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Economic Update
July 2017

By Andrew Kohl

Commentary

The markets have been surprisingly calm thus far this year. The largest peak to trough drop in the S&P 500 this year has been just 2.8%. It is rare that the market doesn't experience a pullback of at least 5% during a calendar year (it has only happened five times over the last sixty years). The market's "fear gauge", the VIX, reached an all-time intraday low this week (the index was created almost 25 years ago). We believe that the low volatility is being driven by an improving worldwide economy and a cautious Fed.

The Fed has increased rates at a historically slow pace and remains wary of creating a rate-induced recession. This is prudent given how close we are to the lower bound of interest rates. It has also helped that the Fed has made major strides over the years to increase transparency. Purposely confusing statements that were the norm under past Fed regimes have been replaced with quarterly press conferences and detailed economic projections. At this week's Fed meeting, the message was to expect more of the same. Rates will continue to climb if inflation starts to creep back towards their 2% target, but the pace of rate increases will be slow.

It is almost impossible to predict how long the relative calm in the markets will last or what will be the impetus for the change. Looking back at the last two "normal" recessions (ignoring the "Great Recession" of 2008-2009), two things preceded a downturn in the markets and the economy. The first was an aggressive Fed. Prior to the 1990 recession, the Fed increased rates by 325 basis points over a one-year timeframe. Prior to the 2001 recession, rates were increased by 175 basis points in less than one year. The second factor was a loss in confidence. In the 1990 recession, confidence fell sharply as oil prices more than doubled when Iraq invaded Kuwait. In the 2001 recession, confidence waned when the stock market suffered a significant decline. Most current stock market valuation measures are elevated versus historical averages, but remain well below the peaks seen in 2000.

For now, our base case remains that the economy will continue to plod along at a 2% GDP growth pace. The first estimate of second quarter GDP was released today and showed a nice bounce back in growth to 2.6% from 1.2% in the first quarter. This puts growth in the first half of the year at 1.9%. Certainly not a torrid pace, but in line with the 2% growth rate that we've experienced since the end of the recession. We don't anticipate that the economy will get any benefit from looser fiscal policy in 2017. Given the controversies surrounding the Trump administration and lack of progress in health care reform, the probability of reaching any consensus on taxes and infrastructure spending is very low. In addition, Congress faces two significant deadlines in the fall. The parties will need to reach agreements to raise the debt ceiling and to fund the government past September 30.

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Fixed Income Outlook

Treasury yields remain in a tight range and have barely moved since the end of June. The Fed meeting this week was largely a non-event and it appears that the balance sheet reduction process will begin in September. All eyes will be on the two inflation data points that we will get prior to the Fed's September meeting. If inflation data comes in at or below estimates, it appears unlikely that the Fed will hike (the market is only pricing in 4% chance of a hike). We will need to see some more progress towards their 2% inflation goal to get a hike in December (current market odds of a hike are 40%).

The biggest news this week for the fixed income markets was the announcement by the UK regulator, the FCA (which is responsible for Libor oversight), that they will no longer support the Libor index after 2021. Libor rates today are determined by a panel of banks that are compelled by the FCA to make rate submissions. The rate submissions are supposed to be based on actual interbank transactions, but since these transactions have become rare, the rates are based on each panel banks' "expert judgement" of where the rates should be. According to the regulator, this is an unsustainable and undesirable process and they are recommending that alternative indices be utilized (the most likely alternative in the U.S. is the Broad Treasury Financing Rate "BTFR", based on Treasury repo trades). Plenty of details still need to be determined, but if Libor rates are no longer available post 2021, a substantial number of financial contracts will need to be rewritten.

