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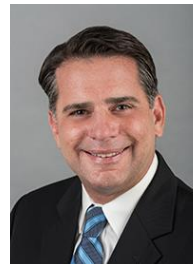
Corporate Federal Credit Union

Economic Update

July 2018

By Andrew Kohl



Andrew Kohl
Chief Investment Officer

Commentary

The increasing threat of a global trade war continues to dominate the headlines. President Trump appears ready to forge ahead with increased tariffs on $200 billion of imports from China in the coming months. A soon-to-be-completed probe by the Commerce Department could give him the ability to raise tariffs on imported autos and auto parts due to national security concerns (which would largely hurt European car manufacturers by making their cars more expensive here). Strangely enough, the U.S. stock market has shrugged off the risk. Absent a late month sell-off, July is poised to be the fourth consecutive month of stock market gains (as measured by the S&P 500). Equity prices are only 3% below their all-time high.

Neither China nor the U.S. is likely to back down unless sentiment changes. Strong economic growth, stock market gains, and robust consumer and business confidence surveys make it easier for the Trump administration to escalate its threats. The stock market in China has taken its lumps this year, but its authoritarian regime can easily handle any public dissent. It’s hard to predict exactly what the endgame is. Perhaps tariffs are being used as leverage to extract increased assistance from China on North Korea or some other grand bargain. If that’s the case, maybe a resolution is on the horizon. If not, we believe that unless American consumers make their voices heard (either through selling stocks or falling confidence), the tariff battle is likely to continue.

Now appears to be a good time to engage China on its trade practices, but we think that it’s a mistake to also threaten other countries with increased tariffs simultaneously. China has taken advantage of the many holes in the World Trade Organization (WTO) rules to pursue its self-interests. (In many markets, China requires that foreign firms can only invest in its market via joint ventures with local companies. In several cases, the local companies have then stolen the intellectual property of the investor.) Confrontation with China would be much easier as a united front. WTO rules can only be changed by a unanimous vote by all 164 members. It will be difficult to gain allies in fair trade with China by threatening those potential allies with higher tariffs as well.

The economic expansion just entered its tenth year this month. It is the second longest U.S. expansion on record and only a year away from being the longest expansion ever. Given the fiscal stimulus, we believe that the economy is poised to set a new longevity record at this time next year. The GDP data released this month should show that the economy grew by approximately 3% in the first half of 2018. The labor market remains strong and inflation remains subdued. This should keep the Fed on its gradual hiking cycle.

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Fixed Income Outlook

The yield curve has moved higher thus far in July. The labor market data was stronger than expected and Fed Chairman Jerome Powell did not steer market thinking away from two more rate hikes for 2018 at his Congressional testimony. President Trump made a lot of news this week by directly commenting on Fed policy. The past few presidential administrations have refrained from commenting on Fed policy to ensure that the Fed maintains the independence to make monetary decisions that may be politically unpopular.

The market is pricing in a 90% chance of a hike in September and a 66% chance of another hike in December. We agree with the market that a hike in September is very likely, but we are less convinced that there will be an additional hike in December unless there is some resolution to the tariff battles.

