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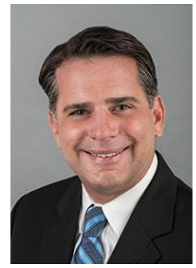
Corporate Federal Credit Union

Economic Update
September 2018



Andrew Kohl
Chief Investment Officer

By Andrew Kohl

Commentary

The stock market continues its march forward and is back to all-time highs. The S&P 500 has gained over 9% thus far in 2018 and has returned over 330% (over 425% if you include dividend reinvestment) since the low point reached amidst the recession in March 2009. The market has gained recently as the prospects of a global trade war have lessened. It now seems likely that NAFTA will be successfully renegotiated and that the tariff battle will be bilateral (between the U.S. and China) rather than a worldwide event.

The tariff battle with China shows little signs of letting up. Today, tariffs on $200 billion of imports from China go into effect (on top of tariffs on $50 billion that went into effect earlier in the year). The President has signaled that tariffs on the remaining $250 billion of imports from China will also be implemented if China retaliates. At this point, that looks likely to happen.

China is unlikely to shift from its current policies as it is trying to build a stronger middle class in an effort to escape the “middle income trap.” The “middle income trap” occurs when a country’s growth rate slows after reaching middle-income levels (approximately $10 thousand to $15 thousand per capita). Growth slows when the pool of unskilled labor transferring to skilled labor (i.e. the transfer of workers from farms to factories) reaches its limit. A shift to a high-income economy requires increases in productivity (via more effective use of resources). According to the World Bank, only 13 of the 101 middle-income economies have been able to transition to high-income economies since 1960.

On the U.S. side, the President has broad authority to impose tariffs on China. In addition, a majority of the public believes that trade with China is “unfair.” The President’s chief trade negotiator believes that China has been skirting the World Trade Organization’s (WTO) rules for years (we concur). This may be the best chance to renegotiate the trade practices with China before their economy gets too large and wields even more global influence.

What would be the overall impacts of 25% tariffs on $500 billion of imports from China? The impact to economic growth would be similar to any increase in taxes. It reduces after-tax income for the consumer and thus, consumer spending would fall. Assuming a tax multiplier of 50%, this would reduce GDP by 0.3%. There could also be indirect effects that could lead to a larger impact (i.e. reduced capital spending). The impact to inflation would shift the inflation rate higher by 0.4% if 100% of the tariffs were passed through to the consumer. But, a full pass-through is unlikely as companies would be apt to share in the tax burden (via lower profits) and consumers would partially shift away from Chinese imports.

The economy is on track for 3% growth in 2018. The positive impacts from fiscal spending will be felt through the rest of the year and into 2019. Most of the impacts from the trade war won’t hit the economy until next year. We look for GDP growth to slow to 2.5% in 2019, with growth trailing off towards the end of the year.

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Fixed Income Outlook

The yield curve has moved substantially higher during September. The higher-than-expected wage growth and reduced probability of a worldwide trade war lifted yields by 20 basis points across the curve. The Federal Open Market Committee will meet this week with little doubt about the rate outcome (the market is pricing in a 98% chance for a rate hike). The key will be if the Fed gives any indication about another hike in December and what the updated economic projections and rate forecasts reveal. We believe the Fed's median projection will show another hike in 2018 and 100 basis points of cumulative hikes over the next two years. The Fed's hawkish voter makeup this year points to a December hike, but we believe the market is pricing in too high a probability (approximately 80%).

