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Weekly Market Monitor

Risk and Uncertainty, Confidence and Fear

In recent weeks, the financial markets appear to have been reacting less to weaker expectations of global growth and more to the increased downside risks – that is, to the fear that things could get a lot worse. The downside risks to Europe are considerable, but America is much less dependent on exports than most other countries and the prospects for moderately strong growth into 2015 remain promising.

Students of forecasting learn that there are two parts to any projection. There's the point estimate, the expected value at a certain point in the future, and there's the uncertainty around that point forecast. In economics, that forecast uncertainty is often embarrassingly high and usually isn't symmetric (meaning that downside risks could be a lot different than upside risks). That doesn't mean that forecasting the economy is a useless effort. It's just that one should take such forecasts with a grain of salt. It's far more important to develop a consistent story and look for ways that the story could go wrong.

Similarly, investors typically face a given set of expectations, while the risks surrounding those expectations can be quite substantial and may increase or decrease over time. Recently, the IMF lowered its outlook for global growth in 2014 and 2015. That should have surprised no one. What has been troublesome for the financial markets is that the downside risks to that outlook have increased. Europe has faced important challenges over the last few years, but the current phase, as it battles the threat of deflation, is expected to be more difficult. Inflation is low in the euro area and the European Central Bank's policy rates are near zero (and in the case of the rate on the deposit facility, a bit negative). The ECB has to do more, and that means quantitative easing. However, there may be legal challenges.

Europe has been an on-again off-again concern for U.S. investors in recent years, mostly reflecting concerns about the survivability of the monetary union. Those fears were put to bed when ECB President Mario Draghi promised to do "whatever it takes." Yet, austerity efforts in Europe have been self-defeating and growth has slowed. While the U.S. economy still has a long way to go, we have remained firmly on the recovery track, with few signs of the types of excesses that would lead to an economic downturn. After a while, U.S. market participants have repeatedly put aside their worries about Europe. This recent focus on Europe may not be much different. Worries about Europe could lead U.S. firms to pull back on hiring and capital expenditure plans. However, foreign trade is much less important to the U.S. than it is to other advanced economies. Trouble in the rest of the world may have a significant impact on some U.S. firms, but it's not expected to have a large effect on the domestic economy as a whole.

One side effect of a soft global economy is a strong U.S. dollar and downward pressure on commodity prices. That should be helpful for consumers. Along the usual seasonal pattern, retail gasoline prices can be expected to fall about 12% from May to December. This year, they've fallen about 13% so far, with further declines expected in the weeks ahead. That's somewhat supportive for the consumer spending outlook, but not enough to boost sales activity sharply for the holiday shopping season. The impact of lower gasoline prices depends on the magnitude of the decline and how long prices remain low.

As Fed Governor Stanley Fischer recently noted, monetary policy, while focused on the outlook for the job market and inflation, must consider what's happening in the rest of the world and take into account the feedback from abroad in reaction to any policy changes. The downward pressure on inflation is likely to contribute to a delay in the Fed's initial increase in short-term interest rates. Indeed, most private-sector economists are likely to push out their forecasts of the timing of the first rate hike. Some are suggesting that the Fed may even want to delay the end of QE3 or introduce QE4. That is unlikely. Remember, QE3 was meant to impart positive momentum in the economy, especially in the job market (mission accomplished). Officials believe that asset purchases are less effective over time and potentially more risky. So QE4 isn't going to happen unless the economy takes a serious turn for the worse, and there's not much chance of that.

The exaggerated fears of Ebola are a good example of the difficulties in defining downside risks. Your chances of contracting the Ebola virus are extremely low. You are much more likely to die of the flu than Ebola (and, as an aside, you can reduce that risk by getting a flu shot). Yet, Ebola fears played a role in last week's market volatility. One recent survey showed that 25% of Americans are worried about catching Ebola. If 10% of those people decide not to travel, then you're talking about a 2.5% reduction in air travel (that's assuming that the 25% are a representative sample of potential travelers, which is a leap). Granted, this is a crude (and almost certainly wrong) estimate of the impact, but it gives you an idea of how a panic can begin to affect the economy. Most likely, the cable news stations will eventually find something else to worry about.

