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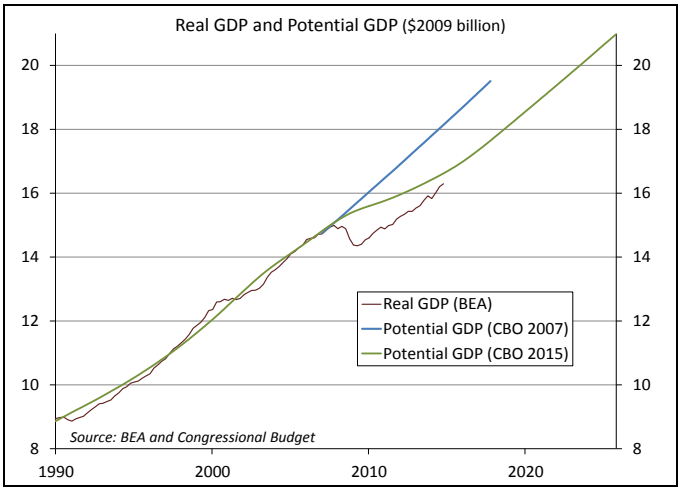
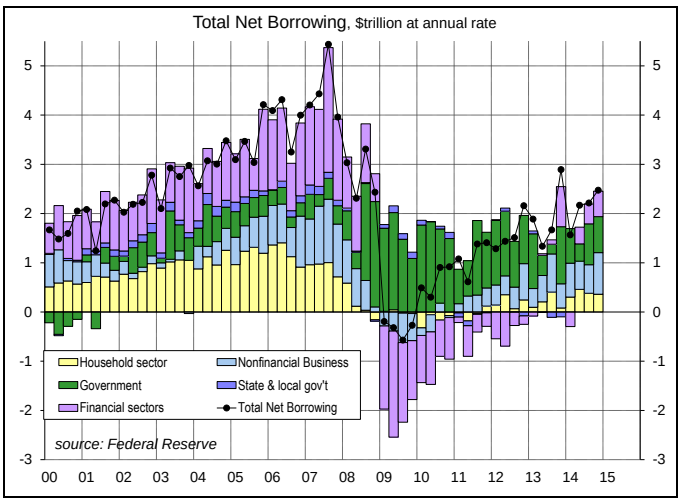
Weekly Economic Monitor

The Long-Term Outlook: Secular Stagnation or Not?

The good news is that the output gap, the difference between real Gross Domestic Product and its potential, has narrowed. The bad news is that's largely because potential GDP has declined. The big question now is whether the economy is on a permanently lower track. The answer is not so clear.



We like to say that the 2008-09 economic downturn was not your father's recession. It was more like your grandfather's depression. This was not the typical Fed-induced recession. This was a collapse of a housing bubble combined with a huge deleveraging within the financial system. More than eight years after the initial downturn and nearly six years into the economic recovery, the borrowing situation appears to be in better balance. That doesn't mean that everything is okay, but we are on better footing and poised for improvement.



It's an odd fact that GDP growth has averaged about 3% per year over the last several decades. Through that time, we've had variations in labor growth (increased female labor force participation in the 1960s, 70s, and 80s) and changes in productivity growth. This trend may go back well before the turn of the last century, as suggested by some historical analysis (GDP, as a concept, did not exist back then). GDP deviated from the trend during the Great Depression, but returned to it after World War II. There is no good theoretical reason to expect 3% GDP growth over a long period of time. Output is equal to labor times the productivity of that labor. Why would labor growth and productivity growth sum to 3% on average?

Potential GDP can be defined to be the level of economic activity consistent with steady inflation (2%) over time – not too hot, not too cold. There are some challenges in forecasting it. The standard approach is to project labor input (considering population growth and the removal of current slack) and apply that to an estimate of productivity growth. Estimating the amount of slack in the labor market isn't terribly difficult, but there are uncertainties. Population growth is slowing, so the longer-term trend in labor input should be slowing accordingly. The estimate of productivity growth will depend on the pace of capital investment. The main reason that the Congressional Budget Office's projection of potential GDP has come down in recent years is that business fixed investment has been subdued through most of the recovery.

The key question is whether the lower track in potential GDP is permanent or secular (persisting over an indefinitely long period). One can imagine a scenario where population growth slows further (Europe is turning Japanese and the U.S. may not be far behind). This is a very important issue. At 1% GDP growth, the economy will be 34% larger in 30 years. At 3%, it will be 143% larger. Even a 0.5% difference in long-term growth will matter a lot for the outlook for the standard of living and for funding government entitlement programs.

