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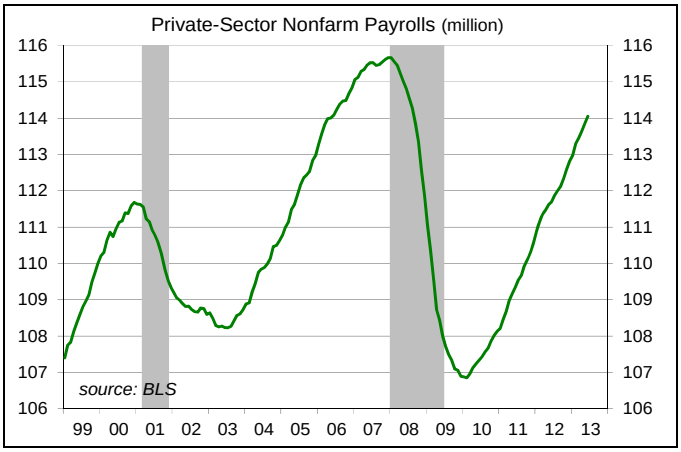
Weekly Market Monitor

Jobs, the Fed, and Long-Term Interest Rates

The June Employment report showed a labor market that is far from fully recovered, but appears to be well on its way. Federal Reserve policymakers are not going to react to any one report, but the trend in nonfarm payrolls has remained strong. Is that enough to ease up on the gas pedal? Perhaps. However, it should still be some time before the Fed has to hit the brakes.

Payrolls rose by 195,000 in the initial estimate for June, while figures for April and May were revised higher. Private-sector payrolls averaged a 199,000 monthly gain in 2Q12, ending the quarter 2.1% higher than a year ago. In comparison, the working-age population is growing at a little less than 1% per year. Long-term unemployment declined, but remains elevated. Unemployment rates for teenagers and young adults remain high. Job gains were mixed in June. Manufacturing continued to shed workers, reflecting weakness in exports. There were decent gains in professional and business services (not just temp help services). We've also had strong gains in retail (+2.0% y/y) and leisure and hospitality (+3.7% y/y), both low-paying sectors.



Within leisure, jobs at restaurants and bars rose 4.0% y/y and accounted for a quarter of overall job gains in 2Q13. Note that there is a longer-term trend of households having more meals outside the home. However, the second quarter strength is likely related to gains in the stock market and rising home prices. The top 20% of income earners account for a little over half of personal income and half of consumer spending. Surveys show that upper income households are feeling a lot better about the economic situation. No doubt, it's great to be in the top 1%, but it's also good to be in the top 20%. The other 80% don't have much in financial assets. Real wage gains have been meager, but that should pick up as the economy improves.

For Fed policymakers, the June employment data should be further evidence that labor market conditions are improving significantly. It's about the data not the date, but the Fed is likely on track to begin reducing the pace of asset purchases in October (after the September policy meeting). However, tapering is not tightening. The majority of senior Fed officials do not expect an increase in the federal funds target rate until 2015, but the Fed funds futures market is now pricing in a rate hike by the middle of 2014. Market participants have either misunderstood the Fed's message or they don't believe it.

Long-term interest rates normally rise in an economic recovery, but as a rule, they should not rise so rapidly that they jeopardize the recovery. In the short term, as we have seen recently, higher long-term rates can lead to even higher long-term rates (the bond market has an expression: "be on the bus or be under it"). How much of a rise is too much? It's hard to say. Initially, the increase in mortgage rates will prompt a spurt in housing activity, as those that had been on the fence become more motivated to act before rates go up even more. Later, the rise in mortgage rates may dampen activity. Lower income households are already getting priced out of the housing market. It will take some time to determine the full impact.

