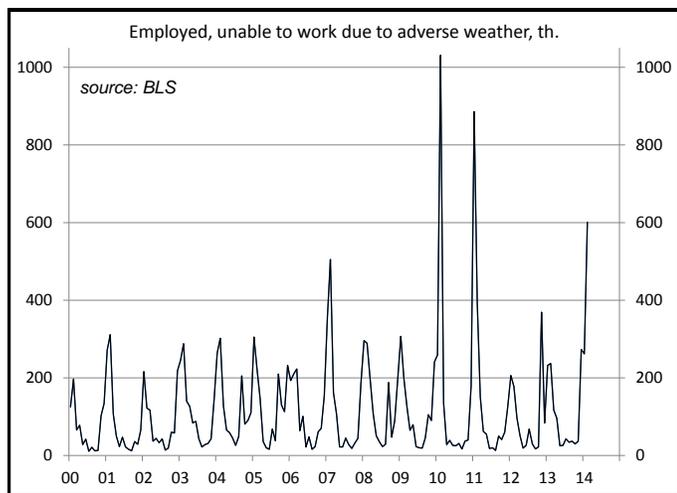


Weekly Market Monitor

The Fed Policy Outlook

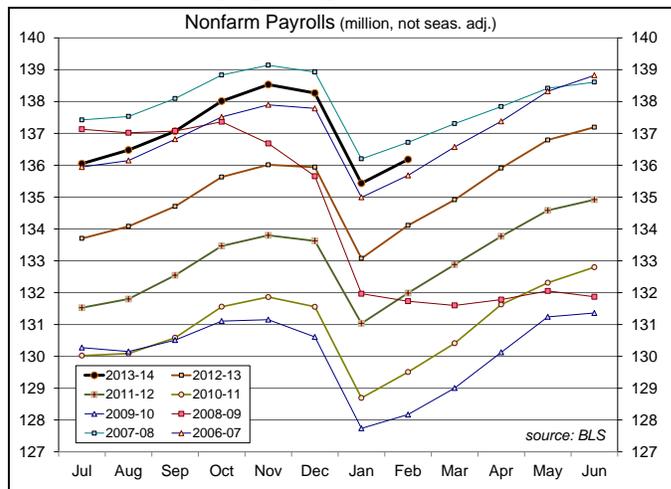
Much of the recent economic data have been distorted by adverse weather, which makes it difficult to gauge the underlying strength. However, while economic activity appears to have slowed in early 2014, the longer-term outlook hasn't changed. Growth should pick up. The Fed's tapering of its asset purchase program is "not on a preset course," but officials are expected to continue with "measured steps" (-\$10 billion per policy meeting), unless there is a significant change in the economic outlook. With the unemployment rate nearing 6.5%, the Fed is going to make adjustments to its forward guidance, but the intent (that short-term interest rates are likely to stay near zero well into 2015) is expected to remain.



The economic data for the winter months should always be taken with a grain of salt. Seasonal adjustment is large and can magnify even minor impacts from the weather. The weather has been hardly minor this year. Poor weather appears to have distorted figures for December, January, and February. The impact can vary a lot, depending on which areas of the country get hit and when. Furthermore, you may see a bounce-back from the weather in some regions, but worse conditions for others. Bottom line: take the data reports with a grain of salt.

Recall that the Employment Report consists of two surveys. The household survey is a telephone survey of 60,000 households. That may not sound like a lot. You're not going to get accurate monthly measurements of levels (the number of unemployed, the size of the labor force), but you get reasonable estimates of ratios (the unemployment rate, labor force participation). The BLS estimates that 601,000 individuals could not get to work due to poor weather during the survey week (vs. a 237,000 a year ago. These people are still classified as "employed." Note that this figure is not comparable to the nonfarm payroll data, which come from a different survey.

The establishment survey covers about 144,000 businesses and government agencies (about 554,000 individual worksites), which are asked about the number of employees, hours, and wages for the pay period that includes the 12th of the month. The data are reported on a seasonally adjusted basis. Prior to seasonal adjustment nonfarm payrolls rose by 750,000 in February, largely reflecting an increase in education (+693,100, following a decline of 811,500 over the two previous months). Ex-education, unadjusted payrolls rose by 56,900 (vs. -2.219 million in January and +324,700 in February 2013). The pattern in the unadjusted payroll figures is close to the usual, but figures suggest some impact from the weather. The data for March, April, and May will be more important, providing a clearer picture of the underlying strength of the labor market.



