Written on 8/19/16

Economic Update
August 2016

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Commentary

There's a sense of déjà vu hitting the markets this past week. We have Fed participants insisting that their next meeting is a "live" meeting (where rates may be raised) at a time when the markets are pricing in only a very small probability that a rate hike is in the cards. The same thing occurred at the lead up to the June Fed meeting. The Fed seemed to be forcibly pushing up rate expectations only to have to pull back when the weakest job growth figure in over five years appeared.

The Fed's renewed confidence is being supported by the rapid bounce back in job creation since that low point in May. Over the last two months, job growth has significantly exceeded estimates and had their highest prints for the year. In addition, wage growth is showing signs of life. Wages are growing at the fastest pace since the recession and getting closer to the pre-crisis levels.

This would seem to argue for hiking rates sooner rather than later. The problem is that inflation continues to undershoot the Fed's target and has been stubbornly low throughout the recovery. Therefore, one part of the Fed's dual mandate is not being met. This would argue for waiting to hike until inflation moves closer to the Fed's goal of 2%.

These are the debates going on at the Fed. Reading through the minutes from their July meeting, there appears to be three distinct camps. One camp believes that the tighter labor market will yield increasing wage inflation, which will lead to higher overall price inflation. They worry that the Fed risks getting behind the curve and needs to start raising rates soon. The second camp believes that the economy is headed in the right direction, but wants further evidence to support their view. The third camp seems willing to risk having a modest overshoot in inflation given the risks that abound in the worldwide economy. This camp would leave rates unchanged for an extended period of time.

We believe that the majority members of the Fed fall into the second camp. This would mean that it is very unlikely that the Fed would hike rates prior to their December meeting. This will give them the opportunity to see two more labor reports and to see evidence if the economy bounces back from the much weaker than anticipated first half of 2016.

We should get very clear evidence if September actually is a "live" meeting once Janet Yellen makes here speech at the Jackson Hole conference on August 26. The Fed is still in the mode where it does not want to surprise markets. Therefore, if she doesn't send a very strong signal that a September hike is the cards, there won't be one.

We look for the economy to bounce back in the second half of the year, but 2016 is likely to have the slowest annual growth rate since the recovery began. The weaker than expected second quarter gross domestic product (GDP) was mainly due to inventory drawdowns and we should bounce back above 2.5% growth for the second half of the year. We believe that the U.S. consumer should remain strong and that some of the weakness related to low oil prices will fade.

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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 interest rates have increased approximately 10 basis points across the curve since the end of July as the labor market data was strong and various Fed speakers sounded more hawkish. The market is pricing in a 25% chance of a hike in September and a 50% chance of a hike by December. While the September odds seem a bit high, we agree with the odds for December and believe that the Treasury curve is fairly valued at current levels. The September Fed meeting brings an update to the Federal Open Market Committee (FOMC)'s economic projections. We believe that the median number of hikes for 2016 will move to only one and that the long-run equilibrium rate will be lowered again.