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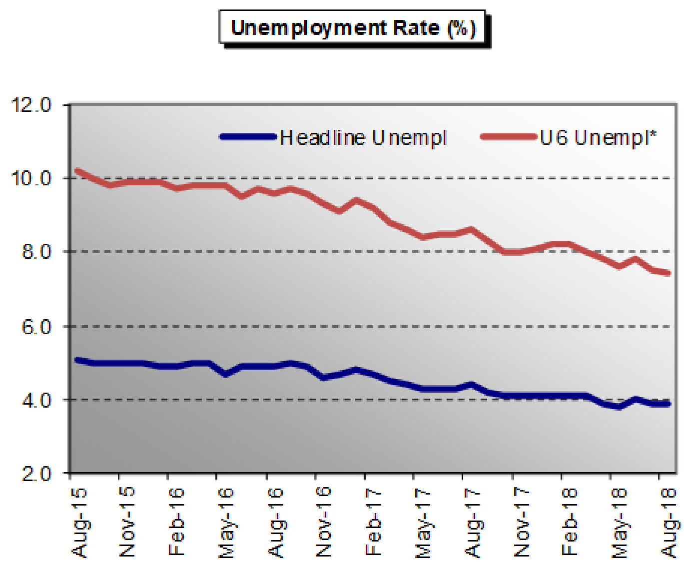
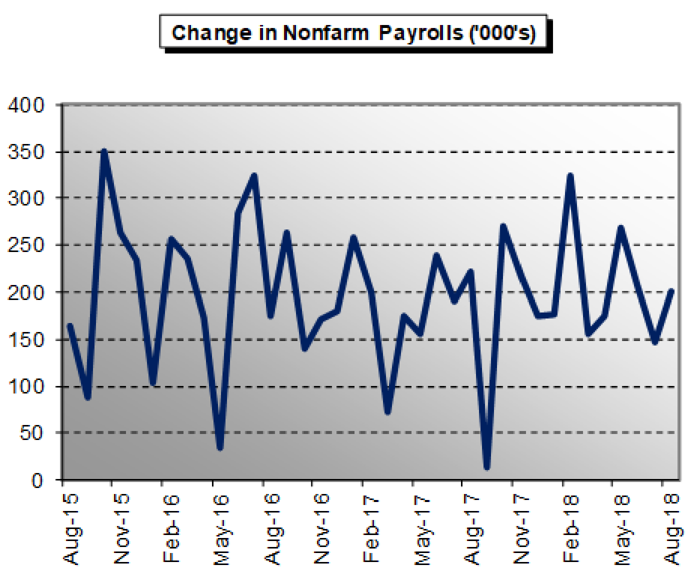
Labor Readings
(Data source: Bloomberg)



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

Unemployment Rate Holds Steady
The unemployment rate remained at 3.9% in August – close to a multi-decade low. The underlying details of the report were mixed. On the negative side, the labor force declined, which pushed the labor force participation rate back to its low for 2018. On the positive side, wage growth was stronger than expected and hit a new cyclical high for the recovery.



Payroll Growth Still Strong
Payroll growth for August came in above estimates, but the prior two months were revised downwards. Jobs gained by 201,000 in August versus an estimated 190,000 gain. The -50,000 revision to the prior two months pushed the three-month moving average to the lowest level in almost a year. Despite the slowdown, overall job growth remains robust for this stage of the economic cycle.

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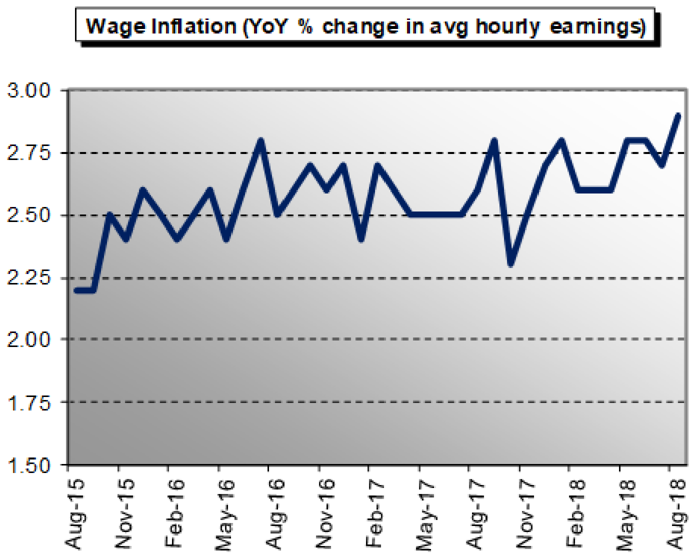
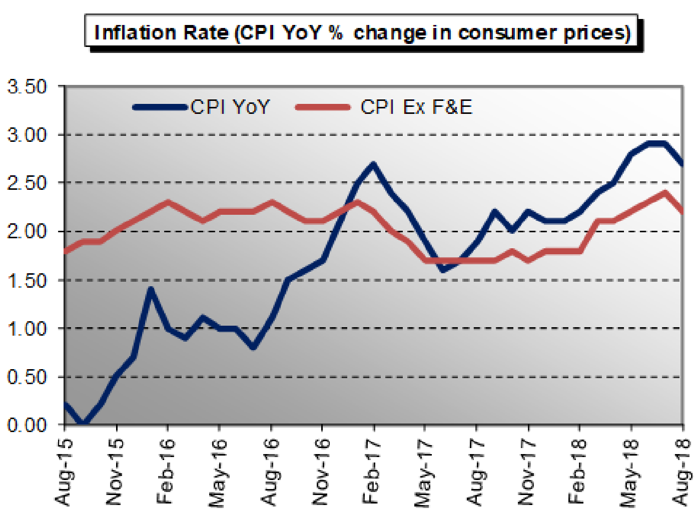
Inflation Readings
(Data source: Bloomberg)



