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Economic Research
Published by Raymond James & Associates

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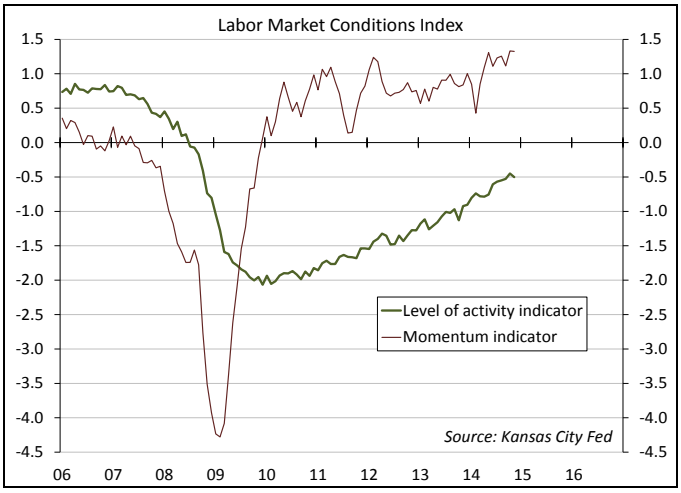
December 15 - 19, 2014

Weekly Market Monitor

High Anxiety

Federal Reserve policymakers meet this week to set monetary policy. The key concern is the timing of policy normalization. Officials may be anxious to begin lifting short-term interest rates, but they need to be very careful about managing market expectations. The risks of tightening too soon or too late are not symmetric and with the financial markets in turmoil, the Fed will not want to add to the level of anxiety.

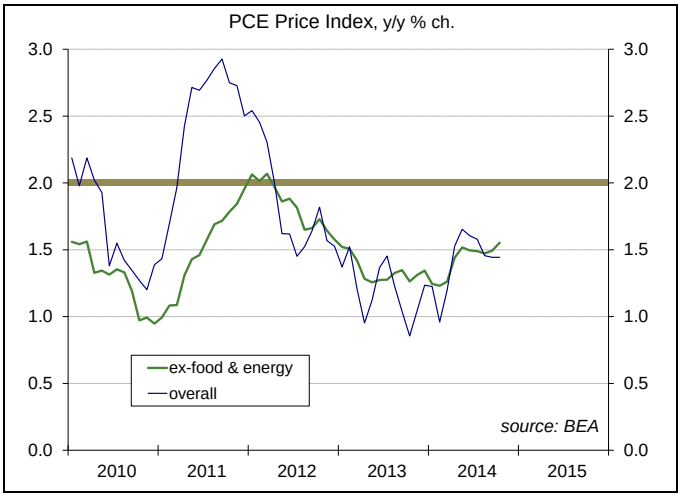


The liftoff for short-term interest rates will be driven largely by the Fed's view of the labor market. There are many labor market gauges. The Labor Market Conditions Index, a composite of 24 indicators, provides a good summary (according to Fed Chair Yellen). While there is some choppiness from month to month, the underlying trend suggests that labor market slack is being gradually taken up and momentum in the job market has been strong in recent month. Still, a lot of slack remains and it will likely be two years or more before we get to what might be considered "normal" labor market conditions.

Working back from where the job market is expected to be in two years and assuming a slow pace of rate hikes (25 bps per FOMC meeting), then it would seem appropriate to begin tightening around the middle of next year. The Fed would not be hitting the brakes. Rather, it would simply be gradually taking the foot off the gas pedal.

What are the risks of tightening too soon or two late? If the Fed tightens too soon and the economy slows, it will have a limited ability to correct course, as short-term interest rates are already close to zero and officials will be very reluctant to pursue another round of quantitative easing. If the Fed tightens too late, the economy would begin to overheat and inflation would begin to rise. However, the Fed has the scope to raise short-term interest rates more rapidly – that is, it has a greater ability to correct its course.

In 2011, inflation picked up. Some observers feared that the Fed was behind the curve and wanted it to unwind accommodation. Instead, the Fed cited "temporary factors" and focused on core inflation, and continued to act aggressively. The current low inflation trend is also seen, by many Fed officials, as transitory. Low inflation, by itself, is not enough to postpone a Fed tightening. However, the conditions driving low inflation matter. For example, some of the drop in energy prices reflects increased supply. The Fed need not worry about that. However, some of the drop reflects weaker demand, which is a concern. Yet, the drop in demand is coming from the rest of the world. It's not due to weakness in the domestic economy.



