RAYMOND JAMES

Economic Research
Published by Raymond James & Associates

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

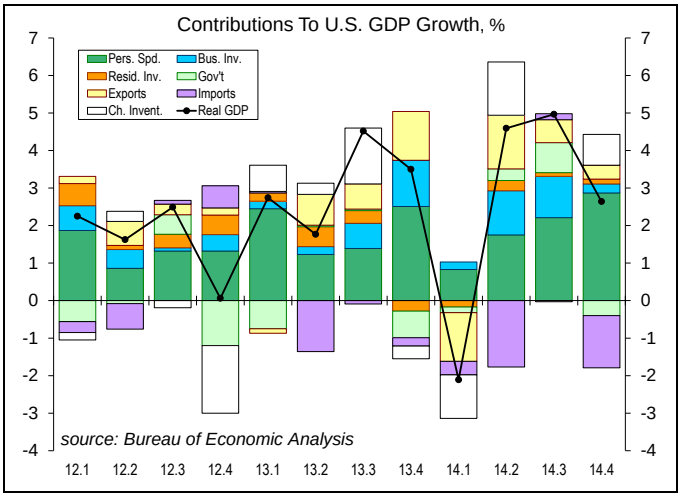
February 2 - 6, 2015

Weekly Economic Monitor

The Advance GDP Report for 4Q14

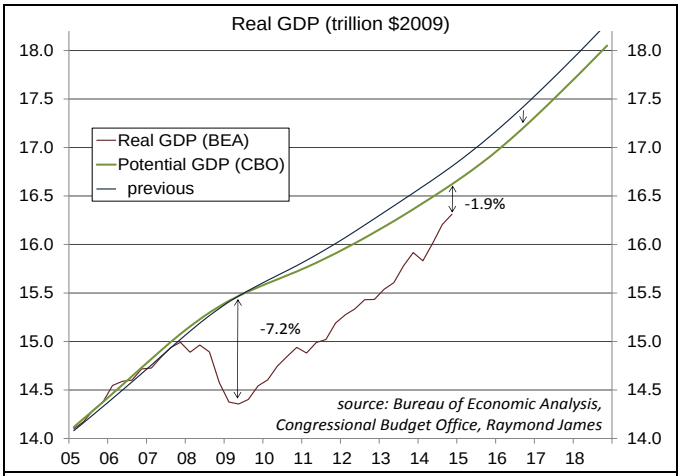
The various news agencies were quick to report that the economy "cooled" or "slowed" in the fourth quarter. However, there's a lot more to the GDP report than the headline figure. Details confirm a lot of what we already knew. The mixed nature of the components likely led investors to focus on global weakness rather than the underlying domestic strength.

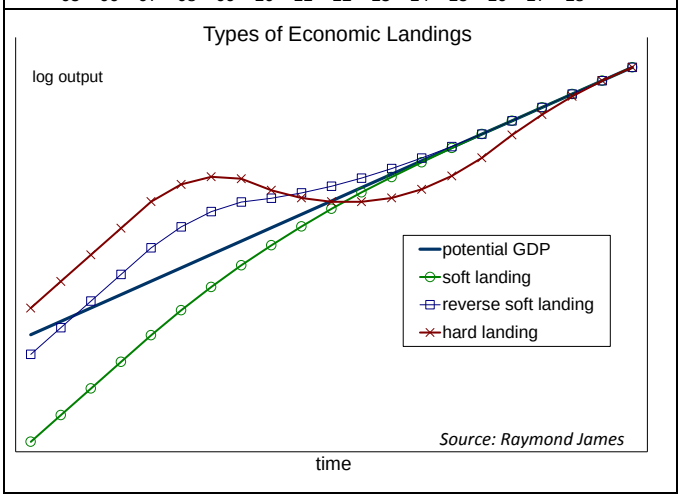
As expected, the GDP report reflected a strong quarter for consumer spending (despite evidence of a "soft" December) and a relatively soft quarter for business fixed investment. Inventories rose sharply, leading to concerns that we'll see a moderate correction in 1Q15 (that is, less production). The trade deficit was much wider than anticipated. Of course, a strong dollar and soft global growth should lead to a wider deficit. However, the data for October and November had suggested little change (hence, a sharp widening assumed for December). Domestic Final Sales (GDP less net exports and the change in inventories), a measure of underlying domestic demand, rose at a 2.8% pace, but would have been closer to 3.4% if not for a drop in defense spending. So somebody please tell me why we should focus on the headline GDP figure.



