9/25/17

Andrew Kohl
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Economic Update
September 2017

By Andrew Kohl

Commentary

The beginning of the process to unwind the Fed's balance sheet came with much less fanfare than the buildup of the assets (aka quantitative easing). The Fed has been signaling that the wind down would occur for several months and delivered on their promise at the September Federal Open Market Committee meeting. They detailed an orderly plan of how their assets will shrink over time in an effort to minimize the impact on the markets. Fed Chair Janet Yellen made it clear the intent is to run the balance sheet reduction program on autopilot and to use changes in the fed funds rate as the main policy tool going forward.

The quantitative easing (QE) program began in late 2008, in the midst of the financial crisis. It was a seldom used tool by central banks at the time it was implemented in the U.S. The use of QE was controversial, but the Fed was running out of tools to deal with the recession given short-term rates were already near zero. Ultimately, the Fed executed three rounds of QE and increased the balance sheet from $900 billion to $4.5 trillion. The effectiveness of the QE program is debatable, but the general consensus is that it brought 10-year bond yields down by approximately 100 basis points. We don't expect the magnitude will be as great to the upside (i.e. 10-year bond yields move 100 basis points higher) as the program is unwound. Mainly because there is no "shock effect" (the initial round of QE was most effective because it was a new program and sent a strong signal that the Fed would keep rates low for an extended period of time). In addition, the process to unwind will be very protracted given the monthly redemption caps built into the Fed's plans.

The other major news out of September's FOMC meeting was the expectation of another 2017 rate hike, held by 12 out of the 16 Fed policymakers. In early September, the market was pricing in only a 20% chance that the Fed would hike again this year. This was largely due to the weaker-than-expected inflation rates experienced for most of 2017. The fact that a large majority still expects to hike rates this year reflects the Fed's belief that the downside inflation effects are transitory. We believe the Fed is also concerned about financial conditions remaining "easy." Despite 100 basis points of Fed hikes since late 2015, many financial metrics are arguably easier than before starting the hiking process. Since the Fed's first hike on December 16, 2015, the 10-year Treasury rate is eight basis points lower, the stock market is up 20% and the dollar is down 5%.

The economic data will be noisy for the next few months given the impacts of Hurricanes Harvey and Irma. We think the storms' economic impact will be a reduction in third quarter GDP followed by a pickup in growth over the next two subsequent quarters. Mirroring the impact of other natural disasters, we believe the net effect on growth will be negligible. We still look for the economy to chug along at the 2% pace for the next few years.

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Fixed Income Outlook

The bond market experienced higher than normal volatility in September. Earlier this month, 10-year Treasury yields hit their lowest level this year as fears of a conflict with North Korea and extensive damage from hurricanes caused a flight to quality. Yields jumped higher in the middle of the month when the September Consumer Price Index report broke a string of five consecutive months of lower-than-expected inflation. Yields rose once again when the Fed meeting was more hawkish than expected. The market is now pricing in a two-thirds chance that the Fed will hike in December.

We think the bar to hike rates in December is low. The Fed seems intent on continuing its gradual approach to reach monetary policy neutrality (which it currently defines as a 2.5% to 3.5% fed funds rate). Along with another hike in 2017, the Fed foresees three more hikes in 2018. The market is skeptical and is only pricing in one hike next year. We don't doubt the Fed's resolve to move rates higher, but it's hard to make predictions when the structure of the Fed may look completely different within the next six months (Yellen's term expires in February and several other Fed seats stand vacant). Therefore, we are neutral on duration at this point in time.

