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Economic Update
October 2017

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By Andrew Kohl

Commentary

The anticipated future composition of the Federal Reserve has led to higher rates and increased volatility in the bond market. Oddly, however, the stock market has been immune to the speculation and continues to reach new highs almost every day. President Trump has indicated he wants to select the next Federal Reserve chair by the end of the month. According to the press, he has narrowed it down to five candidates, with current Fed Chair Janet Yellen being one of them. While it has become commonplace for new presidents to nominate the sitting Fed chairperson over the past several decades (even if they were appointed by a president from the other party), there is a real possibility Trump will choose to go in a different direction. We believe there is also reasonable probability that Yellen would decline the nomination.

Yellen's stance on financial regulation has been the primary source of contention with the Republican Party. She has been steadfast in her defense of the new regulations implemented since the financial crisis, highlighting the benefits in her speech at the Jackson Hole Symposium in late August, which many considered a parting salvo. Many Republicans feel the current regulatory environment is holding down economic growth. Out of the five known Fed chair candidates, she is the only one who doesn't favor looser regulation.

As for interest rates, Yellen is more on the dovish side compared to most of the other candidates. Based on previous speeches, Stanford University economist John Taylor and former Fed Governor Kevin Warsh prefer a more formulaic approach to setting the fed funds rate (most formulas would point to higher rates than today). Both have criticized the easy monetary policy during and since the crisis. Only National Economic Council Director Gary Cohn seems more dovish than Yellen, but it appears he has fallen out of favor with the President. The fifth candidate, current Fed Governor Jerome Powell, has similar rate views as Yellen. Given Powell's stance on looser regulations coupled with his dovish bent and experience at the Fed, we believe he is the leading candidate to be the next Federal Reserve chair, but it's a close call.

On the economic front, the data over the last few weeks has been consistent with what we've experienced so far this year. The labor market looks relatively strong despite some statistical noise created by the hurricanes while inflation continues to come in below estimates. The Fed is admittedly baffled by the lower-than-expected inflation data. Despite the low inflation trend, the Fed believes inflation will pick up once certain transitory effects fade (mainly wireless communication and financial services prices). Most of the Fed sees equal risk between moving rates too slowly (which could exacerbate asset bubbles) and moving rates too fast (which could tilt the economy into a recession). In the face of uncertainty, they favor a slow, steady course. For those of you who live in colder climates, this is akin to driving in a heavy snowstorm on a long stretch of highway. Pulling over to stop isn't an option since you don't know if what's coming up behind you will crash into you. Speeding up is also a poor choice since you're likely to run off the road.

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Fixed Income Outlook

Treasury rates have moved higher during October as speculation that the more hawkish candidates (especially John Taylor) may be nominated as Fed chair. Rates have moved significantly higher (approximately 40 basis points across the curve) since early September. The main impetus for the move higher was the relatively hawkish September Fed meeting. Since that time, Yellen and the other moderate Fed members have not wavered from the view that the Fed will hike in December. Absent a large market correction and/or much weaker-than-expected inflation data, we expect a hike in December. Our view in 2018 is much hazier, as the makeup of the Fed could change dramatically. No matter who is named Fed chair, the annual turnover of Fed presidents' votes on rates will tilt the Federal Open Market Committee more hawkish. The two biggest doves (Neel Kashkari of Minneapolis and Charles Evans of Chicago) will not be voters in 2018. Regardless, we remain neutral on duration given all the uncertainty.

Corporate Federal Credit Union

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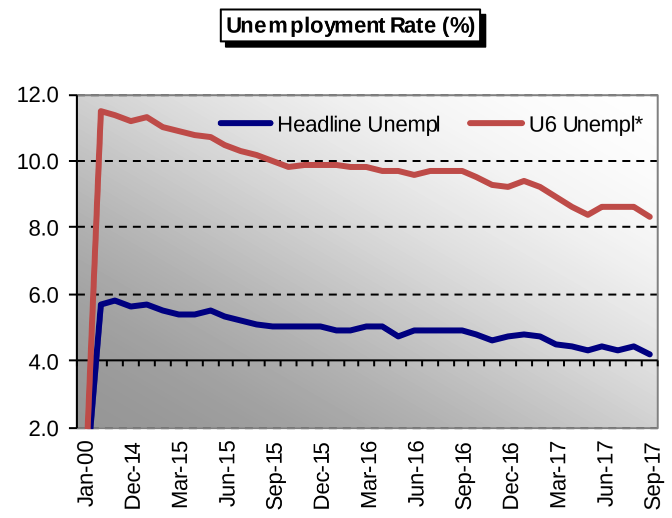
Labor Readings