Secular stagnation is not simply a concern for the U.S. In the analytic chapters of its World Economic Outlook, the IMF reports that "potential output growth across advanced and emerging market economies has declined in recent years." For the advanced economies, the slowdown in potential GDP began well before the financial crisis, but the pace should pick up "as some crisis-related effects wear off (yet will still remain below the pre-recession trend). For emerging economies, the slowdown happened after the crisis. However, the slowdown in potential GDP for emerging economies is likely to continue, as their populations age and productivity slows as they "catch up to the technology frontier." China has had phenomenal growth over the last few decades, but may have a tough time meeting current (lower) growth targets.

Investors tend to focus on the short term, but they would be wise to pay attention to the debate about the long term.

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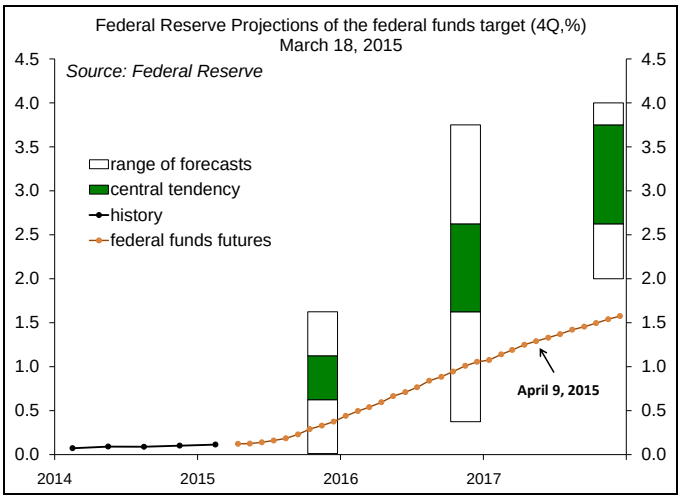
	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
3/13/15	0.03	0.11	0.24	0.68	1.07	1.60	2.13	2.70	1.052	1.476	121.17	1.280	4871.76	2053.40	17749.31
4/03/15	0.02	0.10	0.21	0.49	0.80	1.26	1.85	2.49	1.099	1.492	118.96	1.247	4886.94	2066.96	17676.00
4/10/15	0.02	0.10	0.22	0.56	0.92	1.40	1.95	2.59	1.060	1.464	120.20	1.258	4995.98	2102.07	18057.65

Recent Economic Data and Outlook

The economic data calendar was thin. Minutes of the March 17-18 Fed policy meeting showed that "several" Fed officials (not all of whom get to vote) were leaning toward raising rates at the June meeting. In contrast, Fed Governor Powell suggested that the pace of tightening is likely to be gradual once the Fed begins.



The **FOMC Minutes** from the March 17-18 policy meeting showed that *"several participants judged that the economic data and outlook were likely to warrant beginning normalization at the June meeting."* The minutes indicated that *"others anticipated that the effects of energy price declines and the dollar's appreciation would continue to weigh on inflation in the near term, suggesting that conditions likely would not be appropriate to begin raising rates until later in the year, and a couple of participants suggested that the economic outlook likely would not call for liftoff until 2016."* Note that while all five governors and 12 district bank presidents are "participants" at the meeting, only 10 (the governors and five of the district bank presidents) vote on policy. *"Some"* participants felt that the stance of policy would remain highly accommodative even after the first increase in the target range for the federal funds rate, and *"several"* noted that they expected economic developments would call for *"a fairly gradual pace of normalization"* or that a data-dependent approach would not necessarily dictate increases in rates at every meeting.

Fed Governor Powell said that *"I expect that economic conditions will support the first rate increase later this year,"* adding *"I do not expect that such an increase or the associated market reaction will materially restrain the progress of the economy."* Echoing the comments from other Fed officials, Powell said that *"from a macroeconomic perspective, the precise timing of liftoff is less important than the path of subsequent additional rate increases."* His view is that, *"if the economy continues on its expected path, it will be appropriate for a time to increase rates fairly gradually."*

The **ISM Non-Manufacturing Index** edged down to 56.5 in March, vs. 56.9 in February and 56.7 in January. Business activity slowed somewhat (still moderately strong) and the pace of new orders picked up. Employment growth was strong. Input price pressures edged higher. Comments from supply managers were mixed, with some noting that lower fuel prices are not being passed through to lower freight costs.

