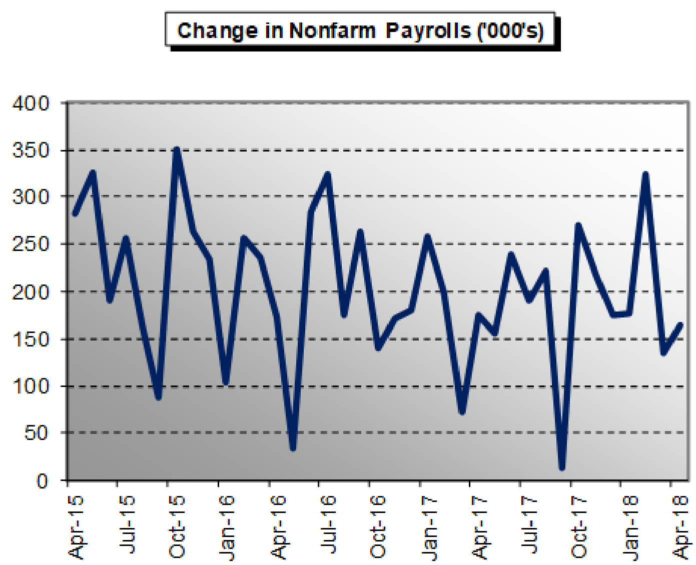
(Data source: Bloomberg)



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

Unemployment Rate Drops Below 4%

The unemployment rate fell below 4% for the first time since the late 2000s. Unfortunately, the decline in April was due to people leaving the labor force rather than strong job gains. Overall, the improvement in the labor market since the unemployment rate peaked at 10% in October 2009 has been dramatic.



Payroll Growth Slightly Below Forecast

Payroll growth in April was below estimates, but upward revisions to the prior two months placed the three-month growth rate on par with expectations. Payrolls increased by 164,000 jobs in April and the three-month average is 208,000 jobs/month. Given the strong pace of job creation, the Fed is very likely to hike rates in June.

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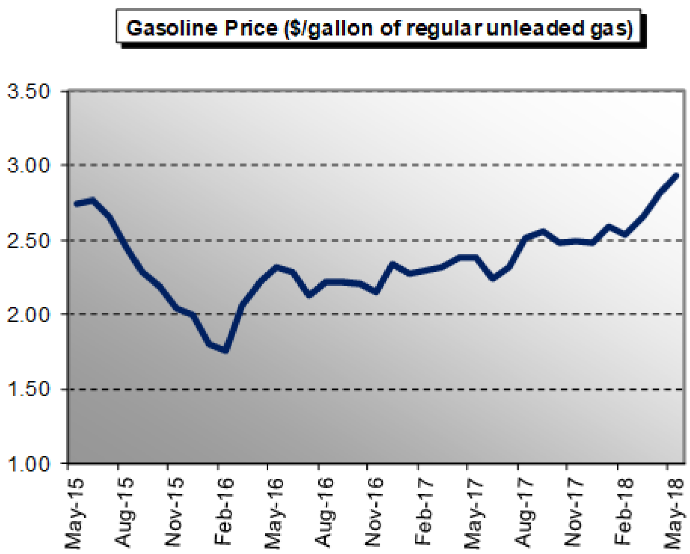
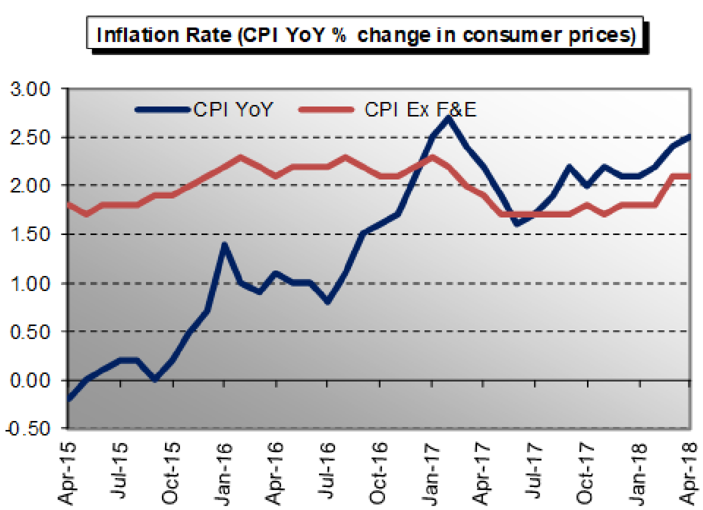
Inflation Readings
(Data source: Bloomberg)



