Written on 6/28/16

Economic Update
June 2016

By Andrew Kohl

Andrew Kohl
Chief Investment Officer

Commentary

The U.K.'s referendum vote to exit the European Union (EU) has created a flight to quality and a rapid decline in risky asset prices. The decision to leave the EU took the market by surprise as many betting sites in Europe had an 80%+ chance that the vote would come out in favor of remaining in the EU (despite the preelection polls being closer to 50/50). At the time of this writing, the S&P 500 is down 4.5% from just prior to the UK's vote. In addition, the trade-weighted dollar is up 3% and the ten-year Treasury rate is down 30 basis points.

The U.K.'s vote to leave was driven by three main factors. First of all, the uneven economic recovery has created a large swath of people that are unhappy with the economy. Income inequality has increased and many people have not recovered from the financial crisis in 2007-2008. Secondly, demographics played a role as older voters (who are more likely to vote) were more anti-EU. Lastly, and most importantly, immigration fears due to recent terrorist actions were high.

So, what happens next? First of all, the U.K. remains in the EU for the time being. The path to exit does not start until the U.K. gives official notice to the EU by triggering Article 50 of the Lisbon Treaty (technically, the U.K. government can choose to ignore the referendum vote, but that seems unlikely at this point). Once that notice is given, the U.K. can remain in the EU for at least the next two years as formal talks are held. Therefore, from an intercountry trading perspective, there is likely to be minimal impact in the near term. The near-term negative, from an economic perspective, will come on the investment side. Companies will be hesitant to make large investments in the U.K. until they know what trade agreements will be set. This will push down U.K.'s economic growth and likely lead to a mild recession. The longer-term ramifications will depend on what trade agreements the U.K. can negotiate with the EU. Given that the EU will not want to encourage an exit by another member, it may be tough for the U.K. to achieve the results they desire.

The impact to the U.S. economy should be more muted. The U.S. exports only about 4% of its goods to the U.K., but U.S. exports will suffer elsewhere if the dollar remains strong. Therefore, the big risk to the U.S. is if a prolonged period of heightened uncertainty occurs. This will be the case if anti-establishment parties in other countries start to gain even more favor. Besides the U.S. election this year, both Germany and France have major elections next year. If the elections result in anti-establishment victories, trade will suffer and the economy will take a hit.

What does all this mean for the Fed? Certainly, there will not be a rate increase in the near future. They were already leaning more dovish prior to the U.K.'s vote due to weakening jobs data. At the Fed Chair's semi-annual Congressional testimony, Janet Yellen indicated that the Fed expected the recent weak labor reports to be transitory, but wanted to see evidence of a reversal before hiking. In addition, the Fed's updated economic projections at June's meeting showed fewer Fed participants calling for more than one hike in 2016, and fewer hikes in 2017 and 2018 than March's projections (and most were probably assuming that the U.K. would vote to remain in the EU).

The Fed has shown an unwillingness to hike rates in periods of economic uncertainty. The dollar strengthening has already resulted in tighter financial conditions, so the Fed will not want to tighten conditions even further. At this point, we believe that the hurdle is relatively high for the Fed to take action in either direction. They don't want to give back the hike that took so long to implement (and Yellen stated that negative rates are "not being contemplated") and they don't want to add fuel to the fire to a rising dollar. Therefore, we don't expect any rate changes in 2016.

