Fixed Income Insight
Second Quarter 2015

May 12, 2015

➔ **The Economic Expansion Continues in the United States:**

- According to the advance estimate of GDP, growth slowed to 0.2% in the first quarter, down sharply from the 2.2% rate reported in the fourth quarter of last year. As expected, growth was negatively impacted by a combination of harsh weather across the northeast and a strengthening dollar.
- Personal Consumption Expenditures grew more slowly than last quarter but added 1.3% to Q1 growth. This represented the largest positive contribution to output and was led by spending on services.
- Business Fixed Investment fell by 0.4% as energy production and exploration slowed sharply in response to last year's plunge in energy prices. Inventory accumulation rebounded from the second half drawdown, adding 0.7% to overall growth in the first quarter.
- Net exports were the biggest economic detractor shaving 1.3% from topline growth. As widely anticipated, the strengthening dollar pressured exports lower.
- State and local spending shifted lower and also served to detract nearly 0.2% from growth during the period.
- The slowdown in growth estimated to have occurred in the first quarter was expected. Despite the deceleration in the pace of growth, the fundamental underpinnings of the economic recovery remain in place. We anticipate a resumption of stronger growth in the current quarter and into the second half of the year.

➔ **The Employment Situation Continues to Make Improvement:**

- Non-farm payrolls rose by 126,000 in March, following downwardly revised gains of 264,000 in February and 201,000 in January. March marked the first time in a year that the month-to-month gain in employment has not exceeded 200,000 persons. While there were no obvious pockets of weakness, there were also no obvious pockets of strength.
- The official rate of unemployment, U3, was unchanged at 5.5% in March, the result of another small decrease in the labor force and another small gain in employment. The broadest measure of labor underemployment, U6, dropped to 10.9%, its lowest reading since August of 2008.
- The debate over the degree of slack in the labor market, both within and outside the Federal Reserve, remains. Dr. Yellen's recent testimony suggests that they are following an array of series in both the Establishment and Household surveys of employment, with emphasis on the level and trend of full-time employment.

➔ **Inflation Remains Moderate:**

- Headline inflation has turned negative in recent months because of falling gasoline prices. Food prices have been on the rise, as beef prices continue to reflect the supply problems occasioned by the dry weather of past years. Owners' equivalent rent, which constitutes almost a quarter of the CPI, has continued to rise and is at its highest level since 2008. Medical costs have started to reverse their prolonged decline partly due to the Affordable Care Act. However, when viewed in the aggregate, inflation still remains tame, whether one uses the headline CPI, the Core CPI or, the Fed's preferred measure, the Personal Consumption Expenditures Index (PCE).

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Please refer to Notes and Disclosures on page 2.

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- The CPI-inflation rate remained below zero in March, and the other key measures of inflation are below the Fed's target as well. The Fed is monitoring several measures of inflation, and Dr. Yellen removed any specific references in her recent testimony. She did say that the Committee anticipates adjusting the policy rate when 'it is reasonably confident that inflation will move back over the medium term toward our 2 percent objective.'*
- On balance, it is difficult to envision demand-pull or cost-push inflation without stronger economic and employment growth as well as a pick-up in wage growth. The capacity utilization rate has been on the rise the past year, and continues to spark a debate regarding how much slack there is in the manufacturing economy.
- The ECB announced an expanded asset purchase program to help counter deflationary pressures and economic weakness across the Eurozone. The program is designed to purchase €1.1T in public and private sector bonds and last at least until September 2016. Importantly, the statement noted that the program would continue 'until we see a see a sustained adjustment in the path of inflation.'**

➔ **Public Finances, Both Here and Abroad, Remain under Intense Scrutiny:**

- Congress was reshaped by the recent mid-term elections. We await substantive change in fiscal policy proposals as the first round of legislative activity has had more to do with politics than the management of economic expansion.
- Events in several regions remain unsettled and continue to pose a threat to the Eurozone. Still at issue are the resolution of the Greek financial crisis and the fighting in Ukraine.
- New issue municipal supply has moved higher from last year's sluggish pace led by a surge in Refunding Issuance. Longer-term concerns over unfunded liabilities, however, have tended to act as a restraint on new borrowing.

** Source: Chair Janet L. Yellen Testimony (02/24/2015), federalreserve.gov*
*** Source: ECB announces expanded asset purchase programme, www.ecb.europa.eu*

Notes and Disclosures

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Sources: Bloomberg; Bureau of Economic Analysis; Bureau of Labor Statistics; Federal Reserve; Census Bureau.

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