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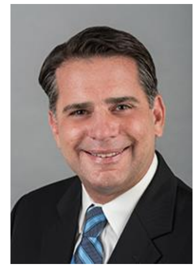

Andrew Kohl
Chief Investment Officer

Economic Update
June 2018

By Andrew Kohl

Commentary

The threat of a global trade war has cast a cloud over the equity markets during the last few weeks. (The S&P 500 is down almost 3% over that timeframe.) Most of the United States' trading partners have threatened retaliatory measures if the U.S. goes through with the tariffs that have been outlined and/or already enacted. Undeniably, an all-out trade war would drag down worldwide economic growth and push inflation higher.

The U.S. has been on a decades-long push towards free trade. Since the 1930s, the effective tariff rate on imports has declined from almost 20% to close to 1% today. Now, it appears that trend is set to reverse. To date, the additional tariffs have been modest (approximately $50 billion on mostly steel and aluminum imports from several countries). The issue is, President Trump has threatened approximately $750 billion in additional tariffs if impacted countries retaliate. If enacted, that would push the effective tariff rate to 5% (a level not seen since the 1970s).

A majority of the tariffs have been targeted at China. Out of the $800 billion of proposed tariffs, more than half are against China. This has prompted China to respond with tough rhetoric. Although U.S. exports to China are relatively modest (the U.S. imports approximately four times the amount that it exports to China), the Chinese government could go beyond just tariffs by potentially banning the purchase of certain American-made products, selling Treasuries and/or devaluing its currency. This would be very harmful to the profitability of many U.S.-based companies.

Our base case assumption is that a full-blown trade war will not break out. The Trump negotiating mantra has been to start at the extreme and meet somewhere in the middle. There are clear inequities in the current trading environment (i.e. intellectual property), which can be hashed out without taking a broad stroke to all trade. We think cooler heads will prevail and some compromise will be reached, but there's no doubt that risks have increased.

The Fed seems unconcerned about trade risks derailing economic growth. They raised rates for the second time this year and indicated that two more hikes may be in order in 2018. When asked about trade concerns at the post-meeting press conference of the Federal Open Market Committee (FOMC), Chairman Jerome Powell stated that while there has been chatter from their business contacts about risks, there has been little evidence in the data that it is harming the economy. Instead, he highlighted the strength of the U.S. economy and the boost that the economy will receive from recent fiscal changes (i.e. tax cuts and increased federal spending).

Stronger-than-expected consumer spending data point to a rebound in GDP growth in the second quarter. The second quarter growth rate will likely be in the 3.5-4.0% range, which would push growth in the first half of 2018 to 3.0%. Absent an improvement in productivity, the growth rate will dip in ensuing years as the fiscal stimulus effects fade. If a trade war were to materialize, it would roughly erase the full benefit of the fiscal changes. In 2020 (when much of the fiscal boost is gone), this would push the U.S. growth rate near 1% (assuming all other economic factors remain where they are today). At that level, it wouldn't take much to push the economy into a recession.

Corporate Federal Credit Union

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Fixed Income Outlook

The yield curve continued to flatten during June. The more hawkish-than-expected Fed meeting pushed up shorter-term rates, while trade concerns left the longer-end of the curve little changed. Until the trade policy works its way through the negotiation process, the 10-year Treasury yield will likely remain below 3.0%.

The spread between the markets' and the Fed's expectations for rates is increasingly diverging. The median Fed forecast has two more hikes in 2018 and three more in 2019 (1.25% cumulative increase in the federal funds rate). The market has one more hike in 2018 and one in 2019 (0.50% cumulative) priced in. Given the large difference, bond prices seem rich at this time.