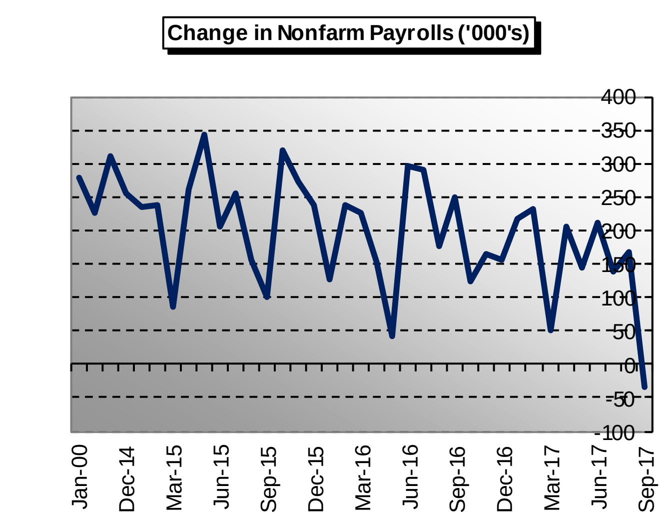
(Data source: Bloomberg)



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

Unemployment Rate Declines

The unemployment rate in September declined from 4.4% to 4.2%, a sixteen-year low. The data was distorted by the impact of two major hurricanes, but outside of the hurricane effects, the labor market still looks solid. Wage inflation surprised to the upside and hit its highest annual increase since 2009. The increase in September was partly due to the storms' impact, but the wage inflation data from the prior two months were revised upwards. This indicates that wage pressure may be starting to build.



Payrolls Miss Estimates

The payroll data for September came in much weaker than expected. Payrolls declined by 33 thousand versus an estimated 80 thousand increase. This is the first decline in payrolls in seven years. The hurricanes played a major role in the poor data. The number of people unable to work due to bad weather hit a 21-year high. The Fed is likely to look past this data due to the distortions from the storms.

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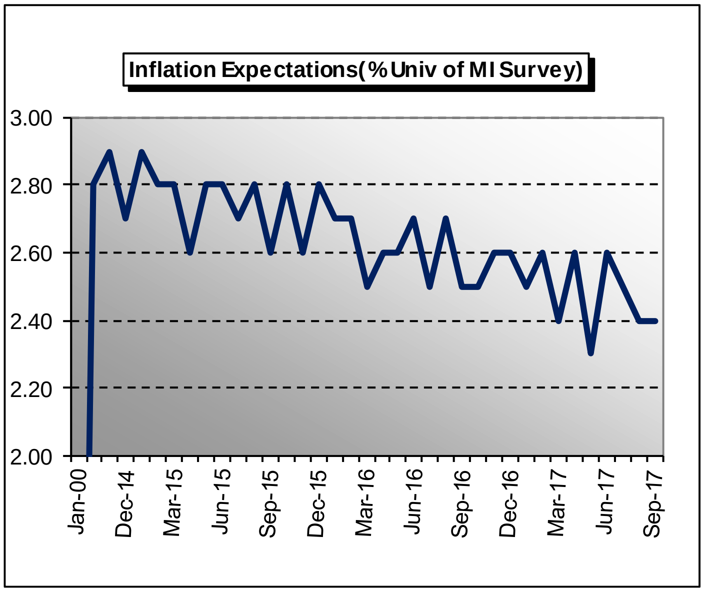
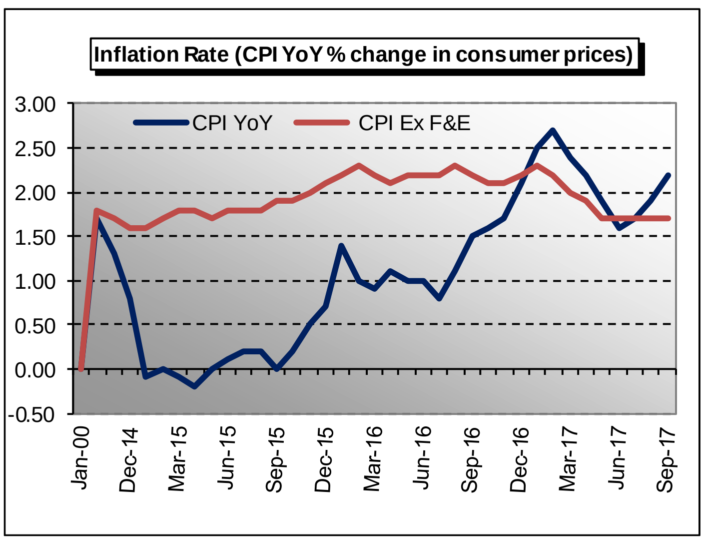
Inflation Readings