Friday's rebound in the stock market was encouraging, but we may still see an elevated level of market volatility in near term. This week's economic calendar is not going to have much of an impact on the overall picture, but the following two weeks will be a lot more eventful, as we get some indication as to where the U.S. economy is heading in the near term. Mostly, the outlook will remain moderately positive, especially in comparison to the rest of the world. Investor confidence should improve.

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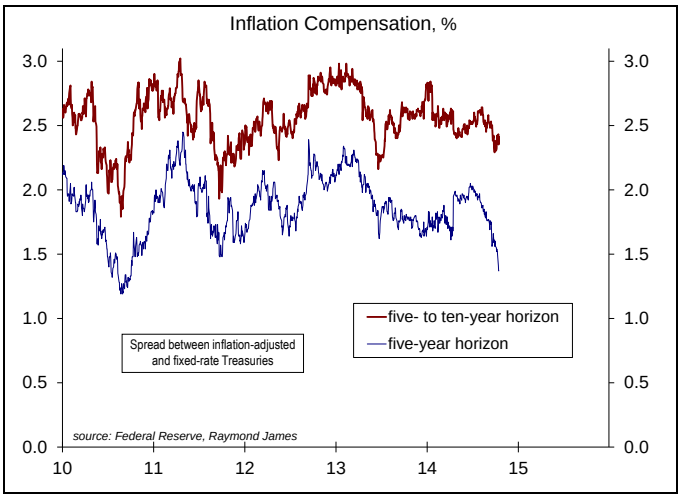
	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
9/19/14	0.02	0.04	0.11	0.59	1.09	1.83	2.59	3.29	1.284	1.631	108.96	1.097	4579.79	2010.40	17279.74
10/10/14	0.01	0.04	0.10	0.45	0.89	1.55	2.31	3.03	1.264	1.605	107.83	1.117	4276.24	1906.13	16544.10
10/17/14	0.03	0.05	0.10	0.38	0.79	1.42	2.20	2.98	1.276	1.609	106.90	1.127	4258.44	1886.71	16380.21

Recent Economic Data and Outlook

Worries about geopolitical tensions, global growth, and Ebola helped send world equity markets lower and the U.S. followed. Bonds yields plunged. However, the markets appeared to begin stabilizing by the end of the week. The economic data reports were of little significance for the markets, but a poor retail sales report worsened the stock market drop on Wednesday.



The **Fed's Beige Book** continued to describe growth across the 12 Federal Reserve districts as *"modest to moderate."* Consumer spending growth ranged from *"slight to moderate,"* but retailers were optimistic about the rest of the year. Tourism activity "remained upbeat." Manufacturing increased. Residential construction and real estate activity were *"mixed,"* as was consumer loan demand. Employment *"continued to expand at the same pace as in the previous Beige Book."* Overall wage growth was *"modest,"* except for a few select occupations and industries. Price pressures *"remained subdued."* Input prices were *"unchanged or up slightly."*

Retail Sales fell 0.3% (+4.3% y/y), down 0.2% ex-autos (+3.1% y/y). Auto dealership sales fell 0.8% (+9.5% y/y), a smaller decline than was suggested by the drop in unit sales reported by the various auto companies. Sales of building materials fell 1.1% (+3.4% y/y). Gasoline sales fell 0.8% (-6.8% before seasonal adjustment, down 2.5% y/y). Ex-autos, building materials, and gasoline, sales were flat (+3.9% y/y) – a 4.3% annual rate in 3Q14 (vs. +6.8% in 2Q14).

Business Inventories rose 0.2% in August (+5.7% y/y), a somewhat slower pace than in the second quarter. Retail inventories, the only new information in the report fell 0.3% (autos -0.7%, ex-autos -0.0%). Business sales (factory shipments plus wholesale and retail sales) fell 0.4% in August, up 4.5% y/y.

