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Corporate Federal Credit Union

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Economic Update
November 2017

By Andrew Kohl

Commentary

Early November brought some major economic announcements. Jerome Powell was nominated as the next Federal Reserve chair and the House of Representatives released its plan for tax reform (officially titled the “Tax Cuts and Jobs Act”). We believe Powell will keep the Fed on its current path of gradual rate increases. The biggest change will be reflected on the regulatory side, where he, along with the current Vice Chair of Supervision Randy Quarles, is expected to push for some easing of the current regulations.

Regarding tax reform, the messy process to create new laws is unfolding; there has been plenty of discussion between Congress and powerful lobbies over the proposed plans. Ultimately, the House’s plan will need to be reconciled with the Senate’s plan before a final law can be made. In some respects, the House’s bold plan is encouraging because it challenges many of the long-standing deductions (i.e. mortgage interest, state and local taxes, etc.) that have little merit from an economic growth perspective (even if the changes do not get enacted).

The reduction in the corporate income tax from 35% to 20% is the key element of the proposed tax reform. A reduction in individual income taxes is also proposed, but given potential changes to deductions, the net impact to individuals will be much smaller than the corporate tax change. According to the Joint Committee on Taxation (JCT) – the official non-partisan Congressional tax scorekeeper – the total cost of the House’s proposal is $1.5 trillion over the next ten years.

We do not expect any Democrats to vote in favor of the proposed tax reform. Therefore, Republicans can afford to lose 22 votes in the House, but only two votes in the Senate in order to pass reform with a simple majority. Given the slim majority in the Senate, the final tax bill will reflect the Senate’s plan more than the House’s plan. In addition, the Senate is limited by the Byrd Rule, which states that any final bill passed with only a simple majority cannot add to the deficit after the tenth year. This means some of the tax cuts will likely need to sunset in ten years. Reaching the necessary 50 votes in the Senate will be a struggle (the failure to pass healthcare reform evidenced this clearly). The biggest challenge, however, will be winning over the deficit hawks (those concerned over ballooning the deficit) and the spending hawks (those concerned that federal spending is too high and believe tax cuts should be even bigger). There are arguably six senators who fall within one of those two camps. Ultimately, with Republicans in desperate need of a “win” before next year’s congressional elections, we believe tax reform will be passed.

Even if tax reform does not get enacted, the economy is on solid footing. Third quarter GDP was higher than expected (3.0% actual versus 2.6% expectation) and posted the highest back-to-back quarterly growth since 2014. Some of the gains were in the more volatile categories (inventories and net exports), but consumer spending should be stronger next quarter with the storms’ impact behind us. We expect growth in 2018 to be slightly stronger than this year given the strength in the worldwide economy.

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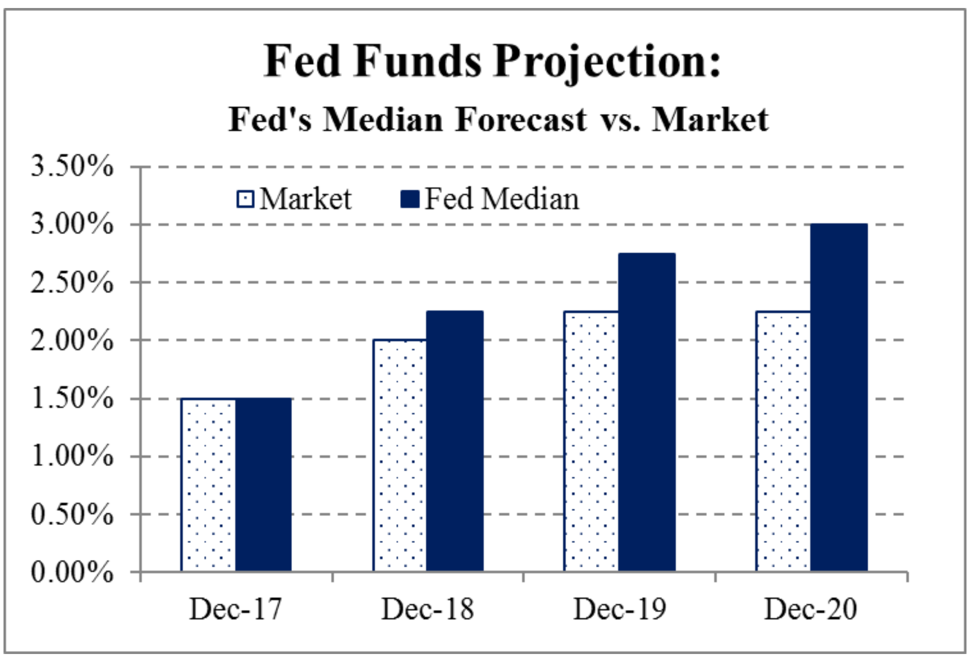
Economic Update

