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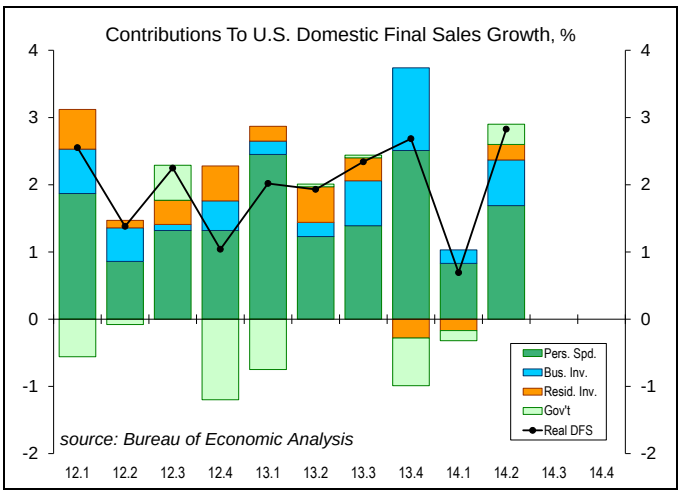
Weekly Market Monitor

So, What Did We Learn?

The busy week of economic news left investors uneasy. The 4.0% GDP growth figure contributed to concerns that the Fed may be forced to raise short-term interest rates sooner rather than later. However, while the economic data reports, and even the Fed policy statement, had something for everybody, the outlook for monetary policy should be essentially unchanged.

Real GDP rose more than expected in the advance estimate for 2Q14 and benchmark revisions showed a somewhat smaller decline in 1Q14 than was reported earlier (-2.1%, vs. -2.9%). That left the average pace for the first half of 2014 at 0.9%, vs. expectations of around 0.0%. Well, whoop-dee-doo! The surprise in the GDP report was the rapid pace of inventory accumulation, which accounted for a little over 40% of the quarter's growth (1.66 percentage points). Inventory growth is often tough to interpret. It could be unintentional, the result of unexpectedly weak demand, or it could be planned, based on expectations of increased demand. It's usually hard to say. Moreover, these figures have a tendency to get revised (the 2Q14 GDP figures will be revised on August 28 and again on September 26). Taken at face value, the second quarter's pace of inventory growth will be difficult to maintain. Hence, if we don't get revisions to the 2Q14 figures, we should see the pace drop in 3Q14 or in 4Q14, restraining overall GDP growth.



Domestic Final Sales (GDP less net exports and the change in inventories) provides a more stable picture of underlying domestic demand. DFS rose at a 2.8% annual rate in 2Q14, vs. +0.7% in 1Q14, for a first-half average of 1.8%.

The key question is, does this tell us anything about the second half of the year? Well, not much. Many of the recent economic data releases, such as retail sales and industrial production, have painted a similar picture. That is, growth rebounded in the second quarter, from weather-related weakness in 1Q14, but the monthly figures suggested some loss of momentum in June. One of the key concerns has not been that the economy would slump back into recession this year, but rather, that we'd end up with "more of the same," with the economy continuing to recover, but at only a moderate pace, where the excesses generated in the economic downturn would continue to be mopped up only gradually over time.

The recent data reports suggest a mixed outlook. Job growth has been strong, but real average wage growth has been flat. Personal income and spending figures show moderate growth heading toward the second half of the year, but the housing recovery has been a major disappointment. A sluggish global economy will likely restrain growth in exports, while geopolitical worries could lead to more cautious business attitudes in general (firms being somewhat less likely to hire or make capital expenditures). In short, there are a variety of crosscurrents, but the pace of growth is likely to remain moderately strong.

