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**Weekly Market Monitor**

## Global Worries (And Some Benefits)

In the latest update of its World Economic Outlook, the IMF revised lower its expectations of global growth in 2014 and 2015. None of that should have surprised anyone. At this point, the IMF expects that European GDP will be relatively weak in 2014 (+0.8% 4Q14/4Q13) and should improve in 2015 (+1.6% 4Q15/4Q14). However, risks are weighted predominately to the downside. Weaker European growth and a stronger dollar will have a significant impact on many U.S. firms, but may have some benefits for the economy as a whole.

Global investors have worried a lot about Europe in the last few years. However, the key fear, that we'd see a breakup of the monetary union, was largely put aside when ECB President Mario Draghi promised to "do whatever it takes." Issues present at the creation of the monetary union had finally come to a point where they had to be addressed. Critics cautioned early on that Europe needed a banking union and a fiscal union to make the monetary union work. European authorities have made progress in recent years, but still have a long way to go.

While Europe's crisis of the last few years has been called a "sovereign debt crisis," government debt was not the catalyst for weakness. It's been a crisis of capital flows. With lower borrowing costs, money poured into the peripheral countries when the euro was introduced (contributing to housing bubbles in Ireland and Spain), then capital started to flow out during the global financial crisis. Many had expected Europe's difficulties to lead to a flight-to-safety in the U.S. dollar. However, the safety flow went largely to Germany, leaving little impact on the exchange rate. More troublesome, the misdiagnosis of the cause of the crisis led to the bad prescription: austerity.

Government budget deficits and debt levels are important long-term issues. There are well-known concerns about using fiscal stimulus (lower taxes, increased government spending) to boost growth (how big, how to unwind), but what's clear is that fiscal tightening (higher taxes, reduced government spending) in an economic recovery is a bad idea. It contracts the economy. Growth will be slower than would have occurred otherwise. Moreover, slower economic growth means a slower recovery in tax revenues, and less budget improvement than was anticipated. It's a self-defeating policy.

Europe is now in a much more precarious phase. Inflation is trending very low. Economists note that it's real (that is, inflation-adjusted) interest rates that matter. For any given level of interest rates, lower inflation implies a higher real rate of interest – and slower economic growth than you'd see otherwise. The European Central Bank has lowered benchmark interest rates to near zero (and in case of the interest rate on the deposit facility, negative). It can't go lower.

Saddled with the zero lower bound on interest rates textbook economics (granted, graduate-level textbooks) suggest that the central bank can expand its balance sheet to support economic growth. The ECB is embarking on an asset purchase program, but this is more akin to the Fed's TALF, the Term Asset-Backed Securities Loan Facility (from March 2009 to June 2010). The central bank receives asset-backed securities and gives the banks cash, which they will use to make more loans (or at least, that's the theory). This is different from outright quantitative easing, but has similar economic effects in the short-run. The ECB is widely expected to undertake real quantitative easing (the outright purchases of sovereign debt) in the months ahead (at the clear objections of the Germans).

Whether the ECB's efforts to spur growth will work soon enough is an open question. The key point for financial market participants is not that Europe's economy will necessarily fall apart, but that the downside risks are considerable. Weak European growth will have a negative impact on countries like China, which remain dependent on exports (China may also have to contend with the collapse of a housing bubble).

European weakness will have a significant impact on many U.S. firms, which are expected to see weaker earnings growth from Europe and a loss in the currency translation (due to the stronger dollar). However, while we should see a decline (or at least softer growth) in exports to Europe, that weakness is unlikely to drag the broader economy down.

There may be some parallels with the Asian financial crisis of 2007 (of course, there are many more differences than similarities to the current situation in Europe – just hear me out). In the Asian financial crisis, the hit to U.S. exports subtracted a full percentage point from GDP growth. However, the crisis put downward pressure on inflation and boosted capital inflows, which was far more significant. Similarly, we are now seeing a stronger dollar put downward pressure on commodity prices. Increased capital inflows should help keep long-term interest rates relatively low and the stronger dollar will likely delay the Fed's first increase in short-term rates.

