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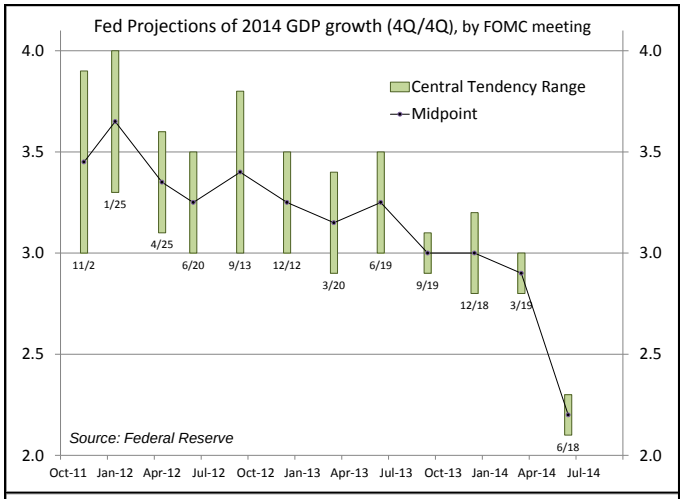
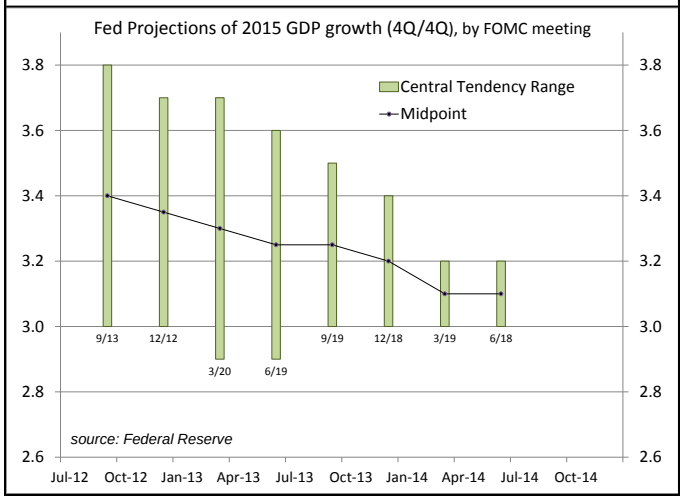
Weekly Market Monitor

The Fed's Outlook: Optimistic? Or Just Hopeful?

As expected, Federal Reserve policymakers left short-term interest rates unchanged, did not alter the forward guidance on the federal funds target rate, and trimmed the monthly pace of asset purchases by another $10 billion (to $35 billion beginning in July). In its policy statement, the FOMC was a bit more optimistic about a pickup in growth. Fed officials' forecasts of 2014 GDP growth were revised lower, but implicitly, forecasts for the final three quarters of 2014 remained strong. The range of expectations for GDP growth in 2015 and 2016 were the same as those made in March. In her press conference, Fed Chair Janet Yellen remained optimistic, but noted uncertainties. She also downplayed the risk of higher inflation.

At every other FOMC meeting, the Fed governors and 12 district bank presidents submit forecasts of GDP growth, unemployment, and inflation. The three highest and three lowest of these forecasts are thrown out to arrive at what are called "central tendency" ranges.





The central tendency range for 2014 GDP growth (4Q/4Q) was revised to 2.1-2.3% (vs. March's range of 2.8-3.0%). That was entirely due to the reported decline in 1Q14 GDP growth (which may be revised even lower this week). Implicitly, the new range corresponds to a 3.1-3.4% average pace of GDP growth for the final three quarters of 2014. Moreover, the central tendency ranges for GDP growth in 2015 and 2016 were exactly the same as in March (3.0-3.2% and 2.5-3.0%, respectively).

In her press conference, Yellen said that, while there is uncertainty, *"there are many good reasons why we should see a period of sustained growth in excess of the economy's potential,"* citing *"a highly accommodative monetary policy, diminishing fiscal drag, easing credit conditions,"* as well as more manageable household debt levels, rising home prices, and higher equity prices. Asked about the impact of developments outside the U.S., Yellen noted that there were geopolitical risks, which could have an impact on energy supplies and prices – but she expressed optimism that growth in emerging economies will be moderate and then pick up.

Asked about whether the Fed was "behind the curve" on inflation, Yellen said that *"the CPI has been a bit on the high side, but the data that we're seeing is noisy,"* adding that *"broadly speaking, inflation is evolving in line with the committee's expectations."* These comments helped to ease the concerns of some market participants that recent higher inflation figures would lead the Fed to begin raising short-term interest rates sooner rather than later. Bond yields dipped.

