Written on 9/23/16

Economic Update
September 2016

Commentary

Despite weeks of prepping the markets that a hike in interest rates could happen at this week's FOMC meeting, the Fed failed to take any action yet again. This did not come as a surprise to the markets as they never truly believed the Fed's insistence that this meeting was "live" (the market-based odds of a hike never got above 50% and stood at 20% on the day of the meeting). Even though the end result was not a surprise, we did learn a few important things.

First of all, the disagreement among the various members at the Fed appears to be even greater than many believed. There were three members of the Fed that dissented from the vote to keep rates unchanged (they all voted in favor of a 25 basis point increase). This marks only the fourth time since 1992 that there were three or more dissenters at a Fed meeting. At her press conference, Janet Yellen downplayed the magnitude of the dissention. She stated that there is general agreement among all members that accommodation needs to be removed, just a difference of opinion of when to start the process. It is important to note that two of the three dissenters (Rosengren and George) will not get to cast a vote on monetary policy in 2017 (due to the annual rotation of Fed regional bank presidents; four out of the eleven get to vote each year), so look for them to increase their rhetoric on the need for higher rates sooner rather than later.

Secondly, the Fed sent a strong signal that rates will be 25 basis points higher by the end of the year. The most obvious signal was their statement that "…the case for an increase in the federal funds rate has strengthened…". The updated projections showed that fourteen of the seventeen Fed participants still expect at least one hike in rates by the end of the year. The Fed also changed their assessment of risks statement regarding the economy to "balanced" (after refraining from giving a risk assessment for much of the year due to market turmoil). The statement from this meeting looks very similar to the statement and rhetoric from the Fed in September of last year. If economic data over the next few months come in at or near expectations (and there isn't a major market meltdown), the Fed will hike rates in December (November is unlikely since the FOMC meeting occurs only one week prior to the presidential election).

Thirdly, the Fed continues to revise down their long-term growth projections for the economy. The current long-term projection is 0.2 percentage points lower than where it was one year ago and almost one full percentage point lower than where it stood five years ago (2.7% in 2011 vs. 1.8% today). The Fed has been much slower than the market to recognize that demographic trends and low productivity growth are powerful forces that are exerting strong downward forces on the economy. A third negative force has been fiscal tightening.

There is not much the Fed can do to reverse these trends, but that does not mean that the U.S. economy has to be stuck in its current low growth mode forever. In the absence of business investment, the government should step in and make investments that can lead to productivity gains in the future. The key is to involve business leaders in the decision making process, rather than leaving spending decisions to politicians looking to fund their "pet projects." With interest rates so low, the hurdle to make a positive net return on investment is much lower than it's been in the past.

We look for the economy to bounce back in the second half of the year, but not enough to push the 2016 growth rate above 2%. Growth in the third quarter should come in around 2.5% - 3.0%. All eyes now move to the upcoming Presidential election. The first debate is on Monday, and should at least be entertaining no matter who you support.

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Fixed Income Outlook
Interest rates have decreased by 10-15 basis points across the curve since the end of August. There is a growing sense throughout worldwide markets that central banks' ability to spur growth is at or near its limits (we generally agree with this view). If perceived central bank support continues to wane, market volatility will increase.

The market is pricing in a 50% chance of a hike in December. This appears a little low given the latest Fed statement and their updated economic projections. We believe that it will take a string of bad economic data to keep the Fed on hold. Looking forward, the market still does not believe that the Fed will be able to hike rates as much are they are projecting. The Fed is projecting 150 basis points in hikes through the end of 2018. The market is pricing in just 50 basis points of hikes during that same timeframe.

