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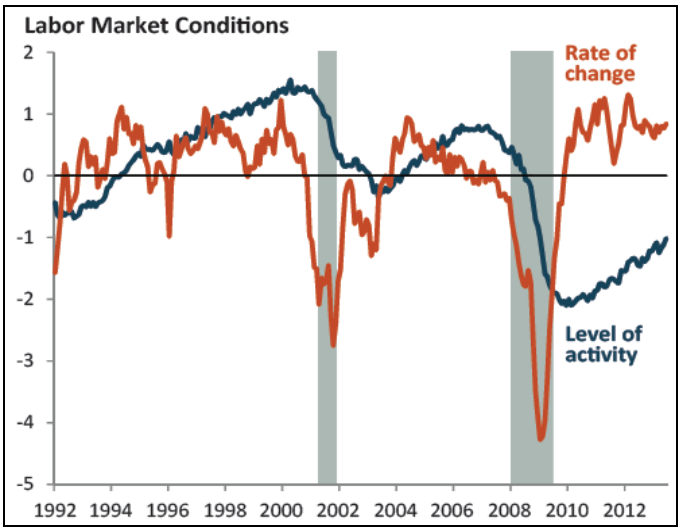
Weekly Market Monitor

Not Quite as Anticipated

In her Jackson Hole speech, Fed Chair Janet Yellen presented a balanced look into the issue of labor market slack and how monetary policy should respond over time. While there is plenty of slack currently, the bigger questions are how rapidly that slack will be taken up and how the Fed should position monetary policy in response. Yellen offered no clear answers.

In past months, Yellen emphasized that the Fed is looking at a broad range of labor market indicators, not simply the unemployment rate and nonfarm payrolls. However, in her Jackson Hole speech, she noted that *"estimates of slack necessitate difficult judgments about the magnitudes of the cyclical and structural influences affecting labor market variables, including labor force participation, the extent of part-time employment for economic reasons, and labor market flows, such as the pace of hires and quits."* Recent research suggests that the behavior of these and other labor market indicators have changed since Great Recession.

Yellen noted a *"convenient way to summarize"* the various labor market indicators. The Fed's Labor Market Conditions Index, derived from 19 labor market indicators, *"supports the conclusion that the labor market has improved significantly over the past year, but also suggests that the decline in the unemployment rate somewhat overstates the improvement in overall labor market conditions."*



Source: Kansas City Fed

Yellen had apparently read beforehand the research papers presented at the KC-Fed's monetary policy symposium, as she incorporated some of the key findings into her speech. Notably, the labor market is significantly less fluid, reducing employment opportunities, keeping unemployment higher, reducing productivity growth, and limiting wage growth.

Another possible explanation for the weak recovery in the labor market is the concept of polarization – growth in high-education, high-wage jobs, growth in low-education, low-wage jobs, and not much in between. One of the papers presented in Jackson Hole makes a compelling argument that this bifurcated labor market phenomenon is due less to technological change and more to globalization and the aftermath of the housing collapse. This need not be permanent, but adjustments are likely to be slow, costly, and disruptive (more on this next week).

A key issue in labor market debate is how much of the soft labor market recovery has been cyclical and how much has been structural, and whether cyclical weakness may be turning into structural weakness. Yellen noted that *"despite challenges in assessing where the share of those employed part time for economic reasons may settle in the long run, the sharp run-up in involuntary part-time employment during the recession and its slow decline thereafter suggest that cyclical factors are significant."* Moreover, *"the balance of evidence leads me to conclude that weak aggregate demand has contributed significantly to the depressed levels of quits and hires during the recession and in the recovery."*

"The pattern of subdued real wage gains suggests that nominal compensation could rise more quickly without exerting any meaningful upward pressure on inflation." And, *"since wage movements have historically been sensitive to tightness in the labor market, the recent behavior of both nominal and real wages point to weaker labor market conditions than would be indicated by the current unemployment rate."* However, Yellen went on to suggest three reasons to be more cautious. One is that firms may have had difficulty in cutting wages during the downturn. This *"pent-up wage deflation"* may be leading to more modest increases in nominal wages currently. Second, weak wage growth may reflect secular trends, such as changing patterns of production and international trade (and possible measurement issues). The third possibility is that dislocations from the Great Recession may be leading to a more permanent lower trend in wage growth, as those dropping out of the labor force may face a difficult time coming back.