The unemployment rate edged back up to 6.7% in February (from 6.6% in January). However, the Bureau of Labor Statistics notes that a 90% confidence interval for the monthly change in the unemployment rate is ±0.2%. In other words, the reported increase in the unemployment rate in February is not statistically different from zero.

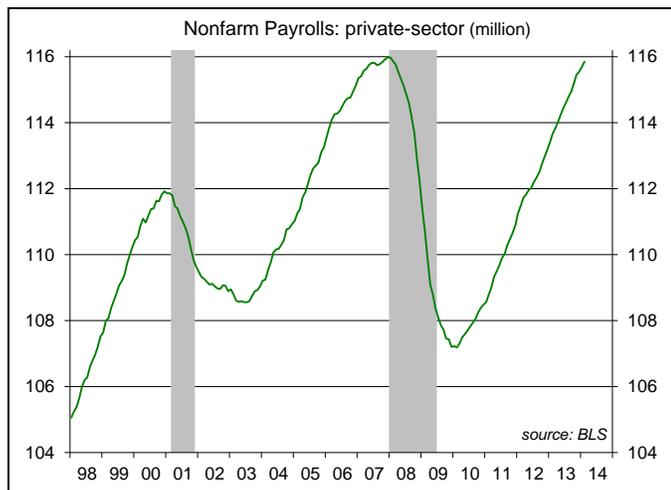
Former Fed Chairman Bernanke described the unemployment rate as the best single measure of the strength of the labor market. Others might disagree, preferring to look at a wide range of labor market indicators. Long-term unemployment remains elevated. Rates of unemployment for teenagers and young adults are a lot higher than normal. Measures of underemployment continue to suggest a large amount of slack.

The 6.5% unemployment rate threshold in the Fed's forward guidance has outlived its usefulness. At the January FOMC meeting, Fed officials debated on how to alter the language, but were far from an agreement. We should see that issue settled in the statement on March 19. Fed Chair Yellen should note that short-term rates aren't going to go up anytime soon.

| | Treasury Yields | | | | | | | | | Dollar | | | | Equities | | |
|---------|-----------------|-------|-------|------|------|------|-------|-------|---------|--------|--------|-------|---------|----------|----------|--|
| | 13-wk | 26-wk | 52-wk | 2-yr | 3-yr | 5-yr | 10-yr | 30-yr | \$/Euro | \$/BP | JY/\$ | CD/\$ | NASD | SPX | DJIA | |
| 2/07/14 | 0.08 | 0.09 | 0.12 | 0.30 | 0.66 | 1.47 | 2.71 | 3.67 | 1.361 | 1.640 | 102.32 | 1.101 | 4125.86 | 1797.02 | 15794.08 | |
| 2/28/14 | 0.05 | 0.08 | 0.12 | 0.33 | 0.69 | 1.51 | 2.66 | 3.59 | 1.381 | 1.675 | 102.08 | 1.108 | 4308.12 | 1859.45 | 16321.71 | |
| 3/07/14 | 0.05 | 0.08 | 0.13 | 0.37 | 0.77 | 1.64 | 2.79 | 3.72 | 1.387 | 1.672 | 103.32 | 1.109 | 4336.22 | 1878.02 | 16452.46 | |

Recent Economic Data and Outlook

The stock market fell and rebounded on developments in Ukraine. The bond market reacted to the stock market. The February employment figures were not as weak as feared, reflecting mixed effects of the weather.



The February **Employment Report** was stronger than expected. Nonfarm payrolls rose by 175,000 (vs. a median forecast of +150,000), while the two previous months were revised a net 25,000 higher. Average weekly hours edged down to 34.2, following 34.3 in January (revised from 34.4). Average hourly earnings rose 0.4% (+2.2% y/y), but average weekly earnings rose just 0.1% (+1.3% y/y). The unemployment rate edged back up to 6.7% (from 6.6%), well within the usual statistical noise.