Gasoline prices have drifted lower in recent months, but not enough for a sharp boost in consumer spending (note that gasoline prices normally fall about 12% from May to December, and have fallen about 10% so far this year). However, gasoline prices are likely to fall faster in the near term and a further decline (to below $3 per gallon) would add more significantly to consumer purchasing power into early 2015.

The Asian financial crisis had a negative impact on the U.S. stock market, but that turned out to be a great buying opportunity. We may see some imbalances develop (a wider trade deficit), but the U.S. may benefit from Europe's weakness.



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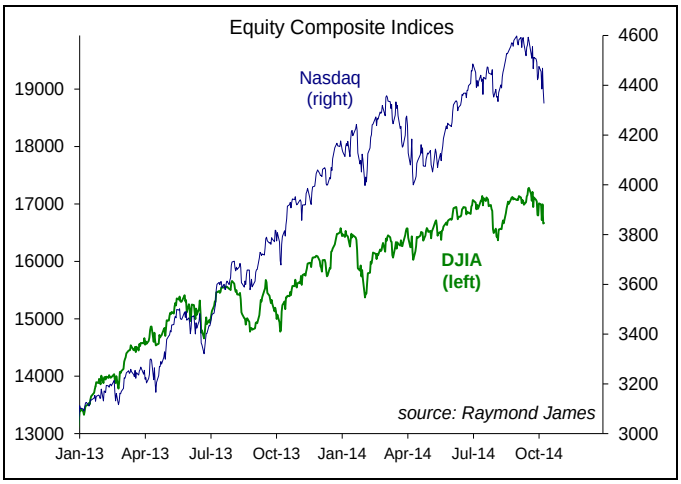
| | Treasury Yields | | | | | | | | Dollar | | | | Equities | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 13-wk | 26-wk | 52-wk | 2-yr | 3-yr | 5-yr | 10-yr | 30-yr | $/Euro | $/BP | JY/$ | CD/$ | NASD | SPX | DJIA |
| 9/12/14 | 0.02 | 0.05 | 0.11 | 0.58 | 1.07 | 1.83 | 2.62 | 3.35 | 1.296 | 1.624 | 107.24 | 1.108 | 4567.60 | 1985.54 | 16987.51 |
| 10/03/14 | 0.01 | 0.03 | 0.11 | 0.57 | 1.05 | 1.73 | 2.45 | 3.13 | 1.252 | 1.596 | 109.70 | 1.125 | 4475.62 | 1967.90 | 17009.69 |
| 10/10/14 | 0.01 | 0.04 | 0.08 | 0.44 | 0.89 | 1.55 | 2.30 | 3.02 | 1.261 | 1.606 | 107.72 | 1.121 | 4276.24 | 1906.13 | 16544.17 |

## Recent Economic Data and Outlook

The economic calendar was thin, leaving a greater focus on the global outlook. While the IMF's downgrade to global growth and the FOMC's reported concern about the strength of the dollar were talked about as catalysts for market moves, they really weren't surprising and seemed more like excuses.




The **FOMC Minutes** from the September 16-17 monetary policy meeting showed some discussion of the dollar (note that the exchange rate of the dollar is the Treasury's responsibility, not the Fed's, although the Fed may intervene in the currency market on behalf of the Treasury). *"Some"* Fed officials expressed concerns that *"the persistent shortfall in economic growth and inflation"* in the euro area could lead to a further appreciation of the dollar and have an adverse effect on U.S. trade. *"Several"* meeting participants added that slower growth in China or Japan or unanticipated events in the Middle East or Ukraine *"might pose similar risk."* In addition, *"a couple"* of participants pointed out that a stronger dollar might tend to slow the gradual increase in inflation toward the 2% goal. Minutes also showed that Fed officials were nervous about potential financial market misinterpretations of any changes in the wording of the forward guidance.