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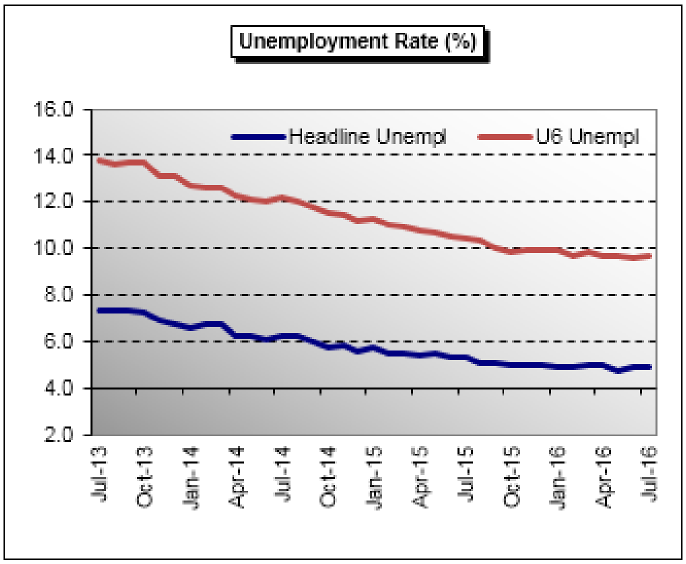
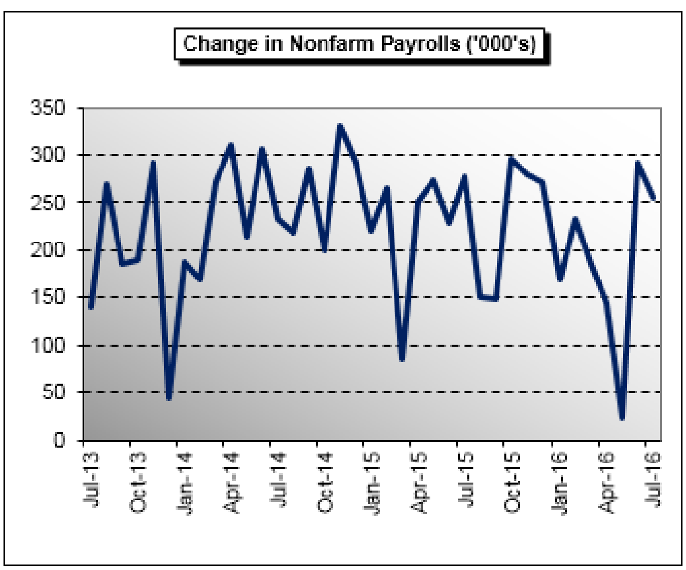
Labor Readings
(Data source: Bloomberg)



Unemployment Rate Holds Steady

The unemployment rate in July remained at 4.9%. The underlying details of the report were positive. Both the labor force and employment increased by 400,000 during the month. In addition, wage growth was higher than expected and the average workweek increased. This means more money in consumers' pockets, which should keep consumer spending strong.



Job Gains Beat Expectations

Payroll growth in July vastly exceeded estimates for the second consecutive month. Payrolls grew by 255,000 jobs versus a 180,000 estimated gain. With two strong months in a row, it now appears that the much weaker than expected result in May was more of an anomaly. The three-month average job growth is now at its highest level since March.

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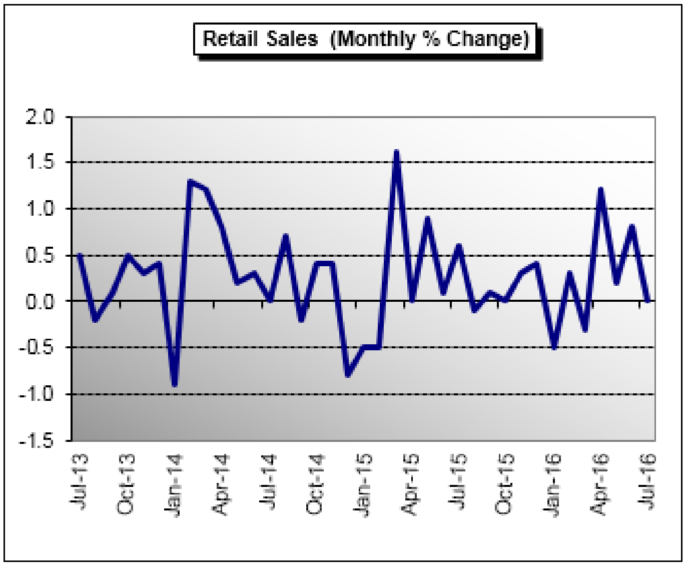
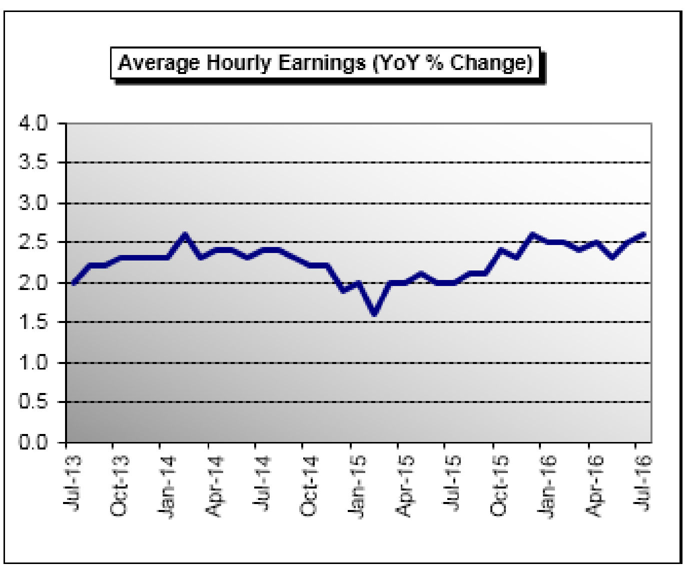
Consumer Readings
(Data source: Bloomberg)



