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Corporate Federal Credit Union

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Economic Update

May 2017

By Andrew Kohl

Commentary

The Trump rally took a hit this week as his firing of FBI director, James Comey, brought new questions about Trump's relationship with Russia and the ability to get his agenda through Congress. The market's reaction to the Comey firing was muted at first, but has since turned negative as more information has become available. Today, a special counsel, Robert Mueller III (a former FBI director), was appointed to handle the probe into the potential collusion between the Trump campaign and Russia. Popular betting sites in Europe (where it seems legal to bet on pretty much anything) place over 50% odds that Trump won't be able to finish his first term and 25% odds that he won't last the year. Regardless of the outcome of the investigation, we believe that the story will remain in the headlines for several months. This will make it less likely for significant policies related to taxes and infrastructure spending to be enacted in 2017.

If the only major changes that are enacted via the Trump presidency are immigration reform and more protectionist trade practices (those that don't need Congressional approval), the economy will suffer. If done correctly (a big "if"), tax reform and infrastructure spending can provide both short-term and long-term benefits to the economy. The same can't be said for Trump's immigration and trade agenda. Limiting immigration constrains the country's workforce. Less trade can make U.S. companies less competitive across the globe and increase the cost of goods for U.S. consumers.

For the remainder of the year, we believe that the economy will continue to plod along just fine. The strong April employment report confirmed that the weakness seen in March was likely an aberration. In addition, the retail sales report showed that the consumer is not dead. Many of the reasons for weak consumer spending in the first quarter were for temporary factors (unusually warm winter weather, delayed tax refunds, etc.). We see a significant bounce back in growth in the second quarter and continue to see 2% growth for the full year.

We don't expect to see a large increase in inflation anytime soon. Even with the unemployment rate reaching its lowest level from the previous recession, wage growth has been anemic. Given that the labor market has the most job openings since 2001 and the highest quit rate since 2007, workers should be experiencing wage growth near 4%. Instead, we are at 2.5%. It seems clear that much of the problem with wage growth is due to structural issues (i.e. skills mismatch between what's needed to do the jobs and what skills the workers have). Closing the gap in skills needs to be a priority to move wages and the economy forward on a higher path.

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Fixed Income Outlook

Treasury yields moved higher to start the month of May after a relatively hawkish Fed meeting and a stronger than expected labor market report. Rates moved sharply lower this week after the Trump news led to an equity market correction (The S&P 500 fell 1.8% yesterday, the largest daily decline since Trump was elected). We currently stand near the lows for the year in medium to long duration Treasuries.

At the May FOMC meeting, the Fed made it clear that they are looking past the weak first quarter data and didn't see a reason to change their stance on the economy. This would mean two more hikes in 2017. The market expects the Fed to hike in June (the current market-based odds of a hike stand at 80%). We think that a June hike is more likely than not, but 80% odds seem a bit high to us. Inflation levels did not bounce back the way that employment did, which gives the Fed more reason to be cautious about hiking too fast. In the end, if the next labor report meets or beats expectations, a June hike will likely occur. After that, if wage inflation remains as low as we expect, we don't expect another hike in 2017.