In its updated World Economic Outlook, the **IMF** lowered its global growth forecast to 3.3% in 2014 (down from July's 3.4%) and 3.8% in 2015 (down from 4.0%). Over the last few years, the IMF has consistently revised lower its growth forecasts. Moreover, "with the weaker-than-expected global growth for the first half of 2014 and increased downside risks, the projected pickup in growth may again fail to materialize or fall short of expectations." The IMF noted that "while geopolitical tensions have been mostly confined to the regions involved, there are tangible risks of more widespread disruptions."

The Kansas City Fed's **Labor Market Conditions Index** rose to -0.532 in September, vs. -0.571 in August and -0.973 a year ago. That's consistent with a gradual improvement in the job market, but with a large level of slack remaining. The Fed's Board of Governors also has a labor market conditions index (reflecting essentially the same story), but while Fed Chair Yellen highlighted these measures as a convenient summary of numerous job market gauges, the Fed downplayed the release of updated figures. That's probably because the Fed doesn't want the financial markets to over-react to minor monthly changes – these measures are going to change glacially.

The job openings rate rose to 3.4% in August, vs. 2.8% a year earlier. However, the hiring rate fell to 3.3% (vs. 3.7% in July and 3.4% a year ago), while the quit rate held steady at 1.8%. These figures are consistent with large degree of slack.

**Wholesale Inventories** rose 0.7% in August (+7.9% y/y). Two month in, the third quarter pace is slightly slower than in 2Q14. Wholesale sales fell 0.7%, reflecting lower petroleum prices and a drop in motor vehicle sales.

The **Congressional Budget Office** estimated that the federal government ran a deficit of about $486 billion in FY14 (the 12 months ending in September 2014), which is about 2.8% of GDP (down from 4.0% of GDP in FY13 and 9.8% of GDP in FY09. Tax receipts rose 8.6% in FY14, while outlays rose 1.2% (reflecting lower defense spending, the end of extended unemployment insurance, and sequester cuts).

The **Bank of England** left short-term interest rates unchanged. The BOE does not provide much color when it doesn't change policy, but most analysts expect that Europe's difficulties will likely push the BOE's initial rate hike further out.

**Economic Outlook (4Q14):** GDP growth of around 3.0%

**Employment:** Short-term gauges, such as weekly jobless claims, are consistent with a strong job market, but other measures continue to suggest that a large amount of slack remains.

**Consumers:** Job growth is supportive, but average wages have struggled to keep up with inflation. Lower gasoline prices could help spur consumer spending growth in the next few months.

**Manufacturing:** Mixed results across industries, but mostly strengthening. Weakness in Europe and a stronger dollar should have a negative impact on export growth. However, the impact should be more than offset by increased domestic demand.

**Housing/Construction:** Affordability issues have remained a constraint for the middle of the market and below. Supply constraints have been an issue for builders, but are fading.

**Prices:** The PCE Price Index, the Fed's chief inflation gauge, remains well below the Fed's 2% target on a y/y basis. Pipeline pressures appear mild. Wage pressures are limited. Inflation expectations remain well-anchored.

