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Economic Update
August 2017

By Andrew Kohl

Commentary

Tensions with North Korea took center stage over the past week. As the leaders of both nations traded barbs, volatility rose and risky asset valuations fell. At least for now, calmer heads have prevailed and the stock market has bounced back near all-time highs. This reaction function has been commonplace for the equity market this year. The stock market has quickly shaken off negative news that may have induced a bear market in years past. As we write this article, the reaction function is being tested again with Trump's comments about the racist rally in Virginia creating dissention between him, business leaders, and members of his own party. To date, we believe that the market's resiliency is due to the underlying belief that central banks will remain supportive and that corporate profits will continue to expand (perhaps due to anticipated tax relief).

We agree that the Fed will take a cautious approach and is unlikely to push the economy into recession by hiking rates too fast. Given how close we still are to the zero bound in interest rates, it is prudent to take a slow, measured approach to reducing monetary stimulus. The Fed is balancing two risks. The first risk is that inflation remains subdued and well below the Fed's 2% target (which argues for keeping rates where they are or even lowering them). Since the end of the recession, inflation (as measured by the Fed's preferred measure, core personal consumption expenditures) has met or exceeded the Fed's target in only four out of 96 months. This year, inflation rates have dropped by 30 percentage points and stand at 1.50%.

The second risk is that keeping rates low for too long will lead to increased financial instability. This could take the form of asset bubbles and/or an inflation overshoot. The latest Fed minutes show that its members are equally divided by the risk that they think is the most prevalent today. The minutes also gave an inordinate amount of coverage to "one participant's" views. That participant's view (which more than likely belongs to Fed Reserve Chair Janet Yellen) was to gradually remove policy accommodation – the best approach to managing both risks. Given the weight that the chair has at the Fed, that is our base view of how they will operate.

As for corporate profits, it has become exceedingly unlikely that there will be any benefit from tax reform in the near term. The Trump administration is still hoping to get something passed before year-end, but his support, even among fellow Republicans, appears to be fading. Major tax reform, without adding to the deficit, is almost impossible without reducing or eliminating the biggest tax breaks (mortgage interest, employer-provided health insurance, and corporate debt interest). We see little hope that any of those tax breaks will get modified given the strong lobbies that support them.

Our overall assessment of economic growth remains unchanged. Even without tax reform, we think 2% real GDP growth this year is probable. We think that similar growth is achievable the next few years, but we are growing somewhat concerned about the sustainability of consumer spending levels. The consumer spending rate has almost doubled the last four years of the recovery versus the first four years. Some of this increase is coming from consumers saving less. The average personal savings rate

this year is at its lowest level since prior to the recession. Savings rates at current low levels can't continue. We believe that increased real income will be able to fill the void and allow consumer spending levels to remain at or near current levels while savings rates increase, but income gains have thus far been elusive.

Fixed Income Outlook

Treasury yields are down slightly from month-end July, with the flight to quality due to North Korean tensions and the terrorist events in Spain. The Fed minutes revealed that, absent a major negative surprise, they will start the process to reduce their balance sheet in September, which makes it unlikely that the Fed would also hike rates in September. Accordingly, the market is currently pricing in 0% chance of a hike in September and only a 35% chance of a hike by the end of the year. We think the bar to hike rates again in 2017 is still relatively low, but we will need to see some uptick in inflation. There are four more monthly inflation data points (as measured by the consumer price index) before the Fed's December meeting, and they bear close watching.

Janet Yellen's term expires in February 2018, and we believe that it is increasingly unlikely that she will remain at the Fed beyond then. We think there are decent odds that President Trump will ask her to stay on, but we believe she is more than likely to decline the offer. The front runner to replace her right now is Gary Cohn, Trump's top economic advisor, but there are likely to be many twists and turns along the way before a new chairman is named. In any case, Trump will get to fill at least six of seven potential open seats at the Fed in the next 12 months, so he will have a large influence on the economic beliefs of its members.

