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- *The first quarter GDP report was weak in all the expected places, and there were no special circumstances to help explain it. The amount of second quarter rebound is very uncertain.*
- *The Fed cannot provide guidance on when they will increase rates, because they do not know. They are looking for an opportunity, but a number of factors must come into alignment to support higher rates.*
- *The relatively small amount of new data to be reported before the next FOMC meeting means low odds of a June rate increase. The July decision will depend on incoming data and other considerations.*

There was a very simple reason the post FOMC meeting statement provided no hints when the next rate increase will occur – the Fed does not know. Policymakers would like to see more distance between zero and the funds rate, but finding the opportunity to increase rates depends most importantly on the economic data. After that, it depends on financial market conditions, global economic conditions, and what other central banks do (or do not do) with their policies. It is a complicated balancing act, making it almost impossible to forecast when the necessary factors will come into proper alignment for the next rate increase. When it happens, the Fed will seize the opportunity, but there may be very little time to prepare markets. It is useful to listen to policymakers like Boston Fed Pres. Rosengren who warn that markets are underestimating the odds of a rate hike.

At present, there is nothing in the data to support another rate hike. The initial estimate of 1Q GDP was weak in all the expected places. Unlike the past few years when events such as port shutdowns, unusually harsh weather, a Japanese earthquake, and a debt ceiling debacle contributed to especially weak first quarters, special factors were largely missing in 2016. This leaves more than the usual amount of uncertainty about how much growth will rebound in 2Q. Perhaps higher oil prices will put an end to the decline in energy related investment (although it has fallen to only 0.3% of GDP, so the downside is now very small) or perhaps a 6% decline in the trade weighted value of the dollar will stop the decline in exports. These possibilities look like a long shot for 2Q. These changes will be helpful, but this help will probably take some time to arrive. Currently, the Fed's nowcasts show a weak rebound in 2Q growth – 1.8% for Atlanta and 0.8% for New York. Of course, these nowcasts are based on little hard data and are subject to large revisions at this point in the quarter.

The trajectory going into 2Q is not encouraging. Weakness in the capital goods sector has not yet run its course – core capital goods orders were flat in March, and orders fell at a 4.9% rate in the first quarter. The Dallas Fed reports energy cutbacks continued to weigh on the region's economy in April. Of the seven regional factory reports, four expanded and three contracted in April. Real disposable income showed a good increase



in the first quarter, but consumption was weak and did not increase in March. Both consumer sentiment surveys fell in April. The employment cost index rose 0.6% in the first quarter and was up a steady 1.9% over the past year. Compensation is inching up very slowly; indicating labor markets have not yet reached the point where wage increases add to price pressures.

Despite these lackluster reports, there are places where the data look better. Industry sources suggest auto sales rebounded to about a 17.6 million unit pace in April. Recent weakness in restaurant sales has been puzzling and could easily reverse. Early signs for April employment growth are also favorable. New claims for unemployment insurance (especially during the survey reference weeks) were very low, there was an extra week between reference periods which provides a small plus, and the Conference Board's consumer survey was favorable for job growth. In addition, tax withholding data point to about a 4 ½ % rise in wage and salaries in April – about the 1Q average rate.

Inflation reports have been mixed. The 1Q core PCE index rose 1.6% year-over-year and at a 2.1% rate over the three month period. The employment cost index shows very little pressure from labor costs. Consumer inflation expectations remain very low and prices received measures in the PMI surveys are near cycle lows. Certainly, higher oil prices and stronger imported goods prices will begin to show soon and (as we indicated last week) we expect shelter rates to ease later in the year, but there is little in the overall inflation picture to create pressure for the Fed to take action.

For a data dependent central bank, there is not a great deal of new data reported before the next policy committee meeting. The Gross Domestic Income report for 1Q may be helpful in determining how much of the weakness was due to residual seasonality, but less than half of the 2Q source data needed to determine whether the economy is rebounding from a weak initial quarter will be available. Price data for only one of the three months will have been reported. It is unlikely there will be enough evidence for policymakers to conclude conditions have improved enough to justify a rate increase. In addition, the Brexit vote will be looming. If this decision still looks as uncertain as it appears today, markets will undoubtedly be unsettled as investors take more defensive positions. The odds of a June rate increase are quite low.

When the FOMC meets in July things will look different. They will know a great deal about 2Q developments and if Britain remains in the European Union, a major source of uncertainty will have been removed. This makes the odds of a rate increase much higher in July, but the decision still depends on the data and a host of other factors coming into alignment. Investors should just remember the Fed is looking for an opportunity to raise rates and may not be able to provide a great deal of advance notice.

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