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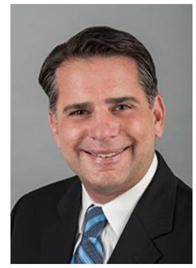

Andrew Kohl
Chief Investment Officer

Corporate Federal Credit Union

Economic Update
August 2018

By Andrew Kohl

Commentary

The rapid deterioration of the economic and financial conditions in Turkey created a temporary pause in the upward movement in U.S. equites. Many feared that the downturn in Turkey could lead to contagion in other world economies. Given that Turkey has limited trade and financial links to much of the world (Europe has the largest exposure, but still relatively modest), contagion seems unlikely. In addition, the Turkish economy is more reliant on overseas funding than other emerging market economies. Therefore, Turkey does not seem representative of the entire group. Once the market digested the news and deemed the external risk to be low, the stock market investors turned their attention back to internal growth in the U.S.

Here, the news has been positive. Consumer spending is the engine that runs the U.S. economy and the underlying fundamentals of consumer financial well-being are favorable. The recently revised personal savings rate shows that consumers have been saving close to 7% of their disposable income. This is a large increase from the previously reported 4% level (which was close to the level seen right before the last recession). The updated data indicates that consumers are not stretching their wallets too far to maintain current spending patterns.

The labor market continues to be favorable. The unemployment rate is near all-time lows and the economy continues to easily absorb new entrants into the labor force. Household wealth is at an all-time high as the stock market and housing prices continue to move higher. In addition, the tax cuts are providing more disposable income to most families.

Corporate and government spending should also be supportive of growth in the near-term. Corporations will need to replenish the large inventory drawdown that occurred last quarter. Tax cuts are also supportive of business investment. The increase in government spending caps, completed in March, will create an increase in federal outlays.

It’s hard to argue that the near-term growth prospects in the U.S. aren’t strong. The main risk in the near-term comes from the possibility of a trade war, but we still believe that a full-blown trade war is unlikely. Much of the bluster reflects negotiating tactics and/or posturing before the mid-term elections. We believe a compromise will be reached.

On a longer-term basis, we are concerned about the increase in government debt. While it is supportive of near-term growth, it will create a drag on the economy in the longer-term in the form of higher debt payments. We anticipate growth near 3% for 2018 and a slowdown to 2% in 2019 as the stimulus fades. Fed rate hikes should start to apply additional brakes to the economy.

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Fixed Income Outlook
The yield curve has flattened thus far in August. Longer-term yields fell as the events in Turkey prompted a flight to quality. Shorter-term yields remained relatively stable as they are more closely tied to expected Fed actions. The spread between the 10-year and two-year Treasuries (currently at 24 basis points), reached its lowest level since 2007.

The market is pricing in a 92% chance of a hike in September and a 60% chance of another hike in December. The market is pricing in 75 basis points of tightening over the next few years, while the Fed's median projection shows 150 basis points of tightening. We expect the economy will perform around its potential next year. Therefore, we believe the Fed will not need to hike rates aggressively and lean towards the market's view on rates.

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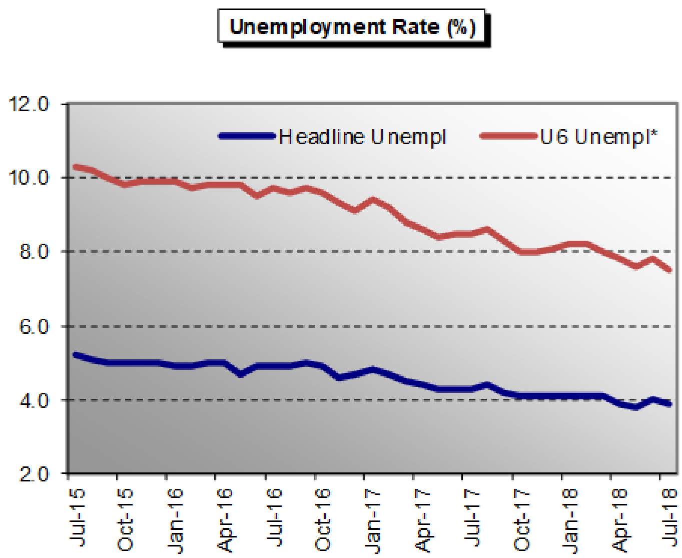
Labor Readings

