Written on 7/26/16

alloya®
Corporate Federal Credit Union

Andrew Kohl
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Economic Update
July 2016

By Andrew Kohl

Commentary

Sentiment has taken a dramatic turn since the end of June. At that time, the U.K.'s vote to exit the European Union (aka "Brexit") sent markets into a panic and created fear that a global economic meltdown was on the horizon. Equity markets and interest rates across most the globe were plunging. Fast forward just a few short weeks later: the U.S. stock market has fully recovered and is now trading at all-time highs, and interest rates have rebounded to roughly where they stood just prior to the Brexit vote (at least in the U.S.).

U.S. markets bounced back so quickly for two main reasons. First of all, the markets came to realize that the impact of Brexit on the U.S. economy is relatively small. The U.S. only exports a tiny portion of its goods to the U.K. and the Brexit process will be long and slow. Secondly, the markets anticipate aggressive central bank easing to help to offset the worldwide impact of Brexit.

Central bank easing will almost certainly come from the U.K. and the European Central Bank over the next few months. It is very doubtful that the U.S. will follow suit any time soon. The incoming economic data since the June Fed meeting has mostly surprised to the upside. Most importantly, the June payroll figures bounced back strongly from the weak May reading that gave pause to the Fed. It is true that the pace of payroll gains has eased this year versus the last few years, but that may be a symptom of a job market that is near full capacity rather than an overall weakening in the labor market. As has been the case over the past few years, wage inflation will be the key metric to watch.

At the July Fed meeting, the official statement offers few clues as to when the next Fed action will occur. There is no reason for them to paint themselves into a corner since there is plenty of economic data that will be released prior to their next meeting in September. This should help to provide some more clarity on the direction of the U.S. economy.

The Fed continues to balance two main temporal risks. One risk is that they hike rates too slowly and have to hike rates much more aggressively later on (which could tip the economy into a recession). The other risk is that they hike rates too fast and kill off the current recovery. Based on Janet Yellen's latest Congressional testimony, the Fed seems more willing to act slowly. We believe that this is the correct course of action with rates so close to zero and lingering economic uncertainty.

If the economy continues on its current trajectory (2% real GDP growth), we believe that the Fed is likely to hike once over the next six to nine months. It is doubtful that a hike would come as early as September, and we still believe that the hurdle to Fed action in either direction is high. International economic concerns will continue to weigh on the Fed's decision making. Even if Brexit turns out being a non-event, the weak Italian banking system and high corporate debt in China are risks that still linger. Expect an extremely slow hiking cycle.

