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Weekly Market Monitor

Many Moving Parts

The U.S. economy contracted in the first quarter, but it appears very unlikely that we've entered a recession. Weather disruptions and the late Easter have made it difficult to gauge the underlying trends in the economic data, but a significant second quarter rebound appears to be baked in. Still, taking the first two quarters together, growth in the first half of the year is likely to be disappointing relative to earlier expectations. The main risk to the economic outlook is that we'll end up with "more of the same" in the second half of the year – that is, the economy continues to recover, but not at a sufficient pace to take up the slack that was created during the downturn.

Econ 1: Gross Domestic Product (GDP) is a flow (dollars per time), while inventories are a stock (dollars). The *change* in inventories (dollars per time) contributes to the *level* of GDP. Hence, *the change in the change* in inventories contributes to GDP *growth*. In other words, if inventory growth increases, that will add to GDP growth. If inventory growth slows, that subtracts from GDP growth. Over time, inventories should rise more or less in line with the pace of final sales.

The pace of inventory growth picked up sharply in 3Q13. With such a pickup, we normally see a slower pace in the following quarter – but that didn't happen in 4Q13. Instead, the pave of inventory growth remained unsustainably high. The 2nd estimate of 1Q14 GDP now shows that this correction has finally arrived. Leaner inventories should bode well for future increases in production. The trade deficit widened in the first quarter, which further subtracted from growth. Taken together, the drop in net exports and the slowdown in inventory growth subtracted 2.6 percentage points from overall GDP growth in 1Q14. Domestic Final Sales, which excludes net exports and the change in inventories, rose at a 1.6% annual rate, the same pace as in 4Q13 – certainly not strong, but not horrible either.

Consumer spending rose at a 3.1% annual rate in the 2nd estimate for 1Q14 (vs. +3.0% in the advance estimate). Weather was a restraining factor, but spending was boosted in two other areas. The Affordable Care Act appears to have contributed to an increase in healthcare, which rose at a 9.1% annual rate and contributed a full percentage point to GDP growth in 1Q14. That followed a 5.6% annual rate in 4Q13 and a 2.4% average over the 10 previous quarters. In addition, colder-than-normal temperatures led to a jump in home heating expenses in 1Q14. Spending on electricity and natural gas fell 7.8% (seasonally adjusted) from March to April, which is the main reason that overall spending slipped 0.1% (-0.3% adjusting for inflation). Assuming moderate increases in spending in May and June, we should see an inflation-adjusted pace of spending of about 2.5% in 2Q14 (but we'll need to see that confirmed in the data).

Long-term interest rates normally trend higher during an economic recovery, but they should not rise so much that they threaten the recovery. Adverse weather was a restraint on housing activity in the first quarter, but softness appears to be due to more than simply bad weather. Higher mortgage rates (relative to a year ago) and rising home values have priced many potential homebuyers out of the markets. The recent drop in mortgage rates will help to improve affordability to some extent, but the housing data bear watching closely in the months ahead. A full housing recovery is not a necessary condition for continued expansion in the overall economy, but all else equal, we'd like to see some strength in housing in the near term.

Long-term interest rates are lower than where they were at the beginning of the year and well below where they were projected to be at this point. There are a number of reasons for the recent drop. The Treasury is borrowing less, but that should have been already factored in. Inflation has remained low. Fed policy has been a bit confusing for the markets. The Fed is still adding policy accommodation as it tapers the monthly pace of asset purchases. Given the drop of Treasuries being issued, the Fed's pullback in asset purchases shouldn't have much of an impact. The Fed has clearly signaled that, barring a significant change in the economic outlook, the tapering will continue *"at a measured pace"* (although *"not on a preset course"*). The key question is when the Fed will begin to tighten policy. Until recently, the Fed was expected to begin the process of unwinding its policy accommodation by first ending its practice of reinvesting maturing securities in its portfolio. However, there's a current debate at the Fed about whether interest rates should be raised first and which rate to use (the federal funds target or the interest rate that the Fed pays on excess reserves held at the Fed). This will be settled over time, but the bottom line is that we're unlikely to see any tightening of monetary policy until around the middle of next year (although that depends on the outlooks for growth and inflation).

