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INVESTMENT MANAGEMENT

Economic Perspectives

ANOTHER SLOW START TO THE YEAR, BUT GROWTH SHOULD REBOUND MAY 2016

Paul Single
Managing Director
Paul.Single@cnr.com
(415) 576-2531

Steven Denike
Portfolio Strategy Analyst
Steven.Denike@cnr.com
(212) 702-3500

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Weak first quarter growth has been a common theme over this expansion. Yet, despite what looks to be another disappointing start to the year, we continue to believe there are a number of reasons to be optimistic about prospects for the U.S. economy. Other economic indicators have been much more upbeat than the official GDP measure recently and, in our analysis, a rebound in growth over coming quarters remains the most likely scenario.

For starters, out of the four monthly indicators used to date turning points in economic cycles, only industrial production is declining. The downward trend in industrial production started as far back as late 2014 when the slump in oil prices began to hit the mining sector and the stronger dollar began to hold back manufacturing. Otherwise, there is no sign of even a slowdown in the growth rate of employment and personal incomes, let alone any outright contraction in those measures. Real business sales have also continued to expand, broadly in line with the earlier trend.

Indeed, the weakness in first quarter GDP growth was in large part due to some now familiar headwinds – shrinking investment in mining structures and negative contributions from both net external demand and inventories. The good news is that over the past couple of months we have seen a marked rebound in the forward-looking survey evidence, consistent with a modest acceleration in GDP growth in the second quarter *(Figure 1)*.

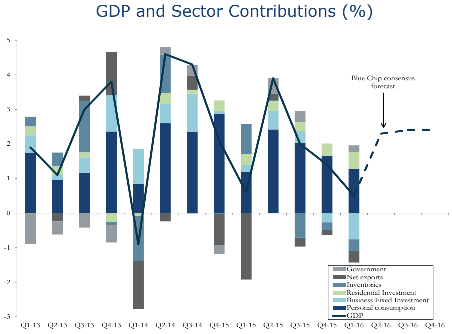
In fact, overall manufacturing activity has trended upward recently, albeit very gradually. Manufacturers, it seems, are finding ways to remain resilient amidst weaker demand and the pullback in the dollar from recent highs appears to be improving sentiment among externally exposed industries. At the same time, commodity prices appear to have levelled out, which should somewhat ease the drag from mining investment on GDP growth in the second half of this year.

The new complication, however, has been the slowdown in consumer spending growth, which represents the largest portion of overall GDP. The 1.9% rise in personal consumption over the first three months of the year was a significant disappointment relative to the average 3.0% pace over the previous nine months. Consumers obviously are not immune to nervous financial market headlines and appear to have recently turned cautious over the past quarter in the face of stock market turbulence. Terrorist attacks in Europe, as well as the progressively negative tone of the U.S. presidential election, have likely restrained confidence as well.

Still, caution is not the same thing as pessimism and we don't believe the slowdown in spending is the start of a more serious downturn. Employment growth remains strong and households continue to enjoy a boost in purchasing power from low energy costs. As a

Figure 1

GDP and Sector Contributions (%)



Source: Bureau of Economic Statistics
March 31, 2016

result, real incomes have been growing at a very healthy pace, easily outpacing spending, and leaving households with further room to draw on their savings going forward.

Household debt now looks relatively low and, factoring in very low interest rates, debt servicing costs remain close to record lows.

However, even if households do not eventually spend their savings from lower gas prices, there is little reason why real consumption growth should not rebound over the remainder of this year. Solid job gains will likely keep income growth close to 3.0% annualized. The continuing rebound in house prices and the associated increase in household wealth is also a positive for consumption, particularly as it helps to reduce the lingering problem of borrowers with negative equity. Finally, household balance sheets are no longer overburden with debt and, with interest rates still very low, consumer demand for credit is growing.