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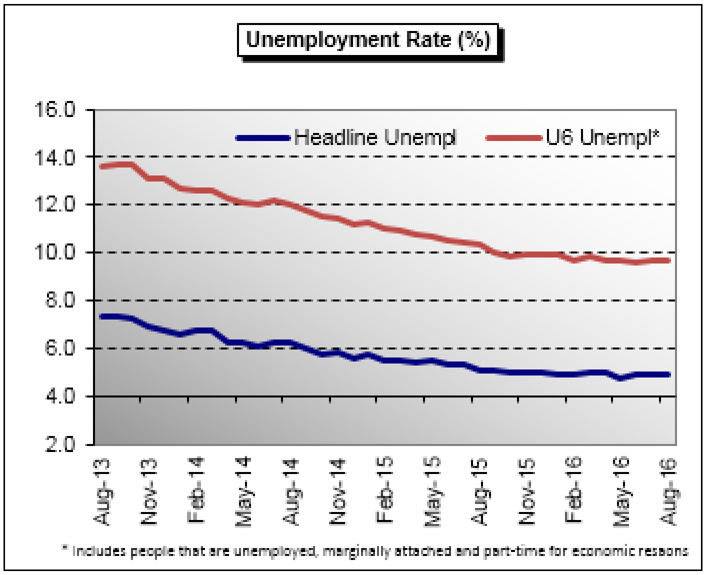
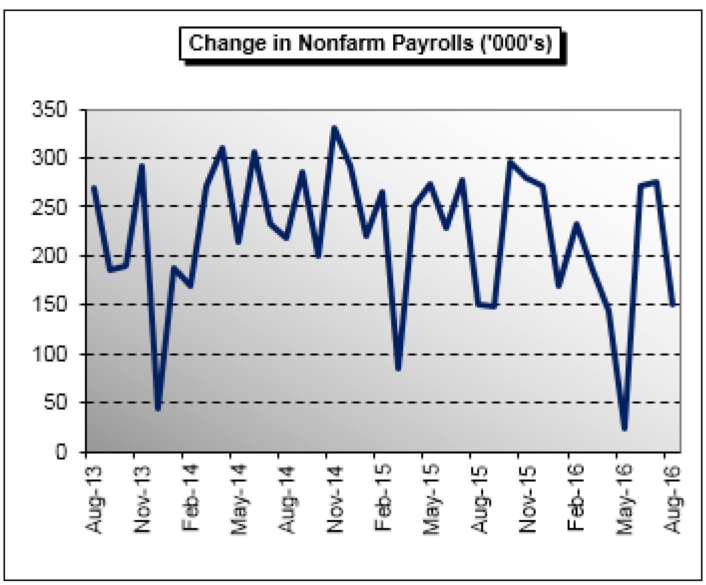
Labor Readings
(Data source: Bloomberg)



Unemployment Rate Remains at 4.9%
The unemployment rate in August held at 4.9% for the third consecutive month. The underlying details of the report were generally weaker than expected. Most importantly, wage gains came in below expectations and the average weekly hours worked declined. This points to weaker income growth and thus, weaker expected consumer spending in the third quarter than original projections.



Job Gains Come in Slightly Below Estimates
Payroll growth in August came in at 151,000 jobs versus an expected 180,000 gain. Despite the softer than expected result, payroll growth thus far in the third quarter is averaging 213,000 jobs per month. This is higher than the average growth rate in the second quarter (146,000) and the first quarter (196,000).

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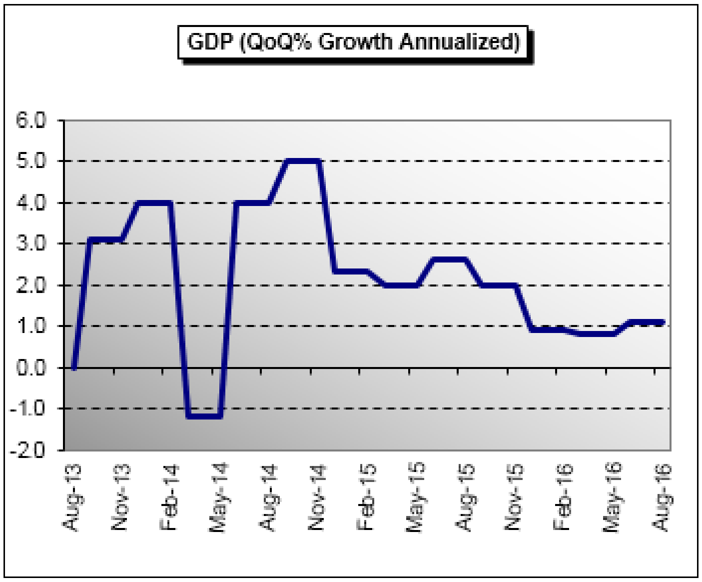
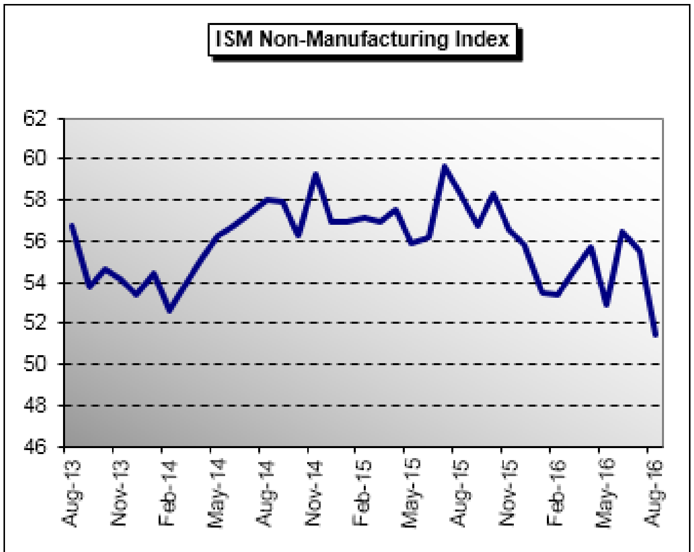
Economic Growth Readings
(Data source: Bloomberg)