Gasoline Prices Rise
Gasoline prices currently stand at a 3.5-year high on fears of reduced supply from the Middle East and Venezuela. Prices at the pump are 25% higher than the recent low in February 2016. With Americans' penchant for SUVs, higher gas prices will eat into consumers' wallets more than before.



Inflation Data Comes in Below Expectations
The inflation data in April was slightly weaker than expected, which helped ease fears that inflation is poised to break out. The monthly increase in "core" inflation was the lowest this year. This data will encourage the Fed to stay on its "gradual" path of rate hikes.

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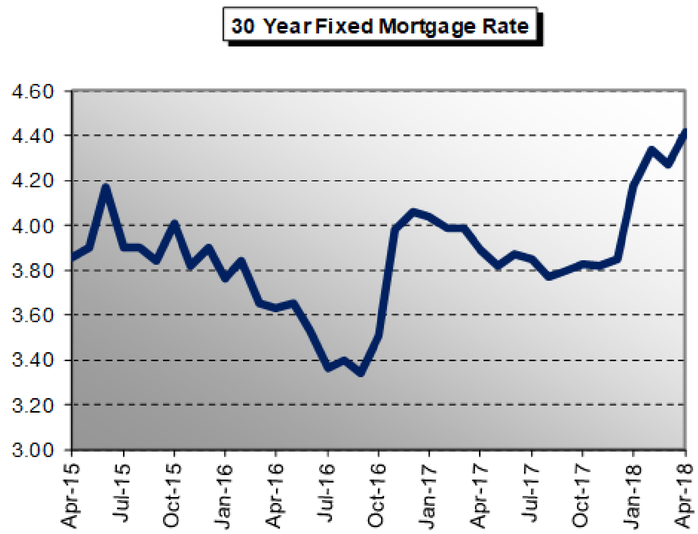
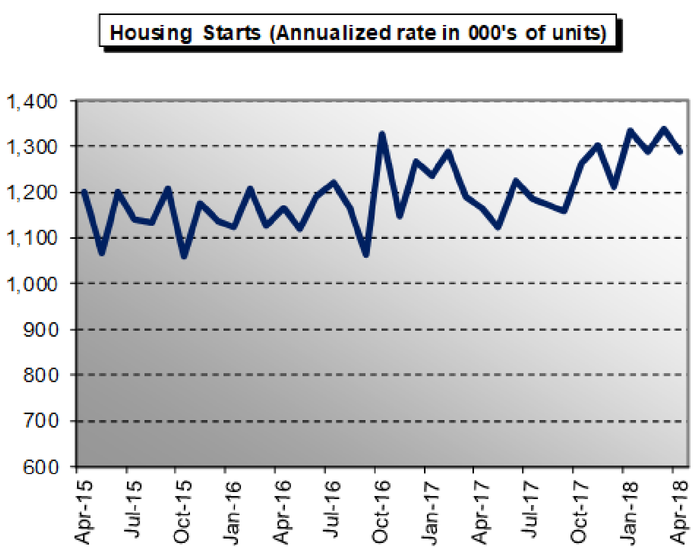
Housing Readings

(Data source: Bloomberg)



Mortgage Rates are Climbing

Thirty-year fixed mortgage rates have increased by 50 basis points thus far in 2018. The current rate of 4.40% is over 100 basis points higher than where it stood in the fall of 2016. Housing affordability measures have been declining since 2012, but remain relatively high given income growth and still historically low mortgage rates.



Housing Starts Weaker than Expected

New home construction came in lower than expectations in April. The weakness was solely in the multifamily housing sector as the momentum in that part of the housing market has continued to fade. Single-family housing starts held steady. Homeownership rates have started to tick up after reaching a 50-year low in 2016.