The **ADP Estimate** of private-sector payrolls rose by 139,000 in February, vs. +127,000 in January (revised from +175,000). The report included annual benchmark revisions, which lowered estimates of job growth over the previous four months, but raised the estimate of January payrolls by 700,000 (0.6%).

The Fed's **Beige Book** (based on info collected on or before February 24) noted that "economic conditions continued to expand in January and early February." Eight of the 12 Federal Reserve districts described growth as "modest to moderate." New York and Philadelphia reported weather-related declines in activity. Growth in Chicago was "slow." Kansas City was "stable." Retail sales weakened in most regions, "as severe winter weather limited activity." Manufacturing sales and production were also affected by the weather. Residential real estate improved in most districts, "albeit modestly." Employment "improved gradually," with continued reports of "shortages of specialized skilled labor." Wage pressures "remained stable."

Personal Income rose 0.3% in January (+4.1% y/y), boosted partly by an expansion of Medicaid. Wage and salary income rose 0.2% (+3.6% y/y). Unemployment insurance payments fell 25.2% (-39.1% y/y). **Personal Spending** rose 0.3%, led by electricity and natural gas (+13.7%) and healthcare (+1.6%). Adjusted for inflation, consumer spending rose 0.3% (+2.2%

y/y). The **PCE Price Index** rose 0.1% (+1.2% y/y), up 0.1% ex-food & energy (+1.1% y/y) – trending below the Fed's 2% goal.

Motor Vehicle Sales edged up to a 15.3 million seasonally adjusted annual rate in February, vs. 15.3 million in January and a 15.6 million pace in 4Q13.

The **ISM Manufacturing Index** rose to 53.2 in February, vs. 51.3 in January. Growth in new orders picked up, but production fell. Employment growth remained positive, but relatively slow. Comments of supply managers were mixed, reflecting weather effects in some sectors, but relative strength in others.

The **ISM Non-Manufacturing Index** fell to 51.6 in February, vs. 54.0 in January. Business activity slowed to a moderate pace. New orders rose modestly. Employment declined. Comments from supply managers referenced the weather.

Factory Orders fell 0.7% in January (+2.0% y/y). Orders for nondefense capital goods ex-aircraft rose 1.5% (-0.8% y/y), following a 1.6% decline in December, with shipments down 1.0%. Factory inventories rose 0.2%, a bit slower than in 4Q13.

Construction Spending rose 0.1% in January, with single-family residential up 2.3%, following a 3.4% gain in December.

The **U.S. Trade Deficit** widened to \$39.1 billion in January, vs. \$39.0 billion in December.

The **Bank of Canada**, the **Bank of England**, and the **European Central Bank** each left monetary policy unchanged.

Economic Outlook (1Q14): Around 2.0% GDP growth.

Employment: The pace of job growth has slowed in recent months, but adverse weather had a lot to do with that. Measures of job destruction remain low, while hiring is expected to improve in the spring and summer.

Consumers: Spending growth appears to have been dampened by poor weather. Wealth has increased, supporting spending. Average wage gains are barely keeping up with inflation.

Manufacturing: Recent data on new orders, production, and employment, while uneven, suggest moderate improvement in the factory sector. However, an inventory correction and global growth will be important concerns in the near term.

Housing/Construction: Higher mortgage rates and rising home prices have reduced housing affordability. Poor weather hasn't helped, although homebuilding activity is expected to improve.

Prices: The PCE Price Index, the Fed's chief inflation gauge, is trending well below the 2% goal. Pipeline pressures have been modest, and the rest of the world is seeing downward inflation pressure. Inflation expectations remain well-anchored.