Economic growth has disappointed in the last few years and Fed officials have generally revised their GDP forecasts lower over time. Some economists fear secular stagnation – a slower trend rate of growth in GDP (due in part to demographic factors). Yellen indicated that part of the reason we're seeing disappointing growth and slower growth of potential output is the weak pace of capital investment. *"As the economy picks up,"* said Yellen, *"I certainly would hope to see that contribution restored."* She also noted that elevated levels of long-term unemployment have also limited the economy's potential, and noted that *"my hope is that, as the economy recovers, we will see some repair,"* drawing discouraged workers and many others at the margins back into the labor force.

A video and transcript of Yellen's press conference is available on the Fed's website. Yellen displays confidence. That's part of the job. However, she used the word "uncertainty" nine times and the word "hope" three times, which suggests that the Fed may not be all that confident about the economic outlook. The first quarter was a weather story; the second quarter will be a rebound story. Monetary policy in 2015 will depend on what happens in the second half of 2014.

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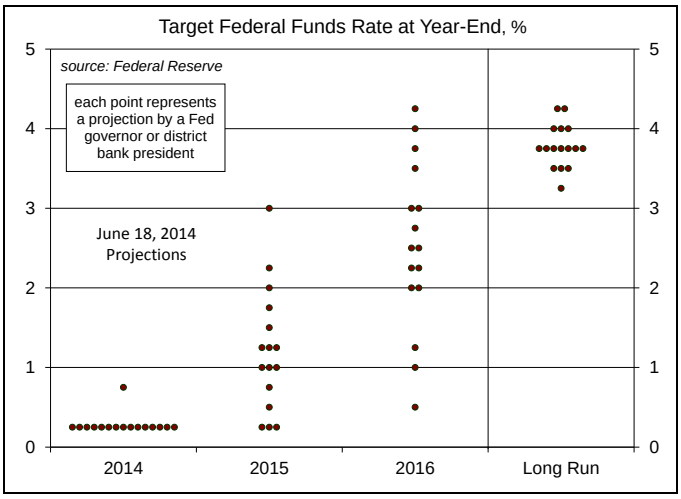
	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
5/23/14	0.04	0.05	0.10	0.37	0.79	1.55	2.54	3.40	1.363	1.682	101.88	1.087	4185.81	1900.53	16606.27
6/13/14	0.04	0.07	0.11	0.45	0.93	1.70	2.60	3.41	1.352	1.695	102.06	1.087	4310.65	1936.16	16775.74
6/20/14	0.02	0.04	0.08	0.46	0.94	1.69	2.61	3.44	1.360	1.701	102.08	1.075	4368.04	1962.90	16947.59

Recent Economic Data and Outlook

No surprises from the Fed. More importantly, Fed Chair Yellen did not say anything to upset the markets.



As expected, the **Federal Open Market Committee** left short-term interest rates unchanged, maintained its forward guidance on the overnight lending target rate, and trimmed another $10 billion in its monthly pace of asset purchases (down to $35 billion starting in July). The FOMC noted that "economic activity has rebounded in recent months," adding that "household spending appears to be rising moderately" and "business fixed investment resumed its advance."

In the **Summary of Economic Projections**, Fed officials forecast slower GDP growth in 2014, but that was due to the reported drop in 1Q14 GDP. The central tendency ranges (which exclude the three lowest and three highest forecasts) of GDP growth for 2015 and 2016 were the same as in March. Given the reported 1% decline in GDP for 1Q14, the Fed's forecast range for 2014 (2.1% to 2.3%) implies an average pace of GDP growth of 3.1% to 3.4% for the final three quarters of 2014.

In her post-meeting press conference Fed Chair **Janet Yellen** remained optimistic that growth would be strong, citing continued monetary policy accommodation, diminishing fiscal drag, easing credit conditions, higher home prices, and rising equity prices. Despite some downside risks to the global outlook, Yellen expects moderate improvement in emerging market economies. She downplayed concerns about the recent uptick in the Consumer Price Index, noting that "the data that we're seeing is noisy." She said that Fed officials are discussing the mechanics of normalizing the stance of monetary policy, but emphasized that was "prudent planning" and not a "signal of any immediate change in the stance of monetary policy." The FOMC is working through the issues of normalization and expects to provide additional details later this year.