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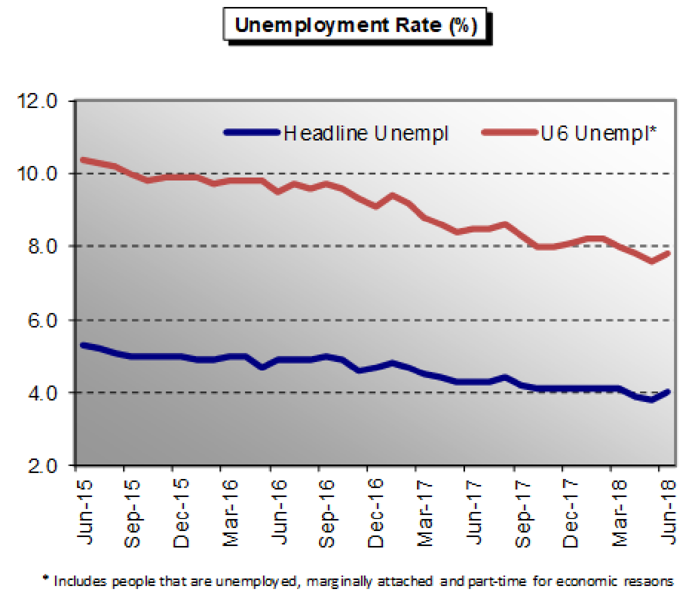
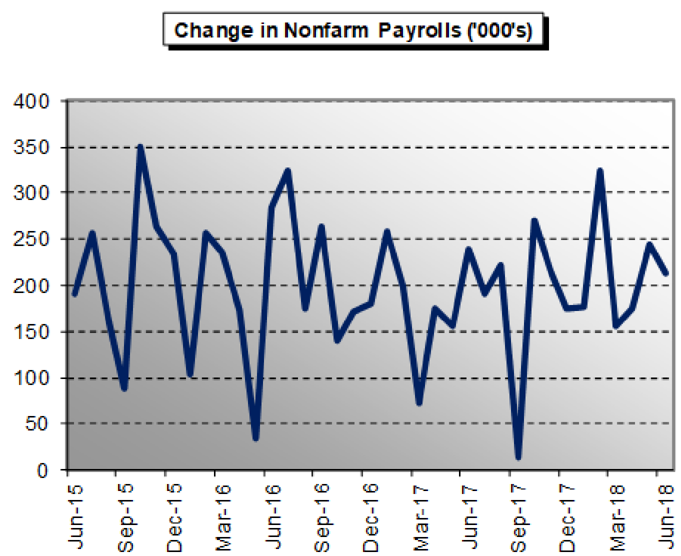
July 2018

Labor Readings
(Data source: Bloomberg)



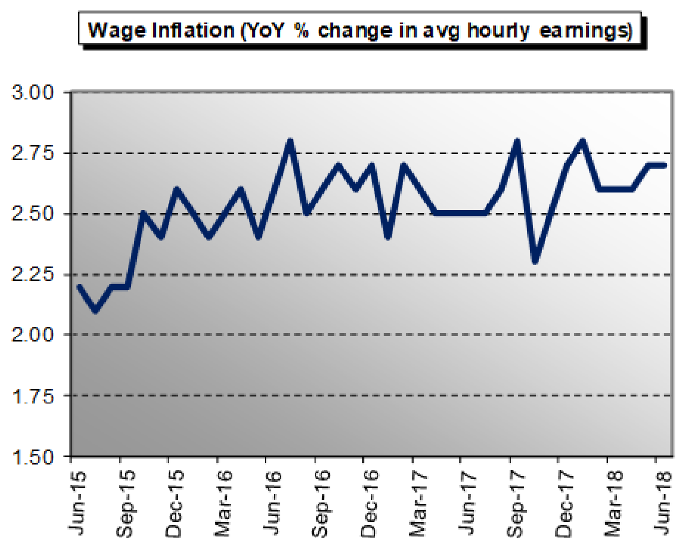


Unemployment Rate Increases
The unemployment rate increased in June due to an influx of people entering the labor force. This was the first increase in the unemployment rate in almost a year. The current unemployment rate stands at 4.0%, which is extremely low by historical standards. The large increase in the labor force indicates that there may still be some more slack in the labor market, which may help to explain why wage growth remains weak.

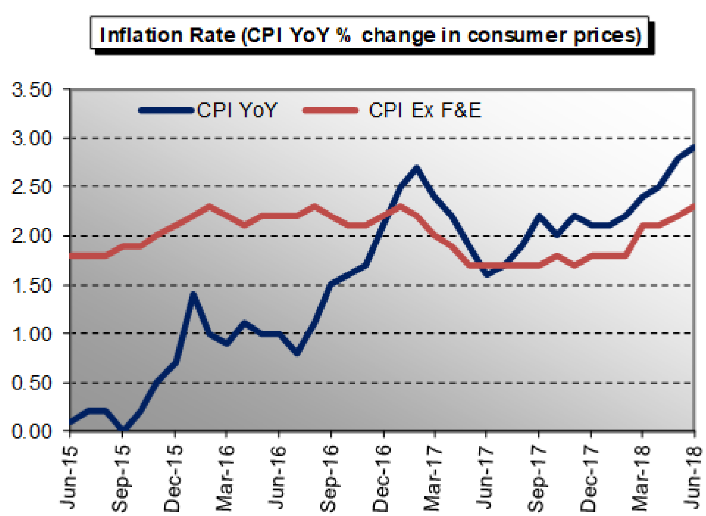
Payroll Growth Exceeds Estimates Again
For the second consecutive month, payroll growth came in higher than expected. Payrolls grew by 213,000 jobs in June versus an estimate of 195,000. In addition, the prior two months were revised upwards by 37,000 jobs. Payroll growth has averaged 215,000/month thus far in 2018, which is ahead of the pace seen over the last two calendar years.