More recently, U.S. bond yields have been pushed down on global concerns. There may be some flight to safety (probably not a lot) due to geopolitical tensions. European investors expect the ECB to ease this week, which has put downward pressure on global bond yields. Softer global growth is a risk for the U.S. economy and may limit the growth in exports.

While the estimate of 1Q14 GDP was revised lower, forecasts of 2Q14 GDP growth are expected to be revised higher. However, even if we see 4% to 5% GDP growth in 2Q14, the first half average would be 2% or less. Growth is still anticipated to pick up to 3.0% to 3.5% in the second half of 2014. The major risk now is that it won't. The longer GDP remains below its potential, the greater the likelihood that potential GDP will slow.

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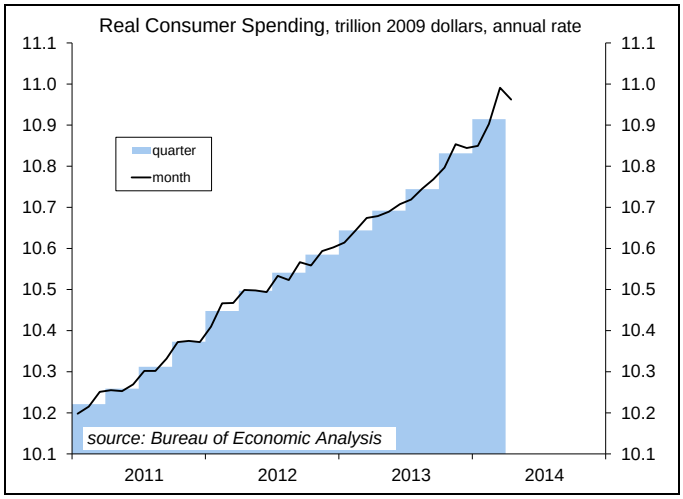
	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
5/02/14	0.02	0.05	0.10	0.42	0.89	1.67	2.60	3.37	1.386	1.687	102.34	1.097	4123.90	1881.14	16512.89
5/23/14	0.04	0.05	0.10	0.37	0.79	1.55	2.54	3.40	1.363	1.682	101.88	1.087	4185.81	1900.53	16606.27
5/30/14	0.04	0.05	0.10	0.38	0.78	1.54	2.48	3.33	1.363	1.676	101.79	1.084	4242.62	1923.49	16715.38

Recent Economic Data and Outlook

Expectations of an easing of monetary policy by the ECB helped push global bond yields lower. U.S. economic data reports were mixed. The estimate of 1Q14 GDP was revised sharply lower.



Real GDP fell at a 1.0% annual rate in the 2nd estimate for 1Q14 (vs. +0.1% in the advance estimate and expectations of -0.5%). Most of the revision was due to a slower pace of inventory accumulation, which subtracted 1.6 percentage points from GDP growth (vs. -0.6 ppt in the advance estimate). The trade deficit was revised a bit wider, subtracting 1.0 percentage point from growth (vs. -0.8 ppt in the advance estimate). Otherwise, the story didn't change by much. Domestic Final Sales (GDP less net exports and the change in inventories) rose at a 1.6% annual rate, the same as in 4Q13 (+1.9% y/y). Consumer spending rose at a 3.1% annual rate, reflecting an increase in the consumption of healthcare (which added a full percentage point to GDP growth, likely reflecting the Affordable Care Act) and higher spending to heat homes (due to colder-than-normal temperatures). Corporate profits were reported to have fallen 9.8% from the fourth quarter (-3.0% y/y), likely reflecting the impact of adverse weather.

Personal Income rose 0.3% in April (+3.6% y/y). Private-sector wages and salaries rose 0.3% (+4.2% y/y), while government wages and salaries rose 0.1% (+1.1% y/y). Disposable income rose 0.3% (+3.6% y/y), up 0.2% (+2.0% y/y) after adjusting for inflation. **Personal Spending** fell 0.1%, reflecting declines in motor vehicles (-2.4%) and in electricity and natural gas (-7.8%, reflecting a return to more normal temperatures). Adjusted for inflation, consumer spending fell 0.3% (+2.7% y/y), but (assuming moderate gains in May and June) still appears to be on track for an annual rate of about 2.5% in the second quarter (vs. 3.1% in 1Q14). The **PCE Price Index** rose 0.2% (+1.6% y/y), up 0.2% ex-food & energy (+0.172% before rounding, +1.4% y/y).

