ECONOMIC AND FINANCIAL MARKET UPDATE

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US economy slowed less than expected in Q1

The US economy's Q1 slowdown wasn't as significant as feared with GDP posting a 2.3% annualized increase to start the year. That is down from the recent 3% pace, but in a quarter that has been plagued by seasonal adjustment issues, still represents the fastest Q1 increase in three years. Those seasonal quirks were evident in consumer spending, with the weakest gain in nearly five years in part reflecting a change in the timing of tax refunds for some households that has shifted spending patterns. But that slowdown was partially offset by another broadly-based increase in business investment, including inventories. And net trade provided a surprising add to growth thanks to a sizeable narrowing in the trade deficit late in the quarter. So even without much support from the household sector, GDP still came in 1/2 percentage point above its longer run growth rate. March's personal spending data confirmed US consumers haven't put away their wallets this year. We think a rebound in Q2 consumption, as households start to spend more of their tax refunds, will push GDP growth back above a 3% pace.

Inflation a factor in bond market moves

Perhaps the bigger takeaway from March's consumer spending report was a jump in the PCE deflator, the Fed's preferred inflation gauge. The increase in year-over-year core inflation from 1.6% to 1.9% was largely due to last March's decline in wireless telephone services dropping out of the calculation. But price growth was running at a 2.5% annualized pace in Q1, indicating the recent trend has also picked up somewhat. That rate isn't enough to cause panic at the Fed, but it certainly reinforces some committee members' views that inflation risks are increasingly skewed to the upside.

Markets have taken notice of the recent pickup in price growth. The inflation premium baked into 10-year Treasury yields has risen by 20 basis points since the start of 2018. Higher oil prices have been a factor in that move. Declining inventory levels and heightened geopolitical risks have pushed WTI oil prices up to nearly $70 per barrel for the first time since late-2014. The increase in breakeven inflation accounts for about 1/3 of the 10-year yield's march to 3% this year. Inflation has arguably been behind some of the move in real yields as well. Growing confidence that the Fed's 2% target will be met (or even surpassed) on a sustained basis has boosted market expectations for monetary policy tightening. Like the Fed, investors are now roughly split on whether three or four total rate hikes will be warranted this year.

Fed takes a pass in May, consistent with gradual tightening

In keeping with their guidance that interest rates will increase only gradually, the Fed held monetary policy steady at the beginning of May following a rate hike at the previous meeting. Most of the changes to the policy statement represented a mark-to-market of recent data. With the advance Q1 GDP report in hand, the Fed confirmed consumer spending growth moderated while business investment continued to grow strongly. There was no mention of seasonal distortions being behind the consumer slowdown, but that issue was flagged in the March minutes so we doubt policymakers are overly concerned. The committee acknowledged inflation has moved close to their 2% objective but still characterized market-based inflation measures as low. That is somewhat surprising with 10-year breakevens now close to their longer run median. At the same time, however, they dropped the previous reference to "monitoring inflation developments closely." We think that is a nod to increased confidence that their inflation objective will be met on a sustained basis after spending much of the last few years below 2%. Our forecast continues to assume the Fed will raise rates in June. They didn't provide an explicit signal in that direction, but arguably didn't need to with markets already almost fully priced for a move at the upcoming meeting.