Turning to monetary policy, Yellen noted that given the *"substantial"* degree of slack in recent years, *"the need for extraordinary accommodation is unambiguous."* However, Fed policymakers are *"naturally shifting to questions about the degree of remaining slack, how quickly that slack is likely to be taken up, and thereby to the question of under what conditions we should begin dialing back our extraordinary accommodation."* As Yellen noted there are dangers in raising rates too soon as well as too late. *"There is no simple recipe for appropriate policy in this context."*

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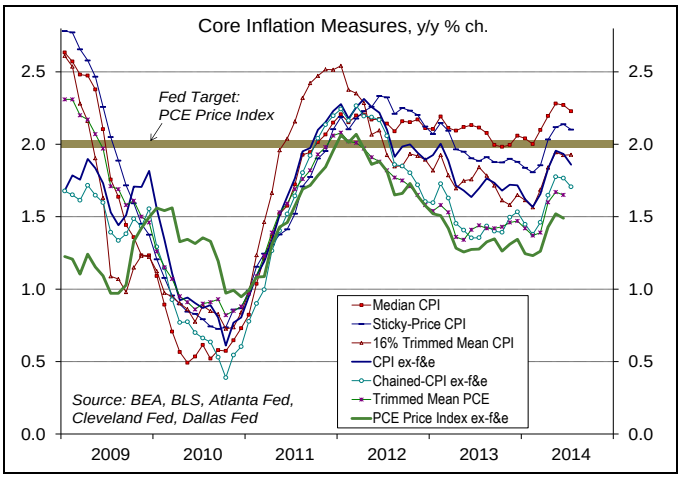
	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
7/25/14	0.03	0.06	0.11	0.53	0.98	1.69	2.48	3.24	1.343	1.697	101.81	1.081	4449.56	1978.34	16960.57
8/15/14	0.02	0.06	0.10	0.49	0.95	1.64	2.41	3.19	1.339	1.669	102.19	1.091	4464.93	1955.06	16662.91
8/22/14	0.02	0.05	0.10	0.49	0.97	1.66	2.40	3.16	1.324	1.657	103.95	1.094	4538.55	1988.39	17001.15

Recent Economic Data and Outlook

Market participants looked optimistically to Janet Yellen's Jackson Hole speech, expecting her to be "dovish." However, the Fed chair presented a balanced look into the issues regarding how much slack remains in the labor market. Repeating a concept included in the Fed policy meeting minutes, Yellen suggested that monetary policy could be firmed sooner if the economy strengthens more than anticipated, but slower if the economy disappoints. Geopolitical worries (Ukraine/Russia) retreated during the week, but resurfaced on Friday.



In her Jackson Hole speech, **Fed Chair Janet Yellen** presented a balanced assessment of the theory and evidence regarding labor market slack. Yellen indicated that there appears to be plenty of slack currently, but the bigger questions are where conditions are heading and how monetary policy should respond. She left the monetary policy outlook as an open-ended question.

The **FOMC Minutes** from the July 29-30 policy meeting showed that meeting participants were generally upbeat in their assessments of the economy, with *"most"* viewing the risks to the outlook for economic growth and the job market as *"nearly balanced."* However, *"some"* pointed to possible sources of downside risk (housing, household income, geopolitical developments). *"Some"* participants viewed the progress toward the Fed's goals as *"sufficient to call for a relatively prompt move toward reducing policy accommodation."* However, *"most participants indicated that any change in their expectations for the appropriate timing of the first increase in the federal funds rate would depend on further information on the trajectories of economic activity, the labor market, and inflation."* Officials generally agreed that labor market conditions had *"moved noticeably closer"* to those viewed as normal in the long run. *"Participants differed, however, in their assessments of the remaining degree of labor market slack and how to measure it."* Many continued to see a large gap, citing elevated levels of long-term unemployment, workers employed part time for economic reasons, low labor force participation, and modestly rising labor compensation.

