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Weekly Market Monitor

Are Interest Rates "Too Low?"

In her monetary policy testimony to Congress, Federal Reserve Chair Janet Yellen offered no new clues regarding when the central bank will begin raising short-term interest rates. The Fed has been criticized for being "behind the curve" on inflation and for fueling bubbles. Neither criticism is right.

Inflation figures have picked up in recent months. The Consumer Price Index rose at a 2.6% annual rate in the first five months of 2014, a 2.3% pace ex-food & energy. The Fed's official gauge, the PCE Price Index, rose at a 1.9% annual rate, a 1.7% pace ex-food & energy (vs. the Fed's official goal of 2%).

In the depth of the recession, when the Fed began its extraordinary policy measures, a number of critics said that inflation would soon take off and some even suggested that hyperinflation was "just around the corner." More sober commentators noted that the huge amount of slack in the economy, especially in the labor market, would keep inflation in check. Nearly six years later, higher inflation has yet to arrive. In her testimony to the Joint Economic Committee last month, Janet Yellen dismissed the recent pickup in the CPI as "noise" and there's good reason to believe that's the case. The Producer Price Report (recently expanded to include services) suggests no significant pipeline pressures. Import price figures show no pressure in raw materials or in finished goods. Wage pressures remain relatively contained.

The inflation mongers dismiss low inflation readings as meaningless – the government either isn't measuring inflation correctly or is purposely distorting the figures. There are a number of empirical issues in how inflation is measured, but the Bureau of Labor Statistics does a remarkably good job. Consider MIT's Billion Price Project, which tracks online retail prices and shows inflation relatively close to the official figures. Note that one's personal inflation rate will vary, depending on what goods and services the individual purchases.

At some point, of course, the Fed will need to begin to normalize monetary policy, but there's nothing to suggest that the Fed is currently behind the curve on inflation.

The other main criticism of monetary policy is that the Fed is fueling bubbles. From the Monetary Policy Report to Congress:

"With regard to asset valuations, house prices have continued to increase, but, for the most part, these increases have left aggregate price-to-rent ratios within historical norms. Moreover, growth in residential mortgage debt has remained anemic, suggesting that the recent increases are not fueled by excessively aggressive lending conditions. More broadly, aggregate measures of the household debt burden appear reasonable despite recent rapid growth in auto lending and student loans, which has strained some borrowers, particularly those in the lower half of the income distribution."

"However, signs of risk-taking have increased in some asset classes. Equity valuations of smaller firms as well as social media and biotechnology firms appear to be stretched, with ratios of prices to forward earnings remaining high relative to historical norms. Beyond equities, risk spreads for corporate bonds have narrowed and yields have reached all-time lows. Issuance of speculative-grade corporate bonds and leveraged loans has been very robust, and underwriting standards have loosened. For example, average debt-to-earnings multiples have risen, and the share rated B or below has moved up further for leveraged loans. The Federal Reserve continues to closely monitor developments in the leveraged lending market and, in conjunction with other federal agencies, is working to enhance compliance with previous guidance on issuance, pricing, and underwriting standards."

So, the Fed definitely sees signs of excess in some areas, but this is not a widespread problem for the financial sector as a whole. Yellen promised that the Fed will continue to monitor the situation closely. Earlier this month, she indicated that the Fed would not use monetary policy as the first line of defense against bubbles, but would instead rely primarily on supervision. Yet, she noted that the Fed's regulatory powers, while having increased since the financial crisis, are not where they need to be. Hence, she didn't rule out a tightening of monetary policy as a tool to restrain financial bubbles if need be. Of course, the track record on this is not very good. Tightening to address a bubble, the Fed risks weakening the economy. The financial crisis demonstrates the problem of not tightening soon enough.

One regularly hears that stock prices are artificially inflated due to the Fed's actions and that the market is bound to correct once the Fed begins to raise short-term rates. Let's consider the logic here. Broadly speaking, there are two ways to value stocks. One is to think of the price as a risk-adjusted discounted stream of future earnings. A lower interest rate means that future earnings are discounted less – hence, a higher stock price (all else equal). As the economy improves, earnings should increase, but higher interest rates mean greater discounting of those earnings. It may not be clear whether the increase in earnings will offset the greater discounting, but risk and uncertainty should decrease as the economy improves. However, note that the shape of the yield curve implies an expected path of interest rates, which should be incorporated into the discounting of future earnings. So, stock market valuations should therefore depend not on whether interest rates rise, but on whether they rise faster or slower than the market currently expects. That's the key question.

