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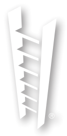

# Economic Perspectives

## IMPLICATIONS OF BREXIT MORE MODEST THAN EXPECTED

AUGUST 2016

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### IN THIS ISSUE

- Resilient consumer spending should continue to drive U.S. GDP growth
- Early Brexit signals provide some comfort
- Financial conditions have eased considerably in recent months

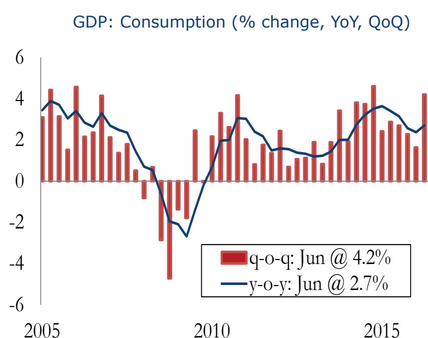
It has been only one month since the EU referendum, but the limited data released up to this point, as well as the reaction in financial markets, support our view that the negative implications of Brexit outside the UK should be modest. It is still early, but a combination of stable economic data, improving financial conditions, and better political sentiment in the EU appear to have reduced the contagion effects for now.

So far, Brexit's immediate fallout appears to be limited to the British economy. The UK looks to be heading for a recession, and may have already begun to contract, with advance PMIs (Purchasing Managers' Index) for both the manufacturing and services sectors slumping to contractionary territory in July. However, activity in the Eurozone has held up better than expected thus far, with business surveys suggesting only a slight deceleration in manufacturing.

Financial conditions have also eased considerably. Despite fears that the Brexit vote would prompt a bout of extreme global risk aversion, the hit to global investor sentiment has been relatively minimal. Measures of volatility, such as the VIX, spiked following the vote, but have since dropped back. Furthermore, the decline in equity prices has been fully reversed (with those in the U.S. having recorded fresh highs). Meanwhile, bond yields are close to record lows. Markets now anticipate at least one rate cut from the Bank of England, but elsewhere, expectations for interest rates over the coming years are little changed.

At this point, the main global risks of Brexit appear to be political, which are likely to play out over the coming years, rather than the next month or two. Still, all parties in Europe seem committed to working together in negotiating the UK's successful exit from the EU and removing uncertainty as quickly as possible so that the terms of trade (and the ways in which the UK will continue to operate in the global economy) become clear. Provided that financial markets continue to take developments in stride, we remain confident that the economic fallout for the rest of the world will be small.

Figure 1




Source: Bureau of Labor Statistics
June 30, 2016

Here at home, the U.S. economy continues to chug along, and there are good reasons for optimism in the second half of the year. Indeed, despite the disappointing 1.2% gain in second quarter GDP, real final sales rose at a much healthier 2.4% rate. That was twice the pace of the first quarter, and a sign that the underlying domestic demand remains strong enough to mitigate risks from overseas. The big story, however, was on the consumer side, where spending surged to 4.2% (the highest level since 2014) and nearly doubled the recovery average of 2.3% *(Figure 1)*.

The consumer is the heart of the U.S. economy, and while it's unlikely that the recent pace of spending can be sustained, there are few signs that households will be retrenching

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anytime soon. Rather, it appears that households may finally be dipping into some of their accumulated savings from a year's worth of low gasoline prices and rising wages. Fundamentals are strong, the labor market remains healthy, and sentiment indicators continue to show that Americans feel generally good about their economic prospects. Indeed, solid consumer spending should continue to drive growth this year, and as long as it does, the expansion should be on solid footing.

## THE FED

"Near-term risks to the economic outlook have diminished (Source: FOMC)."

This has been a wild two months for the Federal Open Market Committee (FOMC). They have shifted from a defensive stance to a somewhat optimistic view. Following the release of the weak May labor report, many believed that the economy was moving downward at a pretty fast clip. Then there was the Brexit vote, which caused a great deal of volatility in the financial markets over the uncertainty about the ramifications of that vote. Since then, the markets have calmed down (the domestic stock market has hit new highs), and the June labor report was robust.

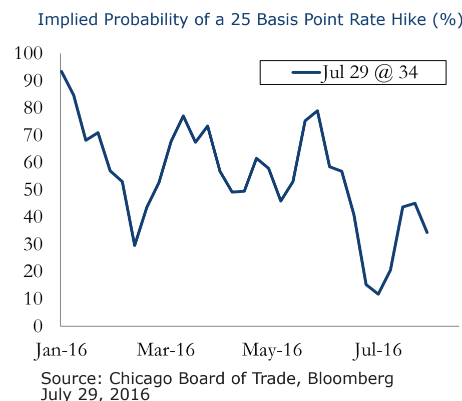
The FOMC met in late July and decided to keep short-term interest rates unchanged; however, they noted that "near-term risks to the economic outlook have diminished." This description of the economy is a significant change and more upbeat than previous statements. This has opened the door to an upcoming hike in the federal funds rate *(Figure 2)*. But they made no commitment to an increase. The Fed will have two more employment reports to observe before their next FOMC meeting on September 20 and 21.

## LABOR

Job hiring bounced back in June after stalling briefly in the spring.