The **Producer Price Index** fell 0.1% in September (+1.6% y/y), reflecting lower prices of food and energy (each down 0.7%). Wholesale gasoline prices fell 2.6% (-3.4% before seasonal adjustment, down 4.7% y/y). Ex-food & energy, the PPI was flat (+1.6% y/y). Pipeline inflation remained generally mild.

Industrial Production rose 1.0% in September, partly reflecting a return to more normal weather (following an unusually cool summer). The output of utilities rose 3.9% (electricity up 4.5%). Manufacturing output rose by 0.5% (+4.1%), with relatively broad-based gains across industries (following mixed results in August) – a 3.5% annual rate in 3Q14.

Building Permits rose 1.5% in September (±1.4%), to a 1.018 million seasonally adjusted annual rate (+2.5% y/y). Single-family starts fell 0.5% (±1.1%), with missed results across regions (+4.5% in the Northeast, +1.0% in the Midwest, -1.4% in the South, and -0.8% in the West). **Housing Starts** rose 6.3% (±9.3%), to a 1.017 million annual rate, with single-family permits up 1.1% (±8.3%).

Homebuilder Sentiment fell to 54 in October, from 59 in September. Builders remained optimistic about current and future sales conditions (albeit less than in September). The foot-traffic of prospective buyers weakened.

The Index of **Small Business Optimism** edged down to 95.3 in September, vs. 96.1 in August and 95.7 in July. Details were mixed. The earnings trend remained weak. Sales expectations were moderate. The general business outlook was a bit pessimistic. Hiring plans were moderate.

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 into early 2015.

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	10/20		no significant data					Happy birthday Snoop Dogg!
Tuesday	10/21		**Existing Home Sales, mln**	Sep	***5.05***	5.05	5.14	the Pending Home Sales Index fell 1.0%
			% change		***0.0***	-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	***290***	264	287	
		9:45	Markit US Manf PMI (flash)	Oct	***NF***	***57.5***	57.9	not market-moving
		10:00	Leading Econ Indicators	Sep	***+0.7%***	***+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	***465***	***504***	427	volatile
			% change		***-7.7***	+18.0	+1.9	watch for revisions
Next Week:								
Monday	10/27	10:00	Pending Home Sales Index	Sep	***+2.0%***	-1.0%	+3.2%	likely to have picked up
			year-over-year		***-0.3%***	-2.2%	-2.2%	stabilizing
Tuesday	10/28	8:30	**Durable Goods Orders**	Sep	***+0.7%***	-18.4%	+22.5%	seen moderately strong
			ex-transportation		***+0.5%***	+0.4%	-0.6%	trending higher again
			nondef cap gds ex-aircraft		***+0.5%***	+0.4%	-0.1%	moderate
		9:00	Case-Shiller Home Prices	Aug	***-0.2%***	-0.5%	-0.2%	seen a bit lower
			year-over-year		***+5.5%***	+6.7%	+8.1%	falling
		10:00	**Consumer Confidence**	Oct	***89.0***	86.0	93.4	likely to improve
		1:00	Treasury Note Auction					2-year notes
Wednesday	10/29	11:30	Treasury FRB Auction					2-year Floating Rate Notes
		1:00	Treasury Note Auction					5-year notes
		2:00	**FOMC Policy Decision**					no press conference, QE to end
Thursday	10/30	8:30	Jobless Claims, th.	10/11	***290***	***290***	264	still low
		8:30	**Real GDP (advance est.)**	3Q14	***+3.0%***	+4.6%	-2.1%	mixed components, moderately strong
			Domestic Final Sales		***+2.8%***	+3.4%	+0.4%	a good pace, following noise in 1H14
		1:00	Treasury Note Auction					7-year notes
Friday	10/31	8:30	Employment Cost Index	3Q14	***+0.5%***	+0.7%	+0.3%	still trending about +2% y/y
		8:30	Personal Income	Sep	***+0.3%***	+0.3%	+0.1%	moderately strong aggregate wage gains
			Personal Spending		***+0.2%***	+0.5%	0.0%	unit auto sales lower, lackluster otherwise
			PCE Price Index ex-f&e		***+0.1%***	+0.1%	+0.1%	mild core inflation
		9:45	Chicago PM Index	Oct	***61.2***	60.5	64.3	moderately strong
		9:55	Consumer Sentiment	Oct	***86.8***	84.6	82.5	86.4 at mid-month

