Federated®

# Orlando's Outlook: Gone

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Bottom Line *In an extraordinary overnight development, the U.K. voted 52% to 48% to leave the European Union. Prime Minister David Cameron, who supported the Remain camp, immediately fell on his sword, announcing he will resign in October after a transition period to select a new U.K. leader. Equity markets here and abroad plunged today, while havens such as the U.S. dollar, gold and Treasuries surged.*

*Despite the fact that yesterday's Brexit vote appeared to be a virtual coin flip—with the forecast for rain in London and its impact on voter turnout perhaps the deciding factor—stocks had inexplicably risen in the two prior weeks. Investors appeared to be whistling past the proverbial graveyard. From our investment perspective, however, taking a decidedly more defensive, risk-off point of view was a wiser course of action, as the financial-market environment remained perilous.*

*Aside from the near-term ramifications from Brexit, the U.S. labor market has stalled over the past three months, core PCE inflation has ticked down over the past two months, and economic growth and corporate results have decelerated sharply over the past several quarters. To be sure, the Federal Reserve is probably now on hold until at least its December policy-setting meeting. But the U.S. presidential-election conventions next month could add to the market's angst, due to the uncertainty surrounding fiscal policy decisions in 2017 and beyond.*

Adjustments to our gross domestic product (GDP) forecast The equity and fixed-income investment professionals who comprise Federated's macroeconomic policy committee met on Wednesday to discuss Brexit and analyze the global economy. We made the following changes to our domestic GDP model:

- The Commerce Department revised first-quarter 2016 GDP higher, from its flash report of 0.5% to 0.8%. The final GDP number will be released June 28, with Bloomberg consensus now at 1.0%.
- Consumer spending in April and May, the trade deficit and the housing market have all improved recently, so we have increased our second-quarter GDP estimate from 2.1% to 2.5%, while the Blue Chip consensus ticked its estimate higher, from 2.3% to 2.4% (within a range of 1.7% to 3.2%).
- Inventory restocking could resume in the third quarter for the first time in a year, which prompted us to increase our third-quarter GDP estimate from 2.0% to 2.2%, while the Blue Chip consensus lowered its estimate from 2.4% to 2.3% (within a range of 1.9% to 2.8%).
- Our ugly presidential election on Nov. 8 may well elicit a sigh-of-relief consumer-spending increase, so we're increasing our fourth-quarter GDP estimate from 2.1% to 2.3%, while the consensus holds steady at 2.4% (within a range of 1.9% to 2.9%).
- Our quarterly increases after the weak first quarter allowed us to raise our full-year 2016 GDP estimate up a tick from 1.8% to 1.9%, while the Blue Chip consensus dropped its full-year estimate down a tick from 2.0% to 1.9% (within a range of 1.7% to 2.0%).
- We are increasing our full-year 2017 GDP estimate from 2.1% to 2.3%, while the Blue Chip consensus remains unchanged at 2.3% (within a range of 1.9% to 2.6%).

Federated's Macro Policy Committee also made the following investment observations:

Should I stay or should I go? The U.K.'s stunning decision to leave the eurozone came down to several key factors: bureaucratic overreach from Brussels, the flood of refugee immigration, sluggish economic growth and massive net subsidies to bail out the EU's perennial weak links that refuse to get their fiscal houses in order. Angry voters opted for change, and they were less concerned about the potential impact of an exit on the value of the British pound and their trade relationships with other European countries. In fact, the pound sterling plummeted nearly 12% today, from 1.50 versus the dollar to a 31-year low of 1.32, which should make U.K. exports more attractive.

Fed on hold until at least December At the conclusion of last week's policy-setting meeting, the Fed made the easy decision not to hike interest rates, due to the stalled labor market, decelerating core PCE inflation, weak economic and corporate profit growth and the uncertainty of the upcoming Brexit vote. Now that we know that the U.K. has voted to extricate itself from the European Union—and not knowing if this is the first of several such dominos to fall in the EU over the balance of 2016 and beyond—the Fed is unlikely, in our view, to entertain their next rate hike at their upcoming July 27 and Sept. 21 meetings.

Core PCE inflation slips The core Personal Consumption Expenditure (PCE) index—the Fed's preferred measure of inflation—started to perk up recently, after holding steady at 1.3% year-over-year (y/y) through October 2015 for nine consecutive months. It rose to 1.7% in both January and February 2016, but slipped back to 1.6% in both March and April, and is still below the Fed's 2.0% target.

However, the Consumer Price Index (CPI) and the Producer Price Index (PPI) have recently risen. Core y/y retail CPI inflation was stuck at 1.9% for several months through October 2015, but rose to 2.3% in February (its highest reading in four years), before slipping back to 2.2% in March and 2.1% in April. However, May just bounced up to 2.2%. Core y/y wholesale PPI inflation, which had languished for months, rose from a 0.2% y/y trough in December 2015 to 1.2% in February 2016, although it slipped to 1.0% in March and 0.9% in April. But core PPI rebounded to 1.2% in May. So we'll see if the core PCE can follow the recent leads of both CPI and PPI.

Gold and dollar up, oil falls In a massive flight-to-safety rally, gold has surged by nearly 30% this year to a two-year high of $1,355 per troy ounce, while the dollar has risen in value 6% versus the euro over the past two months. As a result of the stronger dollar, crude oil as measured by West Texas Intermediate (WTI) prices have fallen by 10% over the past fortnight to $47 per barrel. Given the tight positive correlation between oil and stock prices over the past two years, a retreat in energy prices could facilitate a correction in stocks, particularly if oil prices retrace their recent doubling in price to $52 and re-test $38-$42 per barrel.

