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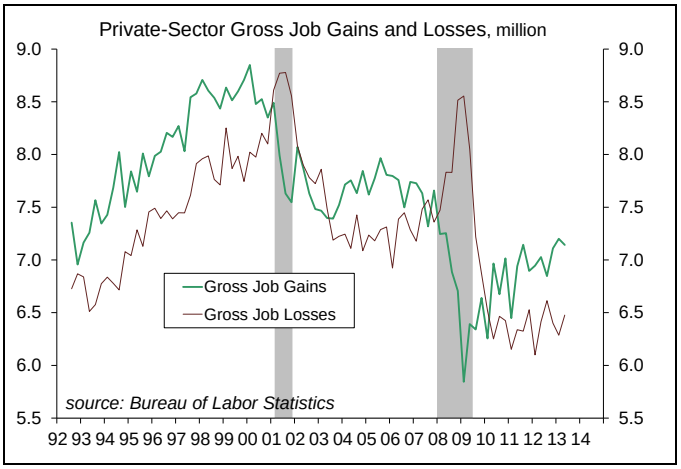
Weekly Market Monitor

Yellen's Three Big Questions (and a Few Others)

Speaking to the Economic Club of New York, Fed Chair Janet Yellen presented an analysis of the monetary policy actions taken to address the Great Recession and offered guidance on what will drive policy decisions going forward. The centerpiece of her talk was about the three big questions that the Fed has to answer. However, there are a number of other debates going on in economics right now that have long-term consequences.

The Fed's first big question is how much slack remains in the labor market. Yellen has spoken at length about the job market. Indeed, her dashboard is full of gauges suggesting that we are a long way from full employment. The unemployment rate has fallen, but the decline overstates the improvement in the job market. Part of the decline in labor force participation is demographics (the aging of the population), but most is due to discouraged workers who have given up on finding a job (hence, are not officially counted as "unemployed") or other individuals who would take a good job if offered. The Business Employment Dynamics data (3Q13 data are due on April 29) suggest that labor turnover has been remarkably low in recent years. Job destruction is trending low, but fewer workers are quitting to pursue more attractive wage offers elsewhere.

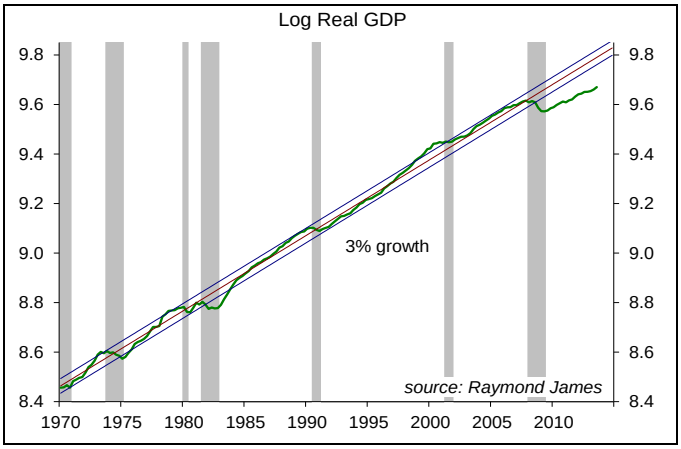


The Fed's second big question is whether inflation is returning to its 2% goal. Some observers are still screaming that, even though it hasn't show up yet, hyperinflation is just around the corner. Hogwash! Inflation is a monetary phenomenon, but it shows up through pressures in resource markets. The soft global economy means limited upward pressure on commodity prices. U.S. imports (raw materials and finished goods) have exhibited modest price increases over the last year. With plenty of excess capacity, we aren't going to see bottleneck or production pressures pushing prices of goods significantly higher. The labor market is the widest channel for inflation pressures, but we're still seeing limited compensation gains.

The Fed expects inflation to trend back toward the 2% goal, but a prolonged period of low inflation creates some risks for the economy. All else equal, a continued low trend in inflation would push out the expected timing of a Fed rate increase.