The **Consumer Price Index** rose 0.4% in May (+2.1% y/y), boosted by a 0.7% rise in food at home (likely reflecting effects of the drought in California). Ex-food & energy, the CPI rose 0.3% (+0.258% before rounding, +2.0% y/y), boosted by a 5.8% jump in airfares and a 0.7% rise in prescription drugs.

Real Weekly Earnings fell 0.1% in May, down 0.1% y/y.

Industrial Production rose 0.6% in May (+4.3% y/y), while April was revised to show a smaller decline (-0.3%, vs. -0.6% reported a month ago). Manufacturing output rose 0.7% (+3.8% y/y), led by a 1.5% increase in motor vehicles (+7.7% y/y).

Building Permits fell 6.1% in May, to a 991,000 seasonally adjusted annual rate (-1.9% y/y). Single-family permits rose 3.7% (-0.8% y/y). **Housing Starts** fell 6.5%, to a 1.001 million pace (+9.4% y/y), with single-family starts down 5.9% (+4.7% y/y).

Homebuilders Sentiment improved to 49 in June, vs. 45 in May. Respondents were more optimistic about current and future sales conditions. The traffic of prospective buyers, while higher than in May, remained relatively poor.

The **Current Account Deficit** widened to $111.2 billion (2.6% of GDP) in 1Q14, vs. $87.3 billion (2.0% of GDP) in 4Q13.

The Index of **Leading Economic Indicators** rose 0.5% in May. The only significant negative contribution came from the reported drop in building permits.

Economic Outlook (2Q14): 3.0% to 3.5% GDP growth, expected to be restrained partly by a wider trade deficit.

Employment: Job destruction has continued to trend at a low level. New hiring appears to be picking up (concentrated in small and medium-sized firms).

Consumers: Lackluster growth in real average wages is a limiting factor for spending, but strong job growth helps fuel aggregate spending. Credit is still relatively tight (except for autos), but is expected to gradually improve.

Manufacturing: Lean inventories usually bode well for future production gains, but softer global growth is likely to limit export growth. Results vary across sectors, but overall manufacturing strength has lagged the overall economy.

Housing/Construction: Builder supply constraints are a factor, but higher home prices have reduced affordability. The spring housing season has been disappointing.

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.