Fears of inflation are overdone. The PCE Price Index picked up in 2Q14, but the year-over-year pace remained well below the Fed's 2% target. Pipeline inflation pressures appear mild. Inflation expectations remain well-anchored. The Employment Cost Index accelerated to 0.7% over the three months ending in June, but that followed a subpar 0.3% pace over the three months ending in March. The ECI rose 2.0% over the last 12 months, about the same pace as the three previous years. As Fed Chair Yellen pointed out, we should see the ECI trending between 3% and 4% under normal job market conditions. The low trend in labor compensation can be taken as one sign of slack in the job market.

In its policy statement, the FOMC noted that the unemployment rate has declined further. However, it also stressed that *"a range of labor market indicators suggests that there remains significant underutilization of labor resources."* This concern will remain a key factor in the Fed policy outlook. Financial market participants will want to pay close attention to the Kansas City Fed's upcoming monetary policy symposium in Jackson Hole, Wyoming. Each of these annual meetings of central bankers from around the world has a theme. This year, it's *"Re-Evaluating Labor Market Dynamics."* We could see policymakers rethink their views on the job market, but more likely, the discussions may reinforce the Fed's resolve to let the economy run (to reduce the amount of slack). We'll see.

The FOMC statement and recent data reports give inflation hawks something to squawk about, but the majority opinion of Fed policymakers should be unchanged. The FOMC will continue to refine its exit strategies, but there's no sign that it is behind the curve on inflation. Policy actions in 2015 will be dictated by the evolution of the economic outlook in 2H14.

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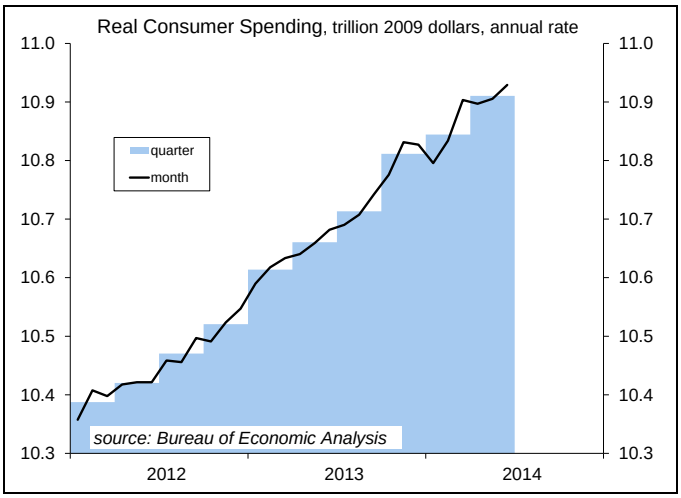
	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
7/03/14	0.01	0.06	0.11	0.52	0.98	1.74	2.65	3.47	1.361	1.715	102.19	1.063	4485.93	1985.44	17068.26
7/25/14	0.03	0.06	0.11	0.53	0.98	1.69	2.48	3.24	1.343	1.697	101.81	1.081	4449.56	1978.34	16960.57
8/01/14	0.03	0.05	0.11	0.48	0.92	1.67	2.50	3.28	1.342	1.682	102.57	1.092	4352.64	1925.20	16493.37

Recent Economic Data and Outlook

Fed policymakers did not surprise, but a stronger-than-expected second quarter GDP number and a pickup in the Employment Cost Index added to concerns that the Fed might raise short-term interest rates sooner than anticipated.



The **Federal Open Market Committee** tapered its monthly pace of asset purchases by another $10 billion (to $25 billion), on track to finish the program at the end of October. The FOMC provided no new guidance on short-term rates, but repeated that *"it likely will be appropriate to maintain the current target range for the federal funds rate for a considerable time after the asset purchase program ends"* and *"economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run."* The FOMC recognized that inflation has *"moved somewhat closer"* to its long-term objective and that labor market conditions have improved, but it also emphasized that "there remains significant underutilization of labor resources."

The July **Employment Report** was moderately strong. Nonfarm payrolls rose by 209,000, less than expected, while May and June were revised a net 15,000 higher. Note that unadjusted payrolls fell by 1.11 million (reflecting the end of the school year), a little less than the decline in July 2013 (1.15 million). The unemployment rate ticked up to 6.2% (vs. 6.1% in June and 6.3% in May), as labor force participation edged up (most likely, that's just statistical noise). Average hourly earnings were flat, up 2.0%, roughly in line with inflation.