This Week…

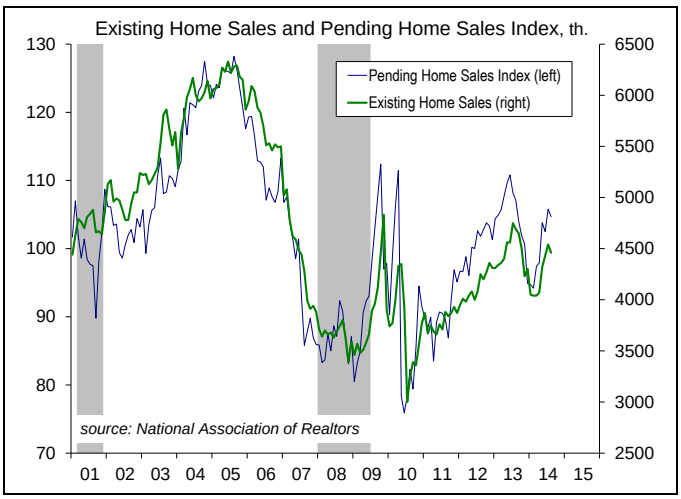
The economic calendar is not highly critical to the overall outlook, but surprises could rattle the financial markets to some extent. The Consumer Price Index is likely to continue to reflect a low trend in inflation (with further downward pressure from gasoline expected in next month's report). Q: if that's the case, why is the Fed even discussing when to begin raising short-term interest rates? A: officials may not see a need to hit the brakes, but they do have to take the foot off the accelerator at some point. The LEI should remain consistent with little chance of a recession. New home sales figures are erratic.

Monday

No significant economic data.

Tuesday

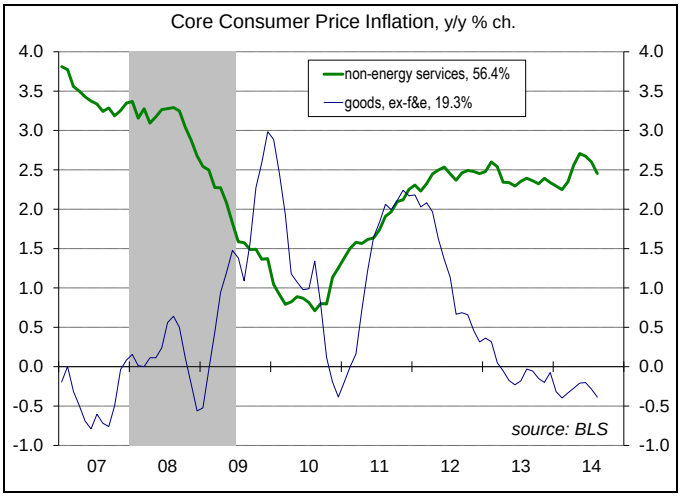
Existing Home Sales (September) – The Pending Home Sales Index fell 1.0%, but the two series are far from perfectly correlated. Low mortgage rates should help, but affordability is less of an issue than it is with new home sales.



Wednesday

Consumer Price Index (September) – Retail gasoline prices fell a little over 2% last month, while the seasonal adjustment anticipates a decline of about 1.1%. We may also see some

unwinding of drought effects in food prices. Core inflation is expected to have remained relatively low. Note there is a big difference between inflation in services and inflation in stuff.