November 2017

Fixed Income Outlook

Both the equity and bond markets are little changed from the end of October. The bond market did continue its flattening trend. The ten-year/two-year Treasury spread stands at its lowest level in a decade and has declined 60 basis points from the start of the year. The short-end of the curve has been moving higher as the market continues increasing the odds of a rate hike in December (current odds are over 90%). The market still does not foresee a significant pickup in inflation and growth; therefore, the longer part of the Treasury curve has barely moved from the end of 2016.

We agree with the market that the Fed will hike rates in December. The latest Consumer Price Index Inflation Report came in slightly higher than expected, and core inflation has been running at an annualized clip of 2.4% over the past three months after showing weakness for most of the early part of the year. The market still has fewer hikes priced in than the median Fed projection, as depicted in the chart below. Given that the Federal Open Market Committee will become more hawkish in 2018 (the two largest doves will become non-voters), we foresee a risk that the short-end of the curve could move higher.



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Economic Update
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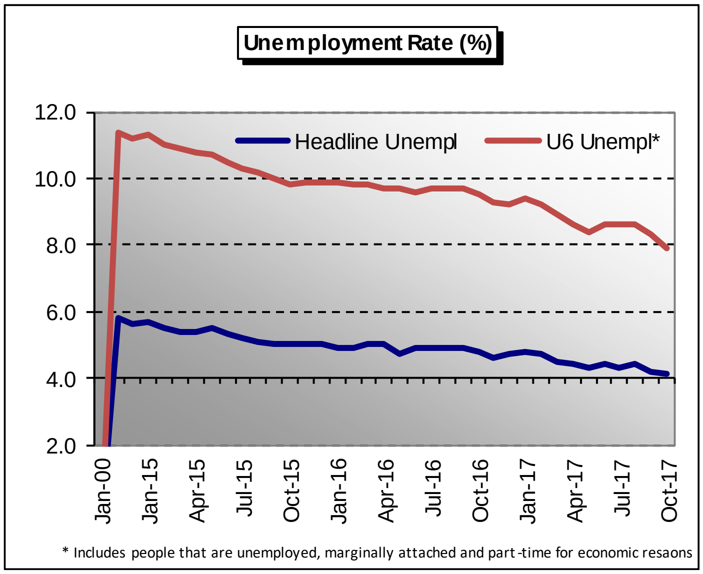
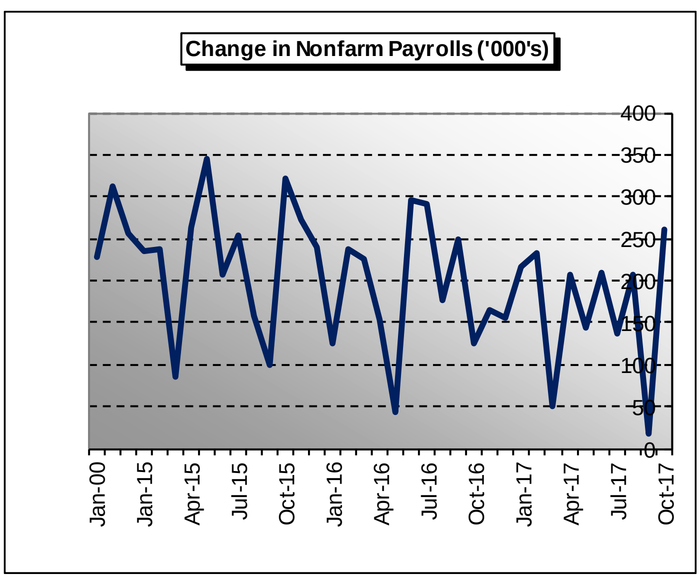
Labor Readings
(Data source: Bloomberg)