The **ADP Estimate** of private-sector job growth slowed to +218,000 in July, vs. +281,000 in June.

Real GDP rose at a 4.0% annual rate in the advance estimate for 2Q14 (+2.4% y/y), following a -2.1% pace in 1Q14 (revised from -2.9%). Consumer spending rose at a 2.5% annual rate (vs. +1.3% in 1Q14). Business fixed investment rose 5.5% (vs. +1.6%). A more rapid pace of inventory accumulation added 1.66 percentage points to GDP (accounting for over 40% of GDP growth), while net exports subtracted 0.61 percentage point.

Personal Income rose 0.4% in June (+3.9% y/y). **Personal Spending** rose 0.4% (+4.0% y/y), up 0.2% adjusting for inflation (+2.3% y/y). The **PCE Price Index** rose 0.2% (+1.6% y/y), up 0.1% excluding food & energy (+1.5% y/y).

The **Employment Cost Index** rose 0.7% over the three months ending in June, rebounding from a subpar reading (+0.3%) in the three months to March – up 2.0% y/y, the same pace as over the 12 previous quarters (vs. a "normal" pace of 3.5% to 4.0%).

The Conference Board's **Consumer Confidence Index** rose to 90.9 in the initial estimate for July (the highest since October 2007). Respondents were less pessimistic about current job conditions and turned a bit optimistic about future job availability. Results varied considerably by region.

The **ISM Manufacturing Index** rose to 57.1 in July, vs. 55.3 in June. Growth in new orders and employment picked up. Comments from supply managers were mixed, but mostly upbeat.

The **Chicago Purchasing Managers Index** fell 10 points in July, to 52.6. The drop followed three unusually strong months.

Construction Spending fell 1.8% in June, but figures for April and May were revised higher (implying, all else equal, a very slight upward revision to the 2Q14 GDP growth figure).

The **Pending Home Sales Index** fell 1.1% in June, following a +6.0% in May (-7.3% y/y), with mixed results across regions.

The **Case-Shiller Home Price Index** fell 0.3% in May (+1.1% before seasonal adjustment), up 9.3% y/y. Prices were lower in May for 14 of the 20 metropolitan areas covered.

Economic Outlook (3Q14): 2.5% to 3.0%

Employment: The pace of job growth is likely to moderate following strong gains in the second quarter. Job losses continue to trend at a low level. Hiring appears to have picked up, but geopolitical risks could be a factor in the months ahead.

Consumers: Real average earnings are trending about flat, but job gains contribute to aggregate wage income, which has helped fuel consumer spending growth.

Manufacturing: Mixed results across industries, but mostly strengthening. Excess inventories and a sluggish global economy are likely to be factors in the remainder of the year.

Housing/Construction: A mixed bag. Affordability issues have weakened demand at the middle level and below. Supply constraints remain an issue for many builders.

Prices: The PCE Price Index, the Fed's chief inflation gauge, picked up in 2Q14, but the year-over-year trend remains well below the Fed's 2% target. Pipeline pressures appear to be mild. Wage pressures are limited. Inflation expectations are steady.

Interest Rates: The tapering of the Fed's monthly pace of asset purchases has continued. Short-term interest rates are expected to remain exceptionally low "for a considerable period" after the asset purchase program ends in late October. The Fed's policy moves in 2015 will be dictated by the evolution of the economic outlook in the second half of 2014.

