1Q18 Economic Summary

Volatility…it's baaaack. After a relatively quiet 2017, the sleeping giant of volatility awoke during the first quarter of 2018. Equity markets continued to climb in January, but February brought fears that fiscal stimulus would spark inflation. Stocks plunged and the yield curve steepened as markets began to fear that the Fed was behind the curve on inflation and would have to raise rates faster than expected. Volatility continued in March as markets digested tariff talk, shake-ups in the Trump administration, rising geopolitical tensions, and the latest Fed action. Equity markets bounced around while the Treasury curve flattened as inflation fears subsided and the flight-to-quality trade came back in vogue at the end of the quarter.

Amid all the market volatility, the US economy continued to grow at a solid pace during the first quarter. After strong job gains in January and February, the non-farm payroll report surprised to the downside in March as the economy added only 103,000 jobs versus the 185,000 economists had forecasted. Although the headline number was a bit of a disappointment, job gains averaged over 200,000 for the quarter, signaling a still strong labor market. The unemployment rate held steady at a low 4.1% for the sixth consecutive month, and wages continued to rise at a moderate pace. Consumer sentiment ended the quarter at its highest level since 2004 as the solid job market helped to offset concerns about trade policy and stock market volatility. Despite the boost in confidence, consumer spending pulled back a bit during the first quarter. Retail sales declined in January and February but bounced back in March on higher auto sales. A lull in spending has been a common first quarter occurrence, but healthy wage gains combined with tax refunds are expected to support a pickup in consumer spending going forward. Business investment also moderated during the quarter but remained on an improving trajectory. Housing demand remained solid, buoyed by steady hiring and elevated consumer confidence. However, home price appreciation and rising borrowing costs are crimping affordability, particularly for first-time homebuyers, which could cool demand down the road. Overall, it appears that first quarter GDP growth is going to be solid albeit softer than the robust growth of the fourth quarter.

Global growth also hit a bit of a soft patch as industrial data came in weaker than expected during the first quarter, particularly in Europe. It appears that the European slowdown can in part be attributed to temporary factors, including unusually cold weather and strikes among German metal and electrical workers. In a show of confidence in the economy, the ECB dropped its quantitative easing bias at its March meeting, signaling its asset purchase program will conclude at the end of this year. Colder weather was also blamed for a pullback in consumer spending and industrial production in Japan. China's GDP growth came in as expected during for the first quarter as strong retail sales offset a slowdown in manufacturing. Overall, despite a slower start to the year, the global growth recovery appears to be on steady footing; however, the IMF warns that if the US engages in a trade war, global growth will suffer.

As expected, the Federal Reserve raised rates by 25 basis points at the March 21 FOMC meeting, resulting in a target range for the fed funds rate of 1.50%-1.75%. Given expectations for stronger growth and the potential for higher inflation, there was much debate prior to the meeting as to whether the Committee would increase its forecast for the number of hikes this year. The dot plot revealed that the Fed's forecast for a total of three rate hikes in 2018 remained unchanged, but Committee members did increase their expectations for the number of hikes in 2019 from two to three. According to the minutes of the meeting, "a number of participants indicated that the stronger outlook for economic activity, along with their increased confidence that inflation would return to 2 percent over the medium term, implied that the appropriate path for the federal funds rate over the next few years would likely be slightly steeper than they had previously expected." Although the minutes appeared to lean hawkish, Chairman Powell continued to tow the company line in his first post-meeting press conference. While acknowledging that economic headwinds have turned into tailwinds, he reconfirmed the Fed's commitment to gradual rate increases. He indicated that the Fed was looking to remove accommodation, not tighten financial conditions. Markets are currently pricing in that the next 25 basis point hike will come at the June meeting.

All said, it appears that growth hit a speed bump during the first quarter, but expectations are high that the slowdown will be temporary. Volatility, on the other hand, may stick around a while as market activity ebbs and flows with the latest Presidential tweets and Fed speak.

Any opinions herein, including forecasts, reflect our judgment as of this date and are subject to change.