The third big question is what could derail the economic expansion. Obviously, we don't know. Yellen cited examples from recent years (the greater-than-expected fiscal tightening and spillover effects from Europe's crisis). Yellen noted that the Fed responded to unexpected weakness in the U.S. economy with aggressive policy actions (QE2, Operation Twist, and QE3).

Yellen said that because the course of the economy is uncertain, the Fed needs to *"watch carefully for signs that it is diverging from the baseline outlook and then respond in a systematic way."* That doesn't mean responding to short-term wiggles, such as adverse weather. Rather, policymakers will respond to more substantial changes in the outlook.



Economists, mostly outside the Fed, are currently debating the longer-term prospects for the U.S. economy. One issue is the possibility of secular stagnation (a concern worldwide, not just for the U.S.). Barring an acceleration in labor productivity, a slowdown in labor input (as the population ages) implies a slower trend in GDP growth. Real GDP has averaged a 3% annual rate over the last several decades, but dipped below the trend line in the Great Recession and appears unlikely to return to that long-term trend in the foreseeable future. Continued subpar economic growth will reduce potential GDP growth.

Another concern is declining real wages for the bottom 90%. Adjusted for inflation, median weekly earnings for full-time and salary workers were the same in 1Q14 as they were in 1Q05. Low wage increases will make it harder for households to service mortgage debt and student debt (which has tripled over the last 10 years). A declining middle class (and deterioration in the lower part of the upper-income cohort) should be an important concern for all Americans, especially investors.

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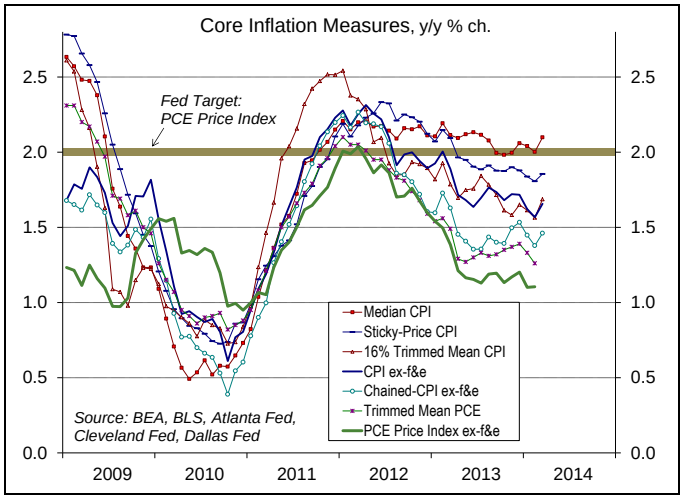
	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
3/21/14	0.06	0.08	0.14	0.45	0.91	1.73	2.75	3.61	1.378	1.650	102.38	1.119	4276.79	1866.52	16302.77
4/11/14	0.04	0.06	0.09	0.37	0.80	1.58	2.63	3.48	1.390	1.674	101.56	1.096	3999.73	1815.69	16026.75
4/17/14	0.03	0.05	0.09	0.40	0.91	1.73	2.72	3.52	1.381	1.679	102.45	1.101			

Recent Economic Data and Outlook

The stock market participants seemed only mildly concerned about ongoing tensions in Ukraine, but were encouraged by comments from Janet Yellen. Bond yields were range-bound.



Fed Chair Yellen suggested that a return to full employment may be over two years away. Monetary policy must respond to *"significant unexpected twists."* She highlighted three *"big questions"* for Fed policymakers: is there significant slack in the labor market, is inflation moving back to 2%, and what factors may push the recovery off track? She noted that *"the larger the shortfall of employment or inflation from their respective objectives, and the slower the projected progress toward those objectives, the longer the current target range for the federal funds rate is likely to be maintained."*

The **Fed's Beige Book** noted that economic activity improved in most of the 12 Federal Reserve districts. The expansion was characterized as *"modest to moderate"* in eight districts, but economic activity was reported to have declined in two others. Labor market conditions were *"mixed, but generally positive,"* while wage pressures were *"contained or minimal."* Price pressures were *"generally stable or slightly higher."*