The minutes also showed the Fed making good progress on its **Policy Normalization Plans**. The federal funds target range will remain the key policy rate. The rate of interest on excess reserves held at the Fed will likely serve as the upper end of the federal funds target range, while the fixed-rate overnight reverse repurchase rate (ON RRP) would be set at the bottom.

The **Consumer Price Index** rose 0.1% in July (+2.0% y/y), held down by declines in energy and airfares. Food rose 0.4% (+2.5% y/y). Energy fell 0.3% (+2.6% y/y), with gasoline down 0.3% (-1.5% before seasonal adjustment, +0.8% y/y). Ex-food & energy, the CPI rose 0.1% (+1.9% y/y).

Real Hourly Earnings were flat in August, unchanged from a year ago. Real Weekly Earnings were also flat, up 0.3% y/y.

Existing Home Sales rose 2.4% in July, to a 5.15 million seasonally adjusted annual rate (-4.3% y/y).

Building Permits jumped 8.1% in July (±1.8%), to a 1.052 million seasonally adjusted annual rate (+7.7%), reflecting the usual volatility in the multi-family sector. Single-family permits, the key figure in the report, rose 0.9% (±1.5%), up 3.9% y/y – with mixed results across regions (Northeast +20.0%, Midwest -4.6%, South +3.6%, West -7.7%). **Housing Starts** rose 15.7% (±10.9%), with single-family starts up 8.3% (±10.3%).

Homebuilder Sentiment rose to 55 in August, vs. 53 in July and 49 in June. Results were mixed across regions.

The Index of **Leading Economic Indicators** rose 0.9% in July, following gains of 0.6% in both June and July.

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.

This Week:					*forecast*	last	last –1	comments
Monday	8/25	8:30	Chicago Fed Nat Act Index	Jul	***NF***	+0.12	+0.16	growth slightly above trend
					NF	+0.13	+0.28	moderate growth, limited inflation
		10:00	**New Home Sales, th.**	Jul	***425***	406	442	choppy, but an unimpressive trend
			% change		***+4.7***	-8.1	+8.3	watch for revisions
Tuesday	8/26	8:30	**Durable Goods Orders**	Jul	***3.0%***	+1.7%	-0.9%	aircraft orders should be up
			ex-transportation		***-0.2%***	+1.9%	-0.1%	some softening, but a moderate trend
			nondef cap gds ex-aircraft		***-0.2%***	+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					$29 billion 2-year notes
Wednesday	8/27	11:30	FRN Auction					$13 billion in 2-year floating rate notes
		1:00	Treasury Note Auction					$35 billion in 5-year notes
Thursday	8/28	8:30	Jobless Claims, th.	8/16	***302***	298	312	a low trend
		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
		1:00	Treasury Note Auction					$29 billion in 7-year notes
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
Next Week:								
Monday	9/01		Labor Day Holiday					markets closed
Tuesday	9/02	9:45	Market US Manf PMI (final)	Aug	***NF***	55.8	57.3	58.0 in the "flash" estimate
		10:00	Construction Spending	Jul	***+1.6%***	-1.8%	+0.8%	seen rebounding, watch for revisions
		10:00	**ISM Manf. Index**	Aug	***57.0***	57.1	55.3	seen moderately strong
Wednesday	9/03	8:15	**ADP Payroll Estimate, th.**	Aug	***+200***	+218	+281	moderately strong
		10:00	Factory Orders	Jul	***NF***	+1.1%	-0.6%	a moderate trend
		2:00	**Fed Beige Book**					seen a bit brighter
		tbd	Motor Vehicle Sales, mln	Aug	***16.6***	16.4	16.8	likely to pickup
			domestically built		***13.1***	12.9	13.2	still a strong trend
Thursday	9/04	8:30	Jobless Claims, th.	8/22	***300***	***302***	298	still low
		8:30	**Trade Balance, $ bln**	Jul	***-42.5***	-41.5	-44.7	likely a bit narrower
			goods only		***-61.3***	-60.3	-63.3	first look at 3Q14 foreign trade
		10:00	**ISM Non-Manf. Index**	Aug	***57.8***	58.7	56.0	moderately strong
Friday	9/05	8:30	**Nonfarm Payrolls, th.**	Aug	***200***	209	298	some pickup in government hiring
			private-sector		***190***	198	270	moderately strong
			Unemployment Rate		***6.1%***	6.2%	6.1%	likely lower
			employment/population		***59.1%***	59.0%	59.0%	a gradual uptrend
			Avg. Weekly Hours		***34.5***	34.5	34.5	steady
			Avg. Hourly Earnings		***+0.2%***	+0.0%	+0.2%	modest wage pressures

