

3Q16 Economic Summary

We had quite a volatile start to the third quarter as the UK's surprise decision to leave the European Union sent stock markets reeling and Treasury yields lower. However, after the dust settled, the fallout from Brexit was less detrimental than expected and markets calmed, resulting in a relatively uneventful rest of the quarter.

Global growth remained subdued during the third quarter, particularly in the world's advanced economies. Japan's economy continued to sputter as stimulus efforts have done little to boost domestic demand. Growth in Europe was also lackluster as the EU and UK continued to deal with the aftermath of Brexit. While the initial drag on economic growth was less than expected, uncertainty surrounding future trade and immigration negotiations is expected to weigh on business investment and consumer sentiment going forward. For the third quarter in a row, China's GDP grew at an annual rate of 6.7%, fueled by stronger government expenditures and an uptick in consumer spending. While growth in China appears to be stabilizing, the country's reliance on government spending and an overheated housing market remains a concern.

Growth in the US continued to plod along with the rest of the world. After lower-than-expected second quarter GDP growth of 1.4%, the US economy appeared poised for a strong rebound in the third quarter. However, a series of mixed economic data caused economists to lower their growth forecasts yet again. The US added an average of 192,000 jobs per month during the third quarter. While monthly payroll gains slowed in August and September, increased labor force participation and rising wages signaled continued strength in the job market. Buoyed by healthy labor market conditions, consumers continued to spend their hard-earned cash, albeit at a slower pace than last quarter. Housing also remained resilient but a shortage of inventory restrained the sector's contribution to growth. Business investment continued to be sluggish but showed some signs of life as weakness in the energy sector bottomed and durable goods orders firmed. Overall, economists are forecasting that US GDP expanded at a 2.5% annualized rate in the third quarter. While not the 3+% rate originally predicted, it is a welcome improvement over the tepid growth experienced during the first half of the year.

With third quarter US data coming in softer than expected, markets were pricing in little chance of a September rate hike. Despite some hawkish pre-meeting rhetoric, the September meeting went as expected, and the Fed left rates unchanged. While participants agreed that the case for increasing the federal funds rate had "strengthened in recent months," they decided to wait for "further evidence of continued progress" in their objectives for the labor market and inflation before raising rates. The Fed hawks did not go quietly, however, as three of the FOMC's voting members dissented, preferring to raise the fed funds rate by 25 basis points. They cautioned that in postponing policy firming, the Fed could get behind the curve and have to raise rates more aggressively than planned, which could shorten the duration of the economic expansion. The Committee agreed that the decision not to raise was a close call, and the September dot-plot forecast showed that most members expected a rate hike by the end of the year. It is unlikely that the Fed will raise rates at the November FOMC meeting, which is just six days before the contentious US presidential election, so the December meeting appears to be the only one left in play for this year.

Markets are currently pricing in a greater than 65% chance of a 25 basis point rate hike in December, but expectations will fluctuate with the strength or weakness of incoming economic data. If labor markets remain strong and we see some firming in inflation, the Fed will likely take another stab at raising rates. However, given the modest pace of US GDP growth, the Fed will remain slow and cautious in removing accommodation. They by no means want to slow the pace of economic expansion, so lower for longer we remain.