12/28/17

Economic Update
December 2017

Andrew Kohl
Chief Investment Officer

By Andrew Kohl

Commentary
Absent a dramatic move lower during the final two business days of the year, the stock market (as measured by the S&P 500) will achieve an annual return of nearly 20% for 2017 – its highest return since 2013. This would place 2017 in the top third of annual stock performance over the past 90 years. Equities and most other risky assets performed well in 2017 as worldwide growth rates increased and the promise of tax reform in the U.S. was fulfilled.

Equities certainly performed better than most economists expected, but the biggest economic surprise of the year was weakness in inflation. After starting the year near the Fed's target of 2%, core inflation (using the Fed's preferred measure, personal consumption expenditures) dropped by 40 basis points and currently stands at 1.5%. This is surprising given the faster-than-expected decline in the unemployment rate (from 4.7% to 4.1%, a 17-year low) and improvement in almost every labor metric. One of the most widely used econometric models, the Phillips Curve, predicts that as unemployment decreases, inflation is supposed to increase. The exact opposite occurred in 2017.

To date, the Fed has been steadfast in their belief that the Phillips Curve is not broken (just a bit flatter than before). They have chalked up the weak inflation data to abnormalities that they do not believe will persist in the upcoming years. The Fed has projected three more rate increases in 2018, followed by two to three more in 2019. It will be difficult to follow through with their projection if inflation does not start to edge higher.

We think tax reform will provide a modest stimulus over the next few years. For personal taxes, most tax bracket rates have been lowered, and the standard deduction was doubled. The net impact should be approximately $150 billion of annual positive impact to total household disposable income until the tax rates sunset in 2025. Economic theories diverge on the effect increased disposable income will have on spending. Most historical data point to a spending multiplier of 60%. Since much of the windfall from the tax cuts will go to higher earners (who have historically spent less as a percentage of their windfall), we project the spending multiplier will be closer to 40%. Given that current U.S. GDP is approximately $20 trillion, this would imply an increase in growth of 0.3% per year. We foresee little economic impact resulting from the change in the corporate tax rates.

Tax laws needed reform as economic tax incentives were misaligned with overall economic growth. Unfortunately, most of the weak incentives were left unchanged. If government spending is left unchecked, the tax reform bill will add $1.5 trillion to the deficit and lead to slower economic growth in the future. This type of fiscal spending is unnecessary at a time when the economy has been performing reasonably well.

In 2018, we look for GDP growth to hit 2.5%. This is higher than the 2.0% annual growth rate that the U.S. economy has experienced this recovery (mainly due to the tax changes). The labor market remains strong and the worldwide economic recovery should continue. There are signs that the U.S. is in the latter stages of an economic recovery, but we don't see a near-term risk of a recession.