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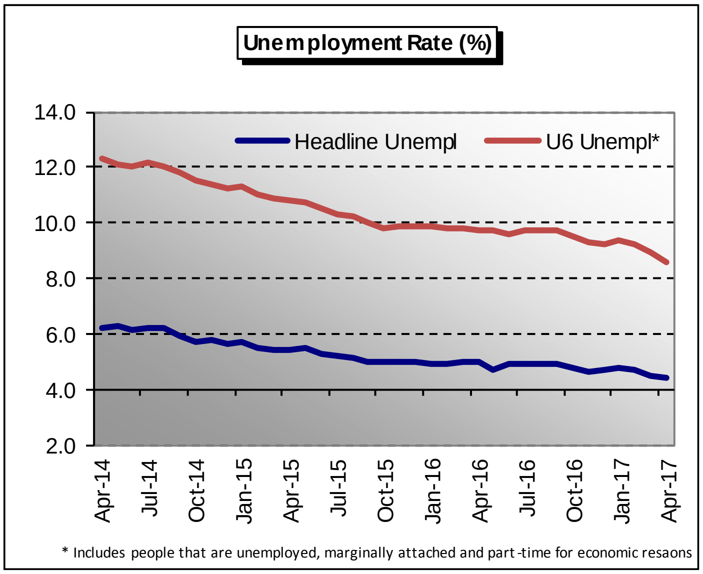
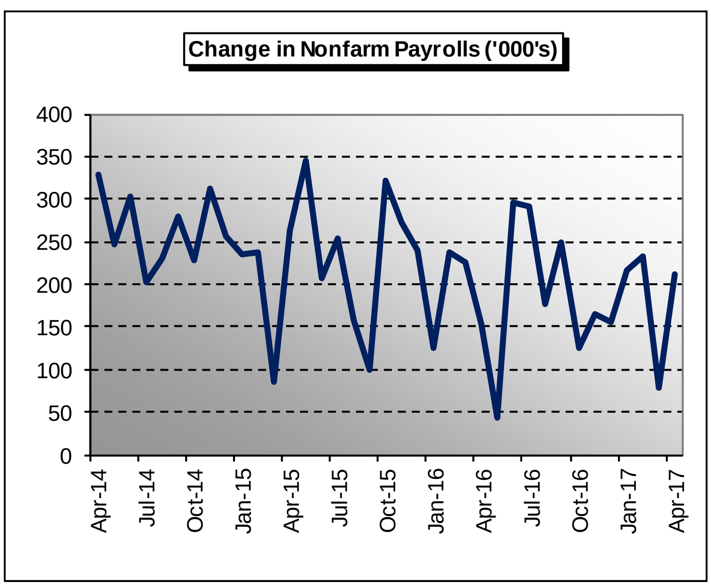
Labor Readings

(Data source: Bloomberg)



Unemployment Rate Continues to Fall

The unemployment rate in April decreased from 4.5% to 4.4% and has now matched the lowest level reached during the previous economic expansion. The current level also stands below the Fed's unemployment rate forecast for the end of the year. Despite the improvement, wage gains are still relatively weak. The year-over-year increase in wages came in below expectations and stands at the lowest level in eight months.



Job Growth Bounces Back

After the much weaker than expected March payroll figure, the April release took on more significance. Job gains managed to bounce back and exceed expectations. Payrolls expanded by 211,000 jobs versus an expected 190,000 gain. The year-to-date monthly job gains of 185,000 per month is now roughly equal to the monthly average gains from last year.

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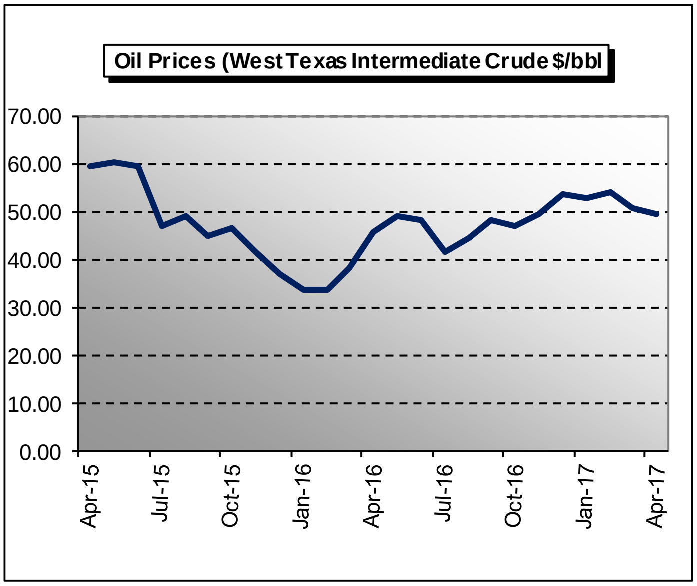
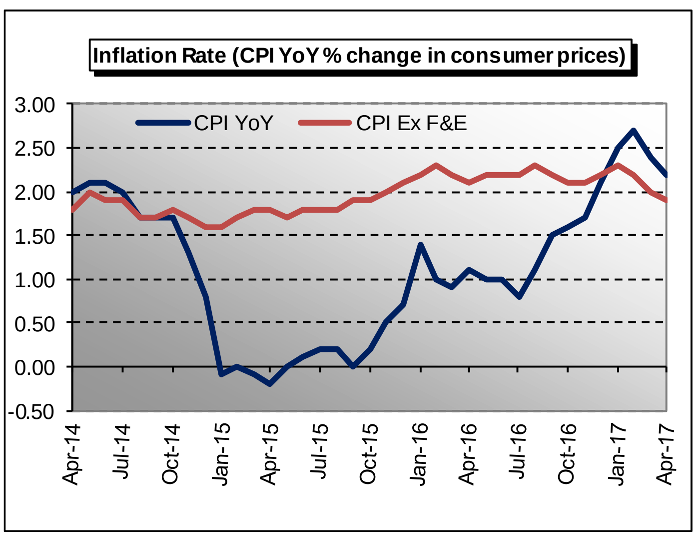
Inflation Readings
(Data source: Bloomberg)