Interest Rates: The Fed has begun reducing the rate of asset purchases and should taper in measured steps as the economy continues to improve. Short-term interest rates are expected to remain exceptionally low into mid-2015. Long-term rates can be expected to trend gradually higher as the economy recovers, but we're likely to see some volatility along the way.

| This Week: | | | | <i>forecast</i> | last | last -1 | comments | |
|------------|----------|------------------------------------|----------------------------------|-----------------|----------------|---------------------------------------|---------------------------------------|--|
| Monday | 3/10 | no significant data | | | | | | |
| Tuesday | 3/11 | 7:30 | Small Business Optimism | Feb | NF | 94.1 | 93.9 | weak, but expecting gradual improvement |
| | | 10:00 | Hiring Rate | Jan | NF | 3.2% | 3.3% | still low, but trending gradually higher |
| | | | Quit Rate | | NF | 1.7% | 1.8% | still low, but trending gradually higher |
| Wednesday | 3/12 | 1:00 | Treasury Note Auction | | | | | \$21 billion in re-opened 10-year notes |
| | | 2:00 | Treasury Budget, \$bln | Feb | NF | -203.5 | -231.7 | some calendar effects, but a low trend |
| Thursday | 3/13 | 8:30 | Jobless Claims, th. | 3/08 | 330 | 323 | 349 | seasonal noise should fade |
| | | 8:30 | Import Prices | Feb | NF | +1.3% | -0.1% | this report may end due to budget cuts |
| | | | ex-food & fuels | | NF | +0.4% | +0.2% | up in January, but a low trend |
| | | 8:30 | Retail Sales | Feb | +0.4% | -0.4% | -0.1% | some rebound in autos |
| | | | ex-autos | | +0.3% | 0.0% | +0.3% | moderate otherwise |
| | | ex-autos, bld mat, gasoline | | +0.3% | -0.3% | +0.1% | watch for revisions | |
| Friday | 3/14 | 10:00 | Business Inventories | Jan | +0.4% | +0.5% | +0.4% | should be a slower pace in 1Q14 |
| | | 10:00 | Fed Nomination Hearing | | | | | Powell, Fischer, Brainard (rescheduled) |
| | | 1:00 | Treasury Bond Auction | | | | | \$13 billion in re-opened 30-year bonds |
| | 3/14 | 8:30 | Producer Price Index (FD) | Feb | +0.2% | +0.2% | +0.1% | moderate |
| | | | ex-food & energy | | +0.1% | +0.2% | 0.0% | mild |
| | | 9:55 | Consumer Sentiment | m-Mar | 82.5 | 81.3 | 81.2 | likely to pick up gradually |
| Next Week: | | | | | | | | |
| Monday | 3/17 | 8:30 | Empire State Manf. Index | Mar | 5.5 | 4.5 | 12.5 | volatile, but likely better |
| | | 9:15 | Industrial Production | Mar | +0.1% | -0.3% | +0.3% | not as cold (lower output of utilities) |
| | | | manufacturing output | | +0.3% | -0.8% | +0.3% | aggregate man-hours were flat |
| Tuesday | 3/18 | | capacity utilization | | 78.5% | 78.5% | 78.9% | no threat to the inflation outlook |
| | | 10:00 | Homebuilder Sentiment | Mar | 50 | 46 | 56 | should rebound |
| | | 8:30 | Consumer Price Index | Feb | +0.2% | +0.1% | +0.2% | gasoline prices in line with seasonals |
| | | | year-over-year | | +1.3% | +1.6% | +1.5% | trending low |
| | | | ex-food & energy | | +0.1% | +0.1% | +0.1% | mild core inflation |
| | | year-over-year | | +1.6% | +1.6% | +1.7% | still low | |
| Wednesday | 3/19 | 8:30 | Real Earnings | Feb | -0.1% | +0.1% | -0.5% | nominal earnings rose 0.1% (lower hours) |
| | | 8:30 | Building Permits, th. | Feb | 960 | 945 | 991 | some weather effects |
| | | | % change | | +1.6 | -4.6 | -2.6 | but January was likely worse |
| | | | Housing Starts | | 945 | 880 | 1048 | extremely choppy |
| | | | % change | | +7.4 | -16.0 | -4.8 | watch for revisions |
| Thursday | 3/20 | 8:30 | Current Account, \$bln | 4Q13 | -88.0 | -94.8 | -96.6 | narrower |
| | | 2:00 | FOMC Policy Decision | | 0-0.25% | 0-0.25% | 0-0.25% | forward guidance language should change |
| | | | LSAP Treasuries (\$bln/mo) | | 30 | 35 | 40 | another taper |
| | | | LSAP MBS | | 25 | 30 | 35 | split evenly between Tsys and MBS |
| Friday | 3/21 | 2:00 | Fed Economic Projections | | | | | still optimistic on growth |
| | | 2:30 | Yellen Press Briefing | | | | | Janet is a good communicator |
| | | 8:30 | Jobless Claims, th. | 3/15 | 334 | 332 | 323 | a low trend |
| | | 10:00 | Philadelphia Fed Index | Mar | 1.2 | -6.3 | 9.4 | erratic, but likely better |
| | | 10:00 | Existing Home Sales, mln | Feb | 4.70 | 4.62 | 4.87 | some impact from weather |
| | % change | | +1.7 | -5.1 | +0.8% | pick should be better than in January | | |
| | | Leading Econ Indicators | Feb | +0.2% | +0.3% | 0.0% | mixed components, but mostly positive | |
| | | 1:00 | TIPS Auction | | | | re-opened 10-year TIPS | |
| | | no significant data | | | | | | |
| | | hope your bracket doesn't go south | | | | | | |