The GDP report adds to the recent underlying themes for investors. Soft global growth and a strong dollar will have a clear negative impact on the earnings of U.S. multinationals. We heard as much from several of these firms last week. However, what most people are missing is the clear strengthening of the underlying domestic economy. The labor market is improving. Consumers and small businesses are growing more optimistic. Bank credit, still relatively tight, is gradually getting easier. The housing recovery, a major disappointment so far, is exhibiting better fundamentals. While wage growth has been relatively soft, the drop in gasoline prices is providing a substantial boost to the household sector.

The Fed's plan to "normalize" monetary policy depends a lot on the perceived amount of slack in the economy. With ample slack, you're not going to see much upward pressure on inflation. Last week, the Congressional Budget Office released revised projections, which included a downward revision to the estimates of potential GDP. The output gap now appears to be about 1.9%, vs. 7.2% at the end of the recession. Granted, these are fuzzy figures. The estimate of potential GDP depends on a lot of assumptions (such as productivity growth, a big unknown). However, taken at face value, the data suggest that the economy can grow above trend for several quarters before running into constraints that would add inflationary pressure.





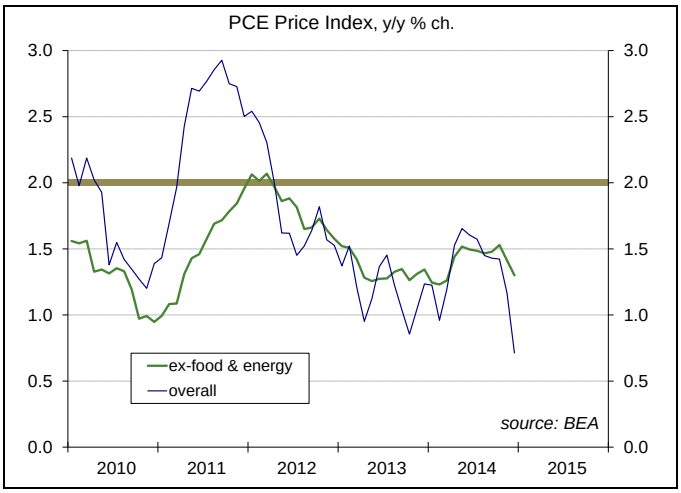
The Fed does need to consider its end game. Its desire is to achieve a soft landing, rather than overshooting and having to endure a hard landing. Yet, there's no sign we are going to overshoot potential GDP anytime soon. The strong dollar and soft global economy are restraints for some parts of the U.S. economy, but should be offset by areas of domestic strength. For the Fed, the bigger concern from abroad is the risk of more substantial financial market disruptions.

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
1/02/15	0.02	0.11	0.25	0.66	1.07	1.61	2.12	2.69	1.202	1.536	120.20	1.173	4726.81	2058.20	17832.99
1/23/15	0.03	0.07	0.17	0.51	0.84	1.28	1.77	2.33	1.128	1.502	117.80	1.240	4757.88	2051.82	17672.60
1/30/15	0.01	0.06	0.15	0.47	0.75	1.17	1.66	2.24	1.130	1.506	117.47	1.270	4635.24	1995.04	17166.10

Recent Economic Data and Outlook

The economic data were mixed, but consistent with strong growth and very low inflation into early 2015. The Fed policy statement was, as expected, a near photocopy of the one from mid-December. Investors were battered by earnings reports and concerns about global growth.