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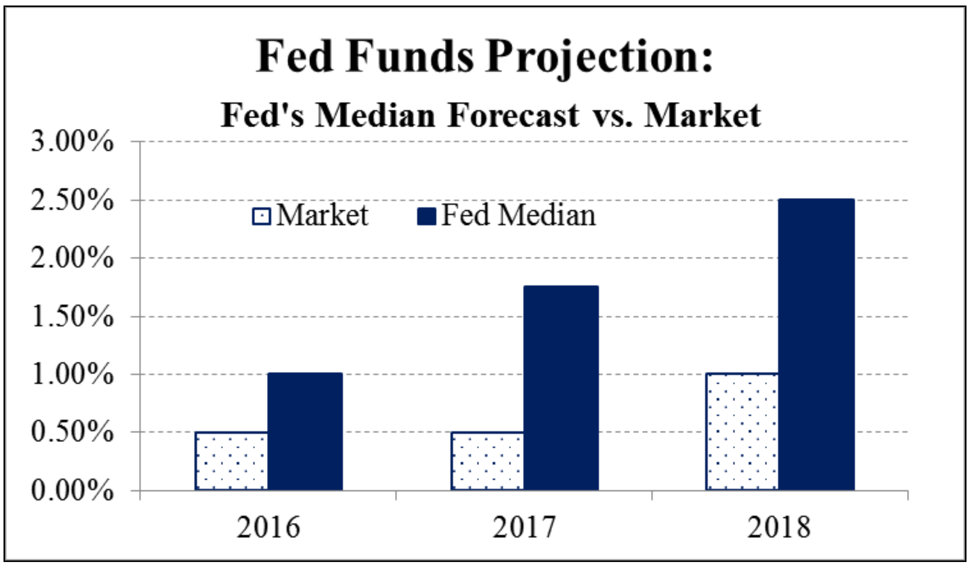
Fixed Income Outlook
Interest rates dropped significantly as the U.K.'s vote caused a flight to quality. Two to thirty-year Treasury rates are 20-30 basis points lower than where they stood the day prior to the vote (although only down 10-15 basis points from the week prior). The market is pricing in approximately a 15% chance of a cut in rates in September or November and a small chance of a cut or a hike at the December meeting. In addition, there is now less than a 50/50 chance of a hike priced in for 2017. We still believe that the next Fed move is more likely a hike than a cut. At this point, it seems that the fears related to U.K.'s vote to exit seem overblown.



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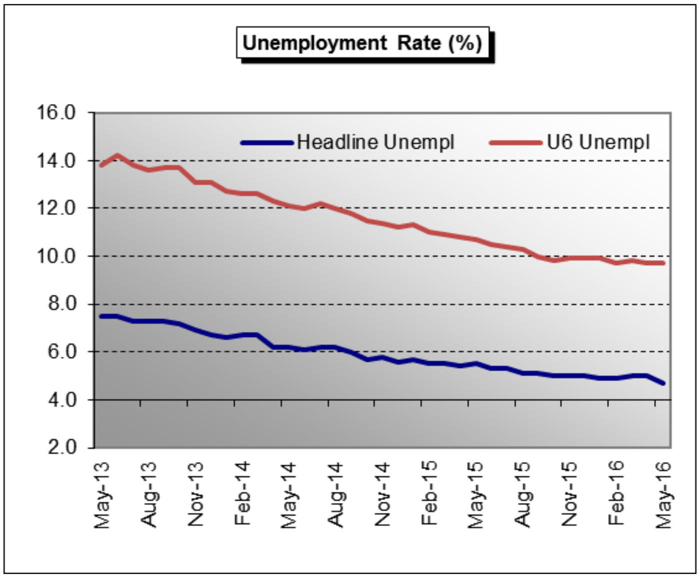
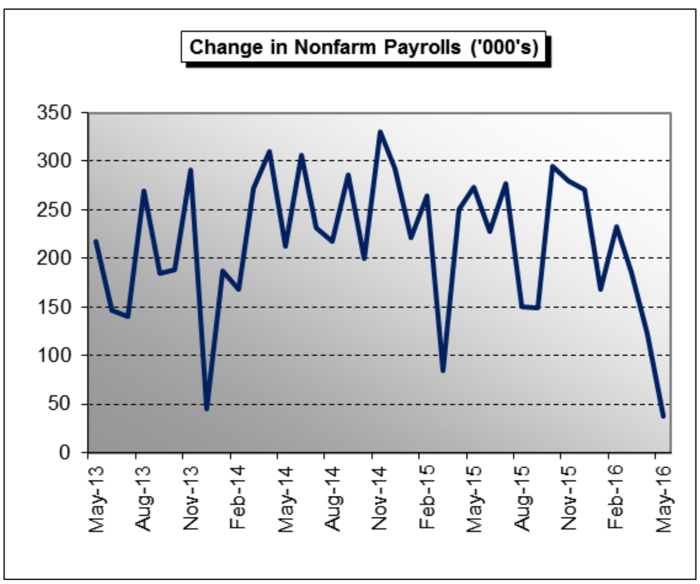
Labor Readings
(Data source: Bloomberg)