The other way to value stocks is the same as the way one values art. That is, what's the next person willing to pay? Technical analysis, the study of chart patterns, is one way to measure market sentiment. That's beyond my ken, but interest rates are probably right about where they should be.

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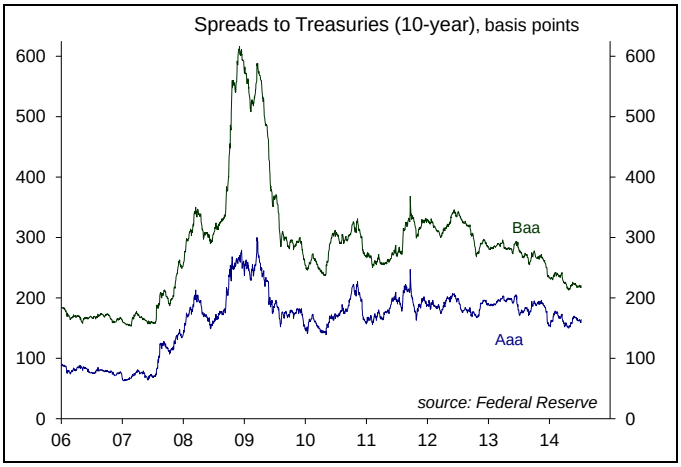
	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
6/20/14	0.02	0.04	0.09	0.50	0.94	1.71	2.63	3.44	1.359	1.701	102.14	1.077	4368.04	1962.87	16947.08
7/11/14	0.02	0.07	0.11	0.48	0.92	1.65	2.53	3.34	1.360	1.711	101.33	1.072	4415.49	1967.57	16943.81
7/18/14	0.02	0.05	0.08	0.48	0.97	1.67	2.49	3.29	1.353	1.709	101.33	1.074	4432.15	1978.19	17098.51

Recent Economic Data and Outlook

Geopolitical tensions escalated (Russia/Ukraine, Middle East), dampening the stock market mood. Reports on retail sales and industrial production had similar narratives: disappointing June numbers, with upward revisions to April and May (consistent with a strong rebound in 2Q14 from weather-related weakness in 1Q14, but with some loss of momentum heading toward 3Q14)



In her monetary policy testimony to Congress, **Fed Chair Yellen** said that *"the recovery is not yet complete"* and *"a high degree of policy accommodation remains appropriate."* She indicated that the Fed's asset purchases should come to an end after October. In Q&A, Yellen refused to be pinned down on a date for the first increase in short-term interest rates. She noted that low rates could lead to a reach for yield, which could create vulnerabilities for the financial system. She said that while valuations may be stretched in some areas (such as speculative-grade corporate bonds), *"prices of real estate, equities, and corporate bonds, remain generally in line with historical norms."*

The **Beige Book** described economic growth among the 12 Federal Reserve districts as either *"modest"* or *"moderate."* Motor vehicle sales were strong in most areas, but retail sales grew *"modestly"* otherwise. Loan volumes increased at a *"slight to moderate"* pace. Job growth was *"slight to moderate."* There were some reports of skilled labor shortages and wage increases for these workers, but overall wage pressures *"remained modest."* Price pressures were *"generally contained."*

Retail Sales rose 0.2% in June (+4.3% y/y), while figures for April and May were revised higher. Ex-autos, building materials, and gasoline, sales rose 0.5% (+4.2% y/y) – a 6.7% annual rate in 2Q14 (vs. +0.1% in 1Q14).

Business Inventories rose 0.5% in May (+5.6% y/y), while sales rose 0.4% (+4.6% y/y). Inventory growth appears likely to have picked up in 2Q14, adding to overall GDP growth.

Industrial Production rose 0.2% in June, while figures for April and May were revised higher. Manufacturing output edged up 0.1% (a 7.0% annual rate in 2Q14, vs. +1.5% in 1Q14). Auto output slipped 0.3% (following +1.9% in May, +6.8% y/y). Ex-autos, factory output rose 0.2% (+3.3% y/y).

Building Permits fell 4.2% in June, to a 963,000 seasonally adjusted annual rate (+2.7% y/y). Single-family permits, the key figure in the report, rose 2.6% (+0.6% y/y). **Housing Starts** sank 9.3%, to an 893,000 pace (+7.5% y/y), with single-family starts down 9.0% (±10.1%, hence not statistically different from 0%).