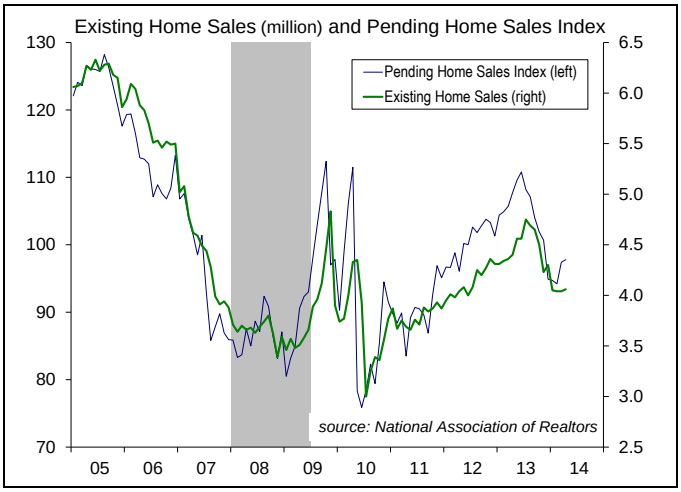
This Week:					*forecast*	last	last –1	comments
Monday	6/23	9:45	Markit US Manf PMI ("flash")	Jun	***NF***	56.4	55.4	not market-moving
		10:00	**Existing Home Sales, mln**	May	***4.72***	4.65	4.59	expecting some pickup
			% change		***+1.5***	+1.3	-0.2	affordability still an issue
Tuesday	6/24	9:00	Case-Shiller Home Prices	Apr	***+0.8%***	+1.2%	+0.8%	still rising
			year-over-year		***11.5%***	+12.4%	+12.9%	but y/y pace should moderate
		10:00	**New Home Sales, th.**	May	***450***	433	407	choppy, but seen higher in May
			% change		***+3.9***	+6.4	-6.9	watch for possible revisions
		10:00	**Consumer Confidence**	Jun	***84.2***	83.0	81.7	should improve
		1:00	Treasury Note Auction					2-year notes
Wednesday	6/25	8:30	Real GDP (3rd estimate)	1Q14	***-1.1%***	+2.6%	+4.1%	-1.0% in the 2nd estimate
		8:30	**Durable Goods Orders**	May	***+0.4%***	+0.6%	+3.7%	choppy, but likely a bit higher
			ex-transportation		***+0.3%***	+0.3%	+3.0%	even with a soft May, 2Q will be higher
			nondef cap gds ex-aircraft		***+0.4%***	-1.2%	+4.7%	choppy, but a moderately strong trend
		1:00	FRN auction					re-opened 2-year floating-rate notes
		1:00	Treasury Note Auction					5-year notes
Thursday	6/26	8:30	Jobless Claims, th.	6/21	***314***	312	318	seen little change
		8:30	Personal Income	May	***+0.4%***	+0.3%	+0.5%	moderate growth in aggregate wages
			Personal Spending		***+0.5%***	-0.1%	+1.0%	watch for revisions to April
			PCE Price Index ex-f&e		***+0.2%***	+0.2%	+0.2%	mild core inflation
		12:00	**WCup: USA vs. Germany**		***Ger***			Good luck! -- we'll need it.
		1:00	Treasury Note Auction					7-year notes
Friday	6/27	9:55	Consumer Sentiment	Jun	**81.7**	81.9	84.1	81.2 at mid-month
Next Week:								
Monday	6/30	9:45	Chicago PM Index	Jun	***62.8***	65.5	63.0	seen a bit lower (still strong)
		10:00	Pending Home Sales Index	May	***+3.0***	+0.4	+3.4	should see a further rebound
Tuesday	7/01	9:45	Markit US Manf. PMI (final)	Jun	***NF***	56.4	55.4	not market-moving
		10:00	Construction Spending	May	***NF***	+0.2	+0.6	choppy and subject to large revisions
		10:00	**ISM Manf. Index**	Jun	***56.0***	55.4	54.9	moderately strong
		tba	Motor Vehicle Sales, mln	Jun	***16.5***	16.7	16.0	still relatively brisk
			domestically built		***12.9***	13.1	12.6	likely to add to GDP growth in 2Q14
Wednesday	7/02	8:15	**ADP Payroll Estimate, th.**	Jun	***+205***	+179	+215	moderately strong
		10:00	Factory Orders	May	***NF***	+0.7	+1.5	moderate improvement
Thursday	7/03	7:45	ECB Policy Decision					no change
		8:30	Jobless Claims, th.	6/28	***313***	***314***	312	some seasonal noise, but a low trend
		8:30	**Nonfarm Payrolls, th.**	Jun	***+225***	+217	+282	seasonal adjustment adds uncertainty
			private-sector		***+220***	+216	+271	a moderately strong trend
			Unemployment Rate		***6.2***	6.3	6.3	trending lower
			employment/population		***59.0***	58.9	58.9	little changed over the last year
			Average Weekly Hours		***34.5***	34.5	34.5	no change
			Average Hourly Earnings		***+0.2***	+0.2	+0.0	mild wage pressures
		8:30	Trade Balance, $bln	May	***-46.2***	-47.2	-44.2	choppy, but likely a bit narrower
			goods only		***-64.2***	-65.2	-62.5	seen wider in 2Q, a drag on GDP growth
		10:00	**ISM Non-Manf. Index**	Jun	***56.6***	56.3	55.2	moderately strong
Friday	7/04		Independence Day holiday					market closed

This Week…

The economic data reports have some potential to surprise, and therefore, move the markets, but none of it will add much to the overall economic outlook. The GDP revision will get more attention than usual (for a 3rd estimate), but revisions to the first quarter growth estimate (which may be more likely to show up in annual benchmark revisions in late July) aren't going to alter growth forecasts for the second half of 2014.

Monday

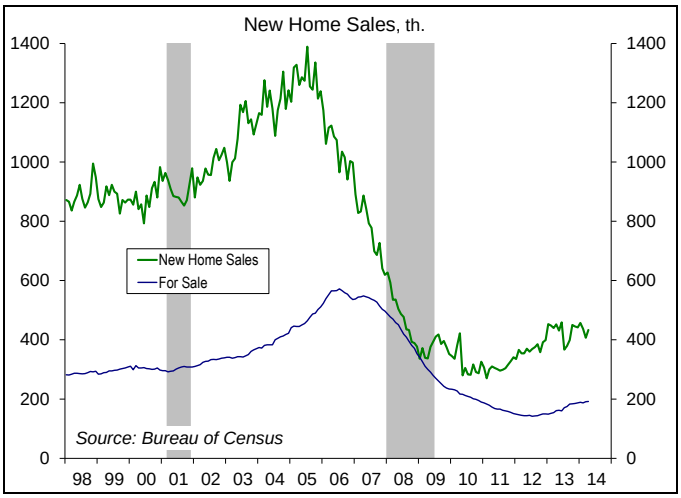
Existing Home Sales (May) – The rise in mortgage rates in the second half of 2013 took some of the wind out of home sales in early 2014. Mortgage rates have come down a bit (still higher than a year ago), which should help in the near term. However, higher home prices have reduced affordability.