Unemployment Rate Falls Again
The unemployment rate fell for the second consecutive month in October. The rate currently stands at 4.1% and has declined faster than most economists had expected this year. For October, the rate decline was mainly due to negative factors. Both the labor force and the number of employed showed significant declines (the labor force participation rate matched its lowest level for the year). In addition, wage growth was much lower than expected.



Payrolls Below Expectations
October payrolls bounced back strongly from the storm-induced weak numbers of September. The bounce was slightly weaker than expected, but significant upward revisions to the prior two months meant the average pace of job growth is about 160 thousand per month. This is about the average pace for the year and more than enough to offset the growth in the working age population.

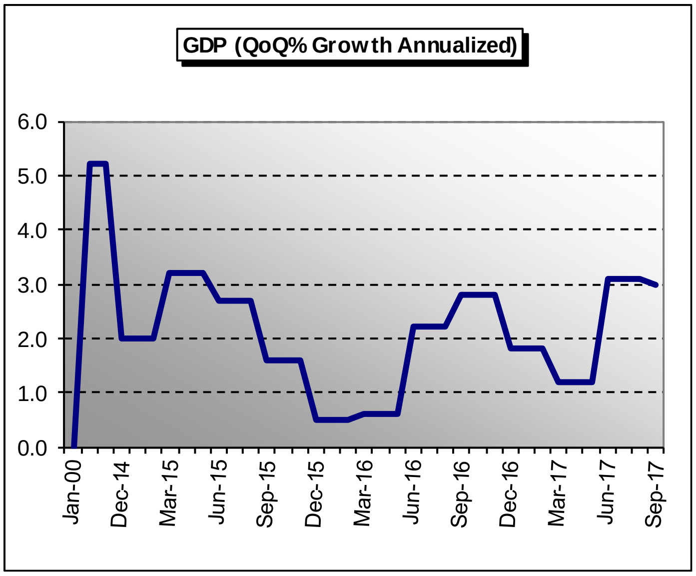
Corporate Federal Credit Union

Economic Update

November 2017

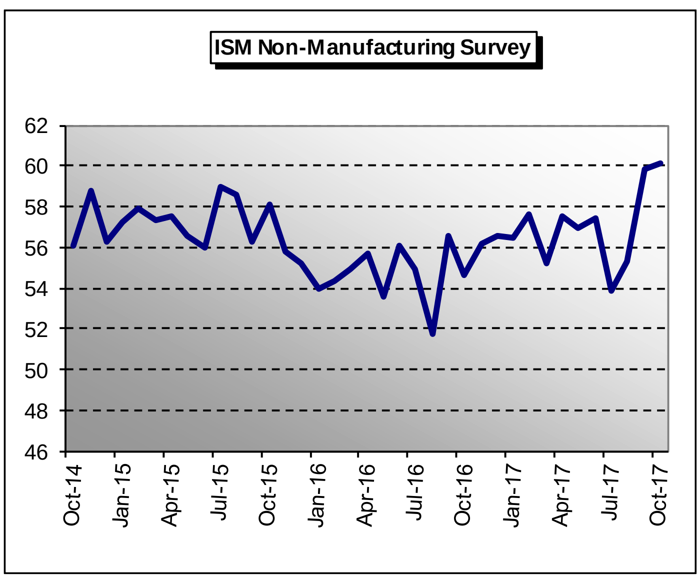
Economic Growth Readings

(Data source: Bloomberg)



Q3 GDP Growth Faster than Expected

The initial estimate of third quarter GDP growth came in higher than expected. Real GDP grew by 3.0% versus a 2.6% estimate, and 3.1% from the previous quarter. The growth rate over the last two quarters represents the highest back-to-back quarters since late 2014. Stripping out the volatile inventory and trade components, final sales to domestic purchasers grew by 1.8%. This was the slowest growth since the first quarter of 2016. Considering the impact of the hurricanes, this data will likely keep the Fed on its course of a gradual hike in rates.