The **Consumer Price Index** rose 0.2% in March (+1.5% y/y). Food rose 0.4% (+1.7% y/y), partly reflecting drought conditions in California. Energy slipped 0.1% (+0.4% y/y), with gasoline down 1.7% (+5.1% before seasonal adjustment, -4.7% y/y). Ex-food & energy, the CPI rose 0.2% (+1.7% y/y). The BLS reported that almost two-thirds of the increase in the core CPI was due to a 0.3% rise in the index for shelter.

Real Weekly Earnings rose 0.3% in March (+0.5% y/y), reflecting a weather-related rebound in hours.

Retail Sales rose 1.1% in March (+3.8% y/y), while February was revised higher. Ex-autos, sales rose 0.7% (+2.6% y/y). Auto sales rose 3.1% (+9.1% y/y). Sales of building materials rose 1.8% (+5.7% y/y). Sales of gasoline slipped 1.3% (-3.3% y/y). Ex-autos, building materials, and gasoline, sales rose 0.9% (+3.3% y/y), but the 1Q14 total was unchanged from that of 4Q13.

Business Inventories rose 0.4% in February (+4.2%), a slower pace than in 4Q13, while business sales rose 0.8% (+1.8% y/y).

Industrial Production rose 0.7% in March (+3.8% y/y), reflecting further gains in mining (+1.5%) and utilities (+1.0%). Manufacturing output rose 0.5% (+3.0%), but February was revised significantly higher. Industrial production rose at a 4.4% annual rate in 1Q14, but most of that was in utilities (a 17.9% annual rate) and mining (a 9.5% annual rate). Manufacturing output rose at a meager 1.7% annual rate, but is now poised for a much stronger gain in 2Q14.

Building Permits fell 2.4% in March, to a 990,000 seasonally adjusted annual rate (+11.2% y/y). Single-family permits rose 0.5% (-1.2% y/y). **Housing Starts** rose 2.8%, to a 946,000 pace (-5.9% y/y), with single-family starts up 6.0% (+1.9% y/y).

Homebuilder Sentiment edged up to 47 in April, vs. 46 in March (revised from 47). The National Association of Home Builders noted that, while demand is expected to improve, "headwinds that are holding up a more robust recovery include ongoing tight credit conditions for buyers and the fact that builders in many markets are facing a limited availability of lots and labor."

The **Empire State Manufacturing Index** fell to 1.3 in April, vs. 5.6 in March and 4.5 in February. The **Philly Fed Index** jumped to 16.6 in April, vs. 9.0 in March and -6.3 in February.

Economic Outlook (2Q14): 3.0%-3.5% GDP growth, following 0.5%-1.0% in 1Q14.

Employment: The pace of job growth is poised to pick up through the spring and early summer. Job destruction remains limited, but job turnover is trending low.

Consumers: Adverse weather dampened the pace of spending growth in the first quarter, but momentum appeared stronger heading into the second quarter. Average wages are barely keeping up with inflation (limited fuel for spending growth).

Manufacturing: Weather appeared to be a factor in the first quarter, but we should see a rebound in orders and factory output in the second quarter.

Housing/Construction: Higher mortgage rates and rising home prices have reduced housing affordability. Poor weather hasn't helped. Homebuilding activity is expected to improve, but supply constraints are likely to remain an issue.

Prices: The PCE Price Index, the Fed's chief inflation gauge, is trending well below the 2% goal, which will be a problem if that continues. Pipeline pressures have been modest. Wage gains are mild. Inflation expectations remain well-anchored.

Interest Rates: The tapering of asset purchases is *"not on a preset course,"* but Fed officials anticipate further reductions *"at a measured pace"* (-$10 billion per FOMC meeting) – and it would take a significant change in the economic outlook for the Fed to deviate from the path. If the economy evolves as the Fed anticipates, short-term interest rates are likely to be raised around the middle of 2015. Long-term interest rates should trend gradually higher, with some volatility along the way.