What about the stronger dollar? Would the Fed postpone tightening to reduce the upward pressure on the greenback? Remember, the exchange rate of the dollar is not the Fed's responsibility. The dollar is under the Treasury's jurisdiction (although the Fed may intervene in the currency markets on behalf of the Treasury). Yet, the Fed needs to consider the impact of a stronger dollar. A stronger dollar, as we've seen, puts downward pressure on commodity prices, but the impact at the consumer level is usually small. It takes a major move in prices of raw materials to move consumer prices even a little. The exception is oil, where the decline has a bigger impact and shows up relatively quickly. Still, oil prices are not expected to fall forever. They should stabilize at some point.

Following NY Fed President Dudley's recent speech, we now know that the Fed will also consider the financial market reactions (or overreactions) to its policy moves, and possibly react to the market's reaction. The recent stock market turmoil and drop in long-term interest rates makes the Fed's decision to remove the *"considerable time"* phrase a lot more complex. Janet Yellen can attempt to calm the financial markets in her press conference, but will the markets listen?

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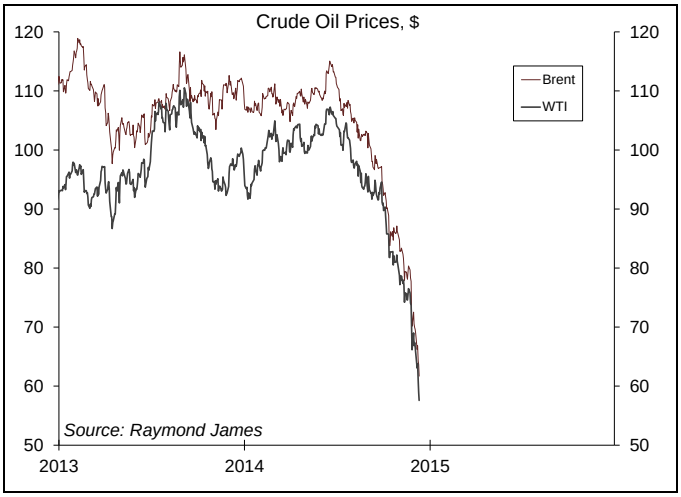
	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
11/14/14	0.02	0.07	0.15	0.54	0.96	1.62	2.32	3.04	1.249	1.566	116.52	1.129	4688.54	2039.82	17634.74
12/05/14	0.02	0.08	0.18	0.65	1.09	1.69	2.31	2.97	1.230	1.560	121.38	1.142	4780.76	2075.37	17958.79
12/12/14	0.02	0.09	0.19	0.55	0.98	1.52	2.09	2.74	1.245	1.572	118.64	1.157	4653.60	2002.38	17958.79

Recent Economic Data and Outlook

Retail sales figures for November were stronger than expected, with upward revisions to the two previous months. However, that did little to offset the negative mood in equities. Falling oil prices seemed to add to the anxiety.



Congress neared an agreement to fund the government through September, which would remove one uncertainty for the financial markets. However, holdouts from both sides tried to stand their ground and a government shutdown was narrowly averted. A Continuing Resolution was enacted to fund the government through Saturday, December 13.

Retail Sales rose 0.7% in November (+5.1% y/y), up 0.5% ex-autos (+4.3% y/y). Figures for September and October were revised higher. Motor vehicle sales rose 1.7% (+8.6% y/y). Sales of building materials rose 1.4% (+7.8% y/y). Sales of gasoline fell 0.8% (-9.4% before seasonal adjustment and -10.4% y/y). Excluding autos, building materials, and gasoline, sales advanced 0.6% (+4.8% y/y). Note that retailers attempted to boost sales ahead of the short holiday shopping period through increased promotions and discounting. Sales at clothing stores rose 1.2% (+3.6% y/y). Sales at department stores rose 1.0% (-1.1% y/y). Sales at nonstore retailers (which includes Internet sales) rose 1.0% (+8.7% y/y). Sales results were consistent with a moderately strong pace of consumer spending growth in 4Q14.

Business Inventories rose 0.2% in October (+4.8% y/y). Business sales slipped 0.1% (+3.4% y/y).

