2Q17 Economic Summary

The second quarter of 2017 was marked by rising geopolitical tensions, a contentious French election, and political drama in Washington. Against this volatile backdrop, equity markets continued to hit new highs while bond markets were a bit mixed. Short-end rates rose during the quarter in reaction to monetary policy action, but long-term rates declined as inflation expectations fell, resulting in a slight flattening of the yield curve.

Things did not get any easier for the Trump administration during the second quarter. With political shenanigans and growing tensions between the US and North Korea taking full focus, zero progress was made on healthcare or tax reform. As Congressional gridlock worsened, expectations for any meaningful policy action in 2017 eroded.

Despite the diminished likelihood of a boost in growth from fiscal stimulus, the US economy held its own in the second quarter. Labor market conditions remained strong with the US adding an average of 194,000 jobs a month during the quarter. After hitting a 16 year low in May, the unemployment rate ticked up slightly to 4.4% in June as improved job prospects drew more Americans off the sidelines and into the workforce. Wages continued to increase steadily but not at the pace expected with the economy running close to full employment. Nonetheless, the healthy job market translated into higher consumer confidence and a pickup in spending. Business investment also expanded at a solid pace during the quarter as corporate earnings rose. Housing demand remained strong, but inventory shortages and rising property prices continued to limit the sector's upward momentum. Overall, it appears that second quarter growth did indeed pickup from the lackluster first quarter start.

The US was not the only place where growth was making a comeback. Most foreign economies reported improved economic data during the quarter. China's economy remained on solid footing as the manufacturing sector continued to recover and government policy remained accommodative. A pickup in manufacturing also helped Japan's economic outlook as domestic demand firmed and exports strengthened. The Eurozone continued to show signs of recovery as well. After centrist candidate Emmanuel Macron won the French presidential election, political uncertainty subsided and confidence in the future of the European Union increased. Expansion in both manufacturing and services was broad-based during the quarter, with job growth and consumer demand picking up across most regions. In contrast, Britain, which elected to withdraw from the economic bloc last year, battled a slowdown in growth as confidence in the country's ability to broker a favorable trade deal with the EU waned.

While global growth was on an upswing, one area that remained elusive for most countries was inflation. Central banks around the world are grappling with stubbornly low inflation despite growing economies and tighter labor markets. The US is no exception. After rising steadily in 2016 and early 2017, US inflation has slowed in recent months. In June, the Federal Reserve raised the fed funds rate by another 25 basis points, resulting in a new target range of 1.00-1.25%. While the hike was expected, the Fed's hawkish tone was somewhat of a surprise given the recent weakness in inflation data. Committee members acknowledged that inflation had fallen off over the past few months but believed that the decline would prove temporary, attributing the weakness to "one-off" factors. As such, they left their median estimate for the fed funds rate unchanged, forecasting one more hike before year-end and three hikes next year. They also gave additional details on the mechanics of balance sheet reduction, stating that they expect to begin implementing the plan within the year. Based on the plan, they will reduce the reinvestment of securities gradually over an extended period. The Fed expects that this measured approach will limit the impact on financial market conditions.

So it appears that the Fed remains committed to advancing the normalization process. For now, the fear of falling behind the curve and finding themselves in a situation where they have to raise rates quickly is outweighing flagging inflation data. However, if inflation does not revert toward target or financial conditions deteriorate, the Fed may pause the hiking cycle.