This Week:					*forecast*	last	last –1	comments
Monday	4/21	10:00	Leading Econ Indicators	Mar	***+0.8%***	+0.5%	+0.1%	most components were positive
Tuesday	4/22	10:00	**Existing Home Sales, mln**	Mar	***4.65***	4.60	4.62	little changed
			ex-food & energy		***+1.1***	-0.4	-5.1	will partly reflect February weather
		1:00	Treasury Note Auction					$32 billion in 2-year notes
Wednesday	4/23	9:45	Markit US Manf PMI (flash)	Apr	***NF***	55.5	57.1	not market-moving
		10:00	**New Home Sales, th.**	Mar	***455***	440	455	likely to rebound
			% change		***+3.4***	-3.3	+3.2	but watch for revisions
		1:00	Treasury Note Auction					$35 billion in 5-year notes (a re-opening?)
Thursday	4/24	8:30	Jobless Claims, th.	4/19	***310***	304	302	the trend has been falling
		8:30	**Durable Goods Orders**	Mar	***+2.0%***	+2.2%	-1.4%	Boeing reported higher aircraft orders
			ex-transportation		***+0.5%***	+0.1%	+0.9%	mixed, but moderate otherwise
			nondef cap gds ex-aircraft		***+1.0%***	-1.4%	+0.8%	choppy
		1:00	Treasury Note Auction					$29 billion in 7-year notes
Friday	4/25	9:55	Consumer Sentiment	Apr	**83.0**	80.0	81.3	82.6 at mid-month
Next Week:								
Monday	4/28	10:00	Pending Home Sales Index	Mar	***+2.0%***	-0.8%	-0.2%	likely to pick up
Tuesday	4/29	9:00	Case-Shiller Home Prices	Feb	***+0.6%***	+0.8%	+0.7%	a weather-related moderation?
			year-over-year		***+12.8%***	+13.2%	+13.4%	should begin to moderate (still high)
		10:00	**Consumer Confidence**	Apr	***84.0***	82.3	78.3	likely to improve
Wednesday	4/30	8:15	**ADP Payroll Estimate, th.**	Apr	***+215***	+191	+178	somewhat stronger
		8:30	Employment Cost Index	1Q14	***+0.5%***	+0.5%	+0.4%	a relatively low trend (+2.0% y/y)
		8:30	**Real GDP (advance est.)**	1Q14	***+0.8%***	+2.6%	+4.1%	lackluster, but not as weak as it looks
		9:45	Chicago PM Index	Apr	***56.5***	55.9	59.8	moderately strong
		2:00	**Fed Policy Decision**		***0-0.25%***	***0-0.25%***	***0-0.25%***	no change in rates
			LSAP, $bln/month		***45***	55	65	another $10 billion taper
Thursday	5/01	8:30	Jobless Claims, th.	4/26	***315***	***310***	304	some potential post-Easter noise
		8:30	Personal Income	Mar	***+0.4%***	+0.3%	+0.3%	a weather-related gain in wage income
			Personal Spending		***+0.6%***	+0.3%	+0.2%	stronger
			PCE Price Index ex-f&e		***+0.2%***	+0.1%	+0.1%	still at a low trend
		9:45	Markit US Manf PMI (final)	Apr	***NF***	55.5	57.1	overshadowed by the ISM data
		10:00	Construction Spending	Mar	***+0.5%***	+0.1%	-0.2%	should improve, but watch for revisions
		10:00	**ISM Manufacturing Index**	Apr	***54.8***	53.7	53.2	improving, but moderate
		tba	Motor Vehicle Sales, mln	Apr	***16.3***	16.3	15.3	expected to hold at a strong pace
			domestically built	Apr	***12.9***	12.8	12.0	driven by replacement needs
Friday	5/02	8:30	**Nonfarm Payrolls, th.**	Apr	***+225***	+192	+197	a pickup due to better weather
			private-sector		***+225***	+192	+188	seasonal adjustment adds uncertainty
			Unemployment Rate		***6.6%***	6.7%	6.7%	likely to have edged lower
			employment/population		***59.0%***	58.9%	58.8%	trending gradually higher
			Avg. Weekly Hours		***34.5***	34.5	34.3	seen steady
			Avg. Hourly Earnings		***+0.2%***	0.0%	+0.4%	a moderate trend