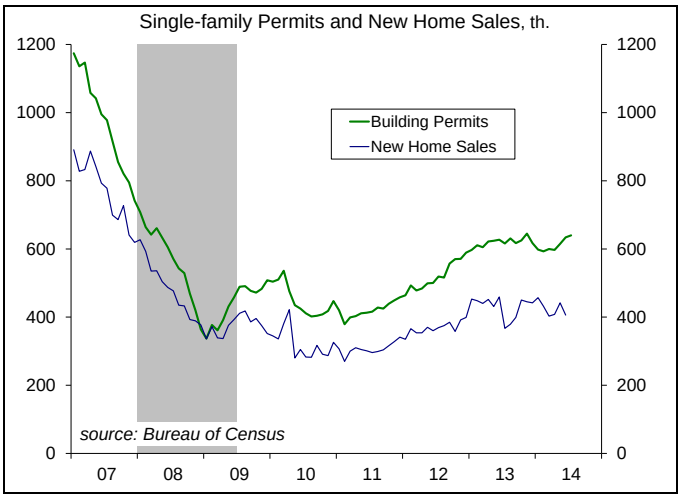
This Week…

The march of economic data continues. New home sales and durable goods orders are often erratic (hence, the reports have some potential to surprise). The estimate of 2Q14 GDP growth is likely to be revised higher. Personal income and spending figures are usually ignored by the markets, but the data will help to fill in the 3Q14 GDP outlook.

Monday

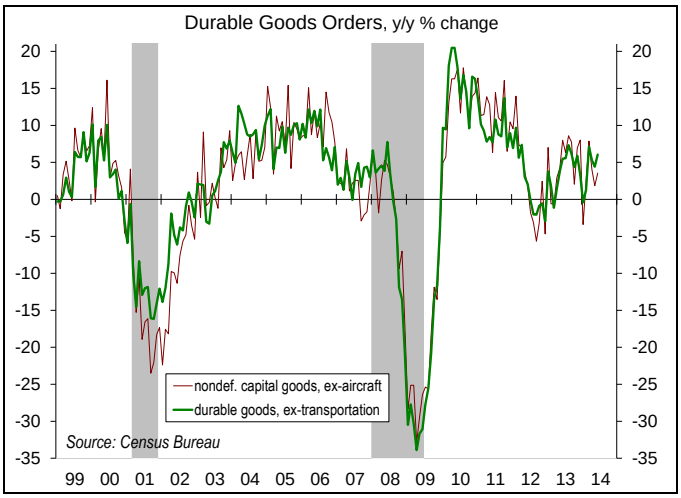
Chicago Fed National Activity Index (July) – Likely to remain consistent with economic growth remaining somewhat above its long-term trend (with limited inflation pressure).

New Home Sales (July) – These data are reported with a huge amount of uncertainty, leading to extreme volatility in the monthly figures and potentially large revisions.