The uneven nature of growth this economic cycle has been frustrating and we have little doubt this year's first quarter slowdown will once again prompt claims that the expansion has slowed to "stall speed," making a recession inevitable. However, in the past five years we have already seen six separate quarters where GDP growth dipped below 1.0%. In two of those quarters, GDP even contracted. Yet, in each instance the broader recovery sailed on. This time is unlikely to be any different.

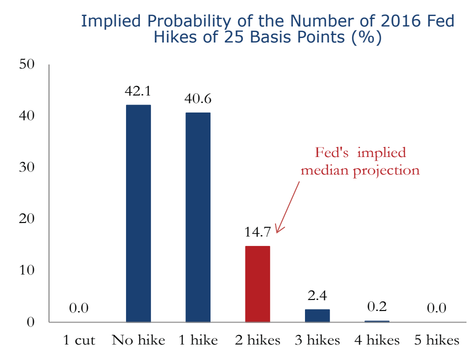
THE FED

As universally expected, the Fed did not change monetary policy during its late April meeting. It decided to maintain the federal funds rate in the range of 0.25% to 0.50%, which was put in place this past December. In March, the Fed had projected to increase the benchmark overnight rate a total of 50 basis points over the course of the year, but the financial markets are less optimistic (*Figure 2*).

Although inflation has been moving up, boosted by the rebound in commodity prices, the Fed seems skeptical about this sustainability.

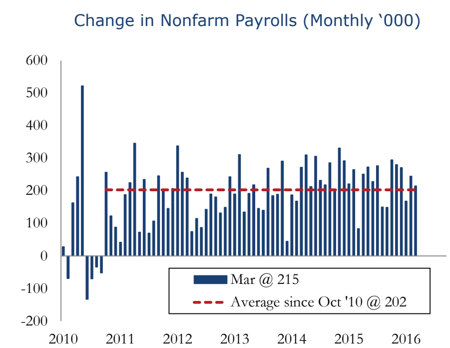
During its April meeting, the Fed updated its assessment of the economy. It downgraded its view of the domestic economy, noting that household spending had slowed down despite continued improvement in the labor market, rising real incomes, and consumer sentiment remaining high. Additionally, the Fed noted concern that investment by businesses remains soft and that net exports have yet to improve, despite the recent trade-off in the value of the dollar. Although inflation has been moving up, boosted by the rebound in commodity prices, the Fed seems skeptical about this sustainability as it is running below the 2.0% long-run target rate.

Figure 2



Source: Federal Reserve Bank, Chicago Board of Trade, Bloomberg
March 29, 2016

Figure 3



Source: Bureau of Labor Statistics
March 31, 2016

On the other hand, the Fed upgraded its view of global issues. At its March meeting it stated that global economic and financial developments pose a risk to the domestic economy. During its most recent meeting, it simply stated that it will monitor global economic and financial developments. This statement clearly reflects the changing environment. In early 2016, there was fear of a downturn in the Chinese economy (along with other emerging markets) and that has since abated.

LABOR

The unemployment rate increased from 4.9% to 5.0% as a result of a large boost in the size of the labor force.

Job growth continues to improve. In March, payrolls grew by 215,000 and there was hiring across many sectors. Payrolls have averaged over the strong threshold level of 200,000 for more than five years (*Figure 3*). The unemployment rate increased from 4.9% to 5.0% as a result of a large boost in the size of the labor force. The cost of labor also went up, which is consistent with a maturing labor market. The year-over-year change in the average hourly earnings bounced 0.3%, bringing it to 2.3%, albeit still down from a recent 2.6%.