The Conference Board's **Consumer Confidence Index** rose to 83.0 in the initial estimate for May, vs. 81.7 in April (revised from 82.3) and 83.9 in March. Evaluations of current job availability were a bit less depressed. Expectations of household income were mixed – a greater percentage expected increases, but the number of those expecting declines also rose.

The University of Michigan's **Consumer Sentiment Index** was 81.9 in May, little changed from the 81.8 reading at mid-month, but down from 84.1 in April.

Durable Goods Orders rose 0.8% in April, reflecting a 13.1% rise in defense aircraft (civilian aircraft orders fell 4.1%). Ex-transportation, orders rose 0.1%, following a 2.9% jump in March (+3.3%), with lackluster results across sectors.

The **Case-Shiller Home Price Index** rose 1.2% in March, following a 0.8% rise in February, up 12.4% from a year ago.

The **Pending Home Sales Index** rose 0.4% in April, following a 3.4% rise in March, down 9.2% from a year ago.

The **Chicago Purchasing Managers Index** rose to 65.5 in May, vs. 63.0 in April and 55.9 in March, reportedly on strength in order backlogs (NAPM-Chicago no longer releases details to the general public). Production and employment expanded at a slower pace (following strong gains in April). Prices paid picked up. Comments from supply managers were said to be cautious.

Economic Outlook (2Q14): 4.0% GDP growth, perhaps higher.

Employment: Job growth has picked up, but April figures may have been distorted by a rebound from poor weather and the late Easter. A large amount of slack remains in the job market.

Consumers: Mixed. Average wage growth remains relatively soft, but job growth contributes to gains in aggregate income.

Manufacturing: Leaner inventories bode well for industrial production, but the soft global economy is likely to limit growth in exports. Factory jobs have lagged in payroll growth.

Housing/Construction: Higher mortgage rates (vs. last year) and rising home prices have reduced affordability. Construction activity is expected to improve in the near term, but supply constraints may remain an issue for most homebuilders.

Prices: The PCE Price Index, the Fed's chief inflation gauge, is trending 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.