(Data source: Bloomberg)



Inflation Expectations Remain Low

Consumers' inflation expectations remain near all-time lows. Given that inflation has been below the Fed's 2% target for most of the economic recovery, it's not surprising inflation expectations have been falling. If they continue to fall, it could lead to diminished economic activity in the near term as consumers wait to make purchases.



Inflation Rate Below Estimates Again

The rate of inflation came in below estimates in September and for the sixth time in the last seven months. The headline rate of inflation rose from the prior month due to increased energy prices as a result of the hurricanes, but the "core" rate of inflation was slower in September. Goods prices are deflating, with lower prices seen in many different categories including autos, apparel and medical goods.

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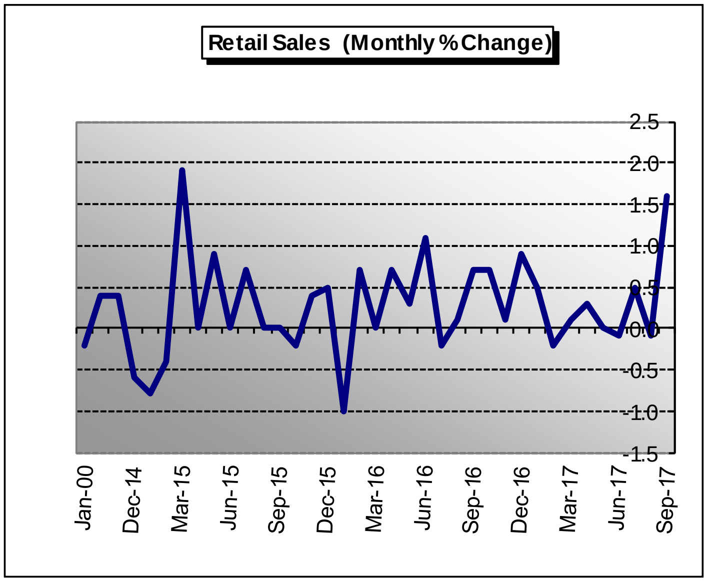
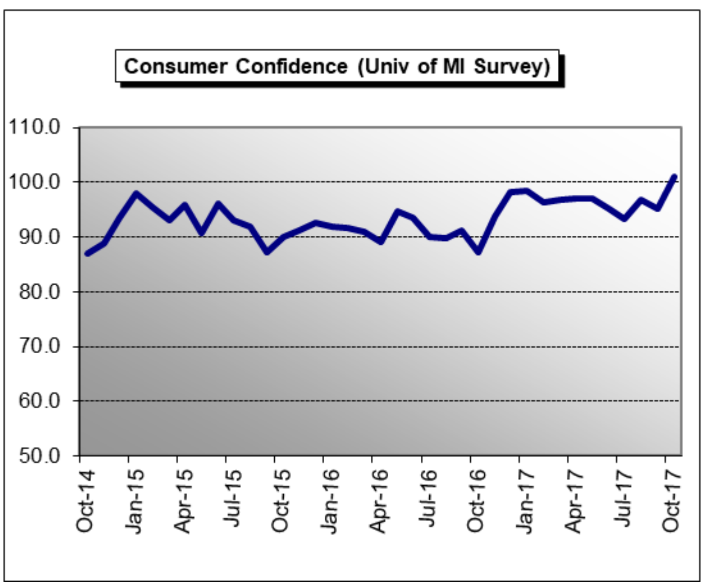
Consumer Readings

(Data source: Bloomberg)



Retail Sales Beat Estimates

Retail sales in September were higher than expected and hit the highest monthly growth level in two and a half years. The strength in sales was mainly due to the large increase in auto sales. Auto sales were elevated due to the need to replace vehicles destroyed in the storms. Stripping out the impact of gasoline prices and autos, the underlying trend of consumer spending still looks strong.



Consumer Confidence Soars

Consumer confidence exceeded expectations and reached the highest level since early 2004. The current conditions component of the survey hit its highest level since late 2000. The improvement in confidence is becoming more broad-based among age, income and political affiliation.