Economic Update
July 2018

Inflation Readings
(Data source: Bloomberg)



Wage Inflation Stalls
Wage inflation came in lower than expected in June. Average hourly earnings rose by 2.7% versus an expected 2.8% increase (on a year-over-year basis). The large influx of workers into the labor force in June indicates that there is still slack remaining in the labor market, which is restraining wage growth.



Inflation Rate Still Relatively Tame
The month-over-month increase in inflation was lower than expected. Year-over-year inflation levels on headline inflation are at the fastest pace in over six years. Core inflation levels are at the fastest pace in a year. The year-over-year inflation levels are elevated due to the impact of mobile phone service pricing wars last year. The weaker-than-expected month-over-month data indicate that inflation is likely to remain subdued.

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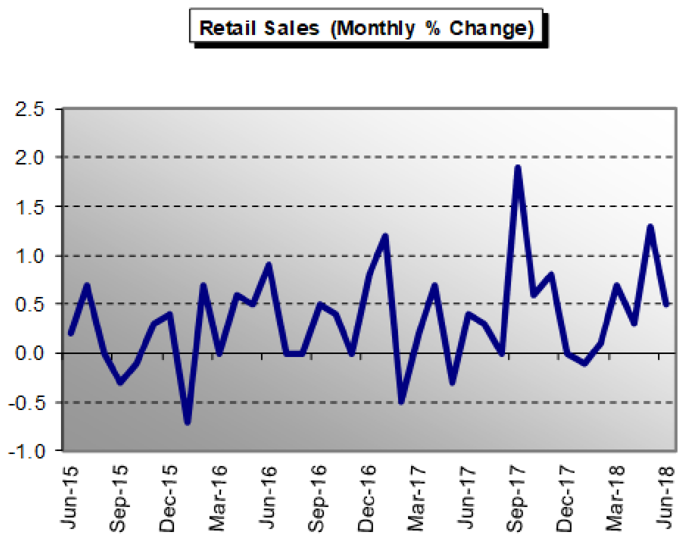
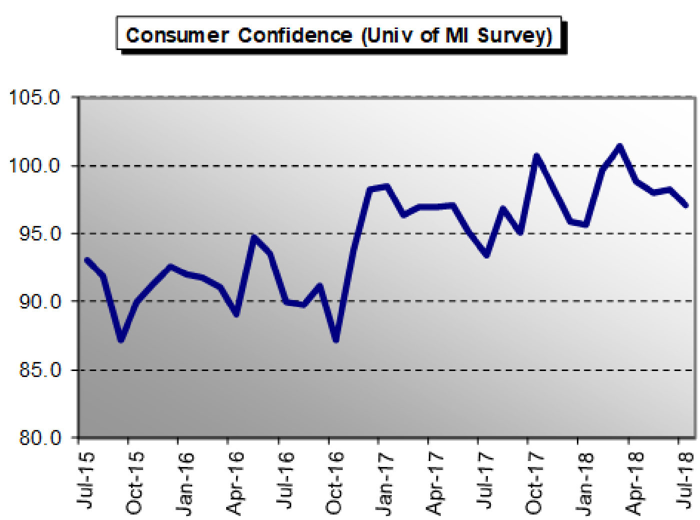
Consumer Readings
(Data source: Bloomberg)



Retail Sales Continue to Advance
Retail sales climbed for the fifth consecutive month in June. June's data met estimates, but the data for May was revised upwards. The data points to a strong bounce-back in consumer spending in the second quarter after a relatively weak first quarter.



Consumer Confidence Declines
The preliminary July data showed that consumer confidence fell to a six-month low. American consumers are becoming increasingly concerned about the economic impact of tariffs. Surprisingly, long-term inflation expectations dropped by the most since December 2016.