This Week:					*forecast*	last	last –1	comments
Monday	8/04		no significant data					1892: Lizzie Borden took an axe…
Tuesday	8/05	10:00	Factory Orders	Jun	***+0.5%***	-0.7%	+0.8%	durable goods orders report at +0.7%
		10:00	**ISM Non-Manf. Index**	Jul	***55.8***	56.0	56.3	moderate
Wednesday	8/06	8:30	**Trade Balance, $bln**	Jun	***-44.8***	-44.4	-47.0	assumed little changed in adv. GDP est.
			goods only		***-63.6***	-63.3	-65.7	but we could see a surprise
		9:00	Quarterly Refunding Annc.					is a 50-year bond on the way?
Thursday	8/07	7:00	BOE Policy Decision					raising short-term rates?
		7:45	ECB Policy Decision					no move, but leaning toward more easing
		8:30	Jobless Claims, th.	8/02	***315***	302	279	still subject to seasonal noise
Friday	8/08	8:30	NF Productivity (prelim.)	2Q14	***+1.4%***	-3.2%	+2.3%	rebounding from bad weather
			Unit Labor Costs		***+1.6%***	+5.7%	-0.6%	choppy, but a low y/y trend
		10:00	Wholesale Inventories		***NF***	+0.5	+1.0	assumed higher in GDP estimate
Next Week:								
Monday	8/11		no significant data					
Tuesday	8/12	7:30	Small Business Optimism	Jul	***NF***	95.0	96.6	down in June, but trending higher
		10:00	JOLTS: hiring rate	Jun	***NF***	3.4%	3.4%	a very gradual trend of improvement
			JOLTS: quit rate		***NF***	1.8%	1.8%	little changed
		1:00	Treasury Note Auction					3-year notes
		2:00	Treasury Budget, $bln	Jul	***NF***	-97.6	-69.5	an improving trend
Wednesday	8/13	8:30	**Retail Sales**	Jul	***+0.3%***	+0.2%	+0.5%	a lackluster-to-moderate gain
			ex-autos		***+0.4%***	+0.4%	+0.4%	some decrease in gasoline prices
			ex-autos, bld mat, gasoline		***+0.5%***	+0.5%	+0.3%	moderate
		10:00	Business Inventories	Jun	***NF***	+0.5%	+0.6%	assumed to have picked up in GDP est.
		1:00	Treasury Note Auction					10-year notes
Thursday	8/14	8:30	Jobless Claims, th.	8/09	***310***	***315***	302	stabilizing at a low level
		8:30	Import Prices	Jul	***NF***	+0.1%	+0.3%	a low trend
			ex-food & fuels		***NF***	-0.1%	+0.1%	no inflation pressure from abroad
		1:00	Treasury Bond Auction					30-year bonds
Friday	8/15	8:30	**Producer Price Index**	Jul	***+0.2%***	+0.4%	-0.2%	moderate
			ex-food & energy		***+0.1%***	+0.2%	-0.1%	a low trend in core inflation
		8:30	Empire St. Manf. Index	Aug	***16.0***	25.6	19.3	likely to moderate
		9:15	**Industrial Production**	Jul	***+0.3%***	+0.2%	+0.5%	moderate, not especially strong
			Manufacturing Output		***+0.2%***	+0.1%	+0.5%	aggregate hours fell 0.2%
			Capacity Utilization		***79.2%***	79.1%	79.1%	little changed
		9:55	UM Consumer Sentiment	m-Aug	***NF***	81.8	82.5	range-bound

This Week…

The economic calendar thins out considerably and that's good. Investors should take some time to digest all the information that came out last week. The ISM Non-Manufacturing Index has some potential to surprise, but it's unlikely to add much to the bigger picture of the economy.