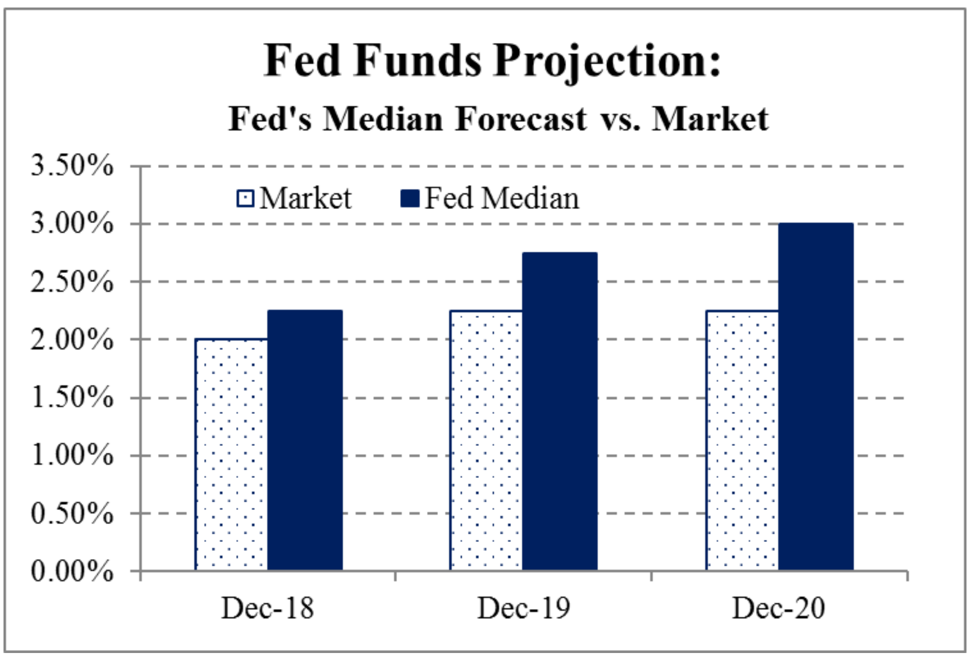
Corporate Federal Credit Union

Economic Update
December 2017

Fixed Income Outlook

The bond market continued to flatten again in December – this time by 10 basis points. For 2017, the 10-year Treasury rate declined by four basis points while the two-year Treasury rate increased by 70 basis points. The market continues to uphold that inflation will remain low and/or economic growth will slow down over the next few years.

We think the newly enacted fiscal stimulus will increase the likelihood of the Fed following through on their rate hike projection in 2018. The Fed turns decidedly hawkish in 2018 and we believe the inflation data will increase enough for them to stay in hiking mode throughout the year. Given the worldwide economic backdrop, we see increased risk of the longer-end of the Treasury curve moving significantly higher than current levels.

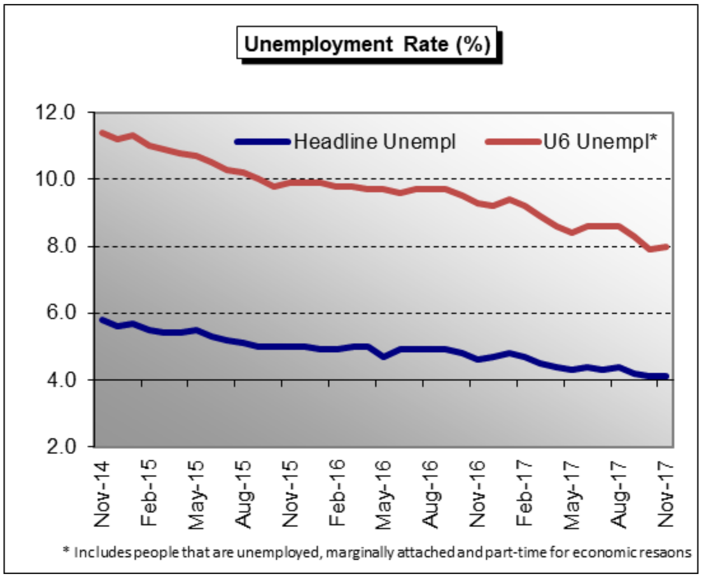


Economic Update

December 2017

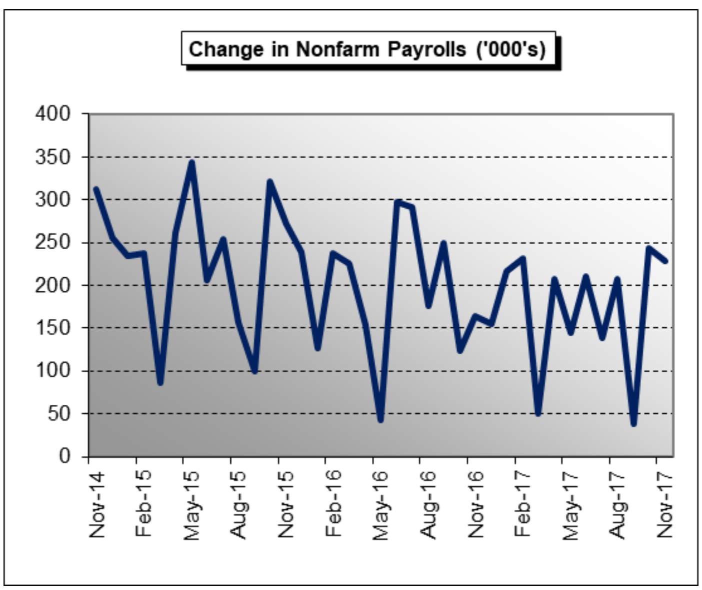
Labor Readings

(Data source: Bloomberg)



