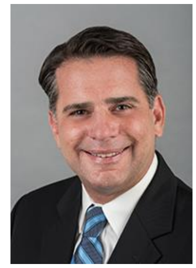
3/18/19

alloya
Corporate Federal Credit Union



Andrew Kohl
Chief Investment Officer

Economic Update
March 2019

By Andrew Kohl

Commentary

Central banks around the world have pivoted to easier policies to combat the weaker global outlook. This has helped to propel riskier assets higher, with almost all the major worldwide equity indices up by double digits thus far in 2019. Bond and equity market volatility is back near the lows from last year. The Fed takes center stage this week as they are due to release updated economic and rate projections at the conclusion of their meeting on March 20.

The Fed will almost assuredly back away from December's projection of two hikes in 2019 and another in 2020. It now seems likely that the median projection will show no hikes in 2019. The conversation has turned away from how to engineer a soft landing for the economy towards how to ensure that inflation expectations have not fallen too much.

Over the past 10 years, inflation (as measured by the Fed's preferred index, core personal consumption expenditures (PCE)) has been below their target ninety-five percent of the time. During that timeframe, the rate of inflation has averaged 1.5% versus a target of 2.0%. The worry is that lower inflation levels get embedded in the public's psyche and that the economy gets trapped in a low growth/low rate/low inflation cycle (i.e. Japan).

In order to combat this, it appears that the Fed is heading towards average inflation targeting rather than using point-in-time data only. The thought process here is that inflation should be allowed to run above the 2.0% target when the economy is performing well to combat the times during a slowdown when inflation runs below the target. The shift to average inflation targeting won't occur until 2020 or later (if it happens at all), but we believe that it is already impacting the mindset of how the Fed sets rates today.

It is unfortunate that the economy continues to rely on monetary policy instead of fiscal policy to help spur growth. The Fed's main policy tool (interest rates) is a blunt instrument that utilizes the wealth effect to help drive economic growth. Lower policy rates increase risky asset prices that create specific winners (mainly capital holders) and can create asset bubbles. Regrettably, given the polarized political environment, fiscal tools that could lead to broad-based economic gains (i.e. infrastructure spending) seem unlikely to be implemented.

Growth in the fourth quarter of 2018 was higher than expected. The calendar year growth rate for 2018 was 3.1%. This was the highest growth rate thus far during the recovery and the most since 2005. We look for growth to slow down in 2019 and come in closer to 2.0%.

Economic Update
March 2019

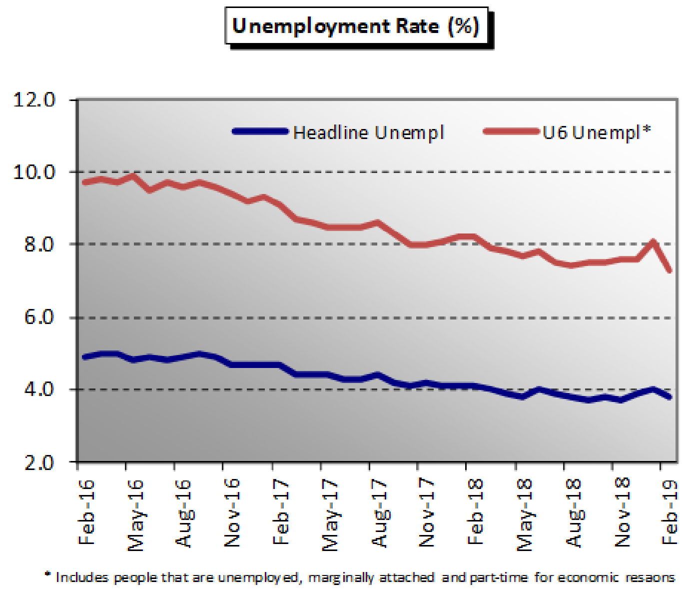
Fixed Income Outlook
Treasury yields are down slightly since the end of February, as the market is anticipating that the Fed is done with their hiking cycle. The market is pricing in a 30% chance of a rate cut in 2019 and a 70% chance that there will be a rate cut by the end of 2020. We still believe that it's closer to 50/50 that the next move is a rate hike or a cut.

We are still at the low end of the range that is considered the neutral fed funds rate and financial conditions have eased substantially since the end of the year. In any case, we believe that the bar is high to change rates in either direction.