The **Producer Price Index** fell 0.2% in November (+1.4% y/y), held down by lower energy costs. Food fell 0.2% (+4.4% y/y). Wholesale gasoline prices fell 6.3% (-10.4% before seasonal adjustment, and -14.2% y/y). Ex-food & energy, the PPI was flat (+1.8% y/y). Final demand trade services (which measure changes in margins received by wholesalers and retailers), spiked in October, but did not unwind that in November. The intermediate indices showed disinflationary pipeline pressures.

Import Prices fell 1.5% in November, following a 1.2% decline in October (-2.3% y/y). Prices of petroleum imports fell 6.9% (-12.3% y/y). Ex-food & fuels, import prices fell 0.2% (-0.3% y/y). Ex-f&f, prices of industrial supplies and materials fell 0.9% (-1.0% y/y). Consumer goods fell 0.1% (+0.6% y/y).

The **Small Business Optimism Index** rose to 98.1 in November (vs. 96.1 in October and 92.5 a year ago). It was the highest level since early 2007. Details were mixed, but mostly positive. The earnings trend remained weak, but respondents were more optimistic about the general business outlook and sales expectations improved. Hiring plans were moderate.

The **Job Opening and Labor Turnover Survey** for October remained consistent with a gradual trend of improvement. The private-sector hiring rate edged down to 4.0%, vs. 4.1% in September and 3.8% in August (it was 3.7% a year ago). The quit rate rose to 3.6%, vs. 3.5% in September and 3.6% in August (it was 3.0% in October 2013).

The Kansas City Fed's **Labor Market Conditions Index**, a composite of 24 job market indicators, signaled further improvement in November. The "level of activity" gauge fell to -0.50, from -0.45 (still suggesting that a lot of slack remains in the labor market). The "momentum" gauge was steady at 1.33 (relatively strong by historical standards).

The University of Michigan's **Consumer Sentiment** Index rose to 93.8 in the mid-month estimate for December, the highest reading since early 2007. Lower gasoline prices likely played a large part in the improvement.

Economic Outlook (4Q14): GDP growth of 2.0% to 2.5%

Employment: Job growth has strengthened. Labor market slack is being taken up, but considerable slack remains.

Consumers: The underlying trend in nominal average wages has been lackluster, but lower gasoline prices will add to consumer purchasing power in the near term and wage growth should pick up later on as the job market tightens.

Manufacturing: Mixed. A stronger dollar and weakness in the global economy are expected to restrain exports, but domestic demand should strengthen in the months ahead.

Housing/Construction: Supply constraints have eased and affordability has improved. Look for a better balance in 2015 (less speculative buying, better consumer fundamentals).

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, but could decline.

Interest Rates: With the Fed's large-scale asset purchases (QE3) completed, short-term interest rates are expected to remain exceptionally low through the middle of 2015. The Fed's policy moves in 2015 will be dictated largely by job market conditions, but the Fed will also react to financial market conditions.

