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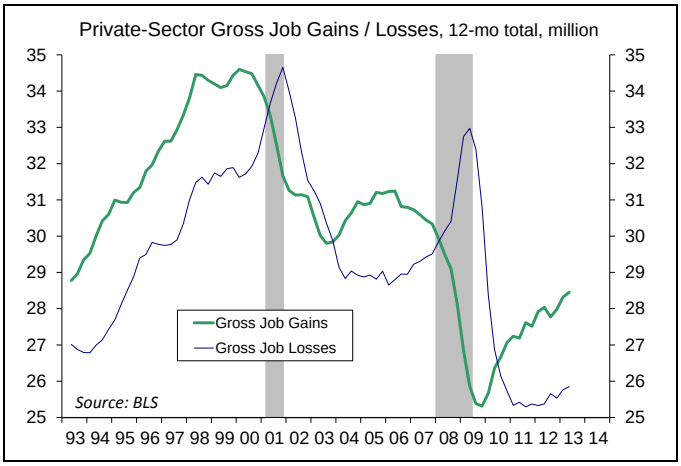
Weekly Market Monitor

A Roadmap, Not a Timetable

On Friday morning, Fed Chair Janet Yellen will deliver the keynote address at the Kansas City Fed's annual monetary policy symposium in Jackson Hole, Wyoming. Those looking for clues on the timing of the first Fed rate hike are likely to be disappointed. As Yellen previously noted, *"it depends."* Yellen's speech should provide insight into how the Fed views the current labor market situation and, more importantly, how monetary policy will respond to changing job conditions as it begins to normalize monetary policy in the months ahead.

We can expect Yellen to address many of the key topics in the labor market and Fed policy debates. Specifically, how much slack remains in the job market? What drives compensation gains; is it overall unemployment, short-term unemployment, measures of under-employment? How much of an increase in wage inflation is the Fed willing to tolerate and for how long?

We already have some indication of how Yellen will characterize the job market. While the unemployment rate has fallen significantly from its recessionary peak, a lot of that is due to a decrease in labor force participation. Some of the decrease in participation is demographics, reflecting the aging of the population. However it's also likely that the job market is a lot more flexible that most people think.



The Bureau of Labor Statistics Business Employment Dynamics (BED) data don't get much attention from the financial markets. They arrive with a lag (we currently have information up to 4Q13). The monthly employment report is by far the most significant of the monthly economic data releases. However, the monthly payroll estimate is a net figure. Millions of jobs are gained and million are lost each quarter, partly reflecting seasonality (the school year, the holiday shopping season). The BED data are gross measures. The recovery from the Great Recession can be characterized as a period of relatively low job destruction and a gradual uptrend in job creation.

Job losses were consistently higher in the previous expansion, but so was job creation. The BED data paint a remarkable picture for the late 1990s. At the time, job losses were very high, but job creation was even higher. It was a transformative time. Cell phones, the Internet, and computer networking transformed the way businesses operate. We also learned that the job market was a lot more flexible than previously believed. While some blame the Fed for inflating the tech stock bubble, monetary policy facilitated a lot of the transformation. Workers moved up, and those on the margins came in to fill the gaps. Lured by more attractive wages, retirees and stay-at-home spouses returned to the job market.

During the next decade, we saw the downside of the new technologies as firms could do more with fewer workers. The initial rebound from the 2001 recession was a "job-loss" recovery. We didn't begin to add jobs until nearly two years after the recession had officially ended.

The Great Recession (or if you prefer, the Lesser Depression) was not your typical economic downturn. Given the collapse in the housing sector and a massive deleveraging of the financial sector, there was never going to be a quick turnaround. The low level of job turnover has been a chief characteristic of this recovery. The housing collapse had a lot to do with that. Tied to their underwater mortgages, workers are less inclined to pull up stakes and pursue employment in other parts of the country. Quit rates are trending higher, but only gradually. There's much less job hopping than there was in previous cycles.

The low labor turnover rate is associated with the relatively weak growth in wages. Weak wage growth in turn limits the pace of growth in consumer spending (and thus, the overall economy). While income inequality has been an important topic this year, most of the focus has been on high-end salaries rather the struggles of the middle class and below. The focus is starting to change. One can easily observe the impact of the squeeze on the middle class in retail sales and housing.

What will reverse the week trend in wage growth? A tighter job market. A recent Chicago Fed letter suggests that there is a strong correlation between real wage growth and medium-term unemployment (those out of work for 5-26 weeks), as well as with marginally attached workers, particularly those working part time involuntarily for economic reasons.

