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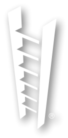

Economic Perspectives

GROWTH PROSPECTS REMAIN SOLID

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IN THIS ISSUE

- The Fed aims to reduce its balance sheet but has provided few details.
- The unemployment rate fell to 4.5%—the lowest level in almost ten years.
- The dip in price pressures should not alter the Fed's view of inflation staying around its target level.
- Consumer spending should rebound in the second quarter and throughout the rest of the year.

Figure 1

With the synchronized upturn in growth that began in late 2016 continuing in the early months of this year, the global economy seems to have left its recent travails behind (see *Figure 1*). World trade, after years of stagnation, is again increasing steadily; manufacturing in many large economies stands at multi-year highs, and higher energy prices are helping major commodity exporters return to growth while easing deflationary fears. In fact, the IMF now forecasts global GDP will rise to 3.5% this year and 3.6% next year. This would be the first time growth has been at or above the 20-year average since 2011.

Of course, uncertainty and structural challenges remain. It is still not clear what approach the new Trump administration will take on a range of important tax and trade issues, U.K. officials will have to effectively manage the Brexit process and a series of European general elections looms where some high polling populist parties advocate major changes in economic policy. But the positive trends underlying the cyclical upturn in global growth do appear entrenched and self-sustaining.

Interestingly, the one source of disappointment among the recent wave of positive global developments has been here at home. With Q1 GDP coming in at a mere 0.7%, it does not look like 2017 will be the year that U.S. growth breaks out of the 2%-2.5% range that it has averaged since the recession ended nearly eight years ago. Still, we are not overly concerned. Weakness in first quarter GDP has not been uncommon in recent years, with average growth well below that of other quarters, and the slow start to 2017 appears for the most part due to some familiar forces such as unusual weather patterns rather than any problem with the economy's generally positive underlying fundamentals.

Still, one of the biggest dilemmas that economists are grappling with is the stark division between strong survey-based measures (soft data) of economic growth and more modest statistics on actual economic activity (hard data). Will the hard and soft data reconcile? And in what direction? Evidence suggests that the strength in the surveys is being driven largely by expectations that lower taxes, increased infrastructure spending, and a rollback in regulation will help spur the U.S. economy to better growth. However, that enthusiasm hasn't yet translated into better economic activity, particularly more shopping, which drives the U.S. economy.

A closer look at the survey data reveals that one reason hard data is not tracking the upturn in headline consumer optimism is the huge splits in the composition of respondents along age and income groups. For households aged 55 and older, consumer confidence has surged 25 points since the election. But for 35-55-year-olds the increase has been a much smaller 9.2 points, and for those younger than 35, confidence has actually dropped 7.8 points. In other words, the strong gain in sentiment among the older cohort has been

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offset by the deterioration in sentiment among the younger generation. The problem is the bulk of consumer spending (about 70%) is done by households 55 years old and younger.

The deep divide in opinion is even stronger along party lines. Overall, the University of Michigan Consumer Sentiment Index has jumped from 87 before the election to 98 today. But that headline figure masks a wild division. While Republicans expect a "new era of robust economic growth" and have seen their confidence index level reach a sky-high 122, confidence among Democrats stands at mere 55 with many believing "a deep recession" is on the way.

With Americans now divided more than ever before, President Trump is quickly learning an age-old political lesson: Governing is a lot harder than running for office. Last month's failure to pass healthcare reform is clear indication that, even with a Republican-controlled Congress, implementing the new administration's ambitious legislative agenda won't be as easy as many hoped and the president will likely need all of his fabled deal-making skills in the months ahead to keep the big promises he made on the campaign trail.

In our view, a fiscal stimulus is increasingly looking more like a 2018 story and could ultimately prove to be watered down relative to expectations. Expectations are volatile and, at some point, action on fiscal policy changes will be needed if the pickup in sentiment since the election is to be sustained and, more importantly, translate into stronger economic activity. The good news is, even without the planned fiscal stimulus, the U.S. economy remains on solid footing, and we suspect it won't be long before it bounces back and joins the global revival underway.

The Fed did not provide many details regarding how quickly and by how much it will reduce its balance sheet.