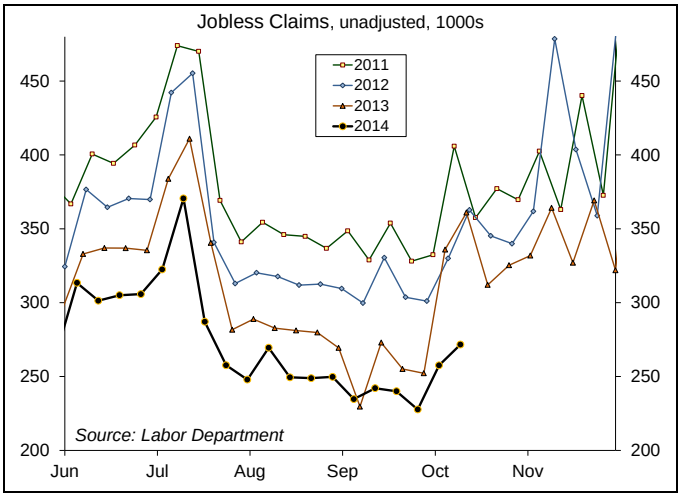


Real Weekly Earnings (September) – Nominal earnings (from the employment report) were reported to have risen 0.2% last month. The year-over-year trend in inflation-adjusted earnings has been about flat, but could improve in the months ahead.

Bank of Canada Policy Decision – The BOC is not expected to alter monetary policy, but investors will be looking for clues regarding the likelihood of future moves and how global economic developments will influence policy decisions.

Thursday

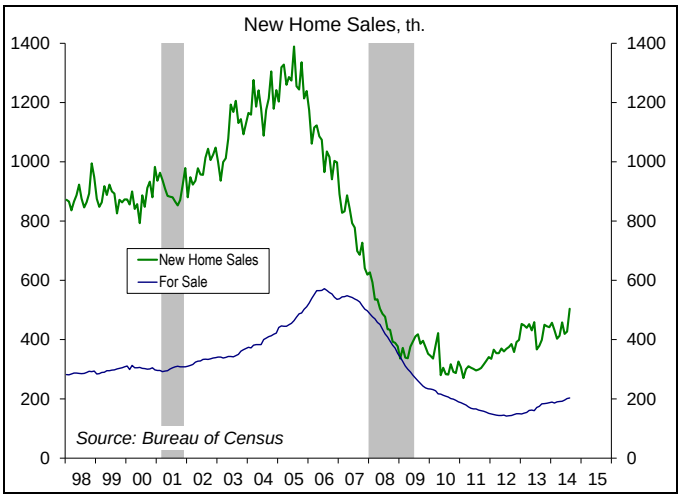
Jobless Claims (week ending October 18) – Weekly figures can get choppy in the last few months of the year, but the underlying trend has remained remarkably low in recent weeks.



Leading Economic Indicators (September) – Most components will make positive contributions.

Friday

New Home Sales (September) – Affordability is a bigger problem for new home sales than for existing home sales. Despite strong job growth and low mortgage rates, sales have been limited by lackluster gains in average incomes, an increase in new home prices, and relatively tight mortgage credit.



Next Week …

The Fed is widely expected to bring its Large-Scale Asset Purchase program (LSAP, more commonly referred to as "QE3") to an end, although there has been some small debate about whether it might be appropriate to extend it (not likely). Fed officials have indicated that asset purchases are less effective the longer they go on, and potentially more risky. The forward guidance will do the heavy lifting from here. We know from the minutes of the mid-September FOMC meeting that officials are worried that the financial markets might misinterpret and over-react to any changes to the language in the forward guidance, but the "considerable period" phrase is likely to stay for now.

As usual, there's uncertainty in the advance estimate of GDP growth. The Bureau of Economic Analysis does not have a full picture of the third quarter and will have to make assumptions about inventories, foreign trade, and other components. Consumer spending appeared to be tracking at a lackluster-to-moderate pace, while data on factory shipments point to a strong quarter for business fixed investment. Slower inventory growth should subtract, while foreign trade will likely add.

Coming Events and Data Releases

November 3	ISM Manufacturing Index (October)
November 4	Election Day
November 5	ISM Non-Manufacturing Index (October)
November 6	ECB Policy Meeting, Draghi Press Conference
November 7	Employment Report (October)
November 11	Veterans Day Holiday (bond market closed)
November 14	Retail Sales (October)
November 27	Thanksgiving Holiday (markets closed)
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