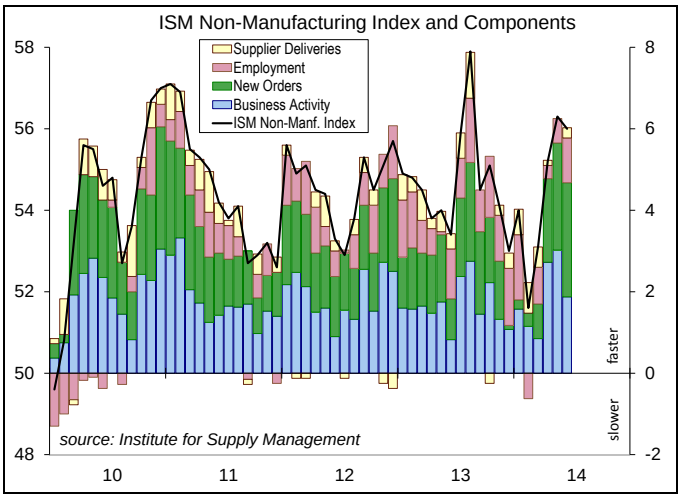
Monday

No significant data.

Tuesday

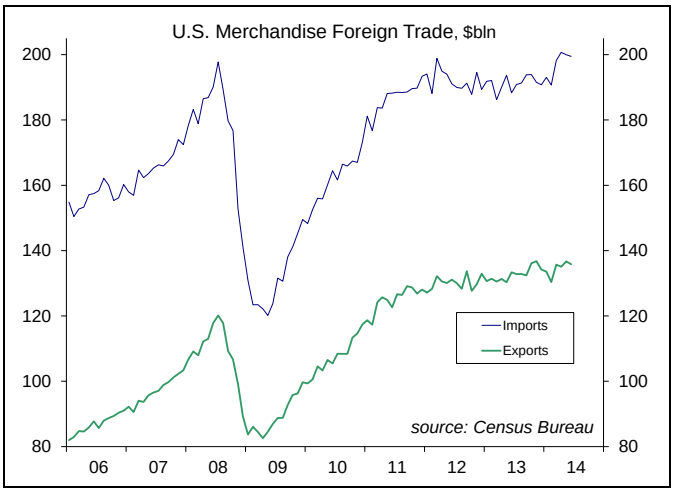
Factory Orders (June) – Almost certainly not market-moving. Factory orders are likely to have risen moderately. Durable goods orders, which account for most of the month-to-month volatility, were reported to have risen 0.7% (although that figure will be subject to revision in this report). Figures on factory shipments and inventories may have some implications for revisions to the 2Q14 GDP growth estimate, but could also influence expectations for 3Q14 GDP.

ISM Non-manufacturing Index (July) – Following strength in recent months, the headline figure is likely to reflect a more moderate pace of growth in July. There's a fair amount of noise in these figures, which means there's some chance of a surprise.



Wednesday

Trade Balance (June) – In the advance estimate of 2Q14 GDP, the trade deficit was assumed to have widened modestly in the final month of the quarter (watch for possible revisions). Looking ahead, growth in exports is likely to sputter a bit, reflecting geopolitical tensions, while growth in imports should remain strong (reflecting improvement in the overall economy).



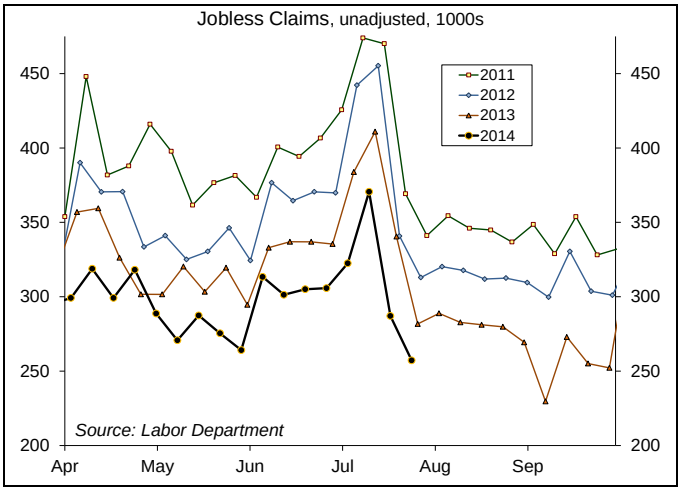
Quarterly Refunding Announcement – Treasury will announce the size of next week's auctions (3-, 10-, and 30-year securities). However, investors may be more interested in possible future changes to the offering mix. In particular, Treasury is considering whether to offer a 50-year bond. That won't likely come anytime soon, but it's something to keep an eye on.