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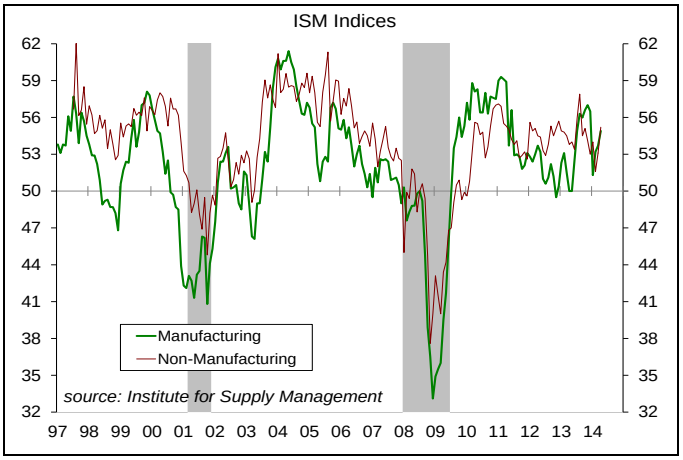
This Week:					*forecast*	last	last –1	comments
Monday	6/02	9:45	Markit US Manf PMI (final)		***NF***	55.4	55.5	56.2 in the "flash" estimate
		10:00	Construction Spending	Apr	***+1.2%***	+0.2%	-0.2%	rebounding from poor weather
		10:00	**ISM Manufacturing Index**	May	***55.6***	54.9	53.7	moderately strong
Tuesday	6/03	10:00	Factory Orders	Apr	***+0.7%***	+1.1%	+1.5%	durable goods orders reported at +0.8%
		tba	Motor Vehicle Sales, mln		***16.2***	16.0	16.3	likely to have remained strong
			domestically built		***12.8***	12.7	12.8	should add to 2Q14 GDP growth
Wednesday	6/04	8:15	**ADP Payroll Estimate, th.**	May	***+220***	+222	+209	moderately strong
		8:30	NF Productivity (revised)		***-2.8%***	+2.3%	+3.5%	-1.7% in the preliminary estimate
			Unit Labor Costs		***+5.1%***	-0.4%	-2.1%	+4.2% in the preliminary estimate
		8:30	**Trade Balance, $bln**	Apr	***-41.0***	-40.4	-41.9	seen a bit wider
			goods only		***-61.2***	-60.7	-61.3	watch the trend in exports
		10:00	**ISM Non-Manf. Index**	May	***55.8***	55.2	53.1	likely to have improved
		10:00	BOC Policy Decision					no change
		2:00	**Fed Beige Book**					mixed, but better overall
Thursday	6/05	7:00	BOE Policy Decision					no change
		7:45	ECB Policy Decision					change expected, but what exactly?
		8:30	Jobless Claims, th.	5/31	***315***	300	327	a low trend
Friday	6/06	8:30	**Nonfarm Payrolls, th.**	May	***+205***	+288	+203	expecting a more moderate gain
			private-sector		**+200**	+273	+202	but watch for revisions
			Unemployment Rate		**6.4%**	6.3%	6.7%	partly reversing April's sharp decline
			employment/population		**59.0%**	58.9%	58.9%	should be trending gradually higher
			Avg. Weekly Hours		**34.5**	34.5	34.5	steady
			Avg. Hourly Earnings		**+0.2%**	0.0%	+0.1%	modest wage pressures
Next Week:								
Monday	6/09		no significant economic data					
Tuesday	6/10	7:30	Small Business Optimism	May	***NF***	95.2	93.4	trending higher, but still relatively soft
		10:00	JOLTS: hiring rate		***NF***	3.2%	3.3%	a flat trend, still well below normal
			JOLTS: quit rate		***NF***	1.7%	1.8%	workers aren't optimistic enough to quit
		1:00	Treasury Note Auction					3-year notes
Wednesday	6/11	1:00	Treasury Note Auction					re-opened 10-year notes
			Treasury Budget, $bln	May	***NF***	-138.7	-124.6	seen narrower
Thursday	6/12	8:30	Jobless Claims, th.	6/07	***315***	315	300	a low trend
		8:30	Import Prices	May	***NF***	-0.4%	+0.4%	a low trend
			ex-food & fuels		***NF***	+0.1%	+0.1%	very mild
		8:30	**Retail Sales**	May	***+0.6%***	+0.1%	+1.5%	some pickup is anticipated
			ex-autos		***+0.5%***	0.0%	+1.0%	a moderately strong trend
			ex-autos, bld mat, gasoline		***+0.4%***	-0.2%	+1.4%	watch for revisions
		10:00	Business Inventories	Apr	***NF***	+0.4%	+0.5%	a moderate pace seen in 2Q14
		1:00	Treasury Bond Auction					re-opened 30-year bonds
Friday	6/13	8:30	**Producer Price Index**	May	***+0.4%***	+0.6%	+0.5%	some pressure expected in food
			ex-food & energy		***+0.1%***	+0.5%	+0.6%	core rate unexpectedly high in Mar, Apr
		9:55	Consumer Sentiment	m-Jun	**82.5**	81.9	84.1	seen higher

This Week…

Busy. The May ISM surveys have some potential to surprise and we could see the markets react. The ECB meeting will be very important to European financial markets (and seems likely to disappoint, because that's usually what the ECB does), which could carry over here. The Employment Report should be the highlight. Payroll growth for April was reported stronger than expected, but how much of that was a rebound from bad weather, how much was the late Easter, and will we see a revision? The May payroll figures will help set economic expectations as we look to the second half of the year.

Monday

ISM Manufacturing Index (May) – The survey is likely to reflect a pickup in activity in May. Leaner inventories are normally a signal of better production ahead. However, the soft global economy is likely to restrain growth in exports. Watch the components on new orders and employment. Note there is a fair amount of noise in these data from month to month.



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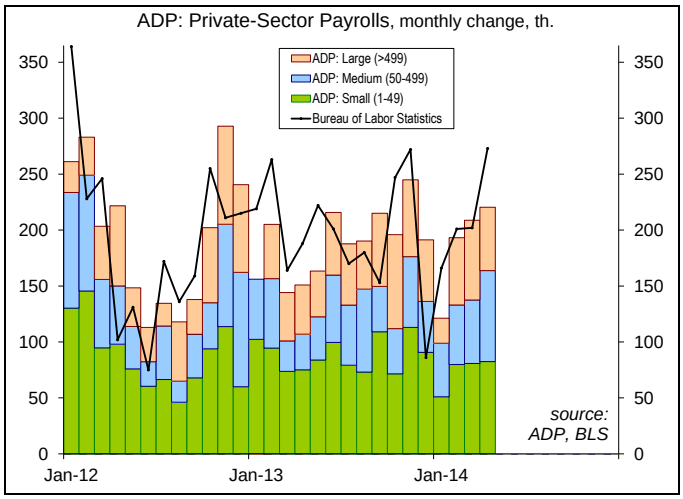
Tuesday