Another difficult quarter on tap Preliminary consensus expectations for the second quarter, which will start to be released on July 11, are for a 4-5% y/y decline in earnings. That compares with a 7-8% y/y earnings decline in the first quarter, due to a 5-6% profit-margin contraction, for the fourth-consecutive disappointing quarter. But investors are expecting that earnings per share (EPS) will start to rise again on a y/y basis in the third quarter, if energy prices remain elevated and if the dollar remains weak, as companies begin to anniversary the earnings weakness from oil and currency. But if the post-Brexit trends hold with a stronger dollar and lower oil prices, it could imperil the earnings improvement expected into 2017.

Labor market stalls The May employment report was the weakest in nearly six years, with nonfarm payrolls plunging to a paltry gain of only 38,000 jobs. This is the third consecutive disappointing report, down from February's recent peak at 233,000, and March and April were revised sharply lower by another 59,000 jobs. Importantly, this miss was more than the 35,100 striking Verizon workers during May, as the manufacturing, construction and temporary-worker categories all posted negative readings last month. The unemployment rate (U-3) fell to a nearly nine-year low of 4.7%, but that decline was for the wrong reasons: a surge in discouraged workers who have left the labor force, witnessed by the two-tick decline in the participation rate to 62.6% (versus a 38-year cycle low of

62.4% in October 2014) and the unchanged reading in the labor-impairment rate (U-6) at 9.7%, a seven-year low. When the labor market is healthy, the spread between U-3 and U-6 should be 3%, not the current elevated 5%. The only good news is that jobless claims for the June survey week fell to only 259,000, which suggests we may see as rebound in monthly payrolls on July 8.

Retail sales rebound After a brutal first quarter, retail sales were much stronger than expected in April and May. The Christmas retail season was among the weakest in seven years, up only 2.5% year over year, and the first half of "Mapril" posted a 0.3% decline in nominal sales in March. But April soared 1.3% to the highest level in a year, and May was solid, with a 0.5% nominal increase. The bounce in both auto sales and retail gasoline prices in April and May contributed to this positive trend. The personal savings rate is still at a healthy 5.4% in April, so we're hopeful that will translate into good Back-to-School (BTS) spending in July, August and September, an important retail season.

Auto sales rebound After a disappointing 5.5% month-over-month (m/m) decline in March 2016 to 16.46 million annualized units, total auto sales rose 5.5% over the past two months back to 17.37 million units. So after three-consecutive months north of 18.0 million units in September, October and November 2015 (which represented a 10-year cycle high), auto sales have been stable at about 17.25-17.5 million units, running about 3% slower so far this year.

Housing remains solid Housing fundamentals still appear relatively solid, thanks to low mortgage rates and healthy demand. New-home sales in May fell 6% to 551,000 annualized units, down from an eight-year high of 586,000 homes in April. Existing home sales, which account for about 90% of total home sales, rose on a month-over-month basis 1.8% in May 2016 to 5.53 million annualized units, the fastest pace since February 2007.

Manufacturing remains choppy We continue to believe that the manufacturing sector is starting to bottom, as dollar strength may have peaked at 1.05 versus the euro, oil prices (WTI) may have already troughed at $26 per barrel, inventory accumulation has been halved over the past year, trade deficits are falling and foreign demand may be marginally improving. After four-consecutive months in economic contraction territory below 50, the ISM manufacturing index (which accounts for about 12% of the economy) has now risen above 50 in each of the past three months, from a six-year low of 48.0 in November and December 2015 through February. It's been a choppy second quarter after a brutal winter, but all of the seven regional Fed indices that we monitor experienced a better March/April, a step back in May and a step in the right direction in June. Factory orders strengthened nicely the past two months, rising 1.9% in April and 1.7% in March, reversing a tough six-month slog. Wholesale inventories, which were negative five months in a row through February, have perked up the past two months, rising 0.6% in April, and wholesale trade sales soared 1.0% in April. Business inventories, after a flat or negative past five months through February, have turned modestly positive in March and April.

But after a nice 0.6% rebound in April, industrial production declined on a m/m basis in May by 0.4%, so four of the past six months have been negative. Same story with capacity utilization, which rebounded to 77.1% in January, but March and May have slipped back below 75.0%. Durable goods orders posted their weakest reading in three months, falling a worse-than-expected 2.2% in May. Capital goods orders and shipments were also surprisingly negative last month. Finally, the trade deficit rose 5.4% in April 2016 to $37.4 billion. But due to annual revisions, March was revised down by nearly 20% to a two-year low of $35.5 billion.

To see Phil Orlando's thinking in action, click here.

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Consumer Price Index (CPI): A measure of inflation at the retail level.
The Conference Board's Composite Index of Leading Economic Indicators is used to predict the direction of the economy's movements in the months to come.
The Conference Board's Consumer Confidence Index measures how optimistic or pessimistic consumers are about the economy.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.
The National Association of Home Builders/Wells Fargo Housing Market Index is a gauge of how well or poorly builders believe their business will do in coming months.
The Institute of Supply Management (ISM) manufacturing index is a composite, forward-looking derived from a monthly survey of U.S. businesses.
Personal Consumption Expenditure (PCE) Index: A measure of inflation at the consumer level.
S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.
The University of Michigan Consumer Sentiment Index is a measure of consumer confidence based on a monthly telephone survey by the University of Michigan that gathers information on consumer expectations regarding the overall economy.
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