The more interesting question is how long the Fed will be willing to tolerate a pickup in wage growth, but we first have to see that pickup before we worry about tighter policy.

Yellen's speech is likely to suggest that there is still ample slack in the job market and to imply that the Fed will be in no hurry to raise short-term interest rates.

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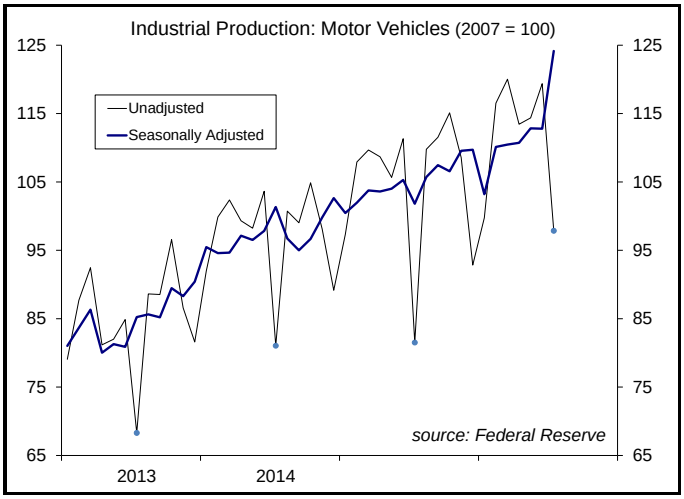
	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
7/18/14	0.02	0.05	0.10	0.51	0.97	1.69	2.50	3.29	1.352	1.707	101.37	1.074	4432.15	1978.22	17100.18
8/08/14	0.04	0.06	0.10	0.42	0.87	1.58	2.40	3.20	1.341	1.678	101.91	1.098	4370.90	1931.59	16553.93
8/15/14	0.03	0.05	0.08	0.42	0.87	1.54	2.35	3.14	1.340	1.670	102.32	1.089	4464.93	1955.08	16662.97

Recent Economic Data and Outlook

Shifting Fed expectations and off-and-on geopolitical tensions (Ukraine, mostly) remained the primary market drivers. Flat 2Q14 GDP in Europe and negative growth in Japan added to concerns about the strength of the global economy and put downward pressure on U.S. bond yields (a "flight to safety").



Retail Sales were reported as flat in July (+3.7% y/y), up just 0.1% excluding autos (+3.1% y/y). Revisions to previous figures were mild. Auto dealership sales slipped 0.2% (+6.0% y/y). Sales of building materials rose 0.2% (+5.1% y/y). Sales of gasoline rose 0.1% (+2.4% before seasonal adjustment, +2.5% y/y). Ex-autos, building materials, and gasoline, sales rose 0.1% (+3.6% y/y) – a lackluster start to 3Q14.

Business Inventories rose 0.4% in June (+5.8% y/y), a bit less than was assumed in the advance GDP report. Business sales rose 0.3% (+4.7% y/y).

Industrial Production rose 0.4% in July (+5.0%), held back by a 3.4% decline in the output of utilities (reflecting cooler-than-normal temperatures). Manufacturing output rose 1.1% (+5.3%), reflecting a 10.1% jump in motor vehicle production. However, seasonal adjustment in autos is tricky in July and seasonal plant closings were more moderate (auto output fell 18.0% before seasonal adjustment, vs. -26.8% in July 2013). Ex-autos, manufacturing output rose 0.4% (+3.9% y/y), with gains across all major industry groupings.

The **Producer Price Index** rose 0.1% in July (+1.7% y/y), reflecting a 0.6% drop in energy (+2.5% y/y). Food rose 0.4% (+3.7% y/y). Ex-food & energy, the PPI rose 0.2% (+1.6% y/y). Pipeline inflation pressures remained mild. The index for processed intermediate goods edged up 0.1% (+1.6% y/y). The index for unprocessed goods fell 2.7% (+0.9% y/y). The index for intermediate services rose 0.3% (+1.7% y/y).

Import Prices fell 0.2% in July (+0.8% y/y), down 0.1% ex-food & fuels (+0.2% y/y). Ex-fuels, the price index for industrial supplies and materials rose 0.5% (+0.7% y/y). The price index for capital equipment was flat (-0.1% y/y). The price index for imported autos fell 0.8% (-0.9% y/y), while the price index for other consumer goods edged up 0.1% (+0.9% y/y).