The **Job Opening and Labor Turnover Survey** data showed a further increase in the rate of job openings (to 3.5% in February, vs. 3.4% in January). However, the hiring rate was unchanged at 3.5%, vs. 3.4% a year ago. The quit rate edged down to 3.3%, from 3.4% in January, the same rate as a year ago. The data remained consistent with the view that there is still a considerable amount of slack in the job market.

Import Prices fell 0.3% in March (-10.5% y/y), down 0.4% excluding food & fuels (-1.8% y/y). Petroleum prices rose 0.8% (-45.1% y/y). Natural gas fell 7.5% (59.1%). Excluding fuels, prices of imported supplies and materials fell 1.3% (-5.5% y/y). Prices of capital goods fell 0.1% (-1.0% y/y). Autos fell 0.3% (-1.8% y/y). Consumer goods slipped 0.3% (-0.6% y/y).

Economic Outlook (2Q15): About a 3.0% annual rate, following around 0.5% in the first quarter.

Employment: The pace of job growth slowed in 1Q15, but from an unusually strong pace in 4Q14. Job losses remain very limited. New hiring appears to have remained strong for small and medium-sized firms, but has slowed for larger firms.

Consumers: The drop in gasoline prices from last summer has sharply boosted consumer purchasing power and we should see a pickup in spending in the spring and early summer.

Manufacturing: The stronger dollar is a constraint. A decline in corporate profits has contributed to a softening trend in capital spending. Domestic demand should be picking up.

Housing/Construction: The spring is a critical time for home sales and residential construction activity. Will this be the year housing takes off? We should see good improvement in the near term, but we're still years away from a full recovery.

Prices: The PCE Price Index is about flat year-over-year – and the core inflation rate has moved lower in recent months. Pipeline pressures are mild. Wage pressures are limited. Inflation expectations remain well-anchored.

Interest Rates: With low inflation and a still-elevated level of slack in the economy, the Fed does not have to hit the brakes, but it does need to consider when to take the foot off the gas pedal. The Fed needs to see further improvement in the job market and has to be "reasonably confident" that inflation will move back toward the official 2% goal.