Retail Sales Disappoint

Retail sales in July came in well below expectations. Sales were unchanged versus the previous month compared to an expectation of a 0.4% increase. Auto sales were strong, but eight of the 12 other major retail categories experienced a decline. Consumer spending is key to overall economic growth as business investment has been virtually non-existent and international trade flows remain weak due to the strong dollar.



Wages Show Improvement

In July, wage growth, as measured by hourly earnings, reached its highest year over year level since January 2010. Wage growth is a key metric that the Fed is watching. Despite the recent improvement, wage gains remain well-below the levels seen prior to the crisis.

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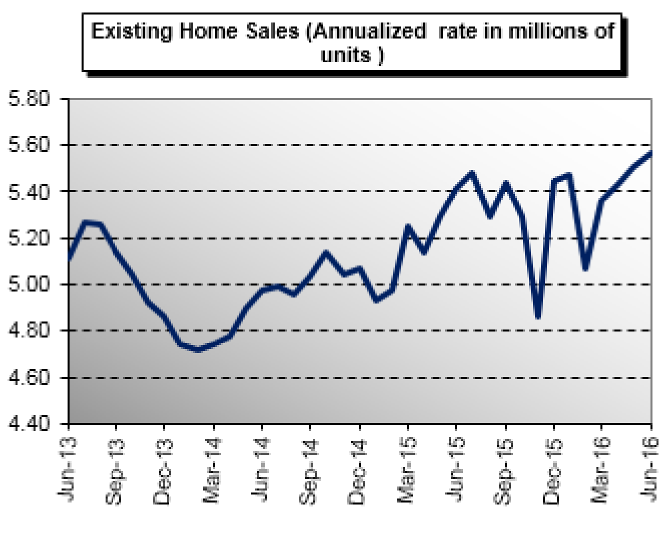
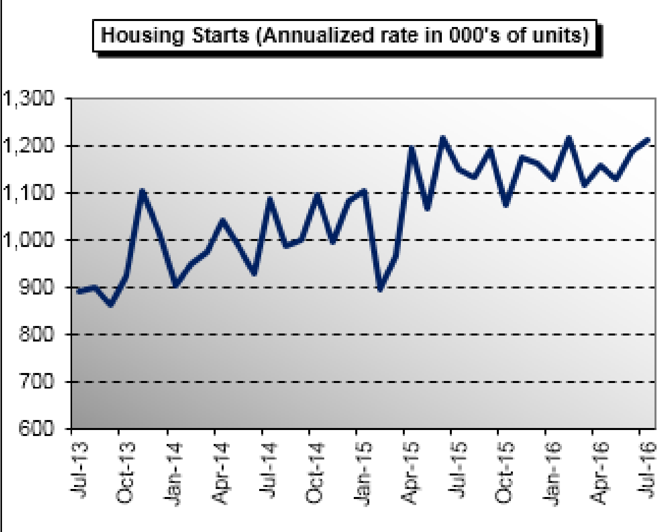
Housing Readings
(Data source: Bloomberg)



Existing Homes Sales Keep Climbing

Sales of existing homes continues to make multi-year highs. The housing market is gaining support from low interest rates and rising incomes. The largest constraint is that the supply of homes for sale remains tight.



Housing Starts Continue to Show Strength

New home construction increased in July to the highest level in five months. July had more homes under construction than at any time since the beginning of 2008. Multifamily housing continues to provide a significant lift as construction on multifamily homes hit the highest level in 10 months.