This Week…

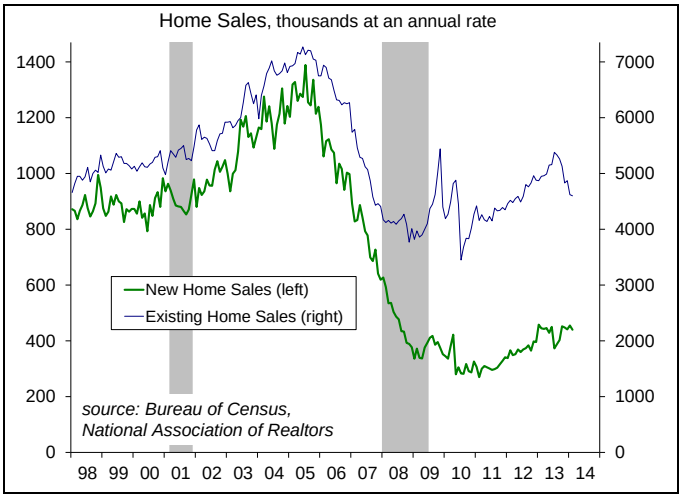
The economic data releases will be subject to noise from the weather and seasonal adjustment. While surprises could generate some reaction in the financial markets, none of the reports is going to alter the overall economic picture. That will change next week, when the April data begin to arrive (including the April Employment Report and the ISM Manufacturing Index).

Monday

Leading Economic Indicators (March) – The LEI should post a strong gain (most components are known and it's a published formula). Positive contributions will be led by the yield curve, a rebound in the factory workweek, and lower jobless claims.

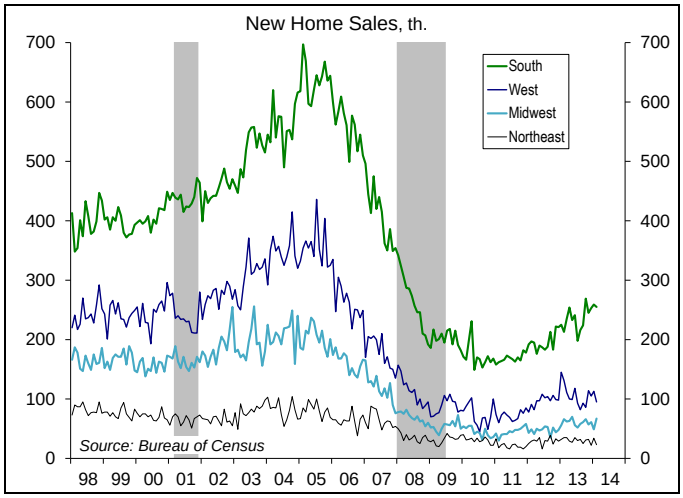
Tuesday

Existing Home Sales (March) – These figures measure closings. Hence, the March data may be more of a reflection of February's bad weather. Weather may not be the whole story. Higher prices and tight mortgage credit may have restrained demand in recent months.