Homebuilder Sentiment rose to 53 in July, vs. 49 in June and 45 in May. Builders were more optimistic about current and future sales conditions. Foot-traffic of prospective buyers improved, but remained relatively low by historical standards.

The **Producer Price Index** rose 0.4% in June (+1.9% y/y), boosted partly by the seasonal adjustment for gasoline. Food fell 0.2% (+3.5% y/y). Energy rose 2.1% (+2.9% y/y). Gasoline rose 6.4% (+1.8% before seasonal adjustment, +1.2% y/y). Ex-food & energy, the PPI rose 0.2% (+1.8% y/y). Outside of energy, pipeline pressures remained relatively mild.

Import Prices rose 0.1% in June (+1.2% y/y). Ex-food & fuels, import prices fell 0.1% (-0.2% y/y).

The **Index of Leading Economic Indicators** rose 0.3% in June, the fifth consecutive monthly increase.

Economic Outlook (3Q14): 2.5% to 3.0% GDP growth, vs. 2.5% to 3.0% in 2Q14 (limited 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 gains. 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 industries, but overall manufacturing strength has lagged the overall economy.

Housing/Construction: Builder supply constraints have been a factor, but should improve over time. Higher home prices have reduced affordability, but may be moderating. 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	7/21		Chicago Fed Nat Act Index	Jun	***NF***	+0.21	-0.15	should be positive
			3-month average		***NF***	+0.18	+0.31	indicating growth above historical trend
Tuesday	7/22	8:30	**Consumer Price Index**	Jun	***+0.3%***	+0.4%	+0.3%	some pressure from gasoline
			year-over-year		***+2.1%***	+2.1%	+2.0%	moderate
			ex-food & energy		***+0.1%***	+0.3%	+0.2%	mild core inflation
			year-over-year		***+2.0%***	+2.0%	+1.8%	still a low trend
		8:30	Real Earnings	Jun	***+0.1%***	-0.1%	-0.2%	nominal weekly earnings rose 0.4%
		10:00	**Existing Home Sales, mln**	Jun	***4.95***	4.89	4.66	likely to have risen
			% change		***+1.3***	+4.9	+1.5	more reflective of activity in May
Wednesday	7/23		no significant data					Happy Birthday, Woody Harrelson!
Thursday	7/24	8:30	Jobless Claims, th.	7/19	***310***	302	305	subject to seasonal noise
		9:45	Markit US Manf PMI (flash)	Jun	***NF***	57.3	56.4	moderate
		10:00	**New Home Sales**	Jun	***475***	504	425	these figures are choppy
			% change		***-5.7***	+18.6	+3.7	watch for revisions
		1:00	TIPS Auction					$15 billion in 10-year TIPS
Friday	7/25	8:30	**Durable Goods Orders**	Jun	***+0.5%***	-0.9%	+0.9%	aircraft orders up a bit
			ex-transportation		***+0.6%***	0.0%	+0.4%	choppy, likely to improve
			nondef cap gds ex-aircraft		***+0.6%***	+0.7%	-1.1%	should trend higher
Next Week:								
Monday	7/28	10:00	Pending Home Sales Index	Jun	***+2.0%***	+6.1%	+0.5%	likely to have risen further
		1:00	Treasury Note Auction					2-year notes
Tuesday	7/29	9:00	Case-Shiller Home Prices	May	***+0.3%***	+0.2%	+1.2%	pace should be slowing
			year-over-year		***+10.1%***	+10.8%	+12.6%	y/y gap still high, but edging lower
		10:00	**Consumer Confidence**	Jul	***85.6***	85.2	82.2	watch for revisions to May
		1:00	Treasury Note Auction					5-year notes
Wednesday	7/30	8:15	**ADP Payroll Estimate, th.**	Jul	***+220***	+281	+179	moderate
		8:30	**Real GDP (advance)**	2Q14	***+2.7%***	-2.9%	+2.6%	annual benchmark revisions due
			Domestic Final Sales		***+3.0%***	+0.3%	+1.6%	rebounding from bad weather
		11:30	FRN Auction					2-year Floating-Rate Notes
		1:00	Treasury Auction					7-year notes
		2:00	**FOMC Policy Decision**		***0-0.25%***	0-0.25%	0-0.25%	no change
			LSAP: Treasuries, $bln/mo		***15***	20	25	another taper
			LSAP: MBS, $bln/mo		***10***	15	20	no surprise
Thursday	7/31	8:30	Jobless Claims, th.	7/26	***320***	***310***	302	subject to seasonal noise
		8:30	Employment Cost Index	2Q14	***+0.4%***	+0.3%	+0.5%	trending below +2% y/y
		9:45	Chicago PMI	Jul	***61.5***	62.6	65.5	some moderation seen (still strong)
Friday	8/01	8:30	**Nonfarm Payrolls, th.**	Jul	***+200***	+288	+224	moderately strong
			private-sector		***+210***	+262	+224	watch for revisions
			Unemployment Rate		***6.1%***	6.1%	6.3%	trending lower
			employment/population		***59.0%***	59.0%	58.9	trending gradually higher
			Avg. Weekly Hours		***34.5***	34.5	34.5	steady
			Avg. Hourly Earnings		***+0.2%***	+0.2%	+0.2%	moderate wage pressures
		8:30	Personal Income	Jun	***+0.5%***	+0.4%	+0.3%	some pickup in jobs and wages
			Personal Spending		***+0.4%***	+0.2%	+0.0%	mixed, but moderate (revisions?)
			PCE Price Index ex-f&e		***+0.2%***	+0.2%	+0.2%	mild core inflation
		9:45	Markit US Manf PMI (final)	Jul	***NF***	57.3	56.4	not market-moving
		9:55	Consumer Sentiment	Jul	***82.2***	82.5	81.9	81.3 at mid-month
		10:00	Construction Spending	Jun	***NF***	+0.1%	+0.8%	watch for revisions to May
		10:00	**ISM Manf. Index**	Jul	***55.2***	55.3	55.4	moderate
		tba	Motor Vehicle Sales, mln	Jul	***17.0***	16.9	16.7	still strong
			domestically built		**13.3**	13.3	13.1	seen flat or slightly higher