This Week:					*forecast*	last	last –1	comments
Monday	4/13		no significant data					1796: first elephant arrives in the U.S.
Tuesday	4/14	8:30	**Producer Price Index**	Mar	***+0.2%***	-0.5%	-0.8%	moderate
			ex-food & energy		***+0.0%***	-0.5%	-0.1%	still low
			ex-f, e, trade services		***+0.1%***	0.0%	-0.3%	mild "new core" inflation
		8:30	**Retail Sales**	Mar	***+0.9%***	-0.6%	-0.8%	unit auto sales rebounded
			ex-autos		***+0.7%***	-0.1%	-1.1%	gasoline not much of a factor
			ex-autos, bld mat, gasoline		***+0.6%***	-0.1%	-0.1%	core spending should pick up
		9:00	IMF World Econ Outlook					
		9:00	Small Business Optimism	Mar	***NA***	98.0	97.9	should improve
		10:00	Business Inventories	Feb	***+0.2***	-0.0%	+0.0%	helping to fill in 1Q15 GDP picture
Wednesday	4/15	7:45	ECB Policy Decision					QE still on track
		8:30	Empire St. Manf. Index	Apr	***8.0***	6.9	7.8	moderate
		9:15	**Industrial Production**	Mar	***-0.2%***	+0.1%	-0.3%	seen lower
			manufacturing output		***+0.1%***	-0.2%	-0.3%	aggregate hours fell 0.2%
			Capacity Utilization		***78.5%***	78.9%	79.1%	expected to have fallen
			manufacturing		***78.0%***	78.1%	78.4%	no threat to the inflation outlook
		10:00	BOC Policy Decision					still in neutral
		10:00	Homebuilder Sentiment	Apr	***56***	53	55	should improve (this time for sure)
		2:00	**Fed Beige Book**					likely to be a mixed bag
Thursday	4/16	8:30	Jobless Claims, th.	4/11	***275***	281	267	Easter adjustments add uncertainty
		8:30	**Building Permits, th.**	Mar	***1105***	1102	1060	single-family up, multi-family down
			% change		***+0.3***	+4.0	0.0	likely to accelerate further in 2Q15
			Housing Starts		***1065***	897	1081	should bounce back sharply
			% change		***+18.7***	-17.0	0.0	but watch for revisions to February
		10:00	Philadelphia Fed Index	Apr	***7.5***	5.0	5.2	moderate
Friday	4/17	8:30	**Consumer Price Index**	Mar	***+0.2%***	+0.2%	-0.7%	gasoline up but in line w/ seas adjustment
			year-over-year		***+0.1%***	-0.0%	-0.1%	still roughly flat y/y
			ex-food & energy		***+0.1%***	+0.2%	+0.2%	mild core inflation
			year-over-year		***+1.6%***	+1.7%	+1.6%	still a low trend
		8:30	Real Hourly Earnings	Mar	***+0.0%***	-0.1%	+1.2%	nominal earnings rose 0.3%
		9:55	UM Consumer Sentiment	m-Apr	***94.8***	93.0	91.2	likely to improve
		10:00	Leading Econ Indicators	Mar	***+0.4%***	+0.2%	+0.2%	components mostly positive
		1:00	G-20 press conference					anything to say about the dollar?
Next Week:								
Monday	4/20		Chicago Fed Nat Act Index	Mar	***NF***	-0.11	-0.10	growth slightly below trend in Jan and Feb
Tuesday	4/21		no significant data					Happy 89th QE2
Wednesday	4/22	10:00	Existing Home Sales, mln	Mar	***4.96***	4.88	4.82	should pick up
			% change		***+1.6***	+1.2	-4.9	but may be limited by low inventories
Thursday	4/23	8:30	Jobless Claims, th.	4/18	***285***	***275***	281	still subject to seasonal noise
		9:45	Markit US Manf PMI (flash)	Mar	***NF***	55.7	55.1	a moderately strong trend
		10:00	New Home Sales, th.	Mar	***540***	539	500	noisy data, but a stronger trend
			% change			+7.8	+4.4	watch for revisions
		1:00	TIPS Auction					5-year TIPS
Friday	4/24	8:30	Durable Goods Orders	Mar	***+0.5%***	-1.4%	+1.9%	lower aircraft orders, mixed otherwise
			ex-transportation		***+1.1%***	-0.6%	-0.9%	looking for a spring bounce
			core capital goods		***+0.3%***	-1.1%	-0.3%	down 6 months in a row

This Week…

The economic data for March and April ought to suggest a rebound in growth following "soft" figures for January and February. However, the pickup in growth may show up more in the April numbers than in the ones for March. The focus this week is likely to be on Tuesday's retail sales report. The global economy will also be important, with the IMF's revised World Economic Outlook (seen a bit brighter) released on Tuesday and the G-20 statement on Friday. Stock market participants will also have to deal with earnings reports.

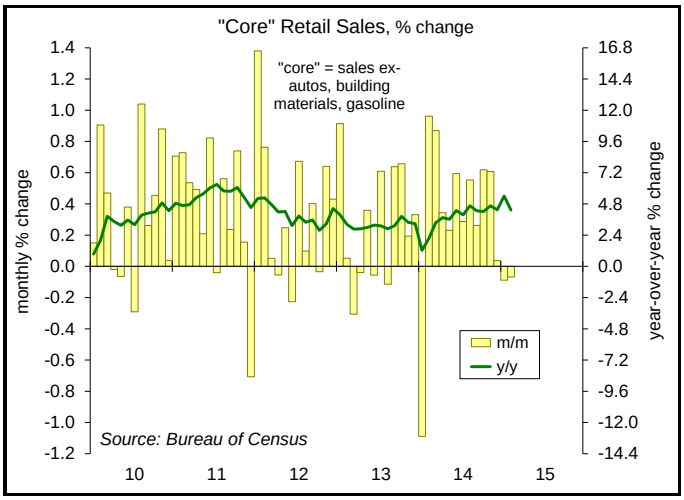
Monday

No significant economic data.

Tuesday

Producer Price Index (March) – Energy is expected to be less of an issue in the March PPI (note that the seasonal adjustment factors in a 6.2% rise in wholesale gasoline prices). Core inflation is expected to remain low (note that the new core rate excludes food, energy, and trade services).

Retail Sales (March) – Unit motor vehicle sales rose last month, which should boost the headline total. The underlying trend in sales was soft in December, January, and February, but that followed strength in October and November. We should see a pickup in March, or a revision to previous figures. These data are adjusted for the timing of Easter, but that can be tricky.