This Week:					*forecast*	last	last –1	comments
Monday	12/15	8:30	Empire St. Manf. Index	Dec	***9.5***	10.2	6.2	moderate (but choppy)
		9:15	**Industrial Production**	Nov	***+0.7%***	-0.1%	+0.8%	moderately strong (watch for revisions)
			Manufacturing Output		***+0.9%***	+0.2%	+0.2%	aggregate hours rose +0.7%
			Capacity Utilization		***79.4%***	78.9%	79.2	no threat to inflation
		10:00	Homebuilder Sentiment	Dec	***60***	58	54	likely to improve further
Tuesday	12/16	8:30	**Building Permits, th.**	Nov	***1100***	1092	1031	likely to pick up
			% change		***+0.7***	+5.9	+2.8	seasonal adjustment may exaggerate
			Housing Starts		***1080***	1009	1038	likely to improve
			% change		***+7.0***	-2.8	+7.8	watch for revisions
Wednesday	12/17	8:30	**Consumer Price Index**	Nov	***-0.1%***	+0.0%	+0.1%	lower gasoline prices
			year-over-year		***+1.5%***	+1.7%	+1.7%	a low trend
			ex-food & energy		***+0.1%***	+0.2%	+0.1%	mild core inflation
			year-over-year		***+1.7%***	+1.8%	+1.7%	still low
		8:30	Real Weekly Earnings	Nov	***+0.7%***	+0.4%	-0.1%	nominal earnings rose 0.66%
		8:30	Current Account	3Q14	***-100.1***	-98.5	-102.1	seen a bit wider
		2:00	**Fed Policy Decision**					time's up for "considerable time" phrase?
		2:00	**Fed Econ Projections**					any consensus forming in the dots?
		2:30	**Yellen Press Conference**					explaining the Fed's outlook
Thursday	12/18	8:30	Jobless Claims, th.	12/13	***295***	294	297	choppy, but a low trend
		9:45	Markit US Manf. PMI (flash)	Dec	***NF***	54.8	55.9	moderate
		10:00	Philadelphia Fed Index	Dec	***20.0***	40.8	20.7	likely moderate (but erratic)
		10:00	Leading Econ Indicators	Nov	***+0.6%***	+0.9%	+0.7%	another strong gain
		1:00	TIPS Auction					$16 billion in re-opened 5-year TIPS
Friday	12/19		no significant data					Solstice on December 21
Next Week:								
Monday	12/22	10:00	**Existing Home Sales, mln**	Nov	***5.30***	5.26	5.18	an improving trend
			% change		***+0.8***	+1.5	+2.6	seasonal adjustment may magnify
		1:00	Treasury Note Auction					2-year notes
Tuesday	12/23	8:30	Real GDP (3rd estimate)	3Q14	***+3.9%***	+4.6%	-2.1%	+3.9% in the 2nd estimate
		8:30	**Durable Goods Orders**	Nov	***+0.2%***	+0.3%	-0.7%	a soft trend generally
			ex-transportation		***+0.4%***	-1.1%	+0.3%	mixed across industries
			nondef cap gds ex-aircraft		***+0.5%***	-1.6%	-1.1%	trend has been weak into 4Q14
		9:55	Consumer Sentiment	Dec	***94.2***	88.8	86.9	93.8 at mid-month
		10:00	Personal Income	Nov	***+0.5%***	+0.2%	+0.2%	picking up (revisions?)
			Personal Spending		***+0.6%***	+0.2%	+0.0%	improving (watch for revisions)
			PCE Price Index ex-f&e		***+0.1%***	+0.2%	+0.1%	mild core inflation
		10:00	**New Home Sales, th.**	Nov	***470***	458	455	improving fundamentals
			% change		***+2.6***	+0.7	+0.4	but these figures are choppy
		11:30	FRN Auction					re-opened FRNs
		1:00	Treasury Note Auction					5-year notes
Wednesday	12/24	8:30	Jobless Claims, th.	12/13	***296***	***295***	294	still subject to seasonal noise
		11:30	Treasury Note Auction					7-year notes
		1:00	NYSE close					still time for last minute shopping, guys
Thursday	12/25		**Christmas Holiday**					Peace on Earth
Friday	12/26		no significant data					markets close early

This Week…

The focus will be on the Federal Open Market Committee meeting, specifically on the wording of the policy statement (and whether the Fed continues to suggest that the federal funds target range will remain low "for a considerable time"). It may be a close call. The Fed will also release revised projections of growth, unemployment, inflation, and the expected "appropriate" federal funds rate for each of the next few years. In September, the federal funds rate forecasts were spread all over the place, implying that there was no consensus view on the timing of the first rate hike. Future policy actions will be data-dependent, but it will be interesting to see whether the dots in the "dot plot" begin to bunch up. Chair Janet Yellen will discuss the Fed's outlook and take questions.

Monday

Empire State Manufacturing Index (December) – The New York Fed's factory sector survey results tend to be erratic, but figures are likely to reflect moderate strength in December.

Industrial Production (November) – Aggregate manufacturing hours rose 0.7% in the November Employment Report. This should translate into a strong gain in factory output. Capacity utilization should pick up, but we're still a long way from levels that would suggest inflationary pressure.

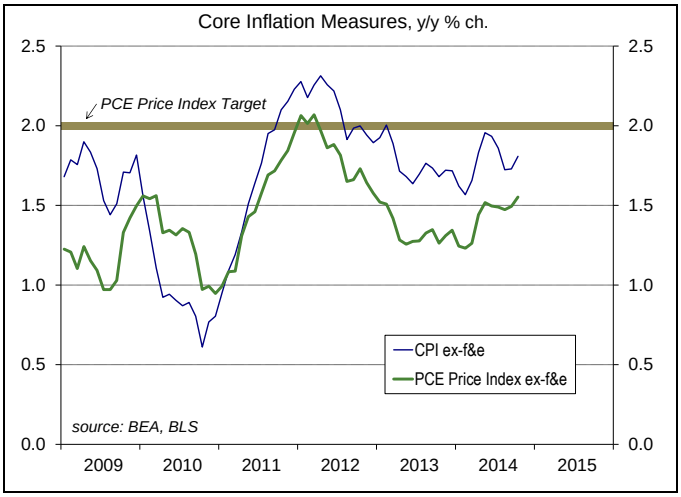
Homebuilder Sentiment (December) – Low mortgage rates and improving consumer fundamentals should continue to support improvement in builder sentiment.

