1Q16 Economic Summary

From hawks to doves - what a difference a quarter makes. After embarking on the path to rate normalization in December, financial market volatility and slowing global growth made for a more cautious Fed during the first quarter of 2016.

After solid growth in 2015, the US economy appears to have hit a bit of a soft patch. Labor market conditions remained strong, but consumer spending came in weaker than expected during the first quarter. Equity market volatility combined with a contentious presidential race and terrorist attacks abroad weighed on sentiment and made consumers less willing to part with their hard earned cash. Business investment also slowed during the quarter as corporate profit growth waned. It was not all gloom and doom for the US though. Manufacturing, which had been in contraction for seven months, expanded slightly in March, signaling that the worst may be over for the sector. Housing also continued its gradual recovery during the quarter. While low inventory levels limited existing home sales, the lack of supply resulted in an increase in housing starts and a pickup in new home sales. First quarter growth slowdowns are not uncommon for the US, but the Fed will need to see a convincing rebound in consumer activity during the second quarter to support further rate increases.

The US was not alone in its suffering of lackluster first quarter growth. Despite efforts by central banks across the globe to ease monetary policy and stimulate growth, economic momentum remained elusive. The Bank of Japan surprised investors by adopting a negative interest rate policy in January. The move, which was designed to spur investment and keep the yen low, has backfired thus far. Bank lending has not increased and the value of the yen has surged against the dollar, hurting exports. Europe is not faring much better. After unleashing a series of interest rate cuts, additional monthly bond purchases, and cheap loans to banks, economic growth remains sluggish and inflation remains stubbornly below target. China's GDP expanded at a pace of 6.7% during the first quarter, which was in line with expectations but was the slowest quarterly growth in seven years as manufacturing remained a drag on the country's transitioning economy. Recognizing the ongoing challenges facing the world's largest economies, the IMF cut its 2016 global growth outlook again in March.

As expected, given the fragile global backdrop and tepid US data, the Fed left rates unchanged at the March FOMC meeting. What was somewhat unexpected was the increased dovish tone of the meeting. While recognizing continued improvement in the US labor market, the Fed cited concerns about the potential toll weaker global growth and financial market turmoil could have on the domestic economy. Given these concerns, the Committee came more in line with market expectations and lowered the median forecast for rate hikes to just two interest rate increases this year, down from the four that were projected in December. While the minutes to the meeting revealed that there was some debate about an April move, several members argued for a cautious approach to raising rates and thought that an April increase would "signal a sense of urgency they did not think appropriate." Federal Reserve Chair Janet Yellen drove home this dovish tone in a March 29th speech to the Economic Club of New York where she said that the FOMC should "proceed cautiously in adjusting policy" given the heightened risks in the global economy. This effectively took an April rate hike off the table and caused markets to further discount the probability of a June increase.

As the Fed's gradual pace to rate normalization becomes more gradual by the day, more investors are asking "if" not "when" the Fed will raise rates in 2016. With 1Q16 US GDP growth expected to be sub 1% and inflation well-contained, the case for additional rate hikes is becoming more difficult to make, particularly when the rest of the world's central banks are easing monetary policy. A strong bounce back in US economic data and sustained gains in inflation are needed to spur the Fed into action. However, the Committee's increased sensitivity to global growth and financial conditions ensures that even with improvements in domestic data, the Fed will remain cautious in removing policy accommodation.