The **Job Opening and Labor Turnover Survey** data suggested gradual improvement in labor market conditions in June. The hiring rate (private-sector) edged up to 3.9% (vs. 3.8% in May and 3.6% a year ago). The quit rate rose to 2.1% (vs. 2.0% in May and 1.8% a year ago). These rates remain below normal.

The New York Fed's **Empire State Manufacturing Index** fell to 14.7 in August, vs. 25.6 in July. Details were mixed.

The Index of **Small Business Optimism** rose to 95.7 in July, little changed over the last three months. The earnings trend remained weak. Sales expectations were moderate. The general business outlook was less pessimistic. Hiring plans picked up.

Real GDP in the **euro area** was flat in the flash estimate for 2Q14 (a -0.2% pace in Germany). Meanwhile, inflation was +0.4% over the 12 months ending in July.

Real GDP in **Japan** fell at a 6.8% annual rate in the Apr-Jun quarter, following a +6.1% pace in the Jan-Mar quarter (sales were pulled forward ahead of tax increases).

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

Employment: The pace of job growth slowed somewhat in July, following a strong pace in 2Q14. Jobless claims are trending 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 growth in 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.

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This Week:					*forecast*	last	last –1	comments
Monday	8/18	10:00	Homebuilder Sentiment	Aug	***54***	53	49	recovering
Tuesday	8/19	8:30	**Consumer Price Index**	Jul	***+0.1%***	+0.3%	+0.4%	moderate
			year-over-year		***+2.0%***	+2.1%	+2.1%	little change in y/y pace
			ex-food & energy		***+0.1%***	+0.1%	+0.3%	mild core inflation
			year-over-year		***+1.9%***	+1.9%	+2.0%	a low trend
		8:30	Real Weekly Earnings	Jul	***-0.2%***	0.0%	-0.1%	nominal earnings were essentially flat
		8:30	**Building Permits, th.**	Jul	***1000***	973	1005	reflecting multi-family volatility
			% change		***+2.8***	-3.2	-5.1	moderate strength in single-family
			Housing Starts		***990***	893	985	likely to rebound sharply
			% change		***+10.8***	-9.3	-7.3	choppy, watch for revisions
Wednesday	8/20	2:00	**FOMC Minutes**	7/30				some insights into endgame outlook
Thursday	8/21	8:30	Jobless Claims, th.	8/16	***309***	311	290	may be bumpy, but still a low trend
		9:45	Markit US Manf PMI (flash)	Aug	***NF***	55.8	57.3	not market-moving
		10:00	Philadelphia Fed Index	Aug	***16.0***	23.9	17.8	likely to moderate
		10:00	**Existing Home Sales, mln**	Jul	***5.02***	5.04	4.91	seen little changed
			% change		***-0.4***	+2.6	+5.4	the Pending Home Sales Index slipped
		10:00	Leading Econ Indicators	Jul	***+0.8%***	+0.3%	+0.7%	most components positive
Friday	8/22	10:00	**Yellen Speaks**					*"Labor Markets"* at Jackson Hole
		12:30	Draghi Speaks					at Jackson Hole
Next Week:								
Monday	8/25	10:00	**New Home Sales, th.**	Jul	***415***	406	442	choppy, but an unimpressive trend
			% change		***+2.2***	-8.1	+8.3	watch for revisions
Tuesday	8/26	8:30	**Durable Goods Orders**	Jul	***0.0%***	+1.7%	-0.9%	aircraft orders should be up
			ex-transportation		***-0.5%***	+1.9%	-0.1%	some softening, but a moderate trend
			nondef cap gds ex-aircraft		***-0.6%***	+3.3%	-1.4%	choppy
		9:00	Case-Shiller Home Prices	Jun	***-0.2%***	-0.3%	+0.1%	some softening
			year-over-year		***+8.2%***	+9.3%	+10.8%	moderating
		10:00	**Consumer Confidence**	Aug	***90.0***	90.9	86.4	watch for revisions to July
		1:00	Treasury Note Auction					2-year notes
Wednesday	8/27	11:30	FRN Auction					re-opened 2-year floating rate notes
		1:00	Treasury Note Auction					5-year notes
Thursday	8/28	8:30	Jobless Claims, th.	8/16	***310***	***309***	311	seen settling
		8:30	**Real GDP (2nd estimate)**	2Q14	***+4.2%***	-2.1%	+3.5%	+4.0% in the advance estimate
			Domestic Final Sales		***+2.9%***	+0.7%	+2.7%	+2.8% in the advance estimate
		10:00	Pending Home Sales Index	Jul	***+0.5%***	-1.1%	+6.0%	a bit choppy, but a lackluster trend
Friday	8/29	8:30	Personal Income	Jul	***+0.3%***	+0.4%	+0.4%	soft growth in average wages
			Personal Spending		***+0.2%***	+0.4%	+0.3%	a lackluster start to 3Q14
			PCE Price Index ex-f&e		***+0.1%***	+0.1%	+0.2%	mild core inflation
		9:45	Chicago PM Index	Aug	***56.0***	52.6	62.6	down sharply in July (fluke or new trend?)
		9:55	Consumer Sentiment	Aug	***79.5***	81.2	82.5	79.2 at mid-month