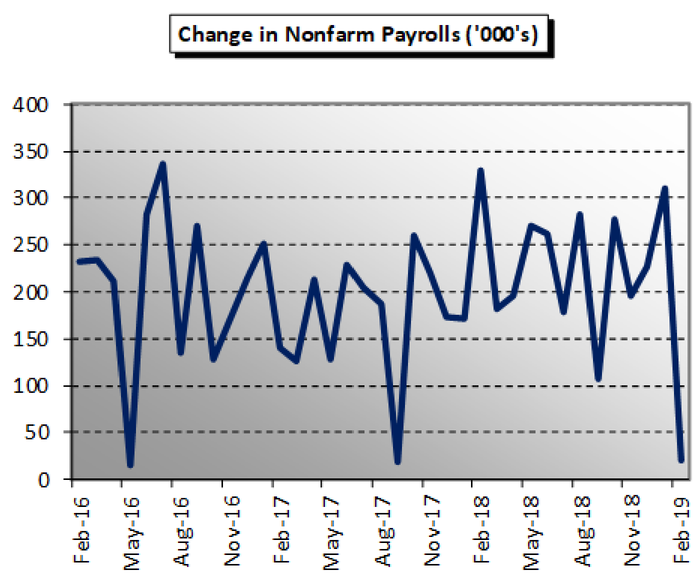
Corporate Federal Credit Union

Economic Update
March 2019

Labor Readings
(Data source: Bloomberg)



Unemployment Rate Declines to 3.8%
The unemployment rate dropped in February and stands at 3.8% (near a 50-year low). The underlying details of the report were relatively strong. Wage inflation came in at 3.4%, which is the highest pace since April 2009. The labor force participation rate held steady and the U6 unemployment rate (which includes those that are marginally attached to the labor force), fell by the largest amount on record (largely due to the end of the government shutdown).



Payrolls Much Weaker than Forecasted
Payroll growth for February came in substantially below expectations. Payrolls expanded by 20,000 jobs versus a forecasted gain of 180,000 jobs. Despite the large miss, the three-month average payroll gain, at 186,000, is still strong. The payroll report has a large margin of error, so a large miss for one month is not overly concerning. The March report will take on greater importance to see if labor market strength is waning or this report was an aberration.

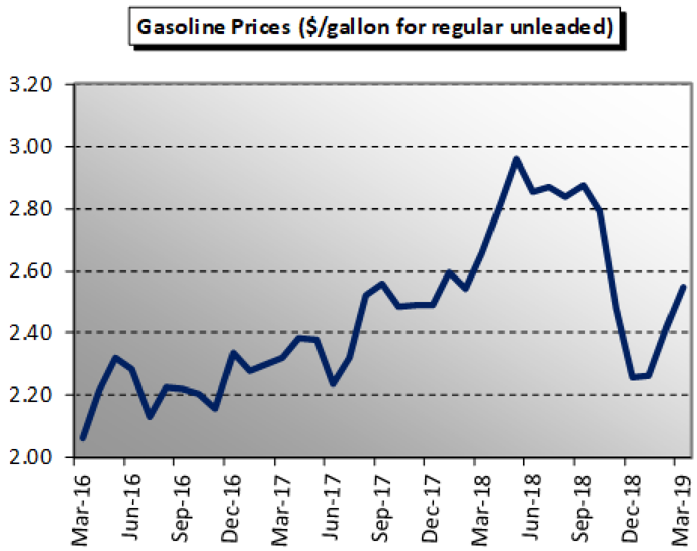
Corporate Federal Credit Union

Economic Update

March 2019

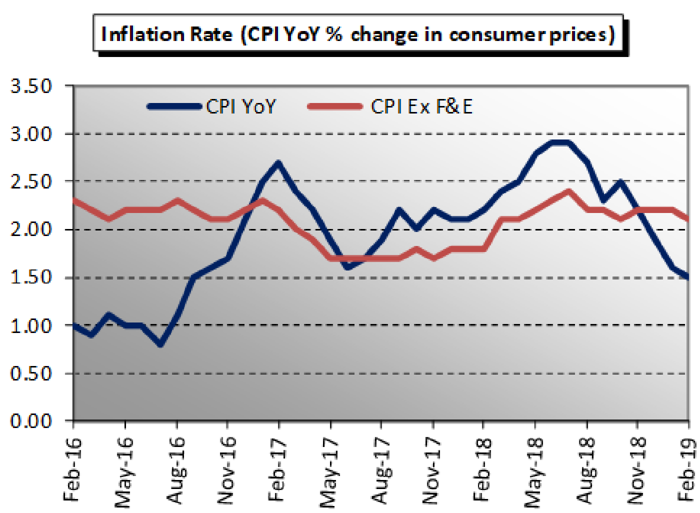
Inflation Readings

(Data source: Bloomberg)