Unemployment Rate Holds Steady

The unemployment rate remained at 4.1% in November – a 17-year low. The underlying details of the report were mixed, but wage growth disappointed again. Average hourly earnings grew by 2.5% on a year-over-year basis versus an expected 2.7% gain.



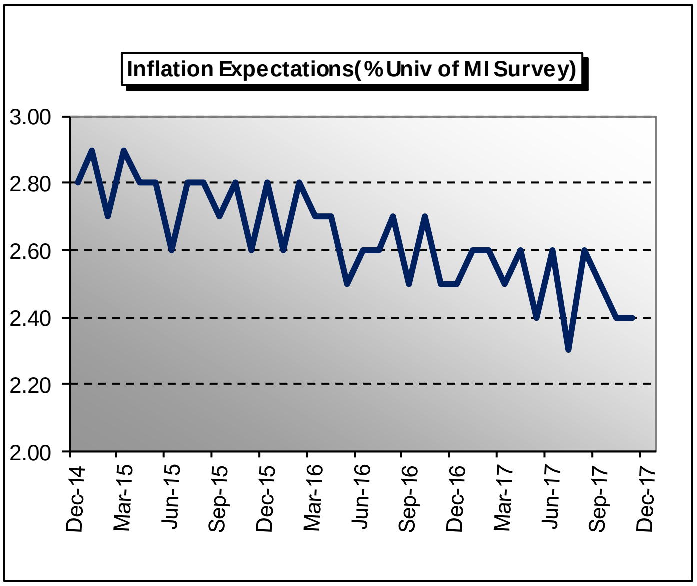
Payrolls Beat Expectations

Payrolls expanded by 228,000 jobs in November versus an expected gain of 195,000. This was the first relatively "clean" report in recent months following the impact of the hurricanes. Importantly, this report shows the economy continues to add jobs at a much faster pace than the increase in the working age population.

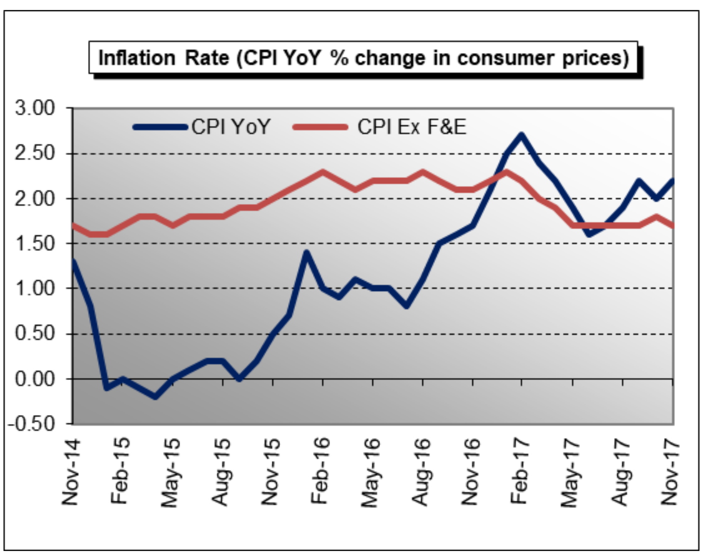
Corporate Federal Credit Union

Economic Update
December 2017

Inflation Readings
(Data source: Bloomberg)