This Week…

Durable goods orders and home sales figures have some potential to move the financial markets, although investors may be more concerned about geopolitical tensions. Gasoline should lift the CPI a bit, but core inflation should remain mild.

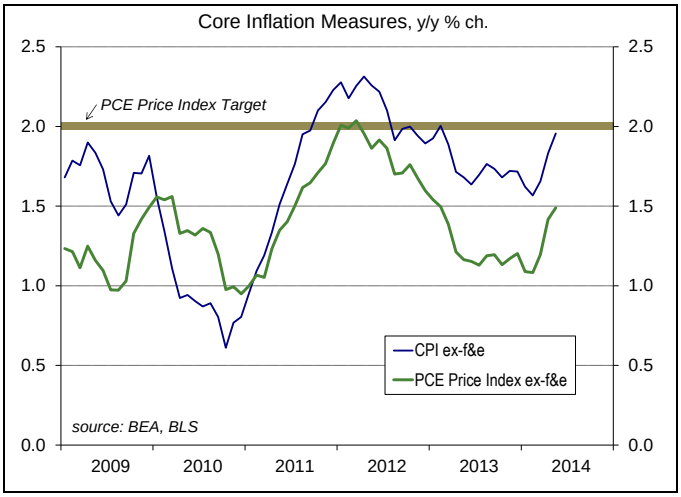
Monday

Chicago Fed National Activity Index (June) – The CFNAI doesn't receive much attention from the markets. However, it does provide a nice summary of the overall economic picture. The three-month average is likely to suggest that economic growth remains a bit above its historical average.

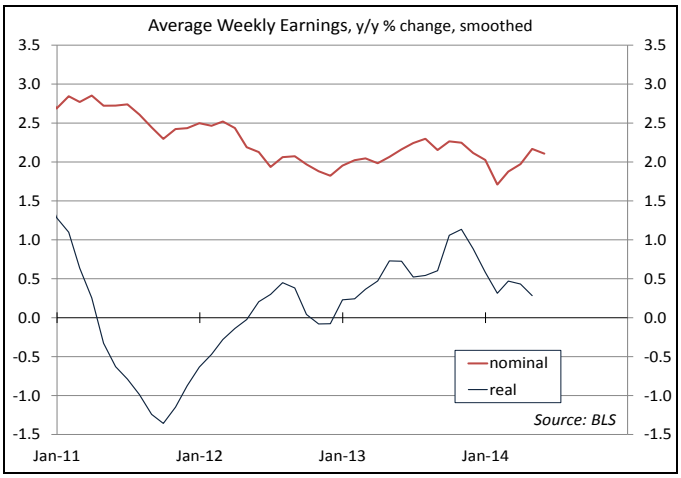
Tuesday

Consumer Price Index (June) – Gasoline prices edged up about 0.5% last month, but the seasonal adjustment will be looking for a decline of about 2.9% (hence, a seasonally adjusted increase of about 3.4% or roughly 0.15 percentage point to the headline