Tuesday

Building Permits, Housing Starts (November) – Residential construction activity should continue to improve, but the headline figures can be noisy from month to month and seasonal adjustment could exaggerate any weather effects.

Wednesday

Consumer Price Index (November) – Retail gasoline prices (5% of the CPI) fell about 7.6% last month, while the seasonal adjustment anticipates a decline of 2.5%. Hence, gasoline should subtract about 0.25 percentage point from the headline CPI. Ex-food and energy, the CPI is likely to remain mild.



Real Wages (November) – Nominal weekly wages rose 0.7% last month, reflecting a 0.3% increase in hours and a 0.4% increase in average hourly earnings. Lower gasoline prices will add a bit to purchasing power in the near term.

Fed Policy Decision – The policy statement will be quickly scanned for the "considerable time" phrase. Minutes of the October 28-29 policy meeting showed officials moving closer to getting rid of that language, but they were also concerned about a possible overreaction in the financial markets. If that phrase disappears, it would likely be replaced with something similar (such as the Fed will be "patient"). Investors should also pay attention to what's said about the rest of the world (which was missing from the October policy statement). In the first half of the year, the FOMC recognized that an extended period of low inflation could generate some problems for the economy. More recently, some Fed officials have suggested that low inflation is reflecting temporary factors.

Fed Summary of Economic Projections – The five Fed governors and twelve district bank presidents will submit revised projections of growth, unemployment, and inflation. However, Fed officials will also forecast the appropriate federal funds target rate at the end of the next few years. Janet Yellen has cautioned against reading too much into the dot plot (specifically whether they move up or down a little). However, what's more interesting is that the dots indicate the disparity in views on the timing of policy tightening. We may not see much of a consensus this time either, but the dots may begin to bunch up a bit, suggesting that a consensus is starting to form.

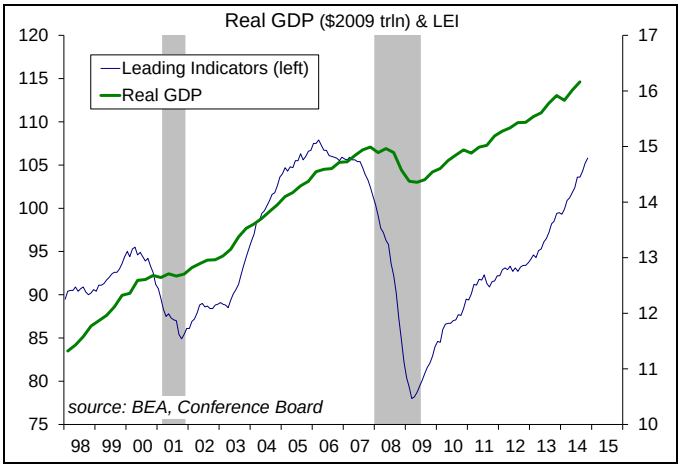
Yellen Press Conference – The Fed Chair will explain any changes in the policy statement, but will continue to stress that action will be data-dependent. The initial rate hike, when it comes, should be a natural consequence of an improving economy. However, the Fed has a big challenge in setting market expectations. The financial markets could misinterpret the Fed's intentions, either overreacting (as with 2013's taper-tantrum) or not reacting enough (as with the actual taper).

Thursday

Jobless Claims (week ending December 13) – The figures are subject to a fair amount of seasonal noise during this time of year. So take any large changes with a grain of salt. The four-week average is trending higher than in October, but still very low by historical standards.

Philadelphia Fed Index (December) – These figures are erratic, but the results should be consistent with moderate growth.

Leading Economic Indicators (November) – The stock market will subtract, but most other components will add.



Friday

No significant economic data.

Next Week …

Orders and home sales are choppy (good chance for a surprise). Personal income and spending data will fill in the 4Q14 picture.

Coming Events and Data Releases

December 23	Durable Goods Orders (November)
December 25	Christmas Holiday (markets closed)
January 1	New Year's Holiday (markets closed)
January 9	Employment Report (December)
January 19	MLK Holiday (markets closed)
January 22	ECB Policy Meeting
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