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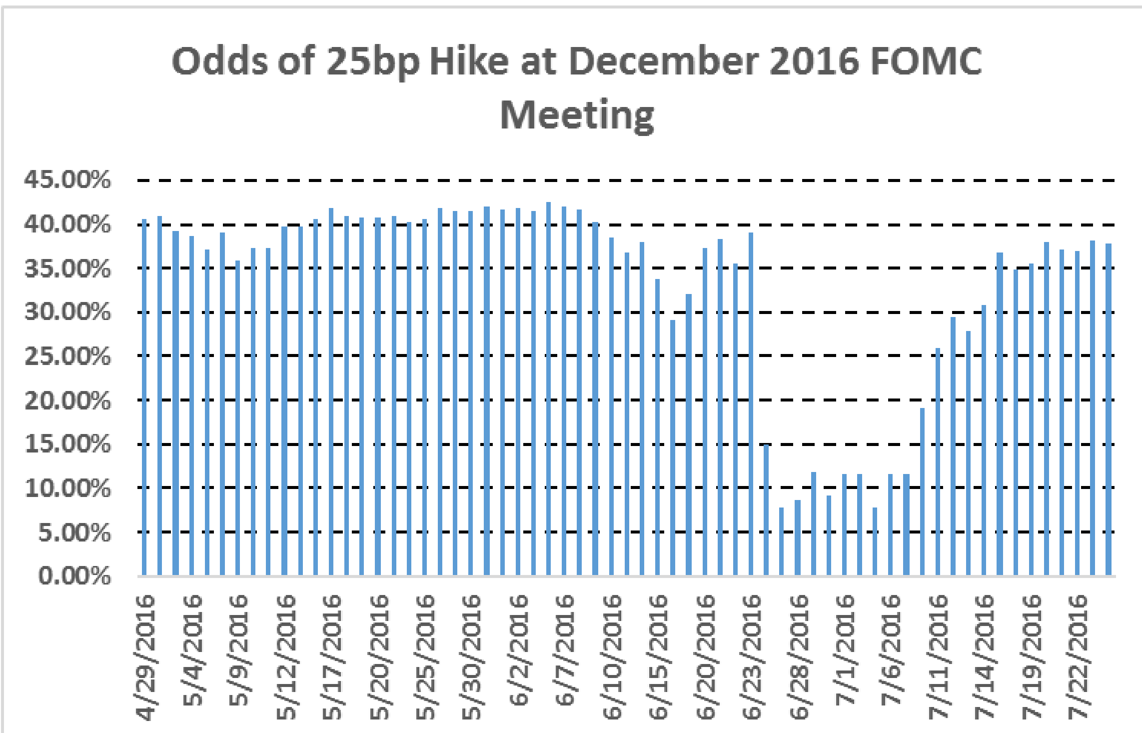
Fixed Income Outlook

Interest rates have increased since June as economic data has surprised to the upside and risky assets have rallied. The curve has flattened as rates on the short-end of the curve have increased more than rates on the long-end. The odds of a rate hike at the December meeting has almost fully recovered to the pre-Brexit levels (see graph below). We agree with the market's current pricing for Fed action this year.



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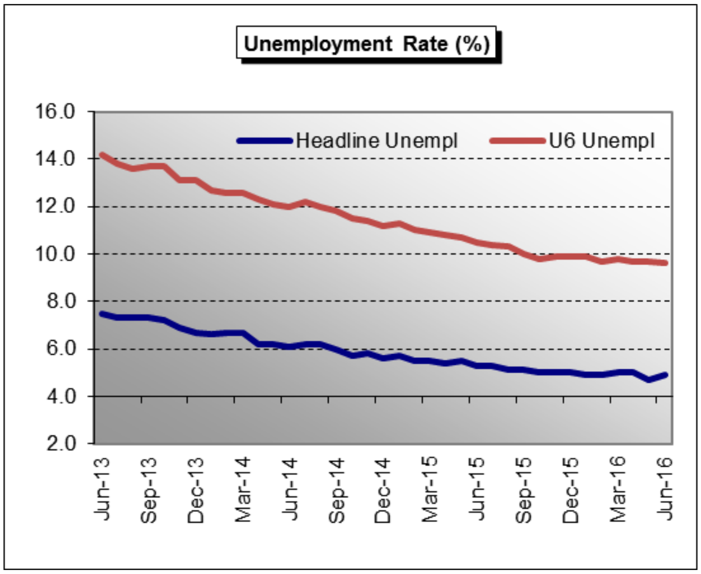
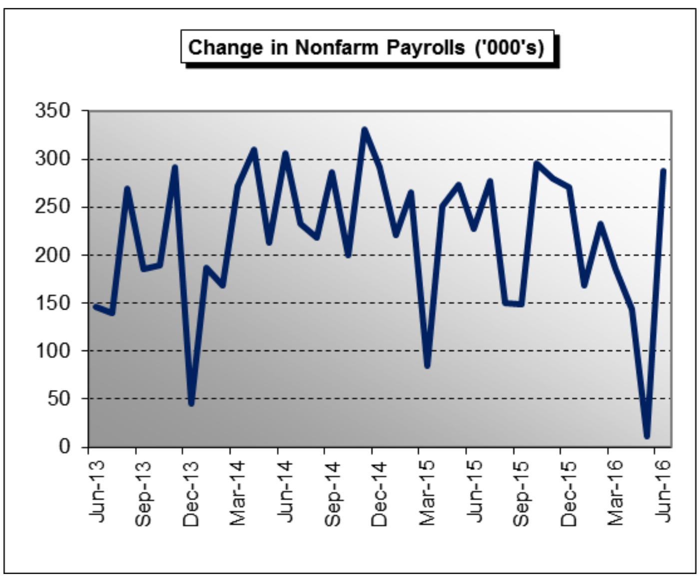
Labor Readings
(Data source: Bloomberg)