Small firms tend to account for the majority of the job creation during an economic expansion. Credit for these firms is still relatively tight (and the ones with good credit don't necessarily want to take on additional financial obligations until they see a more significant pickup in the demand for the goods and services they produce). Uncertainty about healthcare costs for small businesses has been a major concern in the second half outlook for job growth. Firms with more than 50 employees that did not provide health insurance would face a penalty starting in 2014, but not for their employees working less than 30 hours per week – and the calculation was based on the prior six months (which means that firms had to make staffing decisions now). However, the Obama Administration has announced that it is delaying these penalties until 2015.

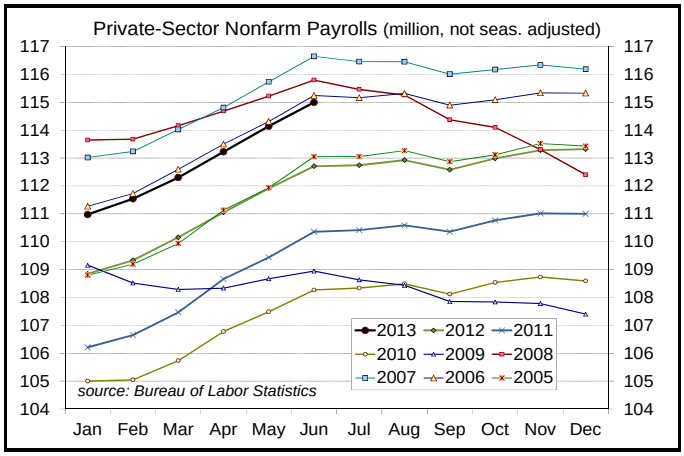
The strong payroll gains suggest a puzzle. Estimates of real GDP growth for 2Q13 have been coming down recently (a 1.5% annual rate or less). That's hard to reconcile with the pace of payrolls. Productivity may be falling. A drop in productivity implies a squeeze on profit margins (as the labor cost per unit of output is rising). As we head into the earnings reporting season, pay close attention to the details. What do firms say about the composition of earnings? Are they coming more from top-line growth or from cost-cutting? What guidance do firms give about the next quarter or two?

Last week, the Bank of England and the European Central Bank moved (independently) toward providing forward guidance on short-term interest rates. In next week's monetary policy testimony, Bernanke is likely to stress the Fed's forward guidance. This should put downward pressure on long-term interest rates.

	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
6/07/13	0.04	0.07	0.12	0.31	0.51	1.10	2.18	3.34	1.324	1.556	97.20	1.021	3469.22	1643.38	15248.12
6/28/13	0.03	0.09	0.14	0.36	0.65	1.39	2.49	3.50	1.301	1.521	99.21	1.051	3403.25	1606.28	14909.60
7/05/13	0.03	0.07	0.13	0.40	0.75	1.60	2.73	3.71	1.283	1.489	101.18	1.057	3479.38	1631.89	15135.84

Recent Economic Data and Outlook

The ISM surveys disappointed, but motor vehicle sales were strong and the Employment Report showed better-than-expected growth in nonfarm payrolls. The BOE and ECB surprised the markets by moving to forward guidance on short-term rates.



The **White House** delayed until 2015 the requirement that businesses with more than 50 employees provide health insurance to their workers or pay a penalty. The penalty was set to go in effect in January 2014 based on a six-month lag (meaning that firms had to decide staffing hours now).

The June **Employment Report** was stronger than expected. Nonfarm payrolls rose by 195,000, while the two previous months were revised a net 70,000 higher (private-sector payrolls averaged a 199,000 monthly gain in 2Q13, vs. 212,000 in 1Q13 and 189,000 2012). Manufacturing payrolls continued to slide (down 6,000, vs. -7,000 in both April and May). Restaurants and bars added 52,000, following similar-sized gains in March and April (accounting for about a quarter of private-sector job growth). The unemployment rate held steady at 7.6%, with a slight increase in labor force participation. The employment/population ratio edged up to 58.7%, vs. 58.6% in May and 58.5% a year ago. Average weekly hours remained at 34.5. Average hourly earnings rose 0.4%, up 2.2% y/y.

Unit **Auto Sales** rose to a 15.9 million seasonally adjusted annual rate in June (the strongest pace since November 2007), vs. 15.2 million in May and 14.3 million a year earlier.