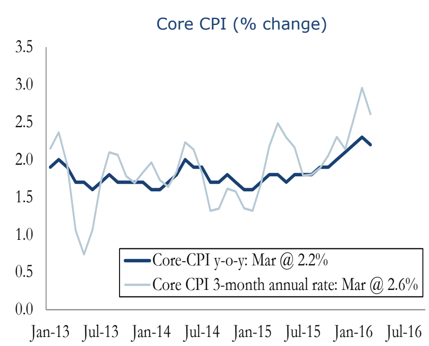
There appears to be an interesting shift in the labor market as it is following some of the macro economic trends. Over the past year, the strong dollar and weak oil prices have resulted in feeble job growth for the affected labor sectors. Manufacturing payrolls have fallen just 0.2%, and mining (where the oil exploration and extraction workers are found) has decreased 17.1%. Meanwhile, the entire workforce has increased 2.0% during the same period. The recent stabilization of petroleum prices and the 5% rally in the dollar since the beginning of the year may portend a reversal in those labor sectors.

INFLATION

The two major factors that have kept inflation low for the past several years have reversed over the past few months.

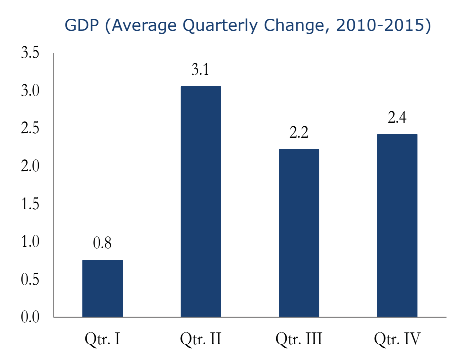
The Consumer Price Index (CPI) rose a modest 0.1% in March (*Figure 4*). It was held down due to a drop in clothing prices principally. Rents and medical costs took a breather. All together, this offset the increase in energy prices which rose (gasoline prices were up 2.2%). The yearly change in CPI now stands at 0.9%. Another measure, Core Personal Consumption Expenditure Price Index (the Fed's preferred inflation metric) has increased 1.6% over the past year. The Fed's target inflation rate is 2.0%.

Figure 4



Source: Bureau of Labor Statistics
March 31, 2016

Figure 5



Source: Bureau of Economic Analysis
December 31, 2015

Inflation has been slowly trending upward since this past autumn. The two major factors that have kept inflation low for the past several years – the stronger dollar and the collapse of commodity prices – have reversed over the past few months. This has been putting upward pressure on the goods portion of CPI. The goods portion, which makes up 39% of CPI, has been the driving force behind both the decrease in inflation and the recent reacceleration. The yearly change is now -2.1%, and it had been as low as -4.1% back in January of 2015. Meanwhile, the service portion of CPI (61%), which has been more stable, has moved up to 2.7% year-over-year. This metric had been as low as 2.0% year-over-year in March of 2015.

GDP

The first quarter report on GDP, the broadest measurement of the economy, came in at just 0.5%, registering the weakest growth rate since early 2014. This, combined with the previous quarter's tepid increase of just 1.4%, has brought down the yearly change to 1.9%, which is also the lowest level since early 2014. This is well below the post-recession average of 2.0% to 2.5%.

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Consumer spending, making up more than two-thirds of GDP, grew just 1.9%, well below the 2.25% annualized growth rate since the recession ended. This slowdown is a result of auto sales pulling back from their record growth rate in 2015 and a decrease in discretionary spending, which probably fell as a result of the hyped-up recession fears earlier in the year. Although the economy has lost some momentum, this does not appear to be an ongoing trend into the future.

Interestingly, the growth rate of first quarter GDP has consistently been below the other three quarters (*Figure 5*). Some of this is a result of horrific weather patterns (remember the polar vortex) and some of it may be due to poor seasonal adjustments used in the calculation.

Index Definitions

Blue Chip Economic Indicators is a monthly survey and associated publication by the Blue Chip Publications division of Aspen Publishers collecting macroeconomic forecasts related to the economy of the U.S. The survey polls America's top business economists, collecting their forecasts of U.S. economic growth, inflation, interest rates, and a host of other critical indicators of future business activity.

The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, including transportation, food, and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

The Core Personal Consumption Expenditures Price Index (Core PCE) measures the prices paid by consumers for goods and services without the volatility caused by movements in food and energy prices to reveal underlying inflation trends.