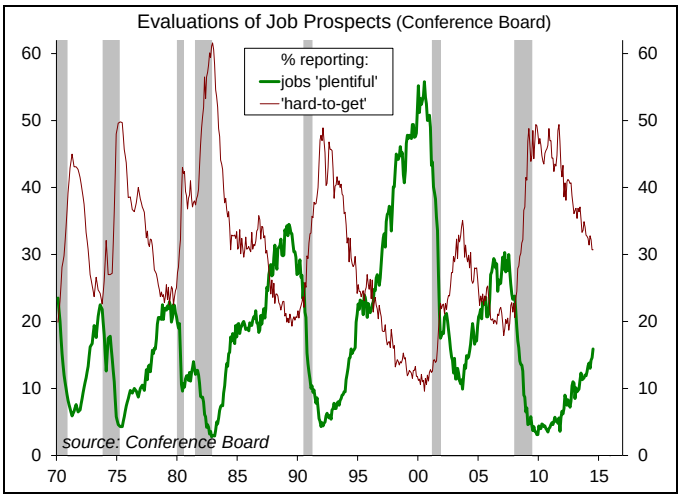
Tuesday

Durable Goods Orders (July) – Orders have a tendency to bunch up over time, leading to choppiness in the monthly changes. Boeing reported higher orders in July. Hence, aircraft orders should boost the headline figure. Note that motor vehicle orders often have seasonal adjustment issues in July. More moderate summer plant closings may lead to a jump in the seasonally adjusted data (as we saw with the industrial production figures). Ex-transportation, orders are likely to be mixed, but perhaps a bit soft.



Case-Shiller Home Price Index (June) – Following a sharp rise over the last year, home prices have begun to soften a bit, helping to reduce affordability issues. There are also more homes on the market, which may put downward pressure on prices. This report will include quarterly national figures.

Consumer Confidence (August) – Likely to be little changed. Note that the initial figure is reported based on a sample covering about half of the month (subject to revision, based on the full-month sample), a month later). The survey includes a direct measure of labor market perceptions. The current job market outlook has become less depressed over time, but is still below normal. However, it is moving in the right direction.



Wednesday

No significant economic data.

Thursday

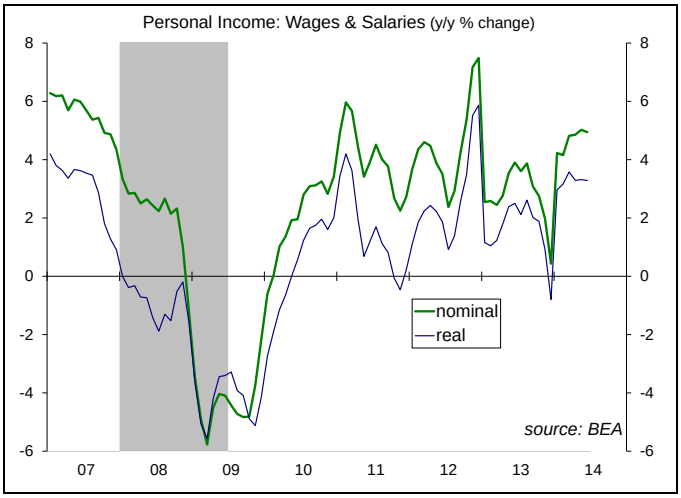
Jobless Claims (week ending August 23) – Weekly figures have been a bit choppy, but the underlying trend has remained relatively low. Unadjusted claims typically decline as the new school year gets underway.

Real GDP (2Q14, 2nd estimate) – Retail sales were revised lower, but factory shipments were revised higher. The trade deficit was narrower than assumed, but inventories rose less than expected. On balance, the second quarter growth estimate should be revised slightly higher, but there are several other pieces that are unobserved and price adjustments add another level of uncertainty. One should really focus on Domestic Final Sales, which excludes net exports and the change in inventories (providing a better picture of underlying domestic demand).

Pending Home Sales Index (July) – A bit choppy from month to month, we ought to see some improvement in July.

Friday

Personal Income and Spending (July) – Income and spending are likely to post lackluster-to-moderate gains for July.



Chicago Purchasing Managers Index (August) – Down in July. Was that a fluke or the start of a more moderate trend?

UM Consumer Sentiment (August) – Seen little changed.

Next Week …

Monday's a holiday. August figures will begin to roll in (ISM surveys, auto sales), with the employment report expected to be the highlight. Payrolls are likely to have risen at a moderately strong pace, while the unemployment rate should edge lower.

Coming Events and Data Releases

September 12	Retail Sales (August)
September 15	Industrial Production (August)
September 17	FOMC Policy Decision, Yellen press conference
September 18	Building Permits, Housing Starts (August)
October 29	FOMC Policy Decision (no press conference)
December 17	FOMC Policy Decision, Yellen press conference