Wednesday

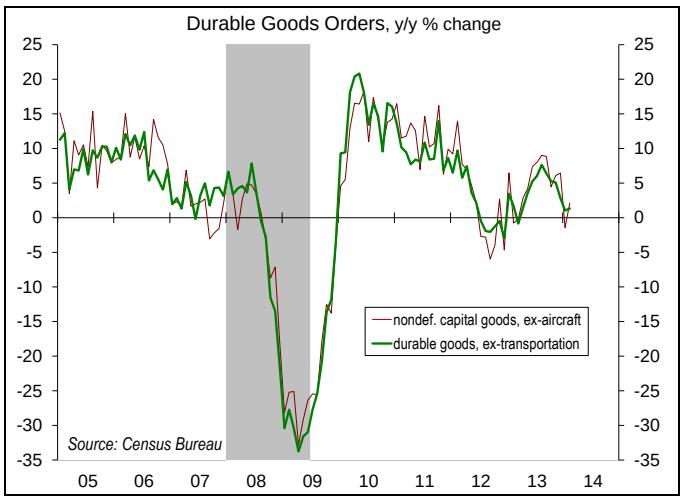
New Home Sales (March) – The figures on new home sales differ from existing home sales in a number of ways. New home sales measure initial transactions (a down payment or a signed contract). Reported sales may not be completed (say, if there is a problem qualifying for a mortgage). Being based on a statistical sample, there is a huge amount of uncertainty in the reported numbers for any particular month. Given all that, the trend appears to have softened over the last several months. Homebuilders cite tight credit for potential buyers and supply constraints (such as a lack of available lots on which to build).



Thursday

Jobless Claims (week ending April 19) – The four-week average has declined. There is some uncertainty in that. Claims can get a little noisy at the start of the quarter (when some states correct for under-reported claims in the previous quarter) and the late Easter may have made the seasonal adjustment more difficult. Yet, taken at face value, the claims data remain consistent with other signs of a low rate of job destruction.

Durable Goods Orders (March) – Boeing reported a sharp rise in aircraft orders, which should dominate the headline figures. Ex-transportation, orders are likely to be mixed, but generally moderate, partly reflecting a rebound from the effects of adverse weather. Watch shipments of capital goods.



Friday

Consumer Sentiment (April) – Should trend higher.

Next Week …

The April economic data begin to arrive. The GDP report and ISM manufacturing survey data could generate some reactions in the financial markets (especially if there is a surprise), but more weight will be placed on the payroll figures.

Consumer Confidence (April) – Consumer attitudes are likely to improve, reflecting broader economic improvement.

Real GDP (1Q14, advance estimate) – Bear in mind that the government does not have a complete picture of the economy in the first quarter and will have to make assumptions about foreign trade, inventories, and other components. These figures will be revised (and revised again). However, the story usually won't change much. Weather was a negative factor, restraining consumer spending growth and residential construction, both of which should bounce back in 2Q14. Inventory accumulation should slow, subtracting from the headline figure. A narrower trade deficit added a full percentage point to 4Q13 GDP growth, but we can expect to see the opposite of that in 1Q14. Government subtracted a percentage point from fourth quarter growth, reflecting the government shutdown in October – a partial rebound would add to GDP growth in the first quarter.

ISM Manufacturing Index (April) – Results for February and March were positive, but not especially strong. We should see improvement in April, reflecting a rebound from bad weather.

Employment Report (April) – Unadjusted payrolls normally rise at a rapid pace from February to June. In April 2013, unadjusted payrolls rose by 994,000 (seems a little silly to worry about the nearest 30,000 or so in the adjusted figures). Weather was a negative factor in January through March, so we should see an even greater pickup in April. By the time of the release, the markets may be braced for an upside surprise – hence, a moderate payroll gain (below 200,000) would be viewed as a disappointment. Seasonal adjustment could be an issue given the late Easter this year. The figures are adjusted for floating holidays, but it's hard to get it right. The unemployment rate is likely to edge lower (the figure is reported accurate to ±0.2%). Remember that the Fed is looking at a broad range of labor market indicators, not just payrolls and the unemployment rate. We have a long way to go for a full recovery in the job market.

Coming Events and Data Releases

May 5	ISM Non-Manufacturing Index (April)
May 13	Retail Sales (April)
May 16	Building Permits, Housing Starts (April)
June 7	Employment Report (May)
June 18	FOMC Policy Decision, Yellen press conference
July 30	FOMC Policy Decision (no press conference)
September 17	FOMC Policy Decision, Yellen press conference