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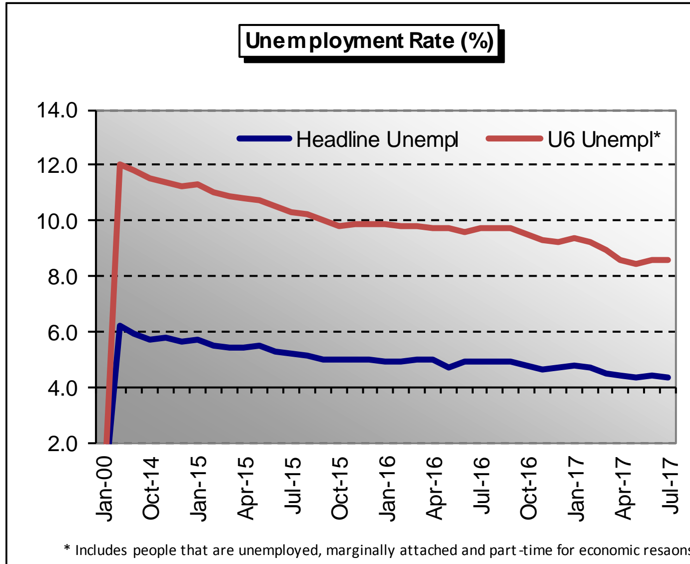
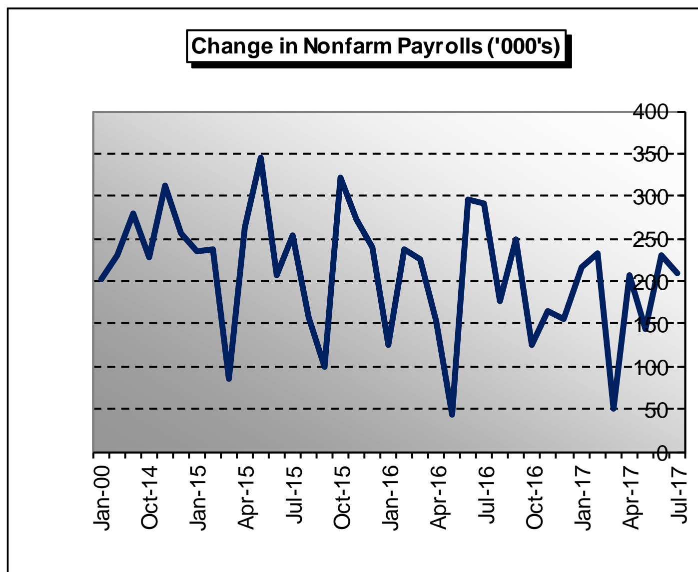
Labor Readings

(Data source: Bloomberg)



Unemployment Rate Returns to Multi-Year Low

The unemployment rate in July declined by 0.1% to 4.3%, matching the lowest rate in over 16 years. The underlying details of the labor report were strong as both the labor force and employment expanded. Importantly, wage growth showed some signs of life. Monthly wage growth reached its fastest pace in five months.



Job Gains Beat Consensus Forecast Again

Job gains were better than expected for the second consecutive month. Payrolls increased by 209,000 in July versus an estimated 180,000. The average monthly payroll gains this year are essentially the same as last year.

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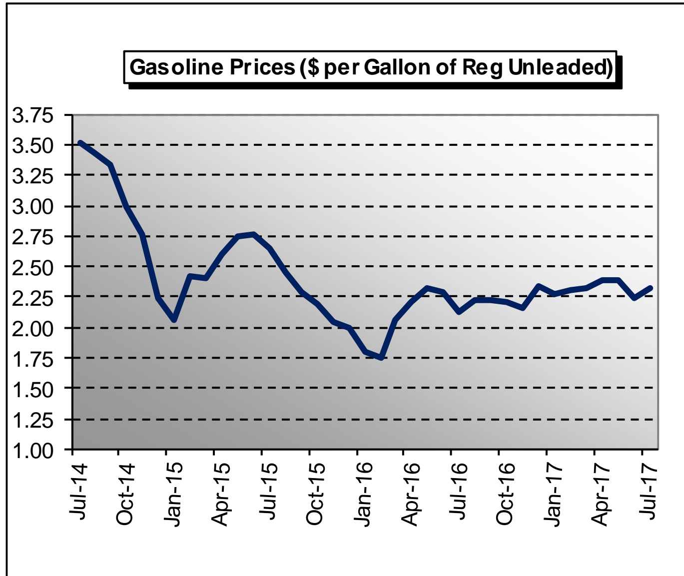
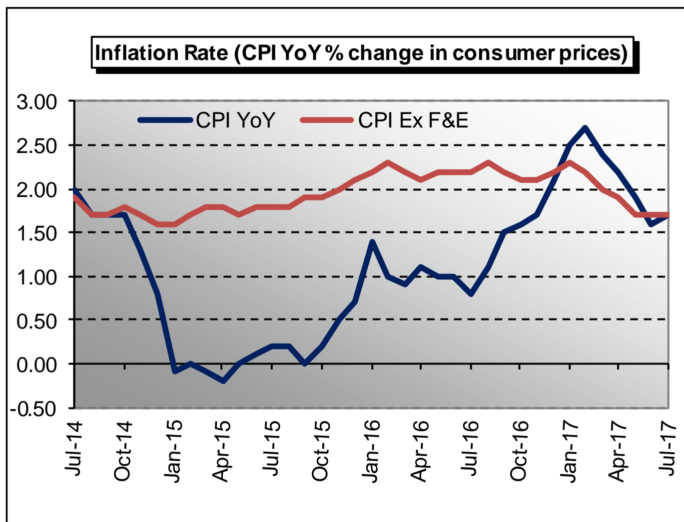
Inflation Readings
(Data source: Bloomberg)