Gasoline Prices Starting to Rise

Amidst a lower supply of global crude oil, gasoline prices in the U.S. have been rising. Prices have increased by 13% since the end of 2018. U.S. sanctions against Venezuela and Iran have lowered the supply of oil. In addition, recent data showed lower domestic supplies and production in the U.S. Higher gas prices should start to move the headline inflation rate higher in the coming months.



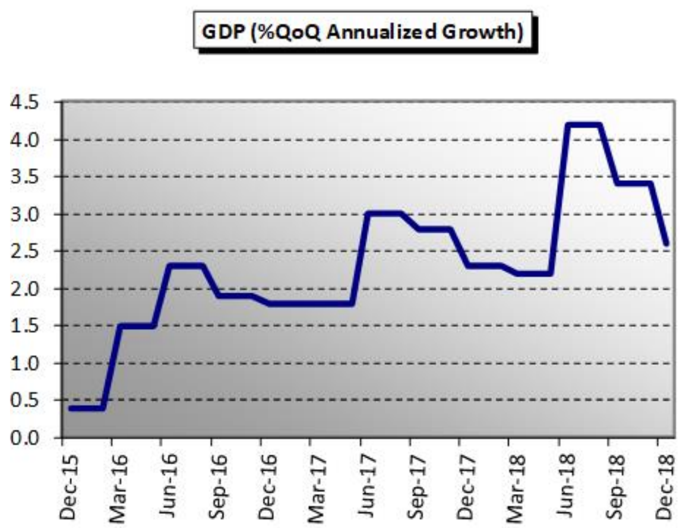
Inflation Data Weaker than Expected

Both the headline and the core (minus food and energy) inflation levels for February were below estimates. Falling auto and prescription drug prices contributed to the slowdown in overall inflation. The Fed has indicated that they are on hold until inflation levels are consistently above 2%.

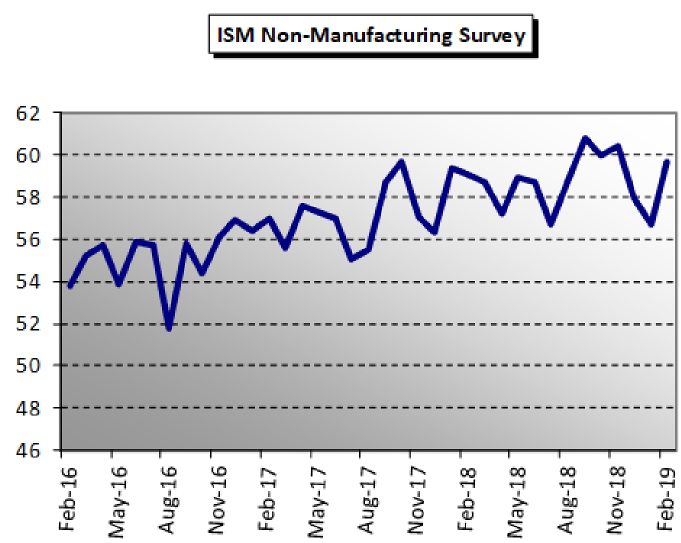
alloya®
Corporate Federal Credit Union

Economic Update
March 2019

Economic Growth Readings
(Data source: Bloomberg)



Fourth Quarter GDP Growth Higher than Expected
GDP growth in the fourth quarter was 2.6% versus an estimate of 2.2%. For the full year of 2018, the growth rate was 3.1%. GDP received a boost from the tax overhaul and increased federal spending. Going into 2019, GDP growth is poised to weaken as the impacts from the fiscal boost begin to fade.



Services Business Survey Improves
The Institute for Supply Management (ISM) service industry survey came in higher than expected and is back close to the cyclical peak. The new orders and business activity components of the index reached a 13-year high. After the dip in the index last month, the sharp uptick in February should help to assuage the fears that a recession is imminent.