THE FED

At its March meeting, the Fed increased the federal funds rate by 25 basis points and confirmed its plans for two more rate hikes this year. The meeting minutes released in early April provided insight into the Fed's plan to reduce the size of its balance sheet—what is being called "balance sheet normalization." The balance sheet had swelled 5.5 times to $4.5 trillion because of all the securities it purchased during their various stages of quantitative easing (see *Figure 2*). QE was an effective form of stimulus for the economy, as it helped bring down short and intermediate interest rates. But since the

Figure 2

Figure 3

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economy is presently on solid footing, the Fed needs to reduce all forms of stimulus, and not just by raising the federal funds rate.

The Fed did not provide many details regarding how quickly and by how much it will reduce its balance sheet. A number of policymakers stated that the speed and magnitude of the reduction should be tied to economic and financial conditions. The general belief by Fed watchers is that the process will begin later this year.

In March, the unemployment rate fell to 4.5%—the lowest level in almost ten years

EMPLOYMENT

The March labor report was a bit conflicted. While the unemployment rate fell to 4.5%, the lowest level in almost ten years, nonfarm payrolls rose just 98,000, well below the 218,000 average from the two previous months (see *Figure 3*). The weather has affected the payroll reports over the past few months. Mild temperatures throughout the country probably pulled forward some hiring in January and February, as evidenced by a jump in construction jobs. Then, the Nor'easter snow storm in March probably reversed the trend. The unemployment rate is calculated from a different survey than nonfarm payrolls. History shows us that it is not uncommon for extreme weather to cause a large variance between the two surveys. Next month we should get a "cleaner" view on the labor market.

Beyond the technical issues of the past few months, the labor market continues to be relatively strong. That said, the trend of job growth has been slowing. Looking at the six-month rolling average, it has been falling for just over two years, reflecting the difficulty that employers are having in finding qualified workers (see *Figure 3*).

The dip in price pressures should not alter the Fed's view of inflation staying around its target level.

INFLATION

Price pressures, which had recently surpassed the Fed's target level of 2.0% after spending most of the previous five years below that, took a hit in March. The consumer price index fell 0.3%, and, more surprisingly, core CPI (which excludes food and energy prices) fell 0.1%, the first decline in more than seven years. That said, the yearly change in CPI stands at 2.4%, while core CPI is at 2.0% (see *Figure 4*).

Many issues contributed to the decrease in March. A 7.0% decrease in the cost of wireless telephone services was enough to take 0.1% from the inflation release. Gasoline prices, which normally increase in March, actually fell. Shelter costs fell and used car prices also

Figure 4

Figure 5

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fell. In the past year, used cars have fallen 4.7%, reflecting the large supply of vehicles from expiring leases entering the market.

This dip should not alter the Fed's view of inflation staying around its target level. We continue to believe the Fed will increase the rate one or two more times this year, with the next one possibly coming as early as its June meeting.

Consumer spending should rebound in the second quarter and throughout the rest of the year.

CONSUMER SENTIMENT

Survey data continues on a steep upward trajectory due to households' continued optimism about the future. The University of Michigan Consumer Sentiment Index has been hovering at levels not seen since 2004 despite setbacks to the administration's plans in Washington.

This and a few other factors support the belief that consumer spending should rebound in the second quarter and throughout the rest of the year. Consumption was held down during the first quarter for several technical reasons, including warm weather reducing spending on utilities, slower tax refunds than last year, and the timing of Easter. In addition, the average consumer is in the best financial shape in decades. Households have the lowest debt-to-disposable income ratio in 15 years, and overall, the debt service burden has been hovering near record lows (see *Figure 5*). Additionally, household wealth is 35% higher than it was at the peak of the previous expansion. All of this should work together as an incentive for households to increase spending.

Index Definitions

The University of Michigan Consumer Sentiment Index is a consumer confidence index published monthly by the University of Michigan. The index is normalized to have a value of 100 in December 1964. Each month at least 500 telephone interviews are conducted of a continental United States sample (Alaska and Hawaii are excluded).

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.

Indices are unmanaged, and one cannot invest directly in an index. Index returns do not reflect a deduction for fees or expenses.

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