RAYMOND JAMES

Economic Research
Published by Raymond James & Associates

Scott J. Brown, Ph.D., (727) 567-2603, Scott.J.Brown@RaymondJames.com

October 27 - 31, 2014

Weekly Market Monitor

Income Inequality and Fed Policy

"The extent of and continuing increase in inequality in the United States greatly concern me… It is no secret that the past few decades of widening inequality can be summed up as significant income and wealth gains for those at the very top and stagnant living standards for the majority. I think it is appropriate to ask whether this trend is compatible with values rooted in our nation's history, among them the high value Americans have traditionally placed on equality of opportunity."

– Janet Yellen, October 17

Income inequality has been an important topic this year, but it is one that is mired in politics. That means it is a potentially treacherous debate for the Federal Reserve chair to wade into. To be fair, Yellen said that the purpose of her recent talk on income inequality and opportunity was *"not to provide answers to these contentious questions, but rather to provide a factual basis for further discussion."* She provided a mountain of evidence from the Fed's triennial Survey of Consumer Finances, and then got out of the way, as appropriate.

However, what she didn't say was even more important. Income inequality has begun to play a larger role in the economic outlook and will likely be increasingly incorporated (albeit indirectly) into the Fed policy outlook. Before she became Fed chair, Yellen was known to place considerable weight on the labor market. This emphasis has only increased since she took the helm. That does not mean that she is willing to sacrifice the Fed's commitment to low inflation. It does mean that she will pay greater attention to the interactions between the job market and inflation in setting monetary policy.

While many short-term gauges of the job market (weekly jobless claims, the percentage pf people unemployed for a half a year or less) are trending at levels that one would normally associate with an economy that has fully hit its stride, other measures continue to suggest that an ample amount of slack remains. Views regarding how much slack are the key difference among policy monetary policy makers.

One of the key indicators of slack is the lack of real wage growth. Job growth is a key element of economic growth. However, average wages have struggled to keep pace with inflation, which means that most of the gains in consumer spending have come from added jobs rather than improvement in average wages (although wealth and borrowing have some impact on spending). The lackluster trend in average wages has also been a factor in income inequality. The share of national income going to profits is up; the share going toward labor compensation is down. Theoretically, this should take care of itself as the economy improves and the labor market tightens, but we may not see that happen for some time.

In its large scale model of the economy, the Federal Reserve sees inflation as a function of inflation expectations, the slack in the job market, and oil prices. Inflation expectations are a measure of inertia and market indicators suggest that they remain well-anchored. Oil is different from other commodities. Oil price increases show up quickly at the pump (declines show through more slowly). Goods have to be shipped. Offices have to be heated or cooled. However, the slack in the job market is seen as the more significant factor. The labor market is the widest channel for inflation pressure. As the job market tightens, wages should be bid up at a faster pace and firms ought to be able to pass some of that added cost along. However, the Fed's economic model is only one factor in setting monetary policy. Officials will incorporate a lot more judgment.

The recent decline in oil and gasoline prices should factor into the Fed's policy decisions, but it's unclear how much and in what direction. Lower gasoline prices will add to consumer purchasing power, but it depends on the magnitude of the decline and how long prices stay low. There may be a small benefit to the consumer during the important holiday shopping season, but we're likely to see a bigger impact in the early part of 2015 (provided gasoline prices continue to fall). Since consumer spending accounts for 70% of the economy, lower oil prices ought to help boost GDP growth in early 2015 and job growth should be higher than it would be otherwise. Hence, more labor market slack will be taken up.

On the other hand, lower oil and gasoline prices will put downward pressure on consumer price inflation, which has already been trending below the Fed's comfort range. It is real (that is, inflation-adjusted) interest rates that matter. So, all else equal, lower inflation implies higher real interest rates. The lower inflation outlook should delay the timing of the Fed's initial increase in short-term interest rates.

Yellen and other senior Fed officials have indicated that they are willing to tolerate some pickup in average wages. However, any meaningful increase in average wages is not expected until the labor market tightens a lot more. Clearly, there are many uncertainties ahead. Fed policy will depend on how the economic outlook evolves over the next several months.