This Week…

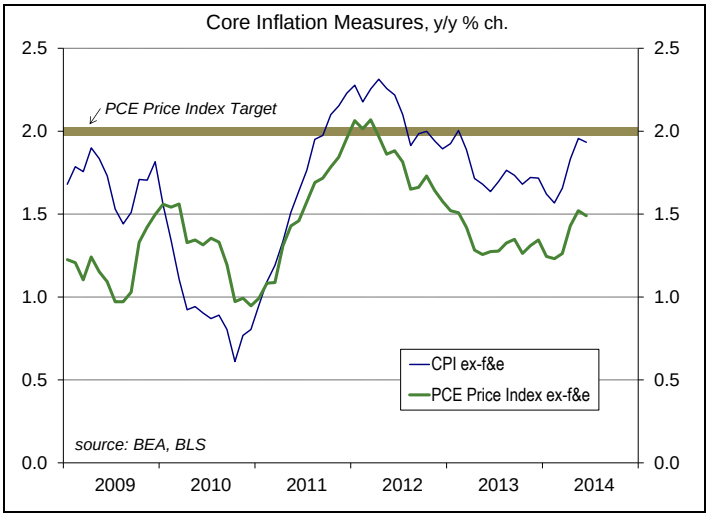
The focus will be on the Fed. We've often seen the markets take something out of context in the FOMC minutes and run away with it, but investors will be more intent on hearing what the Fed chair has to say on Friday. Yellen's exposition on the labor market should provide insight into how the central bank will decide when to begin normalizing monetary policy.

Monday

Homebuilder Sentiment (August) – The National Association of Home Builders' Housing Market Index stumbled in February, providing an early indication that the spring selling season would be disappointing. The index started to recover in June and July. It will be important to see than continue in August.

Tuesday

Consumer Price Index (July) – Retail gasoline prices fell a little over 2% last month, but the CPI's seasonal adjustment anticipates a decline of about 1.2%. There may be a few lingering drought issues in the food component. However, core inflation is likely to remain mild.



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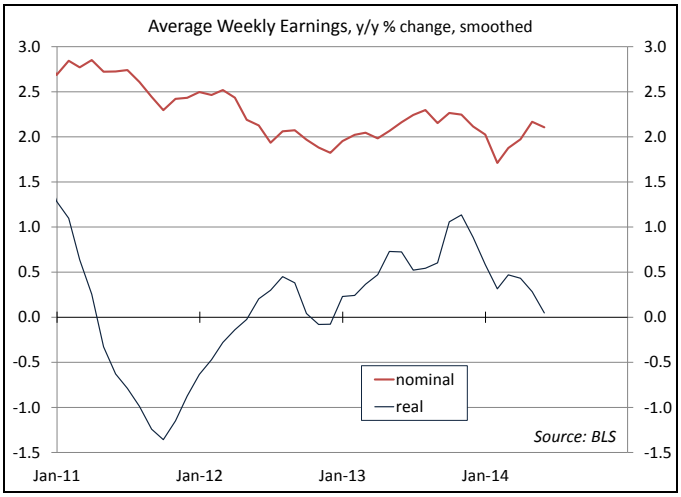
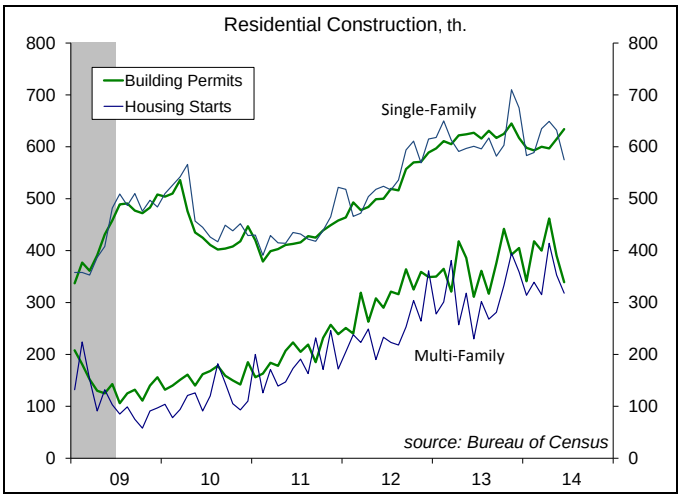
Real Earnings (July) – Despite the low trend in inflation, inflation-adjusted wage growth has slowed. In turn, the lack of real wage growth is a limiting factor for consumer spending growth and implies restraint for the mid- to low-end of the housing market.