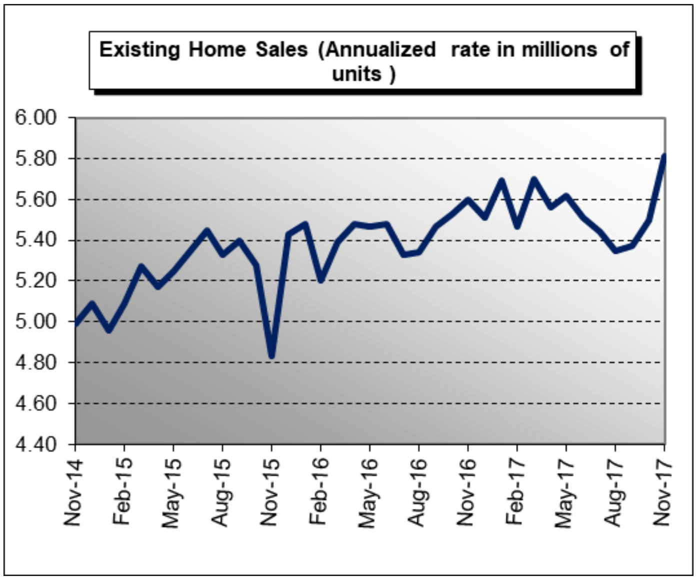
Inflation Expectations Remain Low
Consumers' inflation expectations remain near all-time lows. Low inflation expectations help explain why the longer end of the yield curve has barely changed despite three interest rate hikes in 2017. The yield curve (as measured by the spread between 10-year and two-year maturities) has flattened by 70 basis points this year.



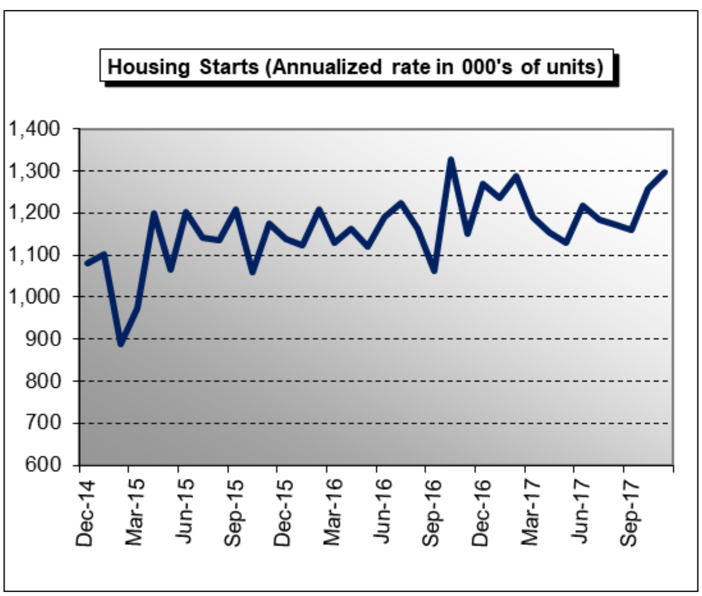
Inflation Data Continues to be Soft
"Core inflation" (minus food and energy prices) continues to come in lower than expectations. For November, core inflation rose 0.1% from the previous month and 1.7% from a year earlier. Both levels were 0.1% lower than expectations. Low inflation rates have been one of the biggest economic surprises in 2017 given the growth in the labor market and the economy.

Economic Update
December 2017

Housing Readings
(Data source: Bloomberg)



Existing Home Sales Soar
Sales of existing homes in November hit a 10-year high. Near-term demand for homes may get a boost from changes to the tax code, which go into effect in 2018. The change encourages higher-end buyers to act before the threshold for the mortgage tax deduction is reduced. Going forward, changes in the tax law should marginally reduce the demand for homes since the value of the tax shield of mortgage interest payments is reduced for many households.



Housing Starts Climb
New home construction hit its highest level in over a year and exceeded estimates. Construction in single family homes hit the highest level in 10 years. The numbers indicate residential construction will provide a boost to fourth quarter GDP after dragging the previous two quarters.