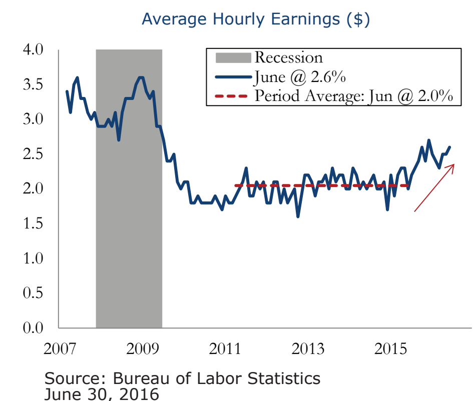
Job hiring bounced back in June after stalling briefly in the spring. Payrolls surged by 287,000, the largest increase since last October and a sharp reversal to the dismal May report of just 11,000 new jobs. This jump has helped to ease concerns about a long-term downward trend in payroll growth. Yes, payroll growth is slowing, but that is a natural occurrence at this stage of the business cycle. The expansion is seven years old, older than the average postwar expansion of five years. The important aspect of this data is that the downward trajectory is not nearly as steep as was feared just one month ago.

Figure 2




Source: Chicago Board of Trade, Bloomberg
July 29, 2016

Figure 3




Source: Bureau of Labor Statistics
June 30, 2016

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The pool of available workers is falling as the economy approaches full employment. This is helping to push wages upward, as businesses are finding it difficult to find qualified workers. The yearly change in average hourly earnings has increased 2.6%, matching the biggest increase since the end of the recession. This is a big change for the labor market, as wage gains have finally broken out of the range of 2.0 - 2.2% increase of the past several years *(Figure 3)*.

The unemployment rate (which comes from another survey) rose to 4.9% from 4.7% in the previous month. This increase was partly due to a rebound in the size of the workforce.

## INFLATION

After spending several years below the Fed's target level, it appears that inflation will make a run this year for the 2.0% target level. Although the annual increase is currently at 1.0%, the consumer price index has increased for four consecutive months and the annualized rate for the past three months stands at 2.5%. This most recent boost can be attributed to stronger wage growth, tighter resource utilization, and increases in energy prices (oil has doubled in price from the lows of the first quarter).

**The annualized rate for the past three months [of CPI] stands at 2.5%.**

The main cause of low inflation levels for the past several years had been the decrease in commodity/goods prices, which make up more than one-third of the Consumer Price Index (CPI). The yearly change of this component hit a nadir earlier in 2015 (-4.3%) and has been working its way upward; it currently stands at -1.9%. This upward price pressure is simply the result of mathematics: the large drop in commodity prices is rolling off the year-over-year calculation. As for services, which make up the remaining two-thirds of CPI, they are increasing at a 2.9% clip and have been above the 2.0% target rate for almost five years *(Figure 4)*. They have been on a recent upswing in the past year, due mainly to housing costs.

## GDP

Second-quarter growth of the U.S. economy came in at a disappointing 1.2%, below the expectations of 2.5% and below the recovery average of 2.1%. Growth has been below 1.5% over the past three quarters, a disappointing trend. The yearly change in GDP is 1.2%, the slowest pace in three years *(Figure 5)*.

Figure 4

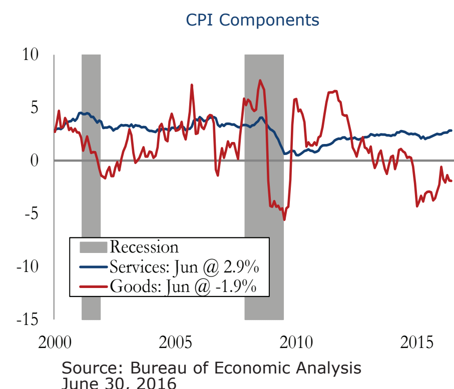
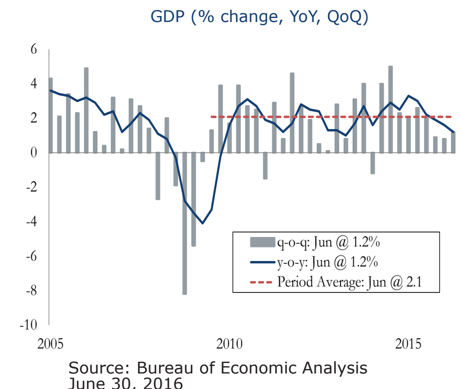



Figure 5

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**The primary cause of the slower rate of growth this past year has been a downshift in investment spending.**

The primary cause of the slower rate of growth this past year has been a downshift in investment spending, brought on by falling oil prices, which has curtailed CAPEX spending in the energy sector. Also, inventory accumulation has been a drag for five consecutive quarters. This past quarter, inventories fell $8.1 billion, the first decrease in almost five years. But household spending, which makes up two-thirds of GDP, surged as the resilient consumer went out on a buying spree, reversing three consecutive quarters of continually lower growth. Consumption rose 4.2%, well above the recovery average of 2.3%. There was a significant increase in purchases across the board: durable goods, non-durable goods, and services. As for the remaining components of GDP, net exports gave a small boost to GDP, but that was mostly offset by a drag on government spending, which fell, mostly at the state and local levels.

## Index Definitions

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 VIX (CBOE volatility index) is the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options.

The Purchasing Managers' Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

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