Unemployment Rate Climbs

The unemployment rate in June increased to 4.9% from 4.7% in May. The increase was for "good" reasons as a large number of people entered the labor force and jobs gained. Wage inflation figures came in below estimates, but year-over-year wage growth now stands at a seven year high.



Job Gains Bounce Back

Payroll growth in June came in much higher than expectations. Payrolls grew by 287,000 jobs, which was 100,000 more than estimates. This was a welcome positive surprise after May's results showed the weakest job growth in almost six years. The overall trend in job gains has been lower than the previous few years, but that is more reflective of a labor market that is operating near full capacity.

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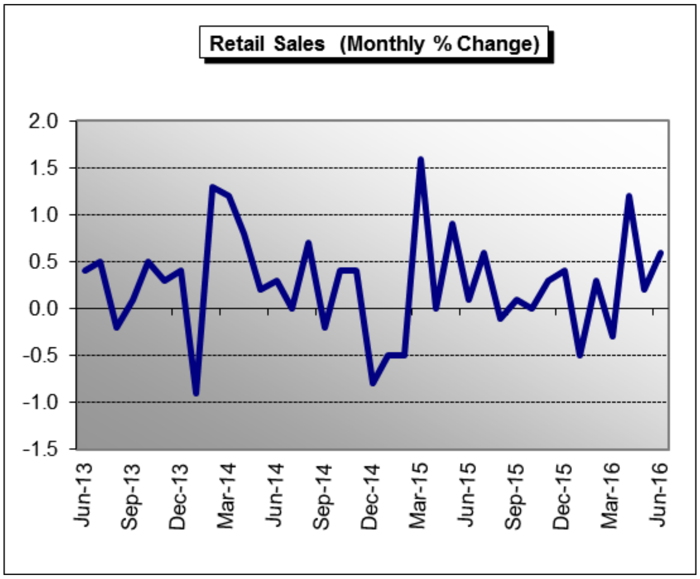
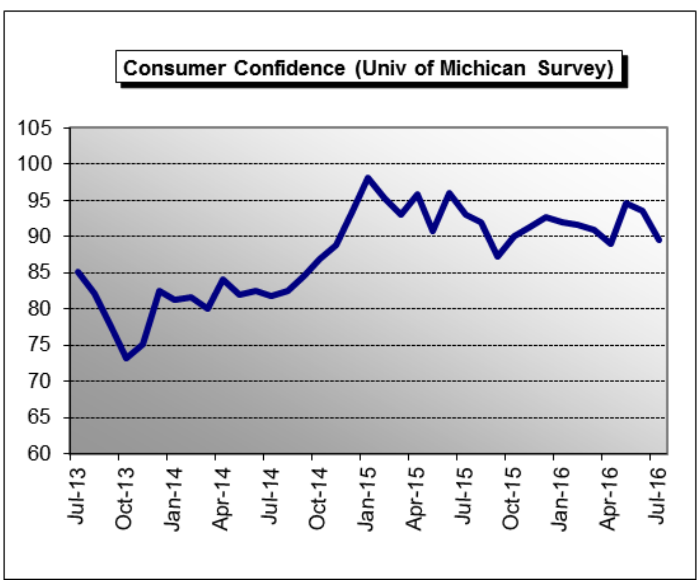
Consumer Readings
(Data source: Bloomberg)



Retail Sales Remain Strong

Retail sales in June beat expectations. Sales rose by .6% on a month-over-month basis versus an estimated .1% increase. Similar to the previous two months, the gains were broad-based. Eleven of the 13 major retail categories showed improvement. The annualized rate of core sales over the past three months is at the highest level in two years.



