Low unemployment is the bright spot in the economy: Chao

By Editorial Staff *Thu, Jul 20, 2017*

'After the failure to repeal and replace Obamacare, it is increasingly unlikely that any major legislation will pass... this year. We expect a difficult September as lawmakers debate the debt ceiling and the 2018 budget,' writes consultant and market watcher Philip Chao.

Even though the U.S. economy, inflation and sentiment all softened in the second quarter of 2017, the Federal Reserve remains committed to "normalizing" interest rates, marveled Philip Chao, principal and Chief Investment Officer of Chao & Co., a retirement plan and fiduciary consulting firm in Vienna, VA, in his 2Q2017 market **commentary**. "Consensus suggests that the Fed will likely raise rate once more this year (possibly in December) and soon (possibly in September) will normalize its balance sheet," he wrote.

"After four 25bps rate hikes [by the Federal Reserve] since 2015, we have witnessed a gradually more accommodative financial condition which is opposite to what was expected. Is the market saying we don't believe the Fed will keep raising rates and in fact it would lower rates if the economy continue to slow? Or is the market saying that with a lower neutral or terminal rate, the rate normalization is almost over and we are not worried?" Chao added.

"Since the Trump win last year, the market has reacted very positively in anticipation of constructive fiscal policies, tax reform and deregulation," he concluded. "After the failure to repeal and replace Obamacare, it is increasingly unlikely that any major legislation will pass during this fiscal or calendar year. We expect a difficult September as lawmakers debate the debt ceiling and the 2018 budget."

Highlights from Chao's commentary included:

- U.S. first quarter real GDP was revised upward to 1.1%. The second quarter is projected to be at or around 2.5%. This means the economy was growing at an annualized rate of 1.8% for the first half-year. Depending on how the second half performs, the economy is on track for around 2% growth this year. This assumes no significant policy changes in Washington, such as infrastructure spending and tax reform.
- Good news remains with the labor economy, with U3 unemployment down to 4.4% and U6 down to 8.6%. Even at the 62.8% participation rate, it is hard to argue that much labor slack remains. Although wage growth has not been obvious, the Employment Cost Index (wage and benefit cost) is now growing at 2.9% while the average weekly earnings is at 2.5%. Both are now above the inflation rate.
- The Federal Reserve has moved from a dovish bias to a normalization bias. The Federal Open Market Committee (FOMC) is expected to raise rates three times this year. The market expects the next hike

to be in December. The FOMC is positive about the U.S. and global economy, positive about the labor economy, confident that the core inflation will return to 2%, confident in a strong banking system, and more able to act under a supportive financial condition environment in the market. But the pace is expected to remain accommodative in supporting its dual mandates.

- The FOMC is expected to embark soon on its efforts to normalize the Fed's balance sheet by not reinvesting all the principal payments from agency debt and MBS and not rolling over maturing Treasury securities at auction. The June FOMC meeting provided an updated guidance and framework of how the FOMC will use an escalating cap system to shrink its balance sheet over time. This process will be gradual. Markets expect the normalization to begin this September.
- Although CPI and Core CPI have taken a surprising turn downward and away from the 2% inflation target, the FOMC expects the effect to be temporary. The FOMC's long-term outlook for inflation remains higher than the market expectation, as evidenced by the 5-year forward inflation expectation value, as well as by the 10-year forward inflation estimate (comparing the 10-year Treasury yield with 10-year TIPS). Historically, the market has proven correct about a lower interest rate with a lower inflation rate; the FOMC had to repeatedly align its projection with the market expectation.
- After almost a decade of unconventional and extraordinary monetary accommodation globally, investors and markets have grown complacent with and reliant on the central bank's safety net. The normalization phase is likely to be tricky, and sooner or later financial conditions will tighten and add stress to the system. This effect will be exaggerated if the European Central Bank and other central banks also begin to normalize. Regardless of the gradual pace of balance sheet and rate normalization, the markets are focused more on the destination than on the path.
- The world dodged a bullet in Europe after the Brexit Referendum. The outcomes of a string of Europe elections did not favor the breakup of the eurozone and the euro under a wave of populism. This has helped to reduce political risk and uncertainty in the eurozone and added support to a cyclical economic rebound.