The **ISM Manufacturing Index** rose to 50.9 in June (slightly ahead of expectations), vs. 49.0 in May. New orders and production picked up. But employment fell.

The **ISM Non-Manufacturing Index** fell to 52.2 in June (the lowest since February 2010), vs. 53.7 in May. Business activity and new orders slowed, but employment growth picked up.

Construction Spending rose 0.5% in May (+5.4% y/y). Single-family residential rose 0.4% +33.2% y/y), while multi-family jumped 2.5% (+51.7% y/y). Nonresidential fell 1.4% (-0.9% y/y). Public construction spending rose 1.8% (-4.7% y/y).

Factory Orders rose 2.1% in May (+3.6% y/y), led by a 50.8% jump in orders for civilian aircraft (ex-transportation, orders rose 0.6%. Orders for durable goods rose 3.7% (revised from +3.6%). Orders for nondefense capital goods ex-aircraft rose 1.5%, with shipments up 1.9% (vs. -2.1% in April).

The **U.S. Trade Balance** widened to $45.0 billion in May, vs. $40.1 billion in April. Merchandise imports rose 2.2% (petroleum +4.4%, +1.8% otherwise), while exports slipped 0.7%. The data suggest that net exports may make a negative contribution to second quarter GDP growth.

The **Bank of England** left the official Bank Rate unchanged and did not alter its asset purchase program. However, under new leadership, BOE policymakers felt that "the implied rise in the expected future path of Bank Rate was not warranted by the recent developments in the domestic economy." The BOE is assessing "the case for adopting some form of forward guidance, including the possible use of intermediate thresholds" with an eye toward the policy meeting in early August.

The **European Central Bank** left short-term interest rates unchanged, but indicated that "our monetary policy stance will remain accommodative for as long as necessary." Based on a "subdued" outlook for inflation, "broad-based weakness" in the real economy, and "subdued" monetary dynamics, ECB policymakers "expect the key interest rates to remain at present or lower levels for an extended period of time." ECB chief Draghi said the BOE's announcement was "just a coincidence."

Economic Outlook (3Q13): 2.0% to 2.5% GDP growth, vs. around a 1.5% pace in 2Q13.

Employment: Growth in nonfarm payrolls has been moderately strong. Job destruction remains low. The unemployment rate is trending lower, but still has a long way to go.

Consumers: A mixed bag across the income scale. Wealth effects have helped to support high-end spending, but real wage gains for the typical worker have remained weak.

Manufacturing: New orders have been choppy, but with a relatively soft underlying trend. Manufacturing output has been mixed, but generally lackluster in recent months. The weak global economy is restraining growth in U.S. exports.

Housing/Construction: Home sales and construction activity have continued to improve, although sales have been constrained by supply shortages and tight mortgage credit.

Prices: The PCE Price Index is expected to trend below the Fed's 2% target over the next few years. Wage pressures are mild and inflation expectations remain well-anchored.

Interest Rates: Federal Reserve officials expect exceptionally low levels of the federal funds rate for at least as long as the unemployment rate remains above 6.5%, the outlook for inflation one to two years out remains below 2.5%, and inflation expectations remain well-anchored. The Fed may lower the rate of asset purchases later this year if the economic recovery improves as anticipated. However, tapering is not tightening and monetary policy will remain data-dependent.