Oil Price Increase Has Stalled
Oil prices increased by 45% in 2016, which helped to push inflation rates higher. So far in 2017, oil prices have remained little changed. OPEC has cut supply in an effort to raise prices and has a meeting next week to extend price cuts through the end of the year. The governor on more price gains is shale oil production in the U.S. As oil prices increase, more shale development occurs, which counteracts the price increase.



Inflation Rate Cools
The headline rate of inflation has slowed down since it reached a five year high in February. After the surprisingly weak March inflation data, April was closer to expectations. Still, the core rate of inflation has declined for three consecutive months. With inflation showing few signs of a breakout, the Fed will likely favor a very gradual approach to hiking rates.

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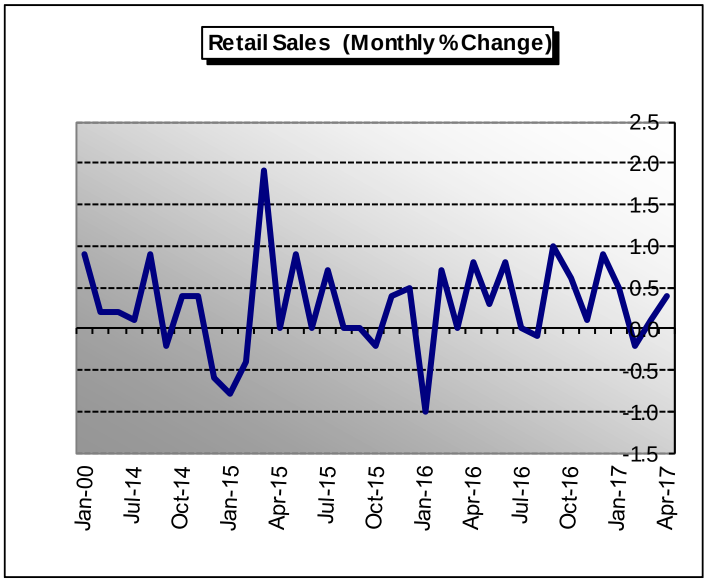
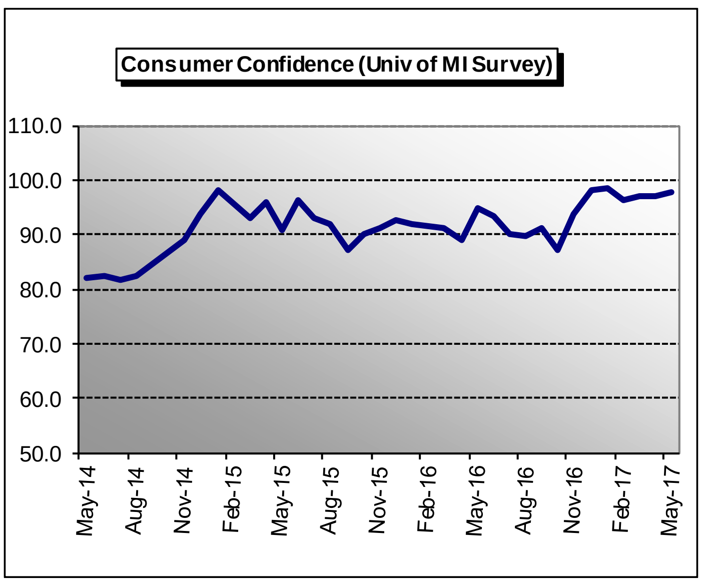
Consumer Readings

(Data source: Bloomberg)



Retail Sales Rebound

Retail sales in April were slightly below estimates, but when combined with upwardly revised data from March, the overall report was relatively strong. The report indicates that first quarter GDP is likely to be revised upwards and the prospects for a bounce back in growth in the second quarter look good.



Consumer Confidence Remains High

Consumer confidence beat estimates and reached a four-month high. Confidence has remained elevated ever since the presidential election in November. The steep partisan divide that has been evident in the index since the election is starting to narrow (Democrats are becoming more confident while Republicans' confidence levels remain extremely high).