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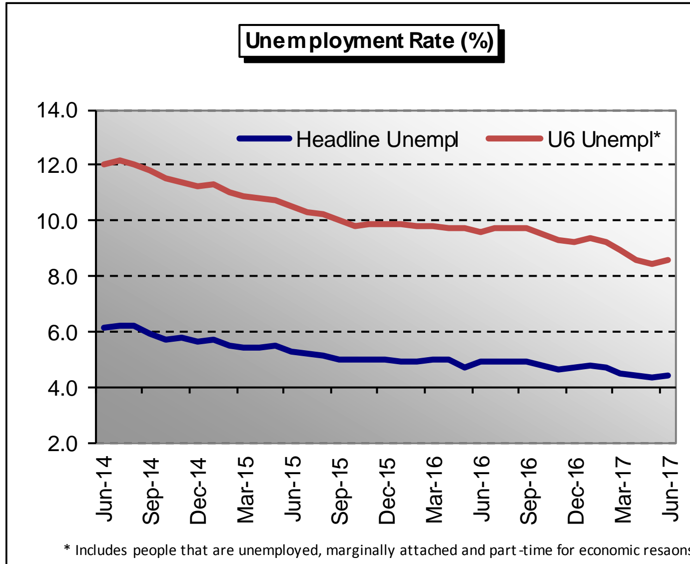
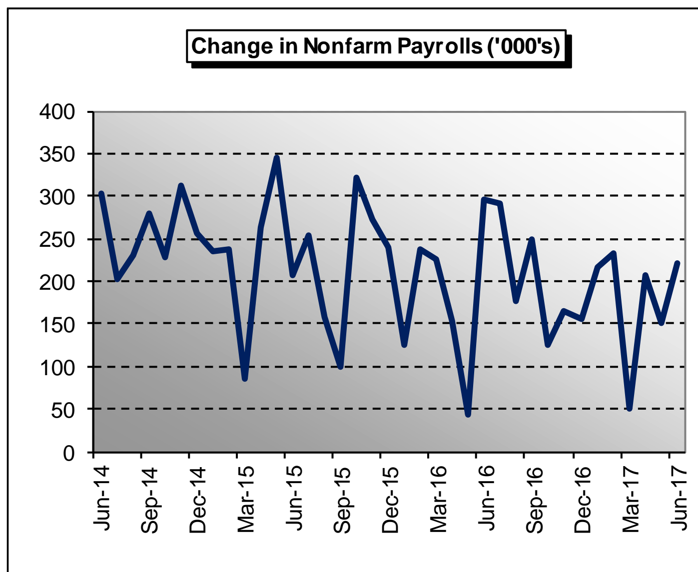
Labor Readings
(Data source: Bloomberg)



Unemployment Rate Ticks Up
The unemployment rate in June increased from 4.3% to 4.4%. The increase was due to "good" reasons as a large number of people re-entered the labor force and most of them were able to find jobs. Wage growth was lower than expectations and continues the trend of anemic wage inflation despite low unemployment rates.



Job Gains Beat Consensus Forecast
Payrolls grew by 222,000 in June versus an expected 178,000 gain. The prior two months were revised up by 47,000 jobs. Job growth thus far this year has essentially matched the pace of last year and remains well above what is necessary to offset the growth in the working age population.

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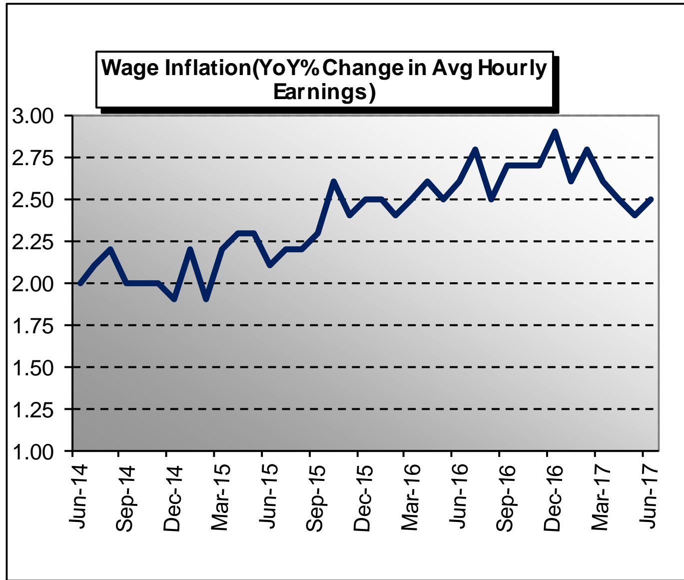
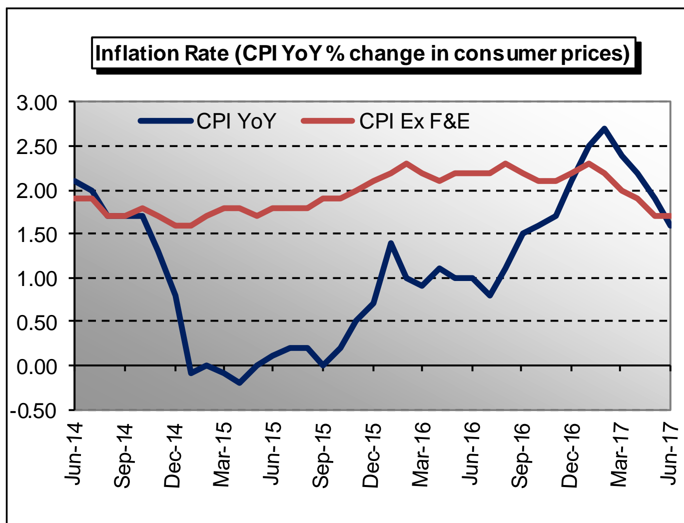
Inflation Readings
(Data source: Bloomberg)



