Healthy economy ahead: Phil Chao

By Philip Chao *Thu, Jul 19, 2018*

With the long end of the Treasury yield curve suppressed by demand for safe assets, the Fed is limited in how high it can raise short-term rates, writes the retirement plan and fiduciary advisor.

Chao and Co., the Vienna, VA-based retirement plan and fiduciary consulting firm led by Philip Chao, has released its second quarter economic **commentary**. Highlights of the report included:

Strong US economy. The press release, press conference and the minutes to the FOMC June meeting along with Chairman Jay Powell's June 20th speech at the ECB Forum on Central Banking, at Sintra, Portugal, all confidently point to a strong U.S. economy.

Low unemployment. Unemployment is expected to remain low and to go lower. This is the brightest spot in the U.S. economy. Over 200,000 new jobs created month after month in the 9th year of an economic recovery is nothing less than spectacular. The June jobs report shows a small uptake in participation rate as well as the unemployment rate. These indicators suggest that there are workers not previously accounted for and now entering the job force or return to looking for a job. If this is true, then the natural employment rate (or NAIRU) has not yet been reached.

Moderate inflation. Core inflation is now at the 2% FOMC objective, and the FOMC wants to be sure that this is sustainable. As such, the FOMC continues to use "symmetry" to frame its policy reaction function. This means that the FOMC will tolerate a slightly above 2% core inflation rate for a period of time before reconsidering its monetary stance.

Interest rates. The long-end of the treasury yield curve is subject to market forces such as rate disparity among central banks, significant demand from pensions due to aging demographics, and the increasing demand for safe assets globally. This drag on the back-end of the yield curve limits the amount of rate hikes the FOMC can effect before the yield curve inverses, which could usher in the next economic slowdown or recession. Historically 2-3-4 is a simple rule of thumb for understanding the Fed. The Fed is looking to maintain a 2% core inflation rate, 3% neutral Fed Fund's rate and promote a 4% GDP. In the New Normal environment, the 2% inflation has been difficult to achieve and sustain. Moreover, the Fed Funds rate of 1% above the core inflation rate is even harder to reach with the fear of failing the 2% inflation rate, which would impact the 4% economy. We believe going forward in the long run, it is more a 2-2-2 world.

Tax cuts and tariffs. The January Tax Cuts and Jobs Act gave the already expanding economy a huge boost. This front-loaded, debt-driven gift is expected to push the 2nd and 3rd quarter to a 3.5-4% annualized GDP rate. Then growth is expected to taper through 2019 and beyond. This very positive economic scenario is now facing a self-imposed headwind of impending global trade war. At its most basic level, tariffs will push up inflation (cost-push), which is equivalent to a tax hike. Further, the jump in oil prices is also a drag.

The reversal of quantitative easing. Uncertainty is rising with interest rate in the front end continuing to rise with positive safe asset returns beginning to bleed into other assets; and at the same time, macro liquidity is shrinking (withdrawal of global QE). The cumulative impact from the reversal of the global central bank policies of the past nine years will not be symmetric or gradual.