Gasoline Prices Hold Steady
Gasoline prices have been largely unchanged since the middle of last year, and well below the levels seen a few years ago. Despite the relatively low prices, there has been a negligible impact on consumer spending.



Inflation Rate Comes in Lower Than Expected
The pace of inflation missed estimates to the downside for the fifth consecutive month, and remains well below the Fed's 2% target. Dollar depreciation since the beginning of the year has not had the anticipated positive impact on inflation. The Fed is likely to pause its hiking cycle unless a higher inflation trend is confirmed.

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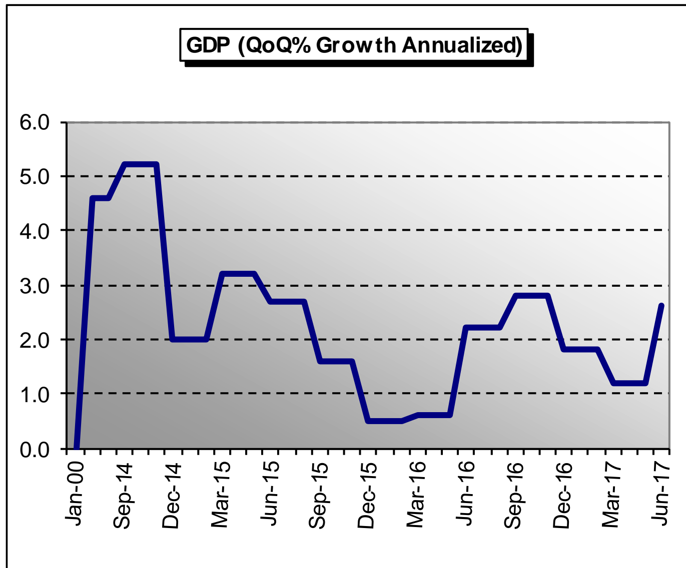
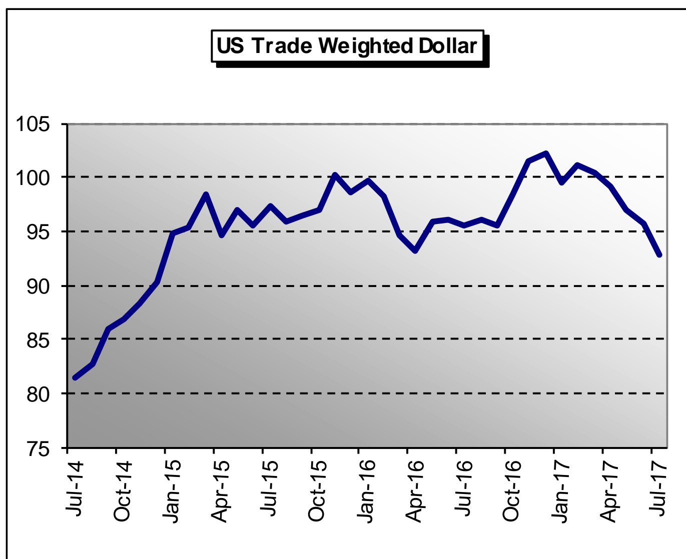
Economic Growth Readings
(Data source: Bloomberg)



Second Quarter GDP Bounces Back
As expected, second quarter GDP growth bounced back from a weak first quarter (2.6% vs. 1.2%). This places growth in the first half of 2017 near 2%, which has been the average growth rate this recovery. Consumer spending and business investment sparked the increase over the previous quarter.



Dollar Continues to Decline in Value
The trade-weighted dollar has declined to the lowest level in two and a half years. The decline is due to improving worldwide economic growth and lowered expectations for rate hikes in the U.S. The declining dollar makes imported goods more expensive and should improve the earnings of U.S. companies that sell goods overseas.