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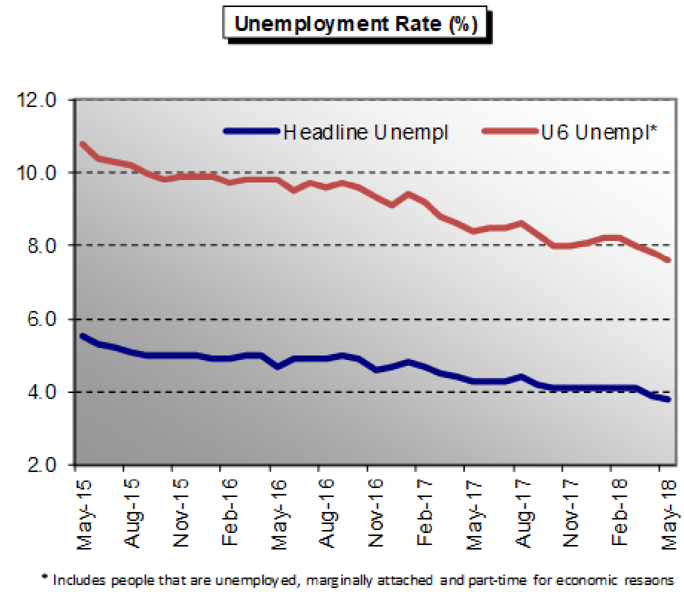
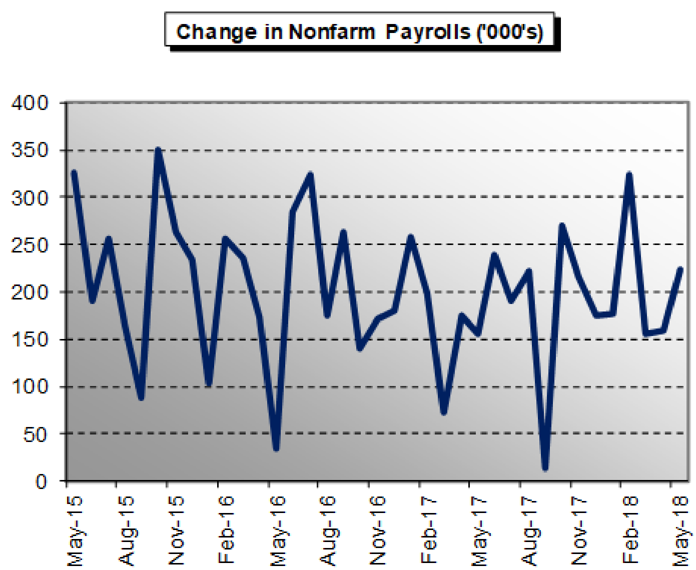
Labor Readings
(Data source: Bloomberg)



Unemployment Rate Continues to Decline
The unemployment rate declined for the second consecutive month and stands at 3.8%. This is the lowest level in over 18 years. The underlying details of the labor report were relatively strong. The labor force increased slightly and employment gains were strong. The employment-to-population ratio is back up to early 2009 levels.



Payroll Growth Exceeds Estimates
Payroll growth in May was higher than expected. Payrolls grew by 223,000 jobs versus the estimate of 190,000. Job gains were broad-based, and the trend remains strong. The pace of job growth is likely to decline in coming months, as the pool of qualified workers shrinks, but remain well above the level needed to offset growth in the labor force.

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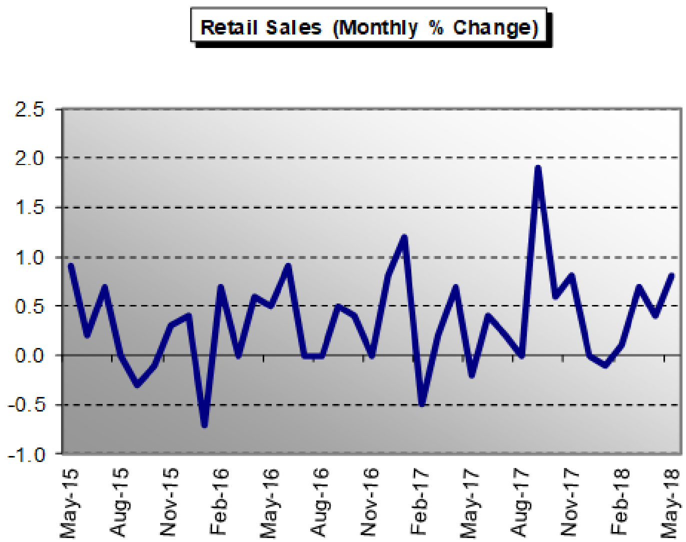
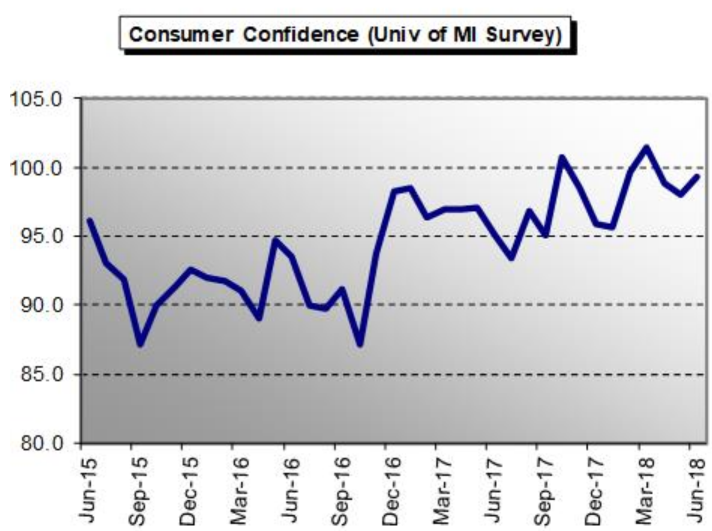
Consumer Readings
(Data source: Bloomberg)