IMF World Economic Outlook – The overall outlook should be a bit brighter, reflecting better prospects for European growth. The U.S. growth outlook may be downgraded a bit.

Small Business Optimism Index (March) – Small business has been a driving force in jobs over the last year. We should see a further increase in the headline index, but there is a fair amount of noise in the data from month to month.

Business Inventories (March) – The only new piece of information here is retail inventories. The quarterly pace is likely to have declined in 1Q15, subtracting from GDP growth.

Wednesday

ECB Policy Decision – No suspense here. The ECB's Governing Council is not going to change rates or alter its asset purchase plans. However, market participants will pay attention to President Draghi's press conference and his evaluation of the QE launch. Someone may ask whether asset purchases may be terminated early (note that what matters in quantitative easing is the total amount purchased, not the monthly pace).

Empire State Manufacturing Index (April) – The New York Fed's manufacturing survey results can be erratic, but we should see a moderately strong trend in the near term.

Industrial Production (March) – Temperatures were more normal following a cold February. Hence, the output of utilities is likely to roll back, subtracting from the headline figure. Manufacturing hours fell 0.2%, which suggests a modest increase (at best) in factory output.

Homebuilder Sentiment (April) – This time for sure. The National Association of Home Builders' Housing Market Index has surprised to the downside in the last few months, but it would be surprising (and disappointing) if we don't see a rebound.

Fed Beige Book – This summary of anecdotal reports from around the country kicks off the discussion of economic conditions at monetary policy meetings (that is, the Fed pays attention to stories as well as the hard data releases).

Thursday

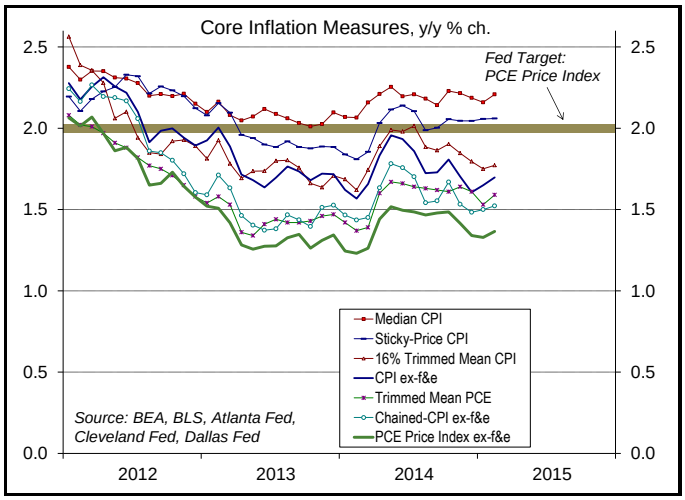
Jobless Claims (week ending April 11) – Unadjusted claims usually increase in the week after Easter. The figures are adjusted for the floating holiday, but it can be tricky. Take any large swing with a grain of salt. The underlying trend should remain low.

Building Permits, Housing Starts (March) – Spring is a critical time for the housing market. Hopes for a better housing recovery could give way if these data disappoint. However, bear in mind that starts are a very unreliable statistic and monthly swings in multi-family activity are common. Focus on single-family permits.

Philadelphia Fed Index (April) – As with the Empire State manufacturing data, the Philly Fed figures can be erratic. That means that there is a good chance for a surprise.

Friday

Consumer Price Index (March) – Gasoline prices rose, but that's largely anticipated by the seasonal adjustment.



Real Earnings (March) – Nominal average hourly earnings rose 0.3%, but that's likely to be mostly offset by a rise in the CPI.

UM Consumer Sentiment (mid-April) – Attitudes are likely to improve, consistent with a stronger consumer spending outlook.

G-20 Statement – Sharp currency moves are a concern.

Next Week …

The economic calendar thins out again. Home sales figures are often noisy. Market participants should look for whether weak trends will be broken in the March report on durable goods.

Coming Events and Data Releases

April 28	Consumer Confidence (April)
April 29	Real GDP (1Q15, advance estimate) FOMC Policy Decision (no press conference)
May 1	ISM Manufacturing Index (April)
May 8	Employment Report (April)
June 17	FOMC Policy Decision, Yellen press conference
July 29	FOMC Policy Decision (no press conference)
September 17	FOMC Policy Decision, Yellen press conference
October 28	FOMC Policy Decision (no press conference)
December 16	FOMC Policy Decision, Yellen press conference