Fixed Income Insight
Third Quarter 2015

August 10, 2015

- **The Economic Expansion Moved into its Seventh Year:**
  - In July, the expansion reached 73 months, making it now the fourth longest expansion of the post-war era. The longest expansion, 120 months, occurred between March of 1991 and March of 2001.
  - According to the advance estimate, Real GDP expanded at a 2.3% seasonally adjusted annual rate in the second quarter. In addition, first quarter growth was revised up to a positive 0.6% contribution in part due to improved estimates of business fixed investment and inventories.
  - Personal Consumption Expenditures contributed 1.99% in the second quarter following a downward revision to its first quarter increase. Motor vehicle purchases were an important factor.
  - Business Fixed Investment registered a modest positive in the second quarter and was revised higher for the first quarter. Investment contributed 0.14% and 0.52%, respectively, according to the most recent estimates.
  - Net Exports improved markedly following a significant first quarter slide. For the second quarter Net Exports were estimated to have made a positive 0.13% contribution to headline GDP and may be reflective of a modestly weaker dollar which corrected after 3 consecutive quarters of gains.
- **The Employment Situation Continues to Make Improvement:**
  - Non-farm payrolls rose by 223,000 in June, following a downwardly revised gain of 254,000 in May and a downwardly revised increase of 187,000 in April. The June numbers were in line with expectations.
  - The official rate of unemployment, U3, was down to 5.5% June, the result of a decline in the labor force and a small drop in total employment. Large swings in the labor force, in both directions, often are seen in June as factors such as the end of the school year affect both the entry and exit of persons from the work force. We also saw a spike in part-time employment for noneconomic reasons reflecting the usual jump in summer part-time hiring.
  - The debate over the degree of slack in the labor market, both within and outside the Federal Reserve, remains. Dr. Yellen's recent comments 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 dipped towards zero in recent months because of falling gasoline prices. Food prices have moderated of late, but further upward pressure is expected from beef and egg prices, where supply problems are being encountered. 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 relatively tame, whether one uses the headline CPI, the Core CPI, or, the Fed's preferred measure, the Personal Consumption Expenditures Index (PCE).

McDonnell Investment Management – Portfolio Management & Research Teams

Please refer to Notes and Disclosures on page 2.

McDonnell Investments

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- The CPI-inflation rate remained around zero in June, 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.

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

- For the first time in several years, it appears that the Federal budget process is proceeding along its normal time line. According to current projections, the fiscal 2016 deficit is expected to be smaller than that of 2015.
- Market focus has recently centered on the economic and debt crisis in Greece. A tentative accord has been reached although significant work remains to be accomplished. The accord is unlikely, however, to set the Greek economy on a path toward economic or financial stability, and the prospect of a member country leaving the Eurozone has now been openly discussed.
- With most states now nearing the end of their fiscal years, we will be closely following developments as they relate to the financing needs of the new budgets. Municipal supply has increased but the advance has been due to refunding volume as opposed to new money issuance.

** Source: Chair Janet L. Yellen Testimony (02/24/2015), federalreserve.gov*

Notes and Disclosures

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