No surprise, **Greece's Election** resulted in a shift to the left. The new leadership indicated that it has no intention of leaving the euro, but is pushing for less austerity and some debt relief, setting up a confrontation with the "Troika," which is demanding its pound of flesh. This could drag on for a while.

The **Federal Open Market Committee** repeated that it can *"be patient in beginning to normalize the stance of monetary policy."* In deciding when to begin raising short-term interest rates, the FOMC repeated that it will take into account *"a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments."* The FOMC noted that the economy has been expanding at a "*solid*" pace (vs. a *"moderate"* pace in the mid-December statement). The FOMC expects inflation to *"decline further in the near term,"* but repeated its belief that inflation will *"rise gradually toward 2% over the medium term as the labor market improves further and the transitory effects of lower energy prices and other factors dissipate."*

Real GDP rose at a 2.6% annual rate in the advance estimate for 4Q14, up 2.5% y/y. Consumer spending rose at a 4.3% pace. Business fixed investment rose 1.9%. A wider trade deficit subtracted a full percentage point from GDP growth, faster inventory growth added 0.8 ppt, and a drop in defense spending subtracted 0.6 ppt. The PCE Price Index fell at a 0.5% annual rate, while core inflation slowed to 1.1% (vs. the Fed's 2% goal).

The Conference Board's **Consumer Confidence Index** jumped to 102.9 in the initial estimate for January (the strongest since August 2007), vs. 93.1 in December and 79.4 a year earlier. Current job market perceptions were less depressed and respondents were more optimistic about future job availability. Expectations of household income improved.

The University of Michigan's **Consumer Sentiment Index** rose to 98.1 in January (the highest since January 2004), vs. 93.6 in December. "Importantly," according to the report, "the gains during the past six months were as large among households with incomes under $75,000 as over that amount."

The **Employment Cost Index** rose 0.6% over the three months ending in December, up 2.2% y/y. Wages and salaries rose 0.5% (+2.1% y/y), while benefit costs rose 0.6% (+2.6% y/y).

Durable Goods Orders fell 3.4% in December, reflecting a 55.5% decline in civilian aircraft orders. However, ex-transportation orders fell 0.8% (vs. -1.3% in November and -1.2% in October). Orders for nondefense capital goods fell 0.6%, the fourth consecutive monthly decline (shipments slipped 0.2%).

The **Chicago Purchasing Managers Index** rose to 59.4 in January, vs. 58.8 in December. Orders, production, and employment strengthened. Inventories fell sharply. Prices paid fell.

New Home Sales rose 11.6% (±16.5%), to a 481,000 seasonally adjusted annual rate (+8.8% ±17.9% y/y).

Existing Home Sales rose 2.4% in December, to a 5.04 million seasonally adjusted annual rate (+3.5% y/y). Results were mixed across regions. Homes for sale fell 11.1% (-0.5% y/y).

The **Pending Home Sales Index** fell 3.7% in December (+6.1% y/y). The National Association of Realtors cited low inventories of homes for sale, but remained optimistic.

The **Congressional Budget Office** expects a deficit of 2.6% of GDP in FY15 (but it should start rising again after FY17).

Economic Outlook (1Q15): Real GDP growth of 2.5-3.0%.

Employment: The unemployment insurance claims data suggest no appreciable increase in layoffs (beyond the usual seasonal pattern) in early 2015. Small firms are hiring.

Consumers: Strong job growth is a plus and lower gasoline prices will boost consumer purchasing power in 2015. Confidence is rising, but we still need to see a pickup in wages.

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 remains well below the Fed's 2% goal – and the core rate is moving in the wrong direction. Pipeline pressures are mild. Wage pressures are limited. Inflation expectations remain well-anchored, but may decline.

Interest Rates: With low inflation and a still-high elevated level of slack in the economy, the Fed can be patient in deciding when to begin raising short-term interest rates. Global financial conditions are also a consideration (along with the outlooks for inflation and the job market).