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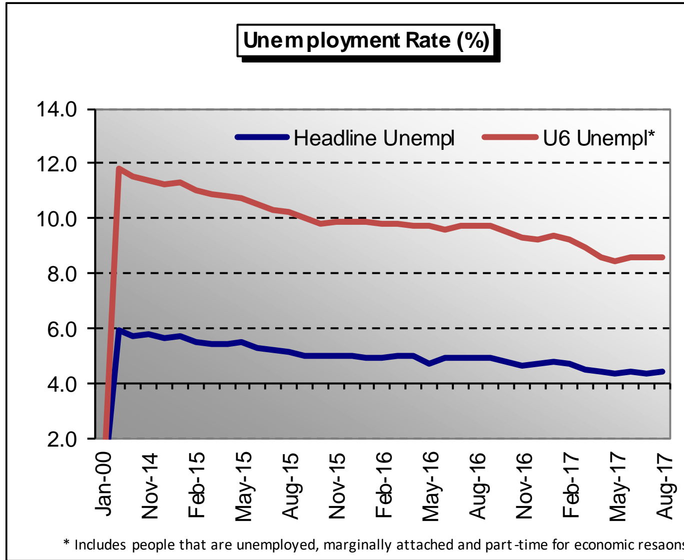
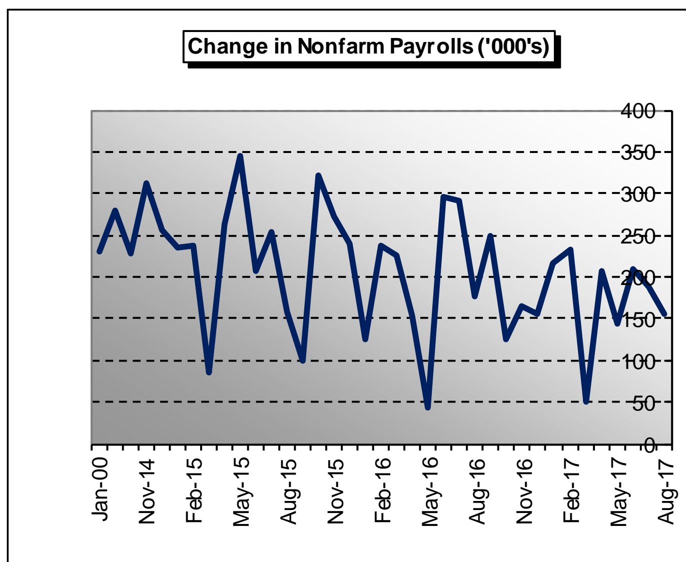
Labor Readings
(Data source: Bloomberg)



Unemployment Rate Experiences Modest Uptick
The unemployment rate in August increased by 0.1% to 4.4%, slightly above a multi-year low. The underlying details of the labor report were not as strong as pervious months, but still show a healthy labor market. In a continuing trend, wage growth was weak and remains well below previous economic expansions.



Another August Miss for Job Growth
For the seventh straight year, job growth in August came in below consensus expectations. This trend seems to be due to the seasonal adjustment factor, which needs to be recalibrated. In any case, job growth was still relatively strong. Payrolls increased by 156,000 jobs versus an expected 180,000 gain. The job numbers over the next few months will be skewed by the hurricanes in Texas and Florida, so it will be more difficult to get an accurate read on the market.

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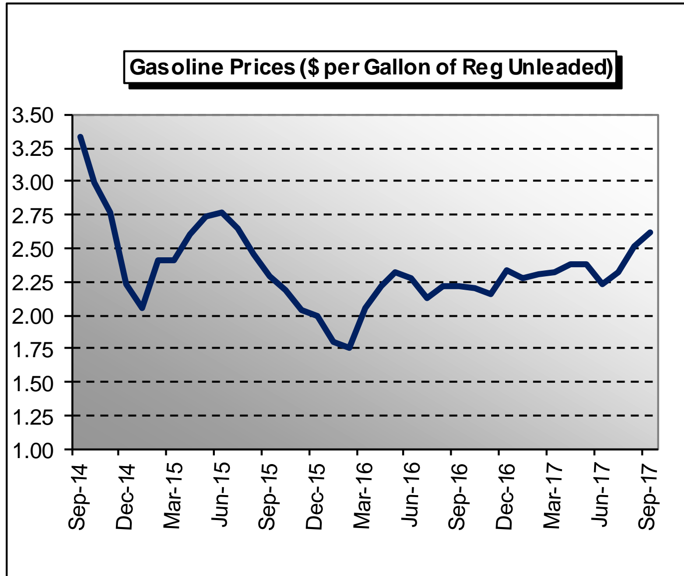
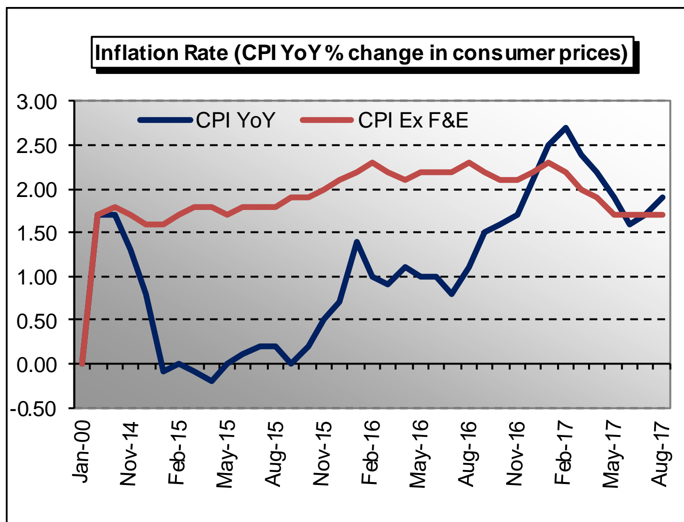
Inflation Readings
(Data source: Bloomberg)