Motor Vehicle Sales (May) – The two key drivers of vehicle sales are likely to remain in effect. One, cars get old. Replacement needs should keep the pace of vehicle sales relatively high. Two, banks are generally very willing to make auto loans (it's a lot easier to repossess a car than a home).

Wednesday

ADP Payroll Estimate (May) – The ADP estimate is not seen as a good predictor of the official BLS payroll figure, but a large enough surprise could rattle the market. Unlike the BLS figures, the ADP data are available by size of firms. We normally look to small and medium-size businesses (really, newer firms) to account for a lot of the job growth in an expansion (and that's definitely been the case in recent months).



ISM Non-Manufacturing Index (May) – Activity picked up in April, but may have been boosted somewhat by the late Easter holiday. Further improvement is expected for the May survey.

Fed Beige Book – Fed policymakers do not make decisions based solely on the hard economic data releases. They also receive an ample amount of anecdotal information, including the Beige Book. Expect a mixed assessment in this report, but conditions are likely to have improved overall. Watch for what is said about the job market, wage pressures, and prices.

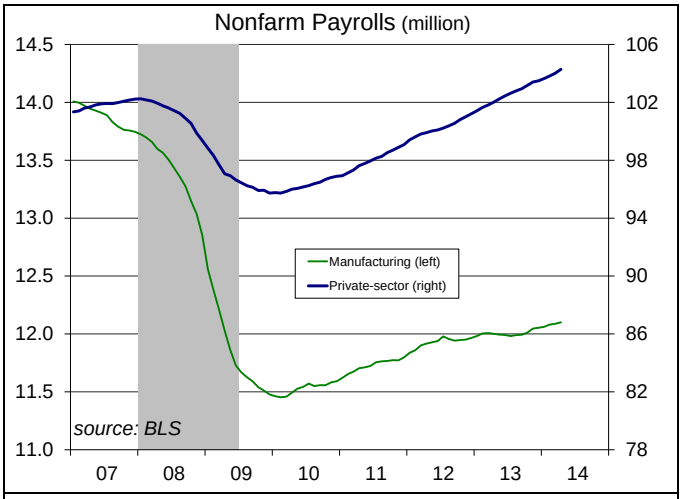
Thursday

ECB Policy Decision – Enough talk. The European Central Bank's Governing Council is expected to ease monetary policy. However, it's unclear exactly what actions it will take. The markets have factored in a rate cut, including a negative deposit rate, but are also expecting other steps to boost the flow of credit. The ECB has a tradition of disappointing the markets, but in his press conference, ECB President Draghi will likely offer hope of further action. We could see some volatility between the release of the policy statement and Draghi's Q&A.

Jobless Claims (week ending May 31) – Claims have been a bit choppy over the last several weeks, but the four-week average has remained relatively low, consistent with improving labor market conditions. However, job destruction hasn't been an issue in years. The main concern is job creation.

Friday

Employment Report (May) – The rebound from poor weather and the late Easter may have exaggerated the payroll gain for April. We should see some moderation in May, but the trend is likely to remain relatively strong. Still, we have a long way to go for a full recovery in the job market.



Next Week …

The economic calendar thins out. The retail sales report stands out as the obvious highlight (in terms of the data), but there may be other things for the markets to worry about.

Coming Events and Data Releases

June 16	Industrial Production (May) Homebuilder Sentiment (June)
June 17	Consumer Price Index (May) Building Permits, Housing Starts (May)
June 18	FOMC Policy Decision, Yellen press conference
July 3	Employment Report (June)
July 4	Independence Day Holiday (markets closed)
July 30	Real GDP (2Q14 advance, benchmark revisions) FOMC Policy Decision (no press conference)
September 17	FOMC Policy Decision, Yellen press conference
October 29	FOMC Policy Decision (no press conference)

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