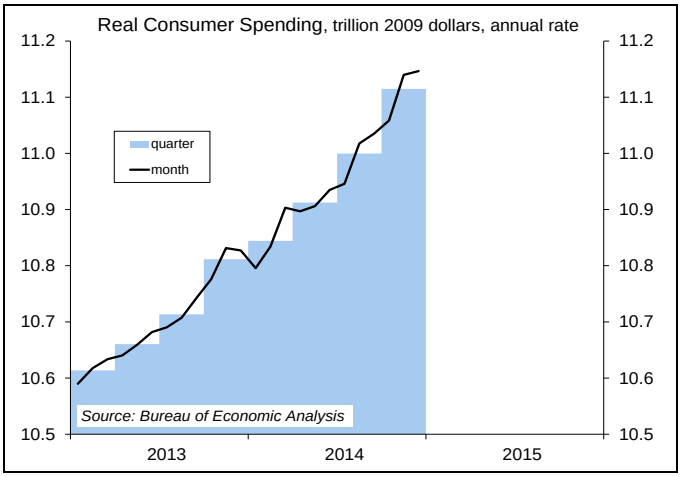
This Week:					*forecast*	last	last –1	comments
Sunday	2/01		Super Bowl XLIX					NE Patriots vs. Seattle Seahawks
Monday	2/02	8:30	Personal Income	Dec	***+0.3%***	+0.4%	+0.3%	soft wage strength pulled into November
			Personal Spending		***-0.2%***	+0.6%	+0.3%	weak retail sales results (but quirky)
			PCE Price Index ex-f&e		***+0.0%***	+0.0%	+0.2%	the core CPI rose 0.003%
		9:45	Markit US Manf PMI (final)	Jan	***NF***	53.9	54.8	53.7 in the flash estimate
		10:00	Construction Spending		***+1.0%***	-0.3%	+1.2%	minor implications for GDP revision
		10:00	**ISM Manf. Index**	Jan	***54.4***	55.1	57.6	likely to be mixed
Tuesday	2/03	10:00	Factory Orders	Dec	***-2.3%***	-0.7%	-0.7%	lower oil, but a soft trend otherwise
		tbd	Motor Vehicle Sales, mln	Jan	***16.9***	16.8	17.1	results usually depend on final weekend
			domestically built		***13.6***	13.5	13.8	but likely to remain relatively strong
Wednesday	2/04	8:15	**ADP Payroll Estimate, th.**	Jan	***+210***	+241	+227	moderately strong
		10:00	**ISM Non-Manf. Index**	Jan	***57.0***	56.5	58.8	some pickup likely
Thursday	2/05	7:00	BOE Policy Decision					no change
		8:30	Jobless Claims, th.	1/31	***295***	265	308	perhaps a mild weather impact
		8:30	Productivity (prelim.)	4Q14	***-0.1%***	+2.3%	+2.9%	seen about flat
			Unit labor Costs		***+2.3%***	-1.0%	-3.7%	uneven in recent quarters
		8:30	**Trade Balance, $bln**	Dec	***-44.4***	-39.0	-42.2	assumed a lot wider in the GDP est.
			goods only		***-63.7***	-58.3	-61.6	imports up, exports down
Friday	2/06	8:30	**Nonfarm Payrolls, th.**	Jan	***+195***	252	353	annual benchmark revisions due
			private-sector		***+190***	240	345	a more moderate pace seen in 1Q15
			Unemployment Rate		***5.6%***	5.6%	5.8%	should be little changed
			Employment/Population		***62.8%***	62.7%	62.9%	trending flat, but better for ages 25-54
			Avg. Weekly Hours		***34.6***	34.6	34.6	seen steady
			Avg. Hourly Earnings		***+0.2%***	-0.2%	+0.2%	mild wage pressures
Next Week:								
Monday	2/09		no significant data					
Tuesday	2/10	7:30	Small Business Optimism	Jan	***NF***	100.4	98.1	trending higher
		10:00	JOLTS: hiring rate	Dec	***NF***	3.6%	3.7%	a gradual trend higher
			JOLTS: quit rate		***NF***	1.9%	1.9%	but still below normal
		1:00	Treasury Note Auction					3-year notes
Wednesday	2/11	1:00	Treasury Note Auction					10-year notes
		2:00	Treasury Budget, $bln	Jan	***NF***	-10.3	+2.9	seen moderate
Thursday	2/12	8:30	Jobless Claims, th.	2/07	***292***	***295***	295	still subject to some seasonal noise
		8:30	**Retail Sales**	Jan	***+0.3%***	-0.9%	+0.4%	moderate (watch for revisions)
			ex-autos		***+0.2%***	-1.0%	+0.1%	lower gasoline prices
			ex-autos, bld mat, gasoline		***+0.5%***	-0.2%	+0.5%	expected to rebound
		10:00	Business Inventories	Dec	***+0.1%***	+0.2%	+0.2%	reduced by lower oil prices
		1:00	Treasury Bond Auction					30-year bonds
Friday	2/13	8:30	Import Prices	Jan	***NF***	-2.5%	-1.8%	falling oil prices
			ex-food & fuel		***NF***	-0.1%	-0.2%	but disinflationary pressure otherwise
		9:55	UM Consumer Sentiment	m-Feb	***100.0***	98.1	93.6	trending higher