Economic Growth Remains Sluggish
For the third consecutive quarter, economic growth has come in near 1%. The average growth rate over the last four quarters is at its lowest level since 2013. Consumer spending continues to be a bright spot and contributed almost three percentage points to second quarter GDP growth. The growth rate was brought back down to 1.1% mainly by inventory contraction and lower government spending. Current estimates for the third quarter (based on the Atlanta Fed's model), is for growth to rebound to 2.9% in the third quarter. Consumer spending is expected to remain strong as the inventory drag diminishes.



Service Industry Index Falls Sharply
The ISM index for the service industry came in well below expectations and fell by the largest amount since 2008. The index came in at 51.4 versus an expected level of 54.9. The business activity component of the index fell to the lowest level since 2010 and new orders fell to the lowest level since 2013. An index level above 50 indicates an economy that is expanding, but the current level of 51.4 indicates a much milder rebound in economic growth than many economists are projecting for the second half of 2016.

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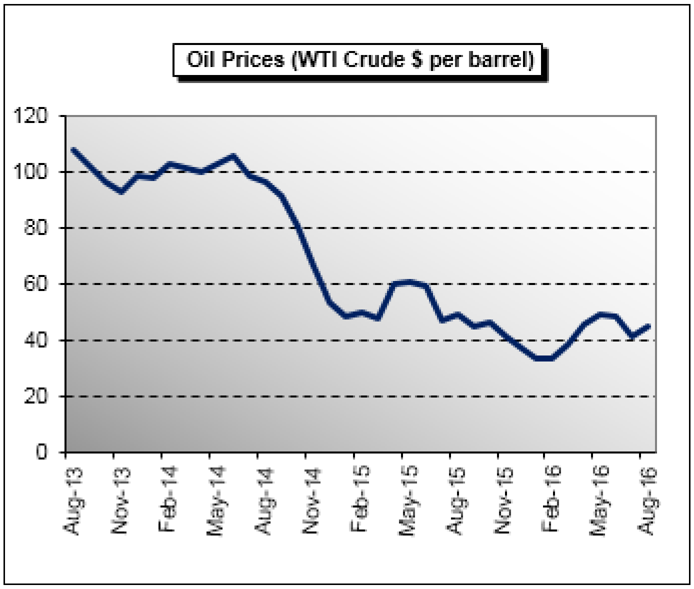
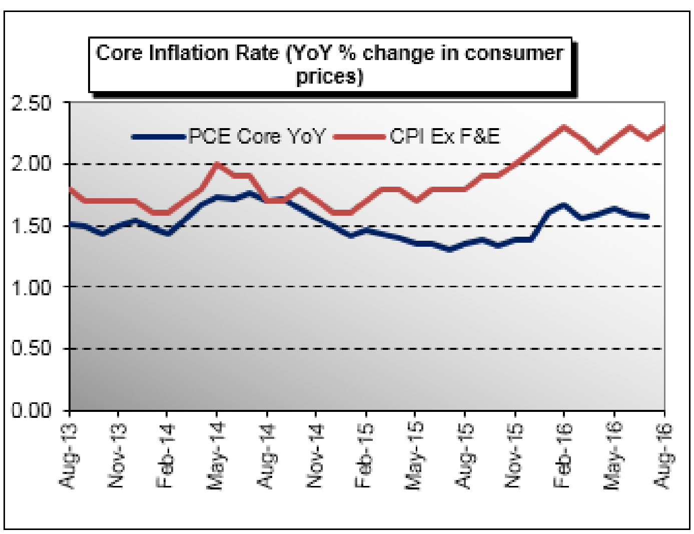
Inflation Readings
(Data source: Bloomberg)



Oil Prices Remain Low, but Stable
Oil prices have recovered from the beginning of the year, but remain almost 60% lower than where they stood three years ago. The lower oil prices have diminished investments made by oil companies, which has created a mild drag to GDP growth. Oil prices have stabilized from the lows in early 2016 and now stand 20% higher than December 31, 2015.



Core Inflation Pushes Marginally Higher
Consumer prices, as measure by core CPI, have moved higher over the past few months. The Fed's preferred inflation measure, core PCE, has also increased, but by a much smaller degree than the CPI measure. The Fed prefers the PCE index since it includes a much broader range of inputs and is weighted by business surveys, instead of the much less reliable consumer surveys that weight the CPI index. The Fed targets 2% core PCE inflation. The measure has remained below that target since April 2012.