Unemployment Rate Declines
The unemployment rate in May declined to 4.7% from 5.0% in April. Unfortunately, the improvement was almost solely due to people exiting the workforce rather than finding new jobs. The labor force has shrunk by a large amount the last two months and much of the improvement seen in the labor force participation rate since last fall has now largely been given back.



Job Gains Plunge
Payrolls increased by just 38,000 in May versus an expectation of a 160,000 gain. It was the smallest gain in jobs in almost six years. In addition, the job gains from the prior two months were revised down by a cumulative 60,000. The weakness was broad-based though out various labor markets. The three month average monthly job growth now stands at 116,000, which is over 100,000 less per month than last year's average.

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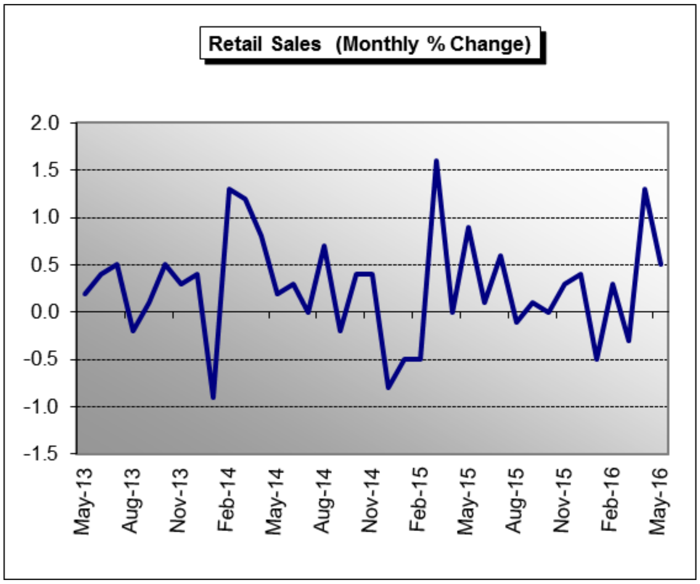
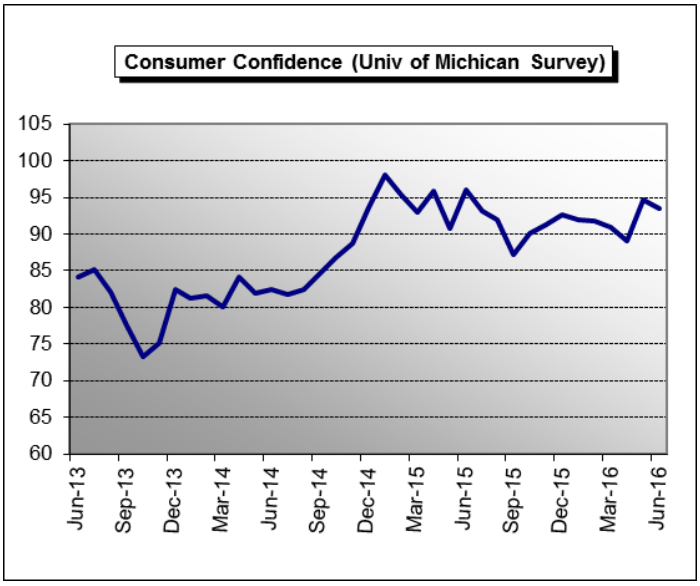
Consumer Readings
(Data source: Bloomberg)



Retail Sales Remain Strong

Retail sales in May came in higher than expected. Sales rose by .5% on a month-over-month basis versus an estimated .3% increase. The gains were broad-based, with nine of the thirteen major categories showing increases from April. The results from the last two months are the largest back-to-back gains in sales in over two years.