This Week…

A busy week for economic data, but we may not get a clear picture due to potential distortions from seasonal adjustment. For example, we can expect to lose more than 2.8 million jobs each January. Are we really going to worry about the nearest 20,000 or so in the adjusted figure? Yes, we are. Even with the onslaught of data, earnings reports and overseas developments are still likely to influence the stock market.

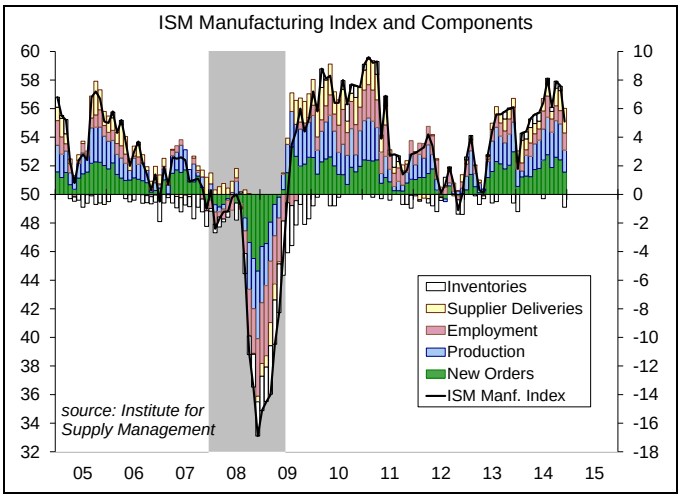
Monday

Personal Income and Spending (December) – Quarterly figures were included in the GDP report. The monthly figures would normally give us a good idea of the momentum heading toward 1Q15. However, other data reports suggest that some of December's seasonal strength was likely pulled forward into November (it was a strong quarter). The 4Q14 GDP data suggest a modest gain in income in December and a decline in consumer spending. Lower gasoline prices will drive inflation lower, but the core rate is also edging down.



Construction Spending (December) – Not market-moving, these figures could have some minor implications for GDP revisions.

ISM Manufacturing Index (January) – Softer global growth and a stronger dollar should be having a negative impact on exporters. Increasing strength in the domestic economy should help offset that somewhat. Results are likely to be mixed across industries. Seasonal adjustment may exaggerate weather effects.



Tuesday

Factory Orders (December) – Orders for durable goods (which account for most of the volatility) were reported to have fallen by 3.4% (following a 2.1% decline in November). Orders for nondurables should reflect the drop in oil prices.

Unit Auto Sales (January) – Replacement needs and relatively easy bank credit should continue to support auto sales in 2015. Strong job growth and lower gasoline prices will also help.

Wednesday

ADP Payroll Estimate (January) – Everyone knows that the ADP figure is not a good predictor of the monthly change in the BLS data. Nevertheless, the financial markets may react to a surprise (and there's a good chance of that).