**Interest Rates:** The tapering of the Fed's monthly pace of asset purchases should be completed at the end of October. Short-term interest rates are expected to remain exceptionally low *"for a considerable time"* after the asset purchase program ends. 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 | 10/13 | | Columbus Day Holiday | | | | | bond market closed |
| Tuesday | 10/14 | 7:30 | Small Business Optimism | Sep | ***NF*** | 96.1 | 95.7 | an improving trend, but still relatively soft |
| Wednesday | 10/15 | 8:30 | **Producer Price Index** | Sep | ***-0.1%*** | 0.0% | +0.1% | lower energy prices |
| | | | **ex- food & energy** | | ***+0.1%*** | +0.1% | +0.2% | modest core inflation |
| | | 8:30 | **Retail Sales** | Sep | ***-0.2%*** | +0.6% | +0.3% | unit auto sales fell |
| | | | **ex-autos** | | ***+0.1%*** | +0.3% | +0.3% | gasoline prices fell |
| | | | ex-autos, bld mat, gasoline | | ***+0.3%*** | +0.4% | +0.4% | moderate core sales |
| | | 8:30 | Empire State Manf. Index | Oct | ***18.0*** | 27.5 | 14.7 | likely to have slowed |
| | | 10:00 | Business Inventories | Aug | ***+0.2%*** | +0.4% | +0.4% | seen slower in 3Q14 |
| | | 2:00 | **Fed Beige Book** | | | | | still mixed, modest-to-moderate |
| Thursday | 10/16 | 8:30 | Jobless Claims, th. | 10/04 | ***296*** | 287 | 288 | |
| | | 9:15 | **Industrial Production** | Sep | ***+0.3%*** | ***-0.1%*** | +0.2% | moderate |
| | | | Manufacturing Output | | ***+0.2%*** | ***-0.4%*** | +0.8% | aggregate hours were flat |
| | | | Capacity Utilization | | ***78.9%*** | ***78.8%*** | 79.1% | no threat to the inflation outlook |
| | | | Manufacturing | | ***78.1%*** | ***78.0%*** | 78.5% | still plenty of slack |
| | | 10:00 | Philadelphia Fed Index | Oct | ***16.5*** | ***22.5*** | 28.0 | likely to have slowed somewhat |
| | | 10:00 | Homebuilder Sentiment | Oct | ***60*** | ***59*** | 55 | trending higher |
| Friday | 10/17 | 8:30 | Yellen Speaks | | | | | on inequality of economic opportunity |
| | | 8:30 | **Building Permits, th.** | Sep | ***1040*** | ***1003*** | 1057 | seen higher |
| | | | % change | | ***+3.7*** | ***-5.1*** | +8.6 | but watch for revisions |
| | | | **Housing Starts** | | ***1030*** | ***956*** | 1117 | likely to have improved |
| | | | % change | | ***+7.8*** | ***-14.4*** | +22.9 | reflecting multi-family volatility |
| | | 9:55 | UM Consumer Sentiment | m-Oct | ***84.4*** | 84.6 | 82.5 | likely little changed |
| Next Week: | | | | | | | | |
| Monday | 10/20 | | no significant data | | | | | Happy birthday Snoop Dogg! |
| Tuesday | 10/21 | | **Existing Home Sales, mln** | Sep | ***5.02*** | 5.05 | 5.14 | the Pending Home Sales Index fell 1.0% |
| | | | % change | | ***-0.6*** | -1.8 | +2.2 | a moderate trend |
| Wednesday | 10/22 | 8:30 | **Consumer Price Index** | Sep | ***+0.0%*** | -0.2% | +0.1% | lower food & energy |
| | | | year-over-year | | ***+1.6%*** | +1.7% | +2.0% | a low trend |
| | | | **ex-food & energy** | | ***+0.1%*** | 0.0% | +0.1% | mild core inflation |
| | | | year-over-year | | ***+1.7%*** | +1.7% | +1.9% | trending low |
| | | 8:30 | Real Weekly Earnings | Sep | ***+0.2%*** | +0.4% | 0.0% | nominal earnings rose 0.2% |
| | | 9:00 | BOC Policy Decision | | | | | no change |
| Thursday | 10/23 | 8:30 | Jobless Claims, th. | 10/11 | ***292*** | ***296*** | 287 | still low |
| | | 9:45 | Markit US Manf PMI (flash) | Oct | ***NF*** | ***57.5*** | 57.9 | not market-moving |
| | | 10:00 | Leading Econ Indicators | Sep | ***+0.6%*** | ***+0.2%*** | +1.1% | most components higher |
| | | 1:00 | TIPS Auction | | | | | reopened 30-year TIPS |
| Friday | 10/24 | 10:00 | **New Home Sales, th.** | Sep | ***460*** | ***504*** | 427 | volatile |
| | | | % change | | ***-8.7*** | +18.0 | +1.9 | watch for revisions |