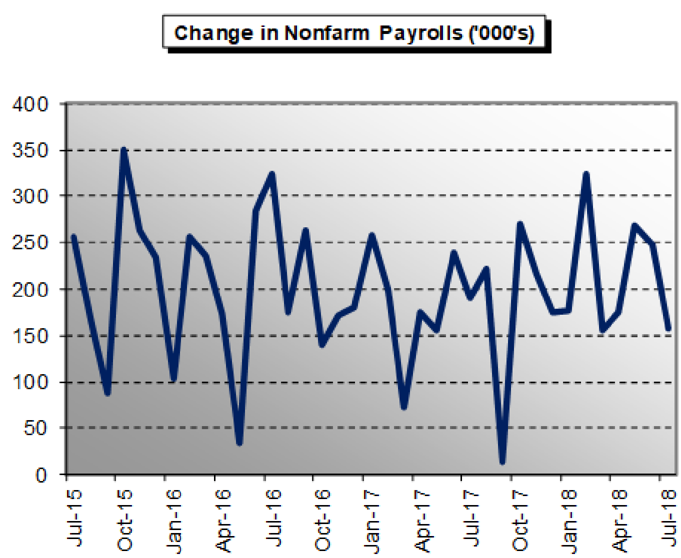
(Data source: Bloomberg)



* Includes people that are unemployed, marginally attached and part-time for economic resaons

Unemployment Rate Declines

The unemployment rate decreased in July from 4.0% to 3.9%. The labor force increased modestly, and employment gains were solid. The unemployment rate for workers without a high school degree hit the lowest level since data collection began in 1992. This indicates that employers are reaching further into the labor pool to fill open positions.



Payroll Growth Remains Strong

Payroll growth for July came in below estimates, but upward revisions to the prior two months show that the job market is still strong. Payrolls grew by 157,000 jobs in July versus an estimate of 193,000. The prior two months were revised upwards by 59,000 jobs.

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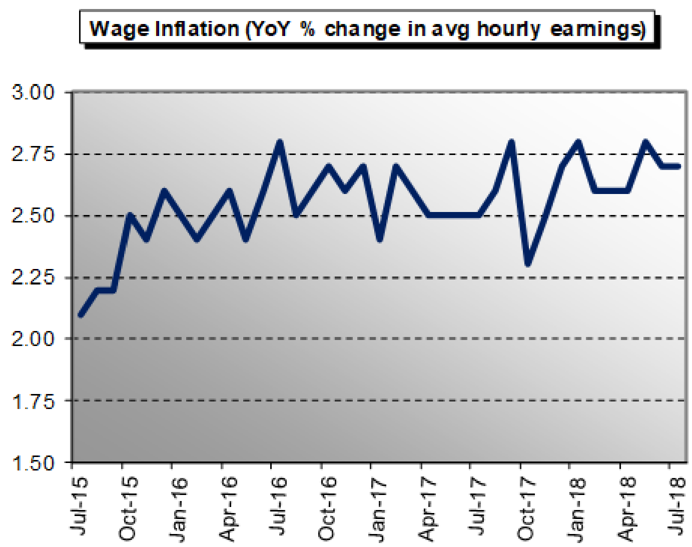
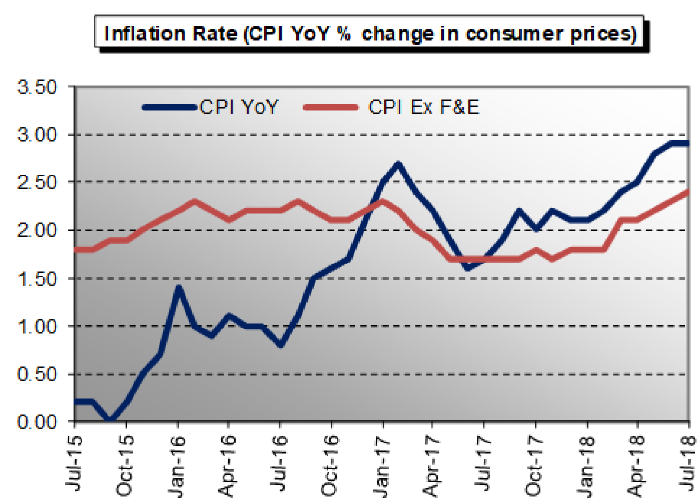
Inflation Readings
(Data source: Bloomberg)



Wage Inflation Still Tame
Wage inflation met expectations in July. Wages grew by 2.70% on a year-over-year basis. This level is near the post-recessionary peak, but well below wage inflation in previous recoveries. Modest wage inflation will keep the Fed on its gradual hiking path.