Wage Inflation Higher than Expected
Wage inflation reached a new cyclical high in August. Year-over-year wage growth was 2.9% versus an estimate of 2.7%. Details of the report show that wage gains are solid for both skilled and unskilled positions. Wage gains are still well below improvements seen in previous recoveries.



Inflation Rate Slows
The pace of inflation slowed in August and came in below estimates. Apparel prices fell by the most in almost 70 years and medical care costs declined. The three main components of the Consumer Price Index (housing, food & transportation) all rose in August. There is still little evidence that a major breakout of inflation to the upside is on the horizon.

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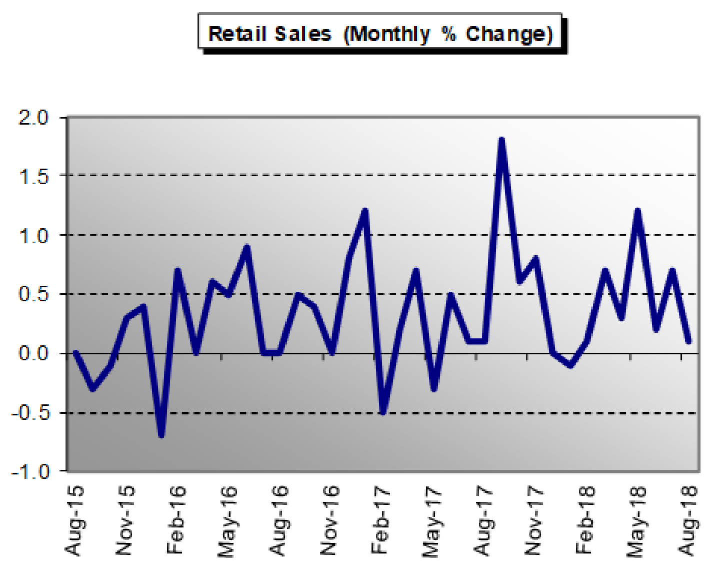
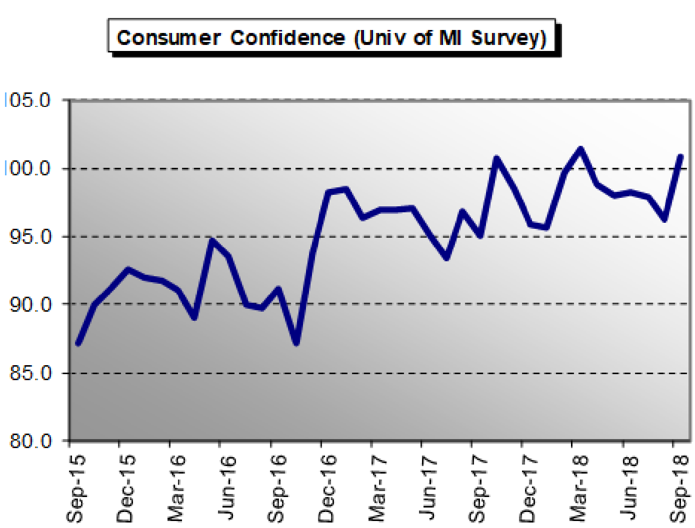
Consumer Readings

(Data source: Bloomberg)



Retail Sales Miss Estimates

Retail sales in August were weaker than expected. Sales came in at 0.1% month-over-month growth versus an estimate of 0.4% growth. Tempering the miss was an upward revision to the previous month. All told, consumer spending looks to weaken from the second quarter, but still remain quite strong.



Consumer Confidence Rises

Recent headlines on tariffs have done little to shake the confidence of the consumer. Consumer confidence reached its second highest level during the recovery thus far based on the preliminary September report. The expectations component of the index climbed to a 14-year high.