CenterState
CORRESPONDENT DIVISION

Market Update

Economic News

April 27, 2018

The first estimate of first quarter GDP beat (2.3% vs. 2.0% forecast), and that's a clearly a positive because if this expansion has one defining characteristic it is for underwhelming first quarter results. In addition, the 2.3% print compares very favorably to the 1.2% number from the first quarter a year ago. The beat and improvement from the prior year's first quarter bodes well for the balance of the year, and if anything may boost the Fed's forecast for full-year GDP which currently stands at 2.7%. It also keeps the Fed's plans for quarterly hikes on schedule for the foreseeable future. One caveat, however, and more fully explained below, the beat was due more to additions from the volatile categories of inventory and foreign trade. The softness in personal consumption will have to reverse to keep GDP reliably above 2% in the quarters ahead. The good news is that has been the case for the last three years. Two big unknowns, however, are whether the higher borrowing rates are slowing consumption and spending (or will), and what transpires from the tough tariff and trade talk? For now, the GDP report keeps the Fed set for a June rate hike and on track for quarterly hikes thereafter. The question becomes whether those two unknowns become larger headwinds as we move through 2018 and into 2019 such that it slows or halts the Fed's expected hiking path. In the meantime, the Treasury market is continuing to reverse higher rates from earlier in the week—3.03% was the top— as some consolidation of the recent run-up is repealed. The 10-year note is up 2/32nd in price to yield 2.97%.

As mentioned above, the first estimate of first quarter GDP was solid and much better than 2017's first quarter 1.2%. The 2.3% QoQ annualized growth beat the 2.0% expectation but was shy of the 2.9% fourth quarter result. As forecasted, consumer consumption took a breather in the quarter rising 1.1% versus the robust 4.0% fourth quarter results. The weaker consumer spending was fairly broad-based but vehicle sales were particularly soft compared to the prior quarter. While the dip in consumption was the primary headwind to GDP, growth was aided by an uptick in business investment which added 119 bps to GDP versus 78bps in the prior quarter. Also, there was much less drag from international trade as net exports added 20bps to GDP versus –116bps last quarter. Inventory building added 43bps versus –53bps prior. Government spending rose but the paced slowed adding 20bps to GDP versus 51bps in the fourth quarter. Stripping out those more volatile categories of inventory, government spending and foreign trade you get Final Sales to Private Domestic Purchasers and that totaled 1.6% versus 4.5% the prior quarter, and 2.4% in the first quarter a year ago. That number relies heavily on personal consumption and when that dips it's reflected in this figure. The good news is first quarter consumption softness has a track record going back three years now of reversing in the second quarter.

The Fed's preferred inflation gauge is also a part of the GDP release and the core PCE gain was a solid 2.5% QoQ (annualized) matching the pre-release estimate and ahead of the 1.9% print in the fourth quarter. While that pop in QoQ core prices will keep the Fed on track for a June rate hike, the March year-over-year number due on Monday will be more important to the Fed and to fixed income investors. That YoY number is expected to be 2.0% versus 1.6% in February. The monthly gain, however, is expected to be an on-trend 0.2% matching February's print. The YoY pop is largely expected and due to the rolling off of large price cuts in cell phone contracts picked up in March of last year. While the YoY increase from 1.6% to 2.0% is sizeable the monthly gains don't signal more gains to come in core YoY PCE numbers. Thus, the YoY pop in March should stabilize around 2.0% in the months ahead.

One of the unknown potential headwinds we mentioned was the potential impact from higher rates and the uncertainty over tariffs and trade negotiations. A U.S. trade delegation is headed to China next week to try and hammer out some agreements and while the Trump administration hosted its first official State visit, which was long on pomp and circumstance, there doesn't appear to be have been much of substance that was accomplished.

French President Macron was hoping to use the seemingly genuine friendship between him and Trump lead to a softening of White House objections over the Iran Nuclear agreement as well as other matters involving trade. It seems the French charm offensive failed to achieve any breakthrough so now the matter is on the plate of German Chancellor Angela Merkel who will visit the White House today.

While her visit won't have the ceremony that the French president received, she will press for a permanent exemption for the EU on steel and aluminum tariffs that are set to expire on Tuesday. Trump's personal relationship with Merkel is much frostier than with Macron, and the fact Germany has a $65 billion trade surplus with the U.S. probably doesn't aid in the trade negotiations either. It's reported that Macron pressed for the permanent exemption but no announcement was forthcoming from the White House. Merkel's transatlantic coordinator, Peter Beyer, told Reuters, "One has to see the Macron and Merkel visits as one. Macron will take care of the nice pictures and Merkel will deliver the hard work."

In the end, if tariff talks continue and trade protectionism escalates, business confidence will sag and eventually trade and economic activity will weaken. Those are matters not yet fully formed but if they do, it will impact GDP and rates.

FHLMC 30yr Mortgage Rate Hits 5yr High

The recent run-up in longer-term Treasury yields has had its impact on the mortgage market as well. The graph tracks the average FHLMC 30yr mortgage rate going back to 2000. As shown, the current rate is the highest in about five years but housing bulls will say that a 4.73% rate is still historically low. That may be so, but consumers have no doubt grown accustomed to rates in the high 3%'s to high 4%'s in the last six to seven years. To date, the rise hasn't slowed business but If longer-term Treasury rates continue moving higher and mortgage rates push over 5%, there is likely to be consumer resistance which could crimp housing activity and hence overall economic growth.

Market Rates

Treasury Curve	Today	Chg Last wk.	LIBOR Rates	Today	Chg Last wk.	FF/Prime	Rate	Swap Rates	Rate
3 Month	1.82%	+0.01%	1 Mo LIBOR	1.90%	UNCH	FF Target Rate	1.50%-1.75%	3 Year	2.842%
6 Month	2.01%	+0.01%	3 Mo LIBOR	2.37%	+0.01%	Prime Rate	4.75%	5 Year	2.924%
2 Year	2.49%	+0.05%	6 Mo LIBOR	2.52%	+0.02%			10 Year	3.005%
10 Year	2.97%	+0.04%	12 Mo LIBOR	2.77%	+0.02%				