Core Inflation Rate Climbs
The year-over-year core inflation rate hit its highest level in in almost a decade in July. Core inflation rose by 2.4% and headline inflation rose by 2.9%. The core index of the Fed's preferred inflation measure (personal consumption expenditures) remains below 2%, so the Fed is unlikely to be overly concerned by the higher Consumer Price Index data.

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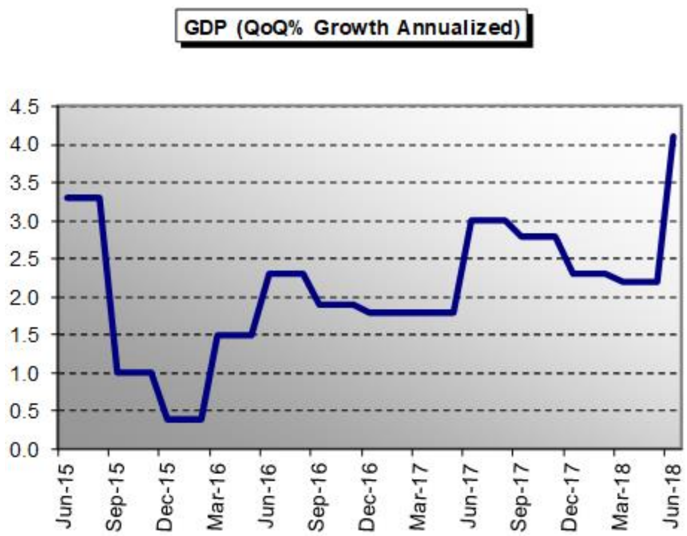
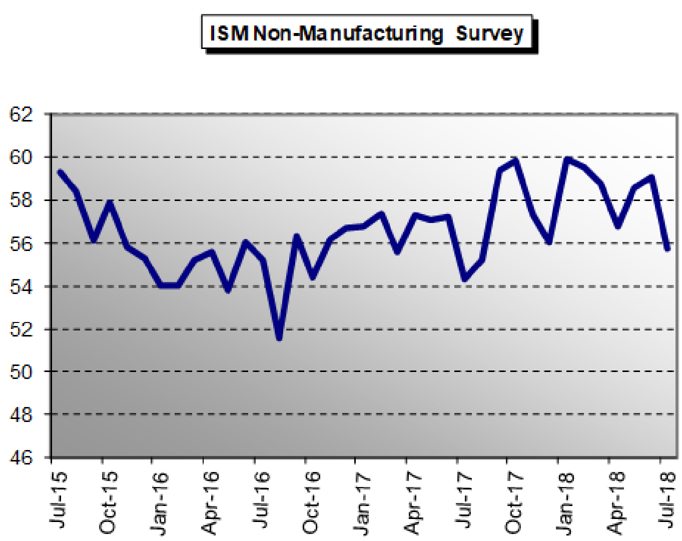
Economic Growth Readings

(Data source: Bloomberg)



Q2 GDP Shows Strong Growth

The initial estimate of second quarter GDP showed a large bounce back from the upwardly revised first quarter (2.2%). GDP expanded by 4.1%, the fastest pace since 2014. The economy got a large boost from consumer spending, business investment and net exports. The pace of growth will likely dip closer to 2.5-3.0% in the second half of 2018 as the impact of the tax cuts diminishes and increased tariffs start to take a toll.



Services Business Survey Drops

The Institute for Supply Management's service industry survey came in much lower than expectations. The index fell to an 11-month low and experienced its largest monthly decline in almost two years. The report suggests that the economy is set to cool off in the third quarter after robust growth in the second quarter.