This Week:					*forecast*	last	last –1	comments
Monday	7/08		no significant data					further digesting June jobs data
Tuesday	7/09	7:30	Small Business Optimism	Jun	***NF***	94.4	92.1	still improving?
		10:00	JOLTS data	May				hiring and quit rates improving, still low
		1:00	Treasury Note Auction					$32 billion in 3-year notes
Wednesday	7/10	10:00	Wholesale Inventories	May	***NF***	+0.2%	+0.3%	likely slower in 2Q13
		1:00	Treasury Note Auction					$21 billion in re-opened 10-year notes
		2:00	**FOMC Minutes**	6/19				a chance for the markets to misinterpret
		4:10	Bernanke Speaks					topic: the history of the Federal Reserve
Thursday	7/11	8:30	Jobless Claims, th.	7/06	***345***	343	348	seasonal noise, a moderately low trend
		8:30	Import Prices	Jun	***-0.2%***	-0.6%	-0.7%	oil should be less of a factor
			ex-food & fuels		***-0.2%***	-0.4%	-0.2%	trending lower
		1:00	Treasury Bond Auction					$13 billion in re-opened 30-year bonds
		2:00	Treasury Budget, $bln	Jun	***NF***	-59.7	-43.1	some spending was shifted into May
Friday	7/12	8:30	**Producer Price Index**	Jun	***+0.5%***	+0.5%	-0.7%	seasonal factors likely to add to energy
			ex-food & energy		***+0.1%***	+0.1%	+0.1%	mild core inflation
		9:55	Consumer Sentiment	m-Jul	***85.0***	84.1	84.5	will market turmoil be a factor?
Next Week:								
Monday	7/15	8:30	**Retail Sales**	Jun	***+0.8%***	+0.6%	+0.1%	strength in auto sales
			ex-autos		***+0.4%***	+0.3%	0.0%	gasoline prices higher (seas. adj.)
			ex-autos, bld mat, gasoline		***+0.3%***	+0.3%	+0.2%	lackluster to moderate
		8:30	Empire State Manf. Index	Jul	***3.0***	7.8	-1.4	erratic in recent months
		10:00	Business Inventories	May	***NF***	+0.2%	-0.1%	slower in 2Q13?
Tuesday	7/16	8:30	**Consumer Price Index**	Jun	***+0.3%***	+0.1%	-0.4%	seasonals expect larger gasoline decline
			year-over-year		***+1.6%***	+1.4%	+1.1%	still low
			ex-food & energy		***+0.1%***	+0.2%	+0.1%	mild core inflation
			year-over-year		***+1.6%***	+1.7%	+1.7%	a low trend
		8:30	Real Weekly Earnings	Jun	***+0.1%***	-0.1%	+0.3%	nominal earnings rose 0.4%
		9:15	**Industrial Production**	Jun	***+0.1%***	0.0%	-0.4%	a soft trend in recent months
			manufacturing output		***+0.0%***	+0.2%	-0.3%	aggregate manufacturing hours fell 0.2%
			Capacity Utilization		***77.8%***	77.6%	77.7%	still low
		10:00	Homebuilder Sentiment	Jul	***54***	52	44	will higher mortgage rates matter?
Wednesday	7/17	8:30	**Building Permits, th.**	Jun	***1000***	985	1005	some rebound is expected
			% change		***+1.5***	-2.0	+12.9	no damage from higher mortgage rates
			Housing Starts		***960***	914	856	expecting a further rebound
			% change		***+5.0***	+6.8	-14.8	but watch for revisions
		9:00	BOC Policy Decision		***1.00%***	1.00%	1.00%	new leadership, no change in policy
		10:00	**Bernanke MPol Testimony**					to House Financial Services Committee
		2:00	**Fed Beige Book**					growth still *"modest to moderate?"*
Thursday	7/18	8:30	Jobless Claims, th.	7/13	***345***	***345***	343	some potential for seasonal noise
		10:00	**Bernanke MPol Testimony**					to Senate Banking Committee (tentative)
		10:00	Philadelphia Fed Index	Jul	***3.0***	12.5	-5.2	your guess is as good as mine
		10:00	Leading Econ Indicators	Jun	***+0.3%***	+0.1%	+0.8%	steeper yield curve
Friday	7/19		no significant data					*Magnum Incendium Romae* (AD 64)

This Week…

It's a relatively quiet week in terms of the economic data. Wednesday's release of the June 18-19 FOMC minutes will give financial market participants another chance to misinterpret the Fed's monetary policy intentions.