## This Week…

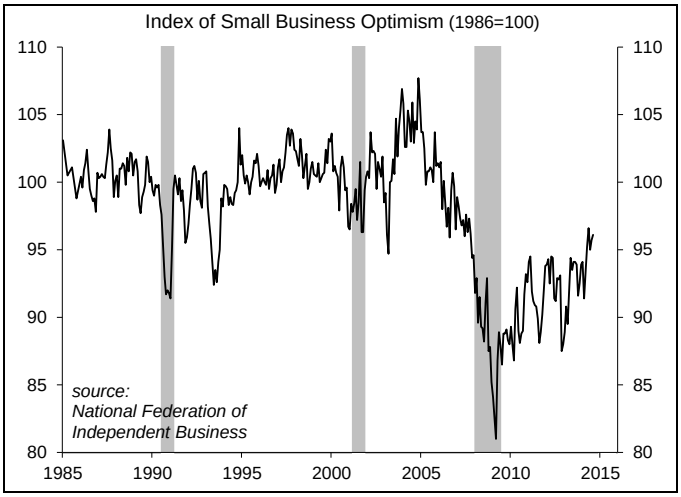
The economic calendar heats up again, with a number of potentially market-moving data releases. However, investors are likely to remain anxious about what's going on in the rest of the world. Retail sales figures should help fill in the near-term picture for the consumer. Fed Chair Janet Yellen speaks at the end of the week, but is not expected to address the economic outlook or the stance of monetary policy.

## Monday

**Columbus Day Holiday** – The bond market will be closed, but it will be business-as-usual for the stock market.

## Tuesday

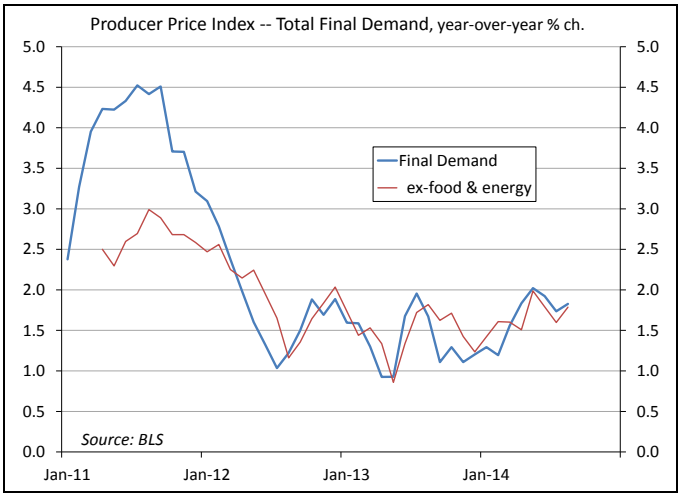
**Small Business Optimism** – While having generally improved, the headline index has remained far below normal in recent months. Small firms normally account for more than their fair share of job growth during an economic expansion. However, bank credit has remained relatively tight.



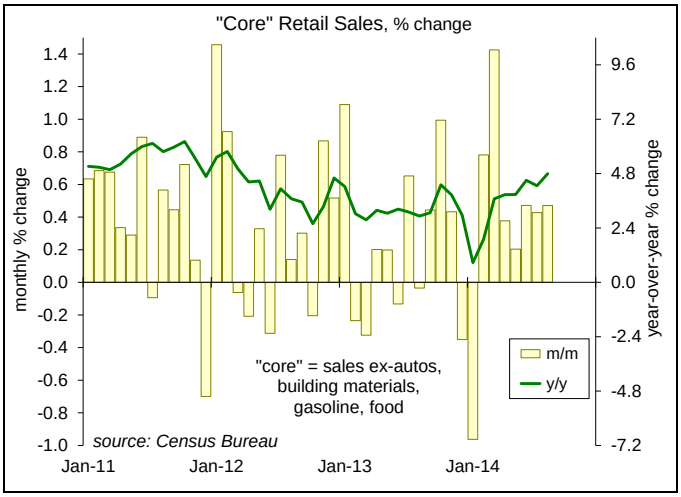

## Wednesday

**Producer Price Index (September)** – The seasonal adjustment anticipates only a 0.6% decline in wholesale gasoline prices (but

a 5.3% drop in October). In food, drought effects may unwind a bit. Core inflation is expected to stay relatively low and pipeline inflation pressures should remain very mild.