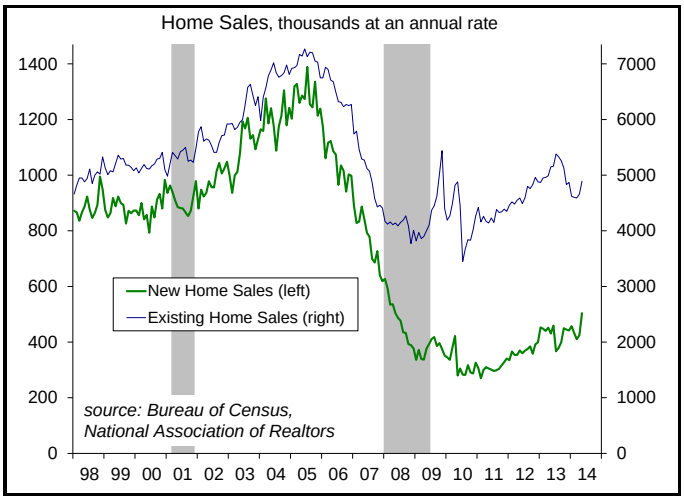
GDP figure. Otherwise, core inflation is likely to be mild. Note that the core CPI is currently trending about 0.5 percentage point below the PCE Price Index (the Fed's target gauge).



Real Earnings (June) – Should be up slightly. The lack of growth in real wages has been a limiting factor for consumer spending growth and the overall economy.



Existing Home Sales (June) – Existing sales, which measure closings, are likely to have improved further last month. The pace is probably not too far from normal, but is still a bit inflated by distressed home sales.



Wednesday

No significant data.

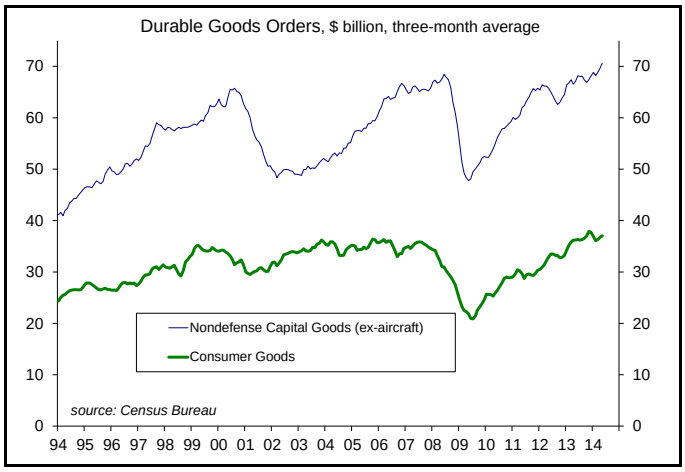
Thursday

Jobless Claims (week ending July 18) – Weekly figures are unreliable in July. However, low figures for the first two weeks of the month suggest that seasonal shutdowns in the auto industry are less severe this year.

New Home Sales (June) – These figures represent initial transactions (a down payment or signed contract), but are extremely volatile from month to month. The May pace of sales was unusually strong, so we may see a pullback in June or a revision to the previously published figure.

Friday

Durable Goods Orders (June) – Boeing reported a moderate increase in orders. Otherwise, results are likely to be mixed across industries. Watch shipments and inventories, which will have some minor implications for 2Q14 GDP estimates.



Next Week …

¡Ay, caramba! Wednesday brings the advance GDP estimate for 2Q14 (along with annual benchmark revisions) in the morning and the Fed policy announcement in the afternoon (no Yellen press conference). Friday brings the July Employment Report and the ISM Manufacturing Index. A lot to digest, but the Fed is unlikely to signal a change in course. The economic figures should help refine estimates of growth in the second half.

Coming Events and Data Releases

August 5	ISM Non-Manufacturing Index (July)
August 6	Trade Balance (June)
August 13	Retail Sales (July)
August 15	Industrial Production (July)
September 1	Labor Day (markets closed)
September 17	FOMC Policy Decision, Yellen press conference
October 29	FOMC Policy Decision (no press conference)
December 17	FOMC Policy Decision, Yellen press conference