Gasoline Prices Climb
Gasoline prices hit their highest level in over two years as Hurricane Harvey shutdown refineries in Texas. At the height of the storm, 25% of the nation's fuel-making capacity was shut down and many refineries are still inoperable today. This forced a large drawdown in U.S. gasoline stockpiles. Prices are almost 20% higher than where they stood at the same time a year ago. If prices remain elevated, it could negatively impact consumer spending and push inflation rates higher.



Pace of Inflation Exceeds Estimates
Breaking a streak of five consecutive misses to the downside, inflation exceeded estimates in August. Both the headline and core inflation rates were 0.1% higher than expected. Energy prices rose the most since the beginning of the year and are likely to move higher since much of the data for this report was collected prior to when the storm hit.

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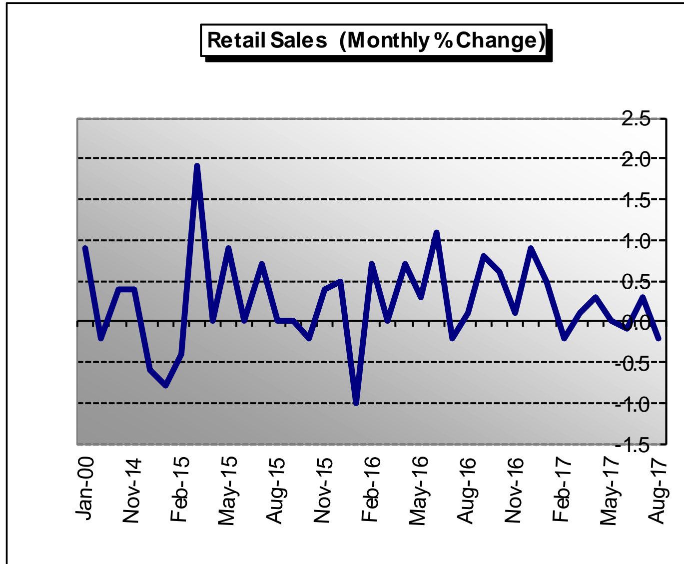
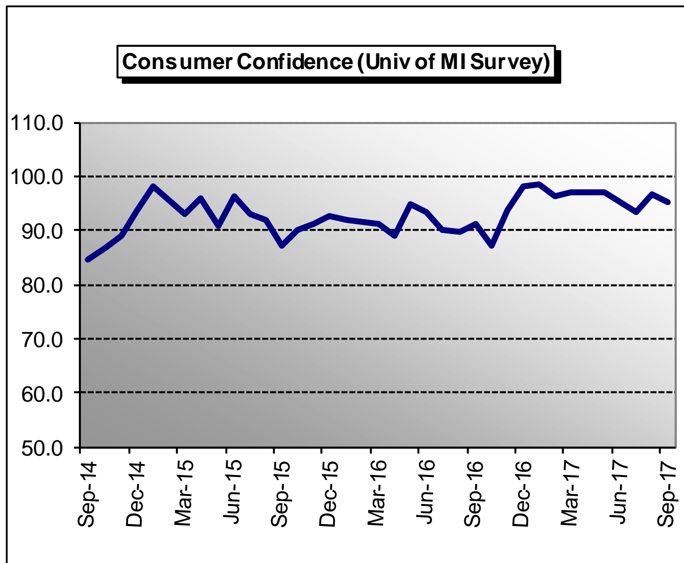
Consumer Readings
(Data source: Bloomberg)



Retail Sales Show Weakness
Retail sales in August were lower than expectations. Sales decreased by 0.2% versus an expected gain of 0.1%. Some weakness was expected due to Hurricane Harvey's impact, but the prior two months' sales data was revised materially downwards. This indicates a loss of consumer spending momentum from the second quarter.



Consumer Confidence Declines
Consumer confidence met expectations, but weakened from the prior month. Consumers expect increases in gasoline prices and inflation due to the impact of Hurricane Harvey. Confidence remains elevated from where it stood prior to the presidential election.