This Week...

The economic calendar is relatively thin. There should be some interest in the retail sales results (Thursday), but figures may be distorted by the weather and February is not a critical month for consumer spending. The recently expanded Producer Price Index should continue to reflect limited inflation pressures. Overseas news could have some influence on the markets and we could see the stock market reacting to external developments over the course of the week.

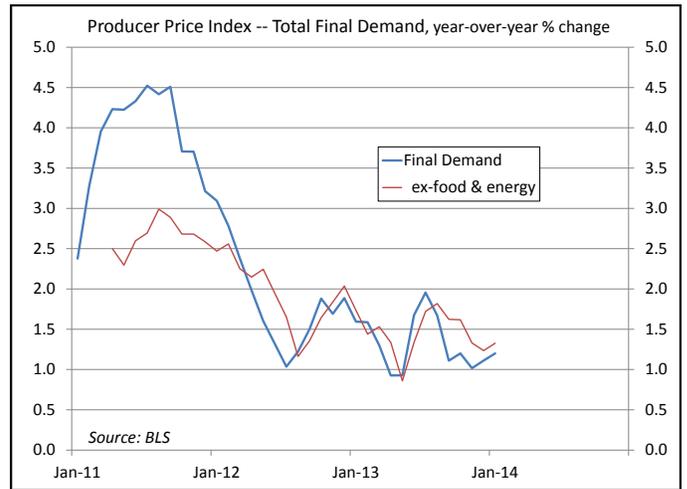
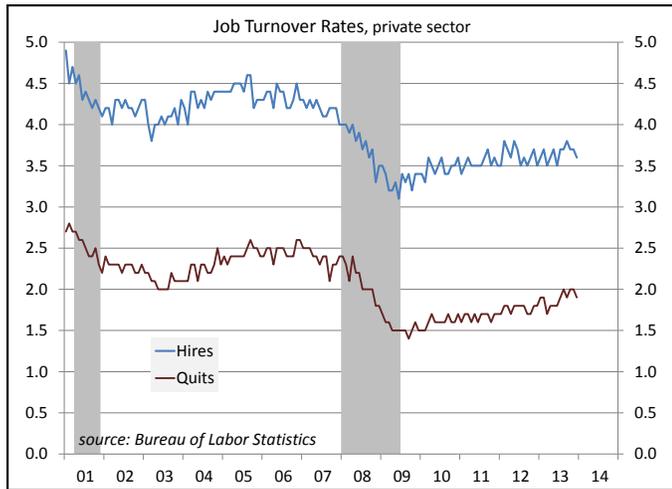
Monday

No significant economic data.

Tuesday

Small Business Optimism Index (February) – Weather may have been a more critical factor for small businesses in February, but the level of sentiment was not particularly high to begin with.

Job Opening and Labor Turnover Survey (January) – With the unemployment rate near 6.5%, Federal Reserve officials will look to other gauges of labor market strength. Hiring rates and quit rates should trend higher as the labor market improves, but recent levels have remained relatively low by historical standards, which is consistent with the view that considerable slack remains.