Retail Sales Beat Estimates
Retail sales in May came in much higher than expected. Sales increased by 0.8% versus an expected gain of 0.4% (on a month-over-month basis). The strong sales figures point to a significant rebound in consumer spending, and thus, GDP in the second quarter.



Consumer Confidence Remains High
The preliminary data for June showed that consumer confidence remains strong. The anticipated gain in annual incomes rose to the highest level since 2008. Inflation expectations rose to a three-year high.

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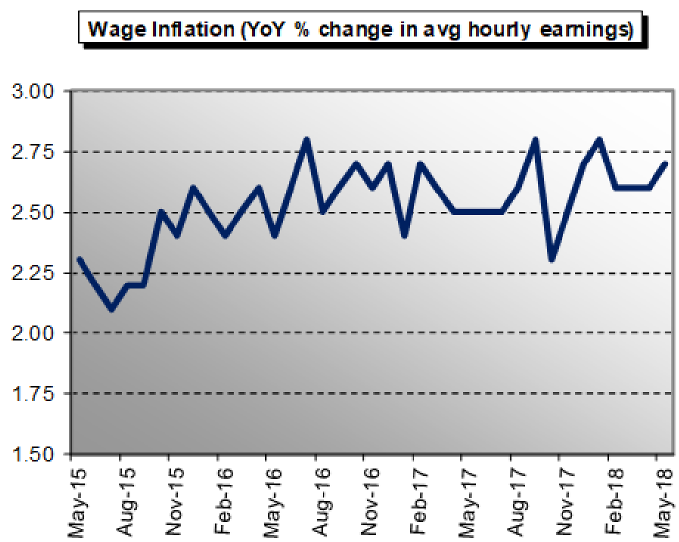
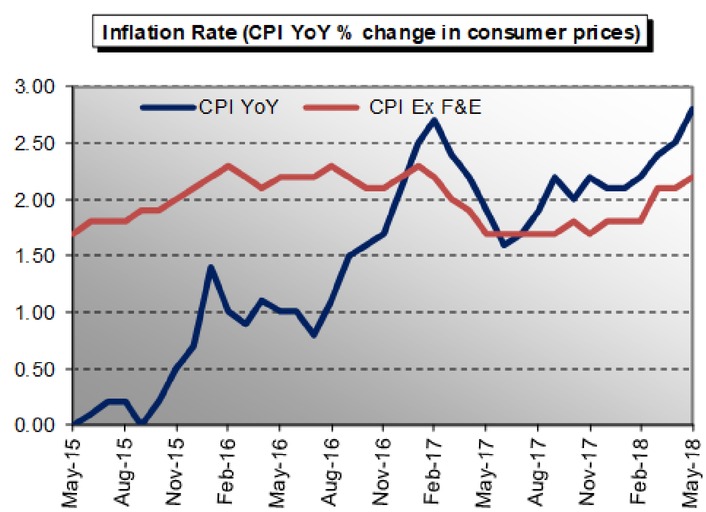
Inflation Readings
(Data source: Bloomberg)



Wage Inflation Picks Up
Wage inflation came in higher than expected in May. Average hourly earnings rose by 2.7% versus an expected 2.6% increase (on a year-over-year basis). The shortage of qualified workers appears to be nudging wages higher, but current wage growth is still historically very slow for an economic recovery.



Inflation Rate Increases
Headline inflation for May increased at the fastest pace in six years (on a year-over-year basis). The annual gain was 2.8%, which was in line with expectations. Core inflation also increased and has been above the 2% mark for three consecutive months.