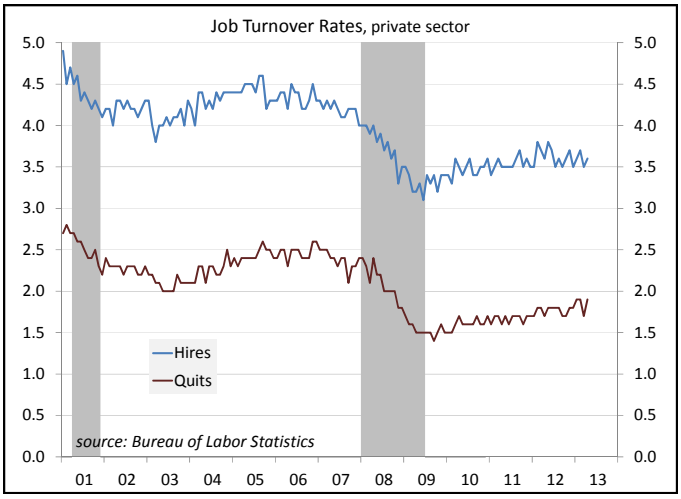
Monday

No significant economic data.

Tuesday

Small Business Optimism Index (June) – The postponement of the healthcare reform penalty was too late to show up here, but we should see a big impact in the report for July.

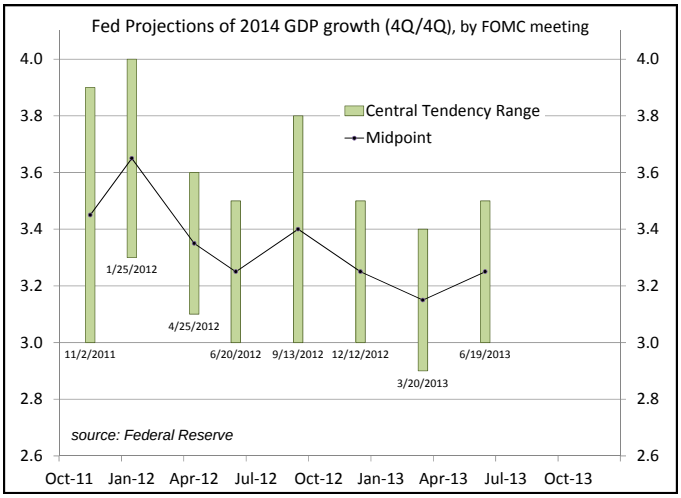
JOLTS Data (May) – In gauging the strength of the labor market, Fed policymakers will keep an eye on hiring and quit rates, which have remained at relatively low levels in recent months.



Wednesday

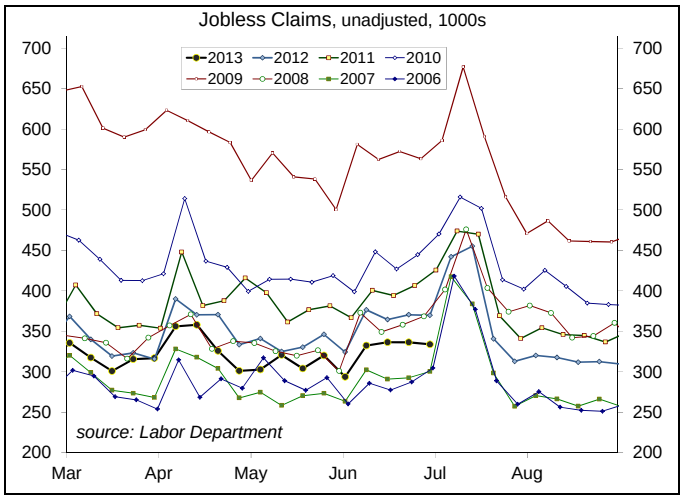
Wholesale Inventories (May) – The wholesale trade report rarely gets attention from the markets, but the inventory figures will help fill in the GDP picture for 2Q13.