Consumer Confidence Declines Marginally

Consumer confidence in June declined slightly from the prior month. Consumers remained optimistic about their current financial situations, but future expectations dropped from the prior month. Inflation expectations increased from the prior month. The survey was taken prior to the U.K.'s vote to exit the EU, so it will likely experience a sizeable decline in July.

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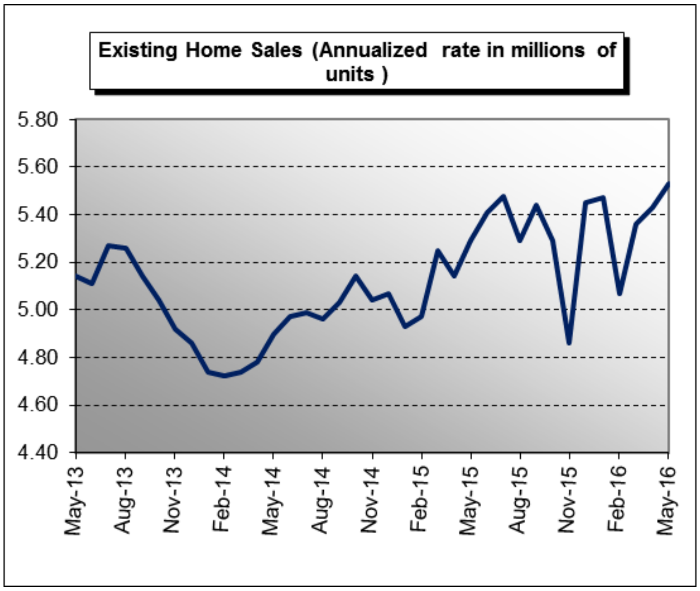
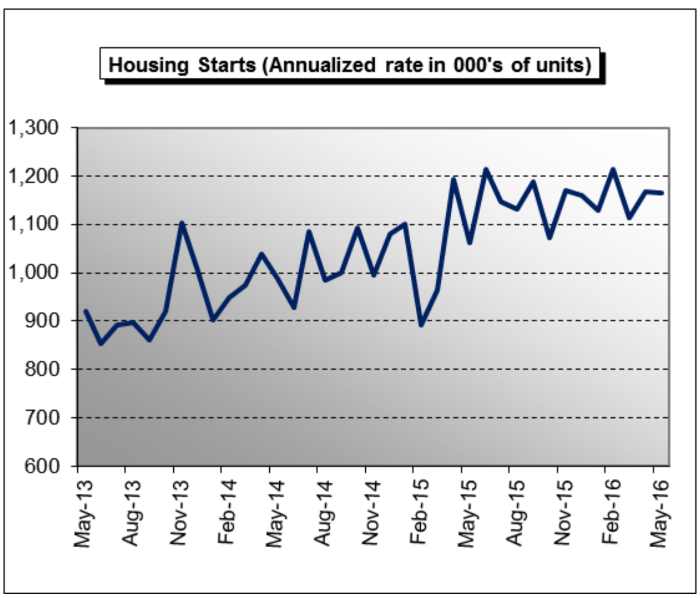
Housing Readings
(Data source: Bloomberg)



Existing Homes Sales Keep Climbing
Sales of existing homes increased in May to the highest level in more than nine years. The median existing home price climbed by 5% on a year-over-year basis. Supply remains tight in the market, and first-time buyers continue to represent a much smaller share of purchases than was the case in the pre-crisis period.



Housing Starts Experience Little Change
New home construction fell slightly in May, but remain at much higher levels than experienced over the past five years. The housing market continues to benefit from low mortgage rates, which is helping to keep affordability high despite increasing prices.