**Retail Sales (September)** – Unit auto sales fell sharply. Gasoline prices were somewhat lower. Core sales have been trending at a moderate pace, which should continue in the near term.




**Empire State Manufacturing Index (October)** – The headline figure is volatile, but the September figure was very strong.

**Business Inventories (August)** – The only missing piece is retail inventories, which are likely to have been mixed. We'll still be missing September data, but it's likely that the pace of inventories will have slowed in 3Q14 (subtracting from GDP growth).

**Fed Beige Book** – In the previous assessment, economic growth was described as either "modest" or "moderate" in most districts. The key will be what the report says about the job market and wage and price pressures (most likely, mild).

## Thursday

**Jobless Claims (week ending October 11)** – The headline figure will be subject to seasonal noise, but the trend remains low.

**Industrial Production (September)** – Aggregate hours (from the employment report) were flat, which should translate into a small increase in factory output. Capacity utilization is nowhere near a level that would suggest inflation pressure.

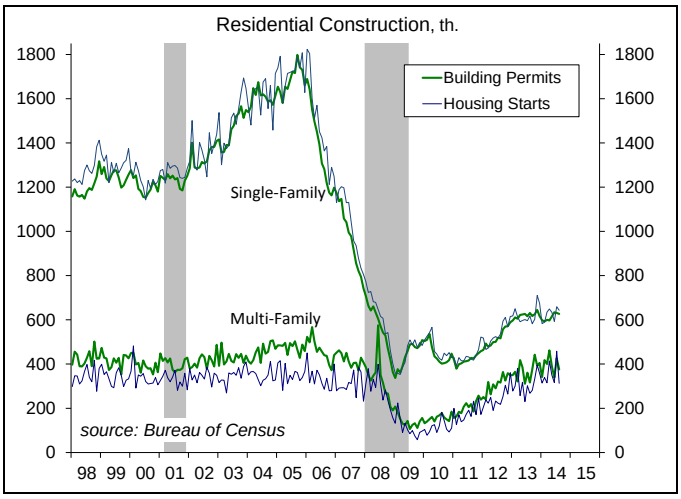
**Philadelphia Fed Index (October)** – The Philly Fed Index is also volatile, but should reflect moderate strength in October.

**Homebuilder Sentiment Index (October)** – Following a big jump in September, little change is anticipated in October.

## Friday

**Janet Yellen Speaks** – The Fed chair will give the keynote address at a Boston Fed conference on the inequality of economic opportunities. This is not the "income inequality" debate that has gone on this year (that is, whether rising income inequality undermines growth, and if so, what to do about it). Rather, it's about providing people the chance to improve their lot in life, largely through education – much less controversial. More importantly for the financial markets, Yellen is unlikely to mention the current economy outlook or monetary policy.

**Building Permits, Housing Starts (September)** – Recent data have indicated the usual high degree of volatility in the multi-family sector and a general trend of meager improvement in the single-family sector. Seasonal adjustment could be a factor in September (as unadjusted activity normally begins to wane).




## Next Week …

The economic calendar is less critical.

## Coming Events and Data Releases

| | |
|---|---|
| October 27 | Pending Home Sales Index (September) |
| October 28 | Consumer Confidence (October)<br>Durable Goods Orders (September) |
| October 29 | FOMC Policy Decision (no press conference) |
| October 30 | Real GDP (3Q14, advance) |
| November 4 | Election Day |
| November 7 | Employment Report (October) |
| December 17 | FOMC Policy Decision, Yellen press conference |
| January 28 | FOMC Policy Decision (no press conference) |
| March 18 | FOMC Policy Decision, Yellen press conference |
| April 29 | FOMC Policy Decision (no press conference) |
| June 17 | FOMC Policy Decision, Yellen press conference |