Thursday

Bank of England Policy Meeting – The BOE's Monetary Policy Committee is reported to be considering a possible increase in short-term interest rates, but that seems a little premature.

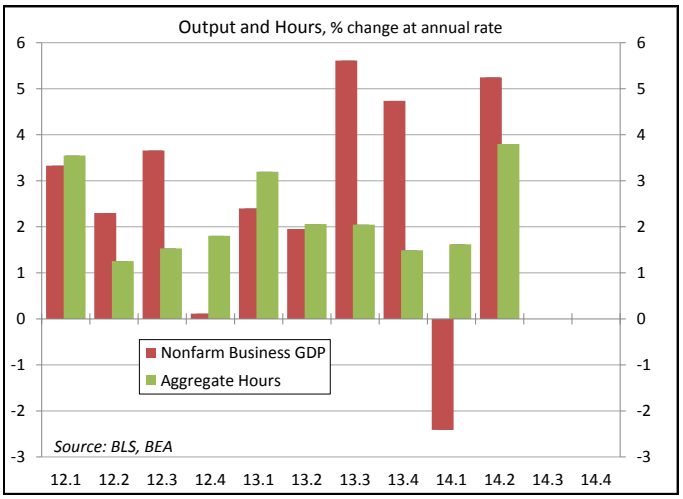
European Central Bank Policy Meeting – The ECB's Governing Council is considering further steps to counter low inflation (+0.4% in the 12 months ending in July). However, these steps aren't expected to be taken until later this year (if at all).

Jobless Claims (week ending August 2) – Noise should fade.



Friday

Nonfarm Productivity (2Q14, preliminary) – In theory, growth in output per worker is perhaps the single most important economic figure. It determines the pace of improvement in the standard of living (although there has been some concern this year about whether gains are being distributed fairly). However, it is also the most difficult to measure. Students of the hard sciences (physics, engineering) know that when you start multiplying and dividing estimates (each subject to measurement uncertainty), the uncertainty of the resulting estimate rises sharply. Hence, the Bureau of Labor Statistics' productivity figures (nominal output divided by a price measure divided by labor input) veer widely from one quarter to the next and are subject to large revisions. Labor compensation is a measure of inflation pressure, but that has to be adjusted for productivity growth (Unit Labor Costs = wage compensation divided by output per worker). The Federal Reserve models inflation as a function of inflation expectations, the amount of slack in the economy, and Unit Labor Costs. However, the Unit Labor Costs data are a bit unreliable from one quarter to the next. You can focus on the year-over-year trend, but you want to take that with a grain of salt. The nonfarm business components of GDP rose at a 5.2% annual rate in the advance estimate for 2Q14 (vs. -2.4% in 1Q14), while aggregate private-sector hours rose at a 3.8% pace (vs. +1.4% in 1Q14). Hence we should see a rebound in productivity reported for 2Q14.



Next Week …

The report on retail sales will likely get the most attention, as investors attempt to gauge the strength of the economy in early 3Q14 and beyond. Looking further ahead, Janet Yellen's upcoming Jackson Hole speech looms large – we could see some rethinking about the amount of slack in the labor market or a firmer conviction to support job market improvement.

Coming Events and Data Releases

August 19	Consumer Price Index (July) Building Permits, Housing Starts (July)
August 20	FOMC Minutes (July 29-30)
August 21	KC Fed Mon Policy Sym (focus: Labor Market)
August 28	Real GDP (2Q14, 2nd estimate)
September 1	Labor Day (markets closed)
September 5	Employment Report (August)
September 17	FOMC Policy Decision, Yellen press conference
October 29	FOMC Policy Decision (no press conference)
December 17	FOMC Policy Decision, Yellen press conference