Wage Growth Remains Weak
Wage growth continues to come in lower than expectations and is currently well below the level it reached at the end of 2016. Historical data has shown that an acceleration in overall inflation is not likely to be sustained in the absence of an acceleration in wages.



Inflation Rate Continues to Decline
The pace of inflation continues to come in lower than expectations and stands at its lowest level since last October. The number of categories experiencing price declines widened out from the previous month and indicate that it could take longer than the Fed's current projections to reach their 2% core inflation target.

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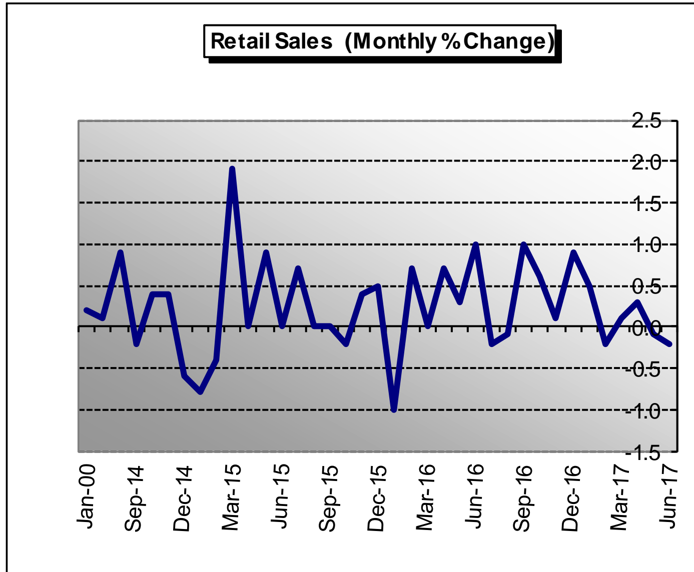
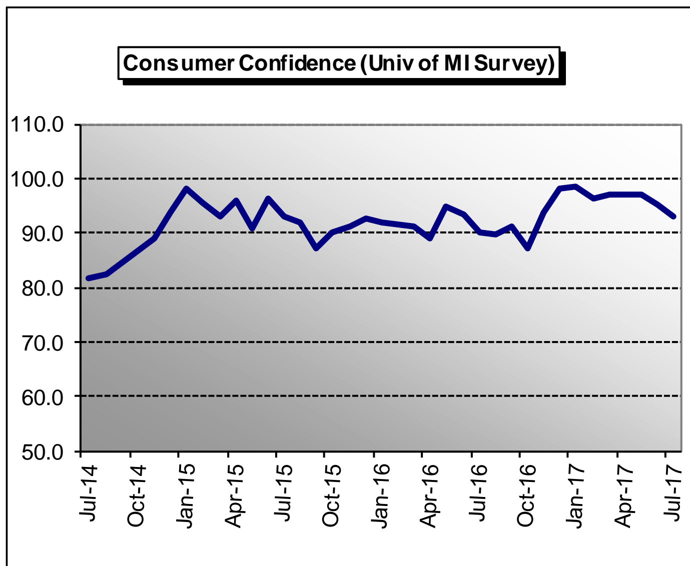
Consumer Readings
(Data source: Bloomberg)



Retail Sales Disappoint
Retail sales in June were lower than expectations. The weakness in auto sales was anticipated, but slower sales were evident in several other categories. Given the weaker than expected sales data, it appears that second quarter GDP won't bounce back as significantly as many had hoped.



Consumer Confidence Declines Again
Consumer confidence was weaker than expected in July and stands at its lowest level since October. Confidence has been hurt by the lack of policy action from the Trump administration. The expectations component of the index experienced a large drop from the previous month and stands well below the cyclical peak reached in January.