2Q16 Economic Summary

If you could narrow down the general sentiment of 2Q16 to just one word, it would be uncertainty. Uncertainty over the Fed's next move – are they hawkish or dovish? Uncertainty over the US labor market – was the May payroll report an anomaly? Uncertainty over global growth – will weak growth abroad spill over to the US? Uncertainty over Brexit – what does the UK's vote to leave mean for the future of the European Union? Among all this uncertainty, one certainty rang true – uncertain markets are volatile markets, and both stock and bond investors had quite a wild ride during the quarter.

After a slow start to the year, the US economy picked up steam in the second quarter as consumers started to spend again. Retail sales accelerated as higher disposable incomes fueled consumers' appetites for goods and services. Increased home sales also contributed to growth during the quarter as steadily rising wages and low mortgage rates drew more first-time homebuyers to the market. While consumers were doing their part to buoy growth, business investment remained sluggish on the back of weaker corporate earnings. Hiring also slowed during the quarter. Payroll growth was particularly anemic in May, with only 11,000 jobs added during the month. This pullback raised concerns about a material weakening in labor market conditions. However, job gains rebounded strongly in June, assuaging fears of broader business retrenchment. Overall, job growth averaged a solid 147,000 during the quarter and the unemployment rate fell to 4.9%. While the pace of hiring slowed from previous quarters, some deceleration is to be expected as the economy approaches full employment.

While the US economy held its own during the quarter, global growth remained sluggish. Despite ongoing monetary and fiscal stimulus, Japan continued to battle weak export growth and downward price pressures as a result of the strengthening yen. Record low interest rates and large fiscal stimulus didn't do much for China either. Weak demand for exports and low commodity prices continued to hurt manufacturing, leaving the country to increasingly rely on state-owned enterprises and government spending to meet its growth targets. But the main global growth story during the quarter focused on our friends across the pond. The Brexit/Bremain debate dominated the airwaves in June, and markets seesawed as early polls indicated that the vote could go either way. However, the week of the vote, market sentiment was leaning decidedly toward a remain outcome, so when the votes were cast and the UK opted to leave, the surprise decision caused stock markets around the world to plummet and US interest rates to fall as investors sought the safety and soundness of US Treasuries.

The June FOMC meeting took place one week prior to the UK referendum, and the Fed cited the uncertainty surrounding the upcoming vote as one reason they left rates unchanged. Given the market volatility that ensued after the UK's decision, it appears that they were wise to remain on hold. Leading up to the June meeting, market expectations for the path of monetary policy fluctuated. Probabilities of a summer hike increased after the minutes to the April FOMC meeting proved to be more hawkish than anticipated. Pre-meeting rhetoric from a bevy of Fed officials also indicated that the door was open for a June or July move. However, the weak May employment report gave the Fed pause and brought market expectations of a summer hike back near zero. Then the Brexit vote sealed the deal. Post vote, markets were pricing in very little chance of a hike at all in 2016. For its part, the Fed did not change its 2016 rate forecast at the June meeting, but committee members did lower their forecasts for 2017 and 2018 to reflect the "new normal" low-growth, low-rate environment. So the dot plot still shows two rate increases by year-end, but members generally agreed that before taking another stab at raising rates, "it was prudent to wait for additional data regarding labor market conditions as well as information that would allow them to assess the consequences of the UK vote."

So data dependent we remain. If Brexit proves to have limited impact on the US and if employment and growth remain solid, the Fed could resume its campaign to reduce accommodation in the second half of the year. If so, we think the path to normalization will continue to be a very gradual one. Given the continued easing of monetary policy by most central banks and the persistence of negative interest rates in several countries, the Fed's ability to raise rates is limited. Thus it looks like the "lower for longer" mantra for monetary policy will remain in vogue.