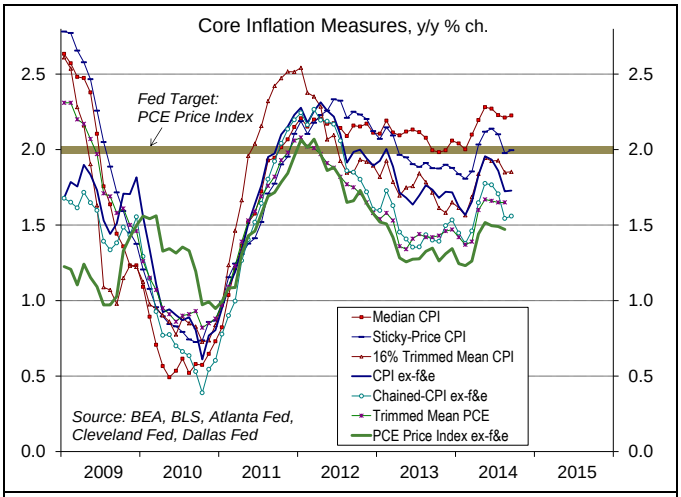
After introducing the Fed's data on income inequality, Chair Yellen was right to step away from the discussion. However, she did address something that just about everyone can agree with – that is, that all Americans should have the opportunity to succeed. One major concern is that the increased level of income inequality is contributing to a decrease in opportunity. Yellen cited support for early childhood education, access to higher education, and greater business formation as important "building blocks" for economic opportunity.

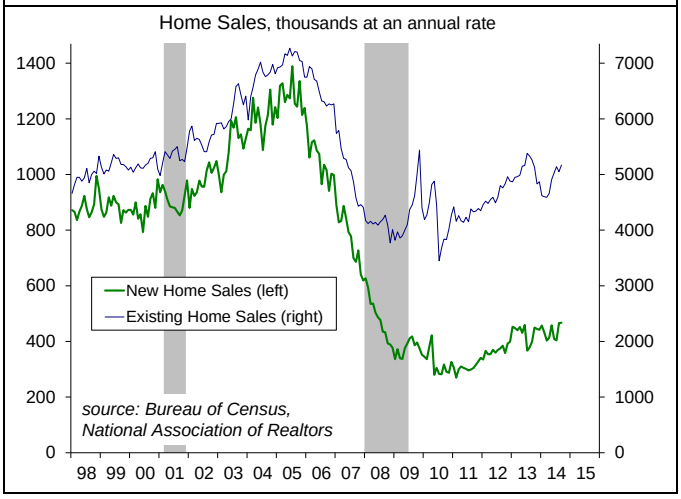
International Headquarters: The Raymond James Financial Center | 880 Carillon Parkway | St. Petersburg, Florida 33716 | 800-248-8863

	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
9/26/14	0.01	0.03	0.11	0.59	1.08	1.80	2.54	3.22	1.269	1.625	109.32	1.116	4512.19	1982.85	17113.15
10/17/14	0.02	0.05	0.11	0.39	0.79	1.44	2.22	2.98	1.276	1.609	106.72	1.125	4258.44	1886.76	16380.41
10/24/14	0.01	0.06	0.10	0.39	0.82	1.50	2.27	3.04	1.267	1.609	108.11	1.123	4483.72	1964.55	16805.16

Recent Economic Data and Outlook

The economic data were largely irrelevant, as investors focused on earnings reports and Ebola fears ebbed.





The **Consumer Price Index** rose 0.1% in September (+1.7% y/y). Food rose 0.3% (+3.0% y/y), while energy fell by 0.7% (-0.6% y/y). Gasoline (5.0% of the overall CPI) fell 1.0% (-2.1% before seasonal adjustment, -3.6% y/y). Ex-food & energy, the CPI rose 0.1% (+1.7% y/y) – a 1.7% annual rate for the first nine months of 2014 (vs. 1.5% for all of 2013). Owners' Equivalent Rent (23.9% of the CPI) rose 0.2% (+2.7%), while rent (6.5% of the CPI) rose 0.3% (+3.3%). Medical care services edged up 0.1% (+1.7% y/y). Ex-food & energy, prices of consumer goods were flat (-0.3%), while non-energy services rose 0.2% (+2.4% y/y).

Real Weekly Earnings rose 0.2% in September (hours up 0.3%, average hourly earnings flat, and the CPI up 0.1%), following a 0.5% rise in August (+0.6% y/y). Lack of real growth in average wages has been a key concern for consumer spending, but lower gasoline prices should add further to consumer purchasing power in the next few months. Unadjusted sales for the last three months were 16.8% higher than the same period in 2013.

Existing Home Sales rose 2.4% in September, to a 5.17 million seasonally adjusted annual rate (-1.7% y/y). Results were mixed across regions (Northeast +1.5%, Midwest -5.6%, South +5.0%, West +7.1%). Unadjusted sales for the last three months were 3.8% below the same period in 2013.