Wednesday

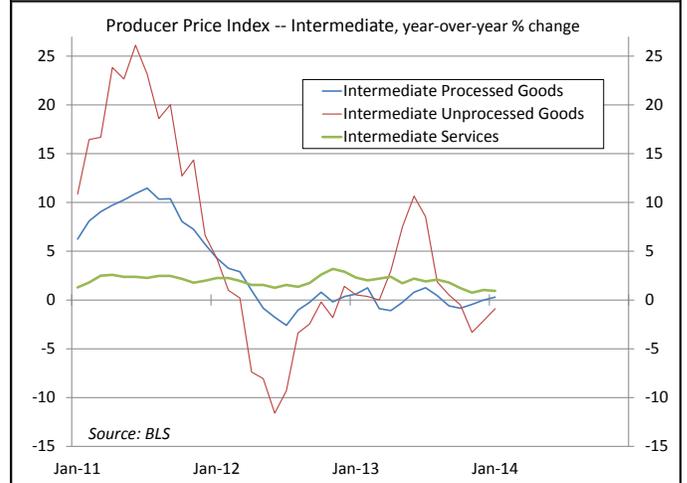
Treasury Budget – March 1 fell on a weekend, shifting some spending into February, but February 1 fell on a weekend, shifting some of February’s spending into January.

Thursday

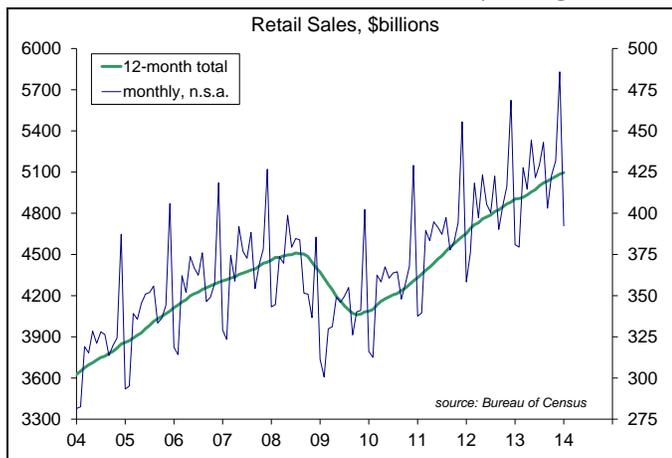
Jobless Claims (week ending March 8) – With seasonal noise fading, the weekly claims figures are expected to settle near the recent trend, but we may see that trend begin to edge lower as we move into spring and weather effects diminish.

Import Prices (February) – Some increase in January, but we should see a return to a lower trend in the near term.

Retail Sales (February) – Who cares? February is a throw-away month for most retailers and weather is expected to have been a factor in some areas. The results for March, April, and May will be much more critical for the consumer spending outlook.



Consumer Sentiment (mid-March) – Likely to pick up.



Fed Nomination Hearings – Postponed from last week. The Senate Banking Committee will grill Fed Governor Powell (nominated for a full term), Stanley Fischer, and Lael Brainard.

Friday

Producer Price Index (February) – The newly expanded PPI Report (now with services) received relatively little fanfare last month, but is a major expansion in the coverage of inflation pressures. Those inflation pressures have been relatively mild in recent months and are unlikely to heat up anytime soon.

Next Week ...

Fed officials are expected to further taper the monthly pace of asset purchases and rework the language (but not the message) of the forward guidance. Fed officials will resubmit their projections of growth, unemployment, inflation, and the federal funds target rates. Fed Chair Yellen will hold her first post-FOMC press briefing. It’s expected that she will be better at getting the Fed’s message across.

Coming Events and Data Releases

- March 18 NCAA Tournament Begins
- March 25 Consumer Confidence (March)
- March 26 Durable Goods Orders (February)
- March 31 Major League Baseball – Opening Day
- April 1 ISM Manufacturing Index (March)
- April 4 Employment Report (March)
- April 7 NCAA Tournament Championship
- April 18 Good Friday Holiday (markets closed)
- April 30 FOMC Policy Decision (no press briefing)
- June 18 FOMC Policy Decision, Yellen Press Briefing