Consumer Confidence Declines

Preliminary data for July shows that consumer confidence declined from the previous month. The decline was likely driven by the U.K.'s vote to exit the European Union (a.k.a. "Brexit"). In late June, the Brexit vote drove equities sharply lower. Since that time, stocks have rallied and are at all-time highs.

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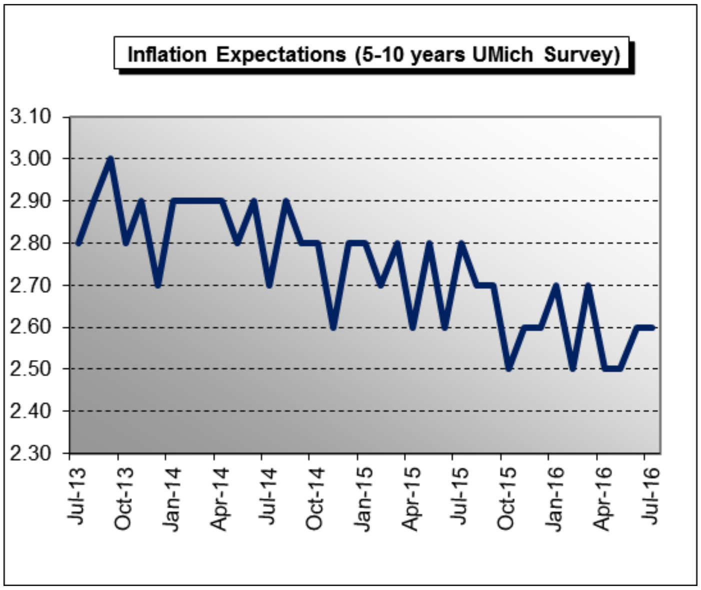
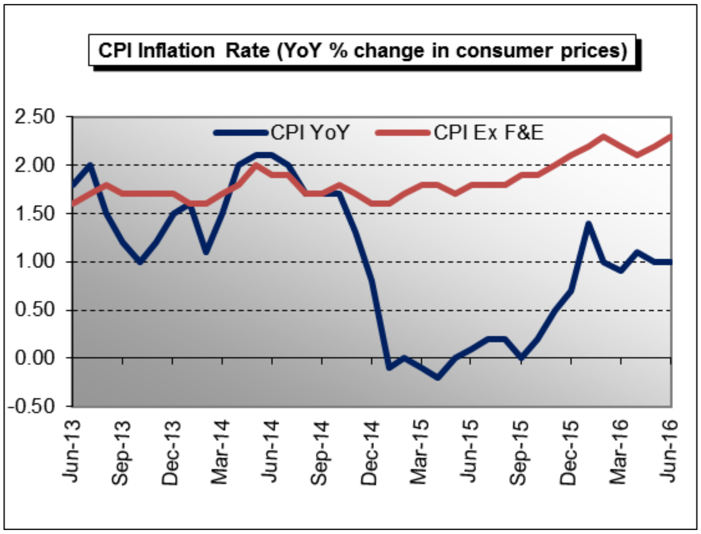
Inflation Readings
(Data source: Bloomberg)



Medium Term Inflation Expectations Hold Steady
According to preliminary estimates, medium term inflation expectations held constant in July. In addition, near-term inflation expectations ticked up. Overall inflation expectations are lower than the five-year average, but appear to have stabilized.



Core Inflation Pushes Higher
Consumer prices edged up in June and matched a post-recession high. Higher inflation is being driven by the service sector as core good prices continue to stagnate. Since labor is the biggest expense for most industries, higher labor costs are driving the costs of services higher.