New Home Sales edged up 0.2% (±15.7%) in September, to a 467,000 seasonally adjusted annual rate (+17.0% y/y). However, figures for June, July, and August were revised lower. Results were mixed across regions.

The Index of **Leading Economic Indicators** rose 0.8% in September, following no change in August (revised from +0.2%). Nine of the ten components made positive contributions. The Conference Board noted that the LEI and its components, taken together with the Index of Coincident Economic Indicators (which rose 0.4% in September), suggest that "the expansion in economic activity should continue at a moderate pace through the final stretch of 2014."

The **Chicago Fed National Activity Index** rose to +0.47 in the initial estimate for September, vs. -0.25 in August and +0.52 in July (figures distorted due to seasonal adjustment issues in the auto industry). The three-month average was +0.25, consistent with an economy growing a bit above its longer-term trend.

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	10/27	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					$29 billion in 2-year notes
Wednesday	10/29	11:30	Treasury FRB Auction					$15 billion in 2-year Floating Rate Notes
		1:00	Treasury Note Auction					$35 billion in 5-year notes (a re-opening?)
		2:00	**FOMC Policy Decision**					no press conference, QE to end
Thursday	10/30	8:30	Jobless Claims, th.	10/25	***290***	283	266	some seasonal noise, but a low trend
		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
		9:00	Yellen speaks					welcoming remarks at Fed diversity conf.
		1:00	Treasury Note Auction					$29 billion in 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
Next Week:								
Monday	11/03	9:45	Markit US Manf PMI (final)	Oct	***NF***	57.5	57.9	56.2 in the flash estimate
		10:00	Construction Spending	Sep	***NF***	-0.8%	+1.2%	likely higher (but watch for revisions)
		10:00	**ISM Manf. Index**	Oct	***57.0***	56.6	59.0	moderately strong
		tbd	Motor Vehicle Sales, mln	Oct	***16.6***	16.3	17.4	likely to pick up
			domestically built		***13.2***	12.9	13.9	a bit uneven, but a strong trend
Tuesday	11/04		Election Day					may not be settled right away
		8:30	**Trade Balance, $bln**	Sep	***-39.3***	-40.1	-40.3	seen somewhat lower
			goods only		***-59.0***	-59.9	-59.8	lower petroleum prices
		10:00	Factory Orders		***NF***	-10.2%	+10.5%	likely mixed
Wednesday	11/05	8:15	**ADP Payroll Estimate (th.)**	Oct	***+220***	+213	+202	moderately strong
		10:00	**ISM Non-Manf. Index**	Oct	***58.2***	58.6	59.6	moderately strong
Thursday	11/06	7:00	BOE Policy Decision					no change
		7:45	ECB Policy Decision					too soon for real QE, but it's coming…
		8:30	Jobless Claims, th.	11/01	***286***	***290***	283	trending low
Friday	11/07	8:30	**Nonfarm Payrolls, th.**	Oct	***+220***	+248	+180	seasonal adjustment still tricky
			private-sector		***+215***	+236	+175	a moderately strong trend
			Unemployment Rate		***5.9%***	5.9%	6.1%	trending lower
			employment/population		***59.1%***	59.0%	59.0%	trending higher, but very gradual
			Avg. Weekly Hours		***34.6***	34.6	34.5	seen steady (watch for revision to Sep)
			Avg. Hourly Earnings		***+0.2%***	-0.0%	+0.3%	mild wage pressures

This Week…

There are two big items on the economic calendar: the FOMC meeting and the advance GDP report. It's widely expected that Fed policymakers will bring the asset purchase program (QE3) to an end (and, at this point, there's very little chance of QE4). The key question is what the Fed will do with the forward guidance. The language is going to change, but it's unclear whether that will come this week or at the FOMC meeting in mid-December (December is more likely). The initial GDP estimate is always an adventure (the government will have to make assumptions about a number of components). Financial market participant typically place too much emphasis on the headline GDP growth figure (which will be revised) and not enough on the underlying details. Earnings reports and the Ebola hysteria are likely to remain factors for the stock market.