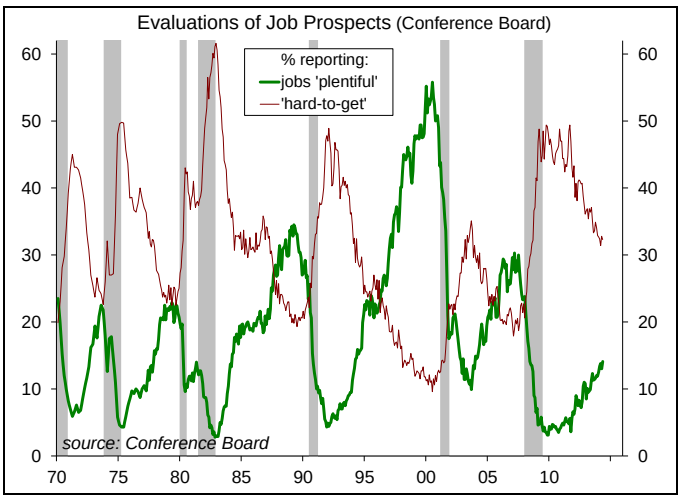
Tuesday

Case-Shiller Home Price Index (April) – Home prices are expected to have risen further in May, although the year-over-year pace should moderate (as a 1.7% rise in April 2013 falls off the back end of the 12-month change calculation).

New Home Sales (May) – By now, investors should be well aware of the various supply and demand issues that have restrained the housing sector this year. Some improvement is expected for May, but bear in mind that the reported figures are unreliable (they are choppy and subject to large revisions).



Conference Board Consumer Confidence (June) – Consumer confidence is likely to have improved in June. Note that the initial estimate is based on information collected over the first half of the month. Figures are revised the next month (to reflect information for the full month). In comparisons to other consumer attitude surveys, the Conference Board's data have a more direct measurement of job market perceptions. These perceptions have remained depressed in recent months, but have become gradually less so (moreover, job perceptions appear to lag actual job market conditions).



Wednesday

Real GDP (1Q14, 3rd estimate) – Some forecasts are anticipating that the first quarter growth figure (+0.1% in the advance estimate, -1.0% in the 2nd estimate) will be revised sharply lower still. The Census Bureau's quarterly report on selected service industries showed substantially less spending on healthcare than was seen in the GDP report. We also had benchmark revisions to the international trade data. However, these and other revisions to the source data may be more likely to show up in the annual benchmark revisions to the National Income and Product Accounts, due July 30 (along with the advance estimate of 2Q14 GDP growth). Typically, revisions between the 2nd estimate and 3rd estimate of GDP growth are mild, but that's not always the case. With a wide range of individual forecasts for the 3rd estimate, somebody is going to end up surprised. Financial market participants would be wise to take it all in stride and not make bets on this particular GDP reading – the numbers are going to change again next month.

Durable Goods Orders (May) – Boeing reported an increase in orders for last month (following a sharp decline in April). Ex-transportation, orders are likely to be mixed, but mostly higher. Monthly changes in these figures tend to be choppy.

Thursday

Jobless Claims (week ending June 21) – There may be some issues with the seasonal adjustment following the end of the school year, but more uncertainty lies ahead with the annual auto plant retooling shutdowns set for early July. Take any large moves over the next few weeks with a grain of salt. The underlying trend in claims should remain relatively low.

Personal Income and Spending (May) – Income and spending numbers are rarely much of a market-mover. We usually have a good idea of income based on the employment report. The retail sales reports tell us a lot about consumer spending. Still, the spending figures are a direct input into the GDP calculation and consumer spending accounts for 70% of GDP.

Friday

UM Consumer Sentiment Index (June) – Seen little changed.

Next Week …

The will be a lot of economic data ahead of the Fourth of July holiday, and most of it should reinforce the idea that 2Q14 growth has been relatively strong. The focus is expected to be on the June payroll estimate (Thursday). Other important data are likely to get lost in the shuffle.

Coming Events and Data Releases

July 15	Retail Sales (June)
July 16	Fed Beige Book
July 17	Building Permits, Housing Starts (June)
mid-July (tbd)	Yellen Monetary Policy Testimony
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)
December 17	FOMC Policy Decision, Yellen press conference