FOMC Minutes (June 18-19) – We know that Fed officials "deputized" Bernanke to explain the monetary policy decision process. Will there be any clues about the timing? Probably not, as that will be "data-dependent." For the markets, this will be another opportunity to get the Fed's message wrong.



Thursday

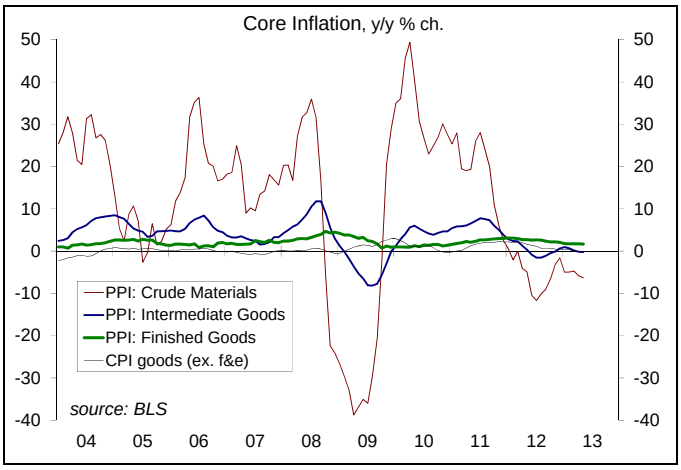
Jobless Claims (week ending July 6) – The data are adjusted for the seasonal plant retooling shutdowns in the auto industry, but it's hard to get it exactly right. Take any large swings in the adjusted figures with a grain of salt.



Import Prices (June) – Petroleum prices should be less of a factor in June. Ex-food and fuels, import prices (raw materials, as well as finished goods) have been trending lower.

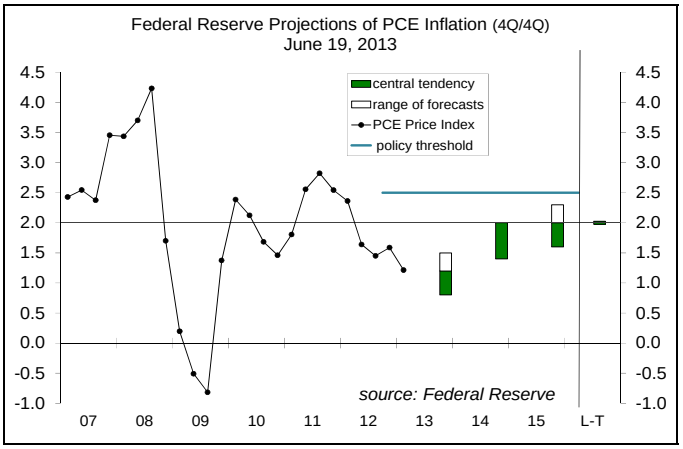
Friday

Producer Price Index (June) – Gasoline prices fell last month, but the seasonal adjustment anticipates a much larger decline. That means, the adjusted figure will be higher. Ex-food and energy, the PPI should rise mildly. Pipeline inflation pressures have been declining in recent months.



Next Week …

The mid-month economic figures are important for the financial markets, but the data reports will take a back seat to Fed chairman's semi-annual monetary policy testimony. Bernanke will once again attempt to explain the Fed's data-dependent monetary policy framework. He should also repeat the view that Congress, through tighter fiscal policy, has imposed a serious restraint on economic growth this year. As the earnings season gets underway, it will be important to hear what firms have to say about the composition (top line, vs. cost-cutting) and the guidance they give about the near term.



Coming Events and Data Releases

July 25	Durable Goods Orders (June)
July 30	Consumer Confidence (July)
July 31	Real GDP (2Q13 advance + comprehensive benchmark revisions) FOMC Policy Decision (no press briefing)
August 2	Employment Report (July)
September 2	Labor Day (markets closed)
September 6	Employment Report (August)
September 18	FOMC Policy Decision, Bernanke Press Briefing
October 30	FOMC Policy Decision (no press briefing)
December 18	FOMC Policy Decision, Bernanke Press Briefing