Monday

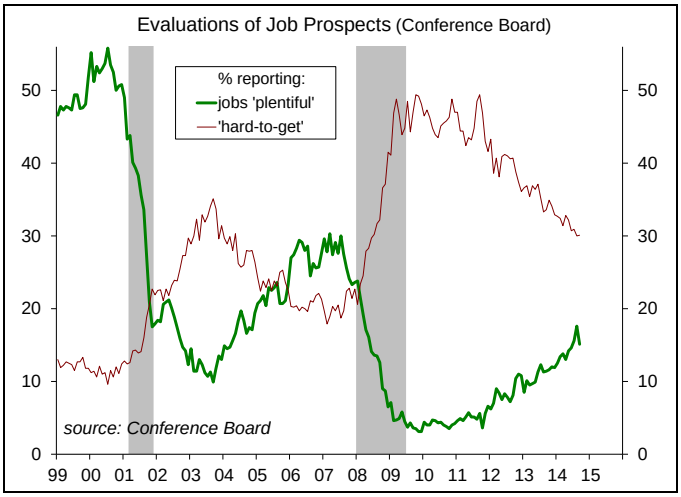
Pending Home Sales Index (September) – The PHSI tends to lead existing home sales, but there is a fair amount of noise from month to month. Some increase is likely for September.

Tuesday

Durable Goods Orders (September) – The reports for July and August were dominated by a spike in civilian aircraft orders. Outside of transportation, orders have been mixed, but moderately higher in recent months. Some of the details in the report (shipments of nondefense capital goods, inventories) have implications for the advance GDP estimate. Note that it's a little too soon to see much impact from the stronger dollar and weaker global growth, but that ought to be coming.

Case-Shiller Home Prices (August) – 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.

Consumer Confidence (October) – Evaluations of current labor market conditions deteriorated in the preliminary data for September, which could be noise. Expect a rebound.



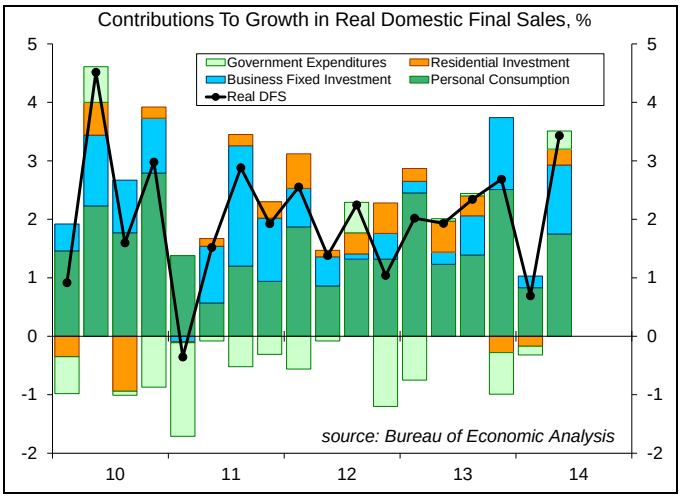
Wednesday

Federal Open Market Committee – After a nine-month gradual tapering, the asset purchase program will come to an end (officials are not even close to considering a QE4). The market's focus will be on the wording of the forward guidance, specifically on the phrase "considerable period." Minutes of the mid-September FOMC meeting showed that Fed officials were worried that the markets might misinterpret any changes to the language. It will change at some point, but that's more likely in December. Yet, the new language is expected to be something similar. The bottom line is that the Fed is still in no hurry to raise short-term interest rates. Pay close attention to what the Fed says about inflation and the risks that it might be too low. The low inflation trend and continued slack in the job market should push out the date of the Fed's first rate hike (now seen in the second half of 2015 or possibly early 2016).

Thursday

Jobless Claims (week ending October 25) – The data will be subject to some seasonal noise, but the underlying trend has remained remarkably low in recent weeks.

Real GDP (3Q14, advance estimate) – The Bureau of Economic Analysis will have to make assumptions about inventories, net exports, and other components, and the figures will be revised and revised again. Focus on Domestic Final Sales (GDP less net exports and the change in inventories), a steadier measure of underlying domestic demand. Consumer spending is expected to have been at a lackluster-to-moderate pace in 3Q14. Factory shipment figures suggest that business fixed investment was relatively strong. Inventories are likely to have risen at a slower pace, subtracting from headline GDP growth, while a narrower trade deficit should add (although the trade deficit is expected to widen in 4Q14 and early 2015).



Friday

Employment Cost Index (3Q14) – The ECI has been trending relatively low, consistent with labor market slack.

Personal Income and Spending (September) – Quarterly figures will have been included in the GDP report, but the September figures should help to gauge the momentum heading into 4Q14.

Next Week …

We'll receive fresh figures on auto sales, ISM manufacturing, and, most importantly, nonfarm payrolls. Republicans are likely to gain control of the Senate, but election results may not be completely settled right away.

Coming Events and Data Releases

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