Services Business Survey Soars

The Institute for Supply Management's Service Industry Survey came in better than expected in October, and hit the highest level since 2005. The business activity and employment components of the survey both advanced strongly. The strength of the survey suggests there will be strong economic growth going forward, as services represent approximately 90% of the economy.

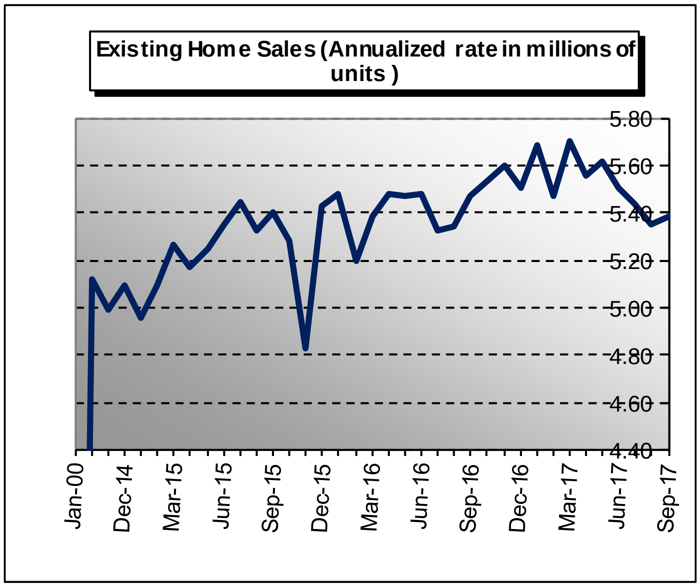
Corporate Federal Credit Union

Economic Update

November 2017

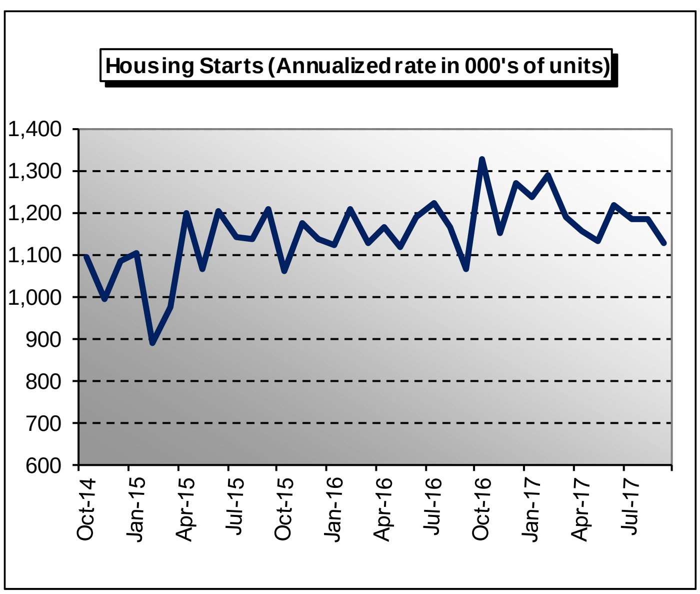
Housing Readings

(Data source: Bloomberg)



Existing Home Sales Beat Estimates

Sales of existing homes grew slightly in September and were greater than expected. A strong labor market and low borrowing rates have kept sales strong. The 30-year mortgage rate is essentially unchanged despite 100 basis points of Fed tightening since the end of 2015.



Housing Starts Decline

New home construction in September was weaker than expected. The hurricanes restrained activity and were a net drag on third quarter GDP growth. Housing starts should bounce back in the fourth quarter due to the need for rebuilding homes. Going forward, single family homes should be the driver, as it appears multi-family construction has peaked.