ISM Non-Manufacturing Index (January) – These figures should remain consistent with moderately strong growth in the overall economy. Watch new orders and employment.

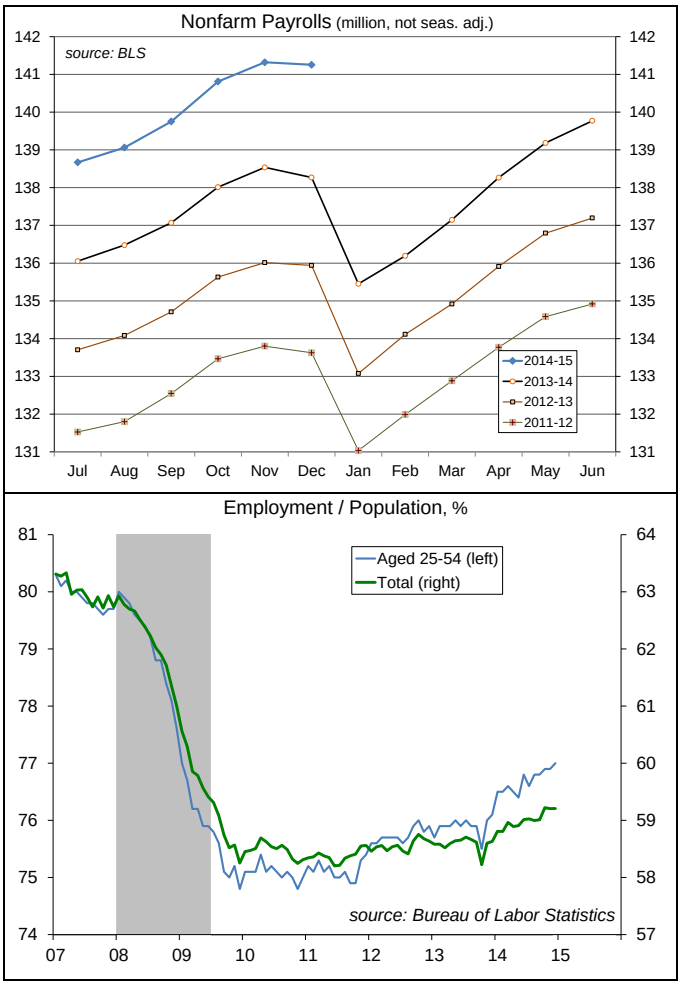
Thursday

Jobless Claims (week ending January 31) – The figures are still subject to seasonal noise, but the underlying trend suggests no appreciable increase in early 2015 (either due to layoffs in the energy sector or due to an unwinding of seasonal strength).

Trade Balance (December) – In the advance GDP estimate, the Bureau of Economic analysis assumed a sharp widening of the trade deficit in December, reflecting a drop in exports and a pickup in imports. The deficit should widen further in 2015.

Friday

Employment Report (January) – We normally lose over 2.8 million jobs each January, largely reflecting the end of the holiday shopping period. Hence, one should not put much weight on the adjusted payroll figure (but the markets likely will). This release will include annual benchmark revisions to the payroll data (based on actual payroll tax receipts), but that shouldn't matter much. In September, the BLS estimated that this revision would lift the March 2014 payroll figure by just 7,000 (less than 0.05%) – that's tiny. The unemployment rate should hold roughly steady, but the trend is lower. While payroll growth has been strong, we haven't seen much of a pickup in the employment/population ratio.



Next Week …

The economic calendar thins out. January is not a critical month for most retailers, but the financial markets are expected to pay attention to the sales data, which should rebound from a "soft" December (the trend was strong in 4Q14).

Coming Events and Data Releases

February 12	Retail Sales (January)
February 16	Presidents Day (markets closed)
March 18	FOMC Policy Decision, Yellen press conference
March 6	Employment Report (February)
April 29	FOMC Policy Decision (no press conference)
June 17	FOMC Policy Decision, Yellen press conference