Building Permits, Housing Starts (July) – Residential construction activity was disappointing in the first half of the year, reflecting a combination of affordability issues and supply constraints. The multi-family sector is choppy, adding noise to the headline figures. Single-family permits, the key figure in the report, picked up in May and June. Home prices have moderated and mortgage rates are a bit lower, which should be helpful.



Wednesday

FOMC Minutes (July 29-30) – The minutes of the Fed's policy meeting should show some differences of opinion regarding the amount of slack in the economy and the need to return to normal, but pay close attention to the language ("a few," "some," "several"). Note also that only Federal Open Market Committee "members" get to vote on policy, not all meeting "participants." The hawkish policy view is a minority opinion among those on the FOMC.

Thursday

Jobless Claims (week ending August 16) – A bit noisy in recent weeks, the underlying trend in claims has remained remarkably low. Yet, we should see the trend tick up a bit relative to July.

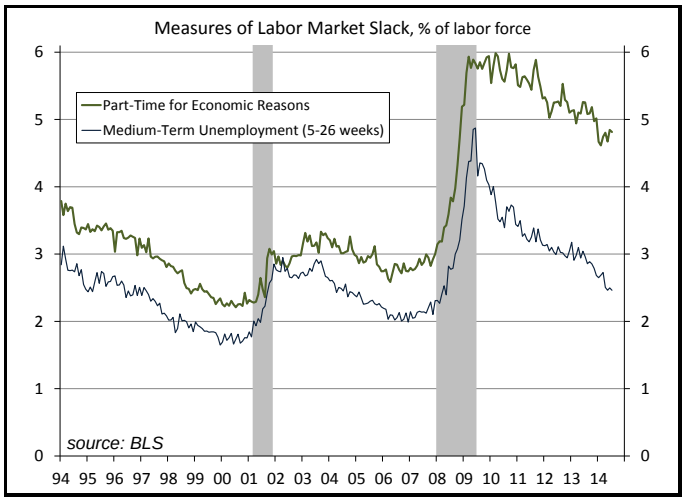
Philly Fed Index (August) – Some moderation is likely.

Existing Home Sales (July) – The pace is likely to remain little changed in the near term.

Leading Economic Indicators (July) – The yield curve, jobless claims, and ISM orders will make strong positive contributions. A shorter factory workweek will be the only significant drag.

Friday

Fed Chair Yellen Speaks (*"Labor Market"*) – Prior to becoming Fed chair, Janet Yellen had a reputation of being more concerned about the job market and that emphasis has only increased during her time at the helm; that's rightly so. The job market is the key issue in the outlook for growth and inflation. This speech is expected to be the definitive document on how the Fed views the labor market and should provide solid clues as to what will drive policy decisions in the months ahead. The financial markets appear to be anticipating a relatively dovish tone in Yellen's speech, but this will be more of a manual of how the Fed will respond to labor market developments (rather than what it will actually do, since it doesn't know).



Next Week …

We'll close out August with a smattering of economic data. While the new home sales, durable goods, and consumer confidence data have potential to move the markets, the reports are unlikely to alter the bigger picture. The 2Q14 GDP revision and July personal income and spending figures could help refine the GDP outlook for 3Q14.

Coming Events and Data Releases

September 1	Labor Day (markets closed)
September 2	ISM Manufacturing Index (August)
September 3	Fed Beige Book
September 5	Employment Report (August)
September 12	Retail Sales (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

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