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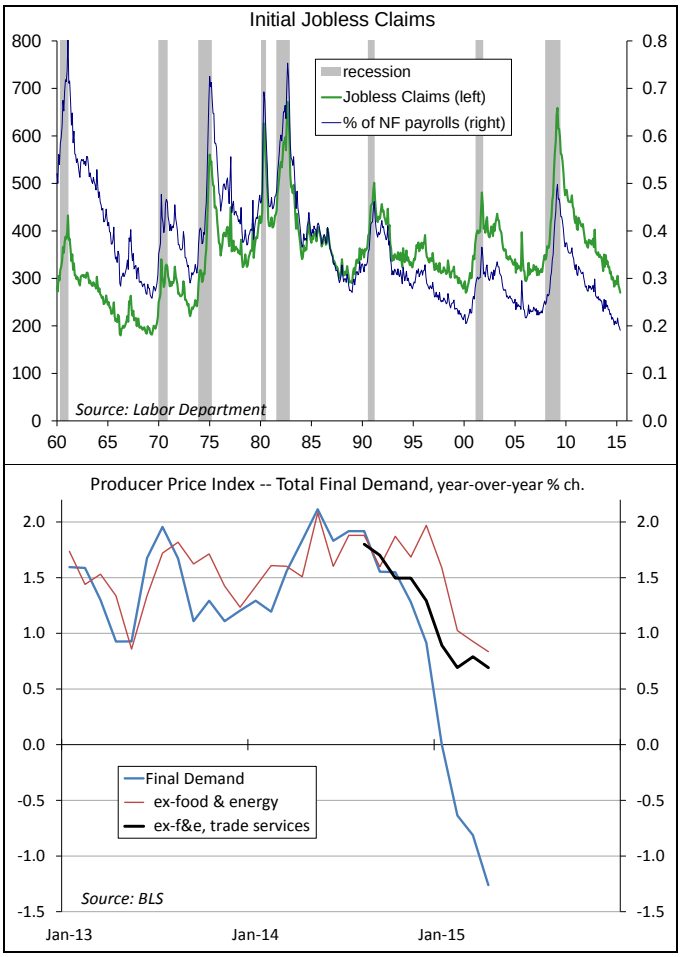
Weekly Economic Monitor

Back to the Drawing Board

The data reports for April suggest that the second quarter's anticipated rebound from a weak 1Q15 will fall far short of expectations. We could get revisions, figures for May and June could be a lot stronger, but at face value, the economy has disappointed. However, the Fed is still on track to begin raising short-term interest rates later this year. We should come away with a better understanding of how the Fed sees the situation when the central bank's two top officials speak later this week.

Not all of the news is bad. Weekly claims for unemployment benefits have been trending at a remarkably low level in early May. It's hard to dismiss the low trend as being due to seasonal adjustment difficulties (which aren't much of an issue in May). Jobless claims are near at a record low as a percentage of nonfarm payrolls. Yet, job losses really haven't been an issue in recent years. The real concern is job creation. Recent data suggest that hiring at small and medium-sized firms is still going strong. However, hiring at large firms has slowed to a crawl. The key question is whether that's temporary.



April consumer price figures will be reported at the end of the week. However, the Producer Price Index and the report on import prices suggest continued disinflationary pressures. There's very little inflation in "stuff." Inflation in consumer services is running at a moderate pace. Although there were some supply-chain disruptions related to delays at West Coast ports, manufacturers are generally not seeing the type of bottleneck production pressures that would push inflation higher. Of course, the labor market is the widest channel for inflation pressure. While wage increases have remained relatively lackluster, a decrease in productivity has contributed to an increase in unit labor costs (the labor expense per unit of output). Productivity figures are often erratic and unreliable, but weak productivity growth is a major concern. If firms can't pass higher unit labor costs along, they will eat into corporate profits. Uncertainties in the productivity outlook, here and abroad, are unlikely to be settled anytime soon.

Where does this leave the Fed? In its April 29 policy statement, the Federal Open Market Committees recognized that the economy slowed in the first quarter, but it pinned that on *"transitory factors."* In other words, officials viewed the first quarter softness as temporary. The data reports that have arrived since then (a drop in unit auto sales, soft retail sales, disappointing industrial production, and declining consumer sentiment) point to a subpar pickup for the economy in April and GDP growth in the second quarter is likely to be a lot softer than was anticipated at the time of the Fed policy meeting.

Despite disappointing growth in the first half of the year, Fed officials are still likely to expect conditions that will warrant an initial hike in short-term interest rates later this year. Why would the Fed tighten? The focus is on the job market. We are likely to see more slack taken up in the months ahead. The Fed has to consider where the economy will be 12 to 18 months from now. Monetary policy will still be very accommodative even after the first few rate hikes. There's no need for the Fed to hit the brakes, but officials do need to take the foot off the gas at some point. Still, Fed officials have emphasized that the pace of tightening after the first rate increase is a lot more important than the timing of the initial move. Fed officials have indicated that that pace will be very gradual.

Later this week, we should gain a lot more insight into how the Fed sees things. Vice Chair Fischer will speak on the euro area on Thursday (some implications for long-term interest rates and exchange rates). On Friday afternoon, Fed Chair Yellen will speak on the economic outlook. Market participants may eye an early exit ahead of a three-day weekend, but Yellen should provide an up-to-date view of how the Fed sees things.

RIP B.B. King – The thrill, indeed, is *gone*.

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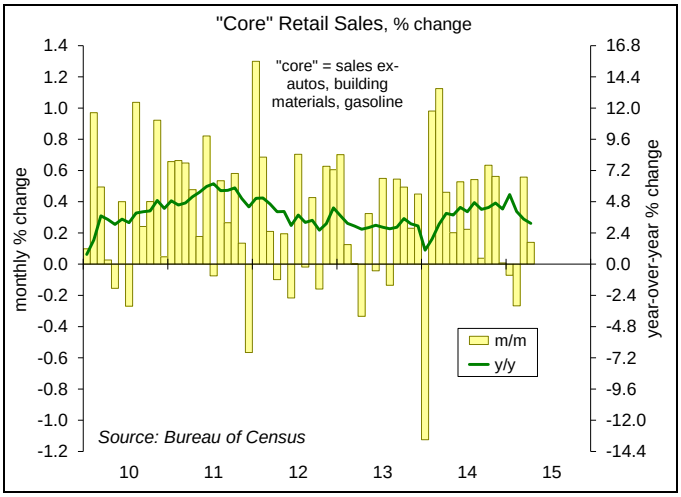
	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
4/17/15	0.01	0.08	0.23	0.51	0.84	1.31	1.87	2.51	1.078	1.494	119.02	1.223	4931.81	2081.18	17826.30
5/08/15	0.01	0.08	0.23	0.59	0.96	1.50	2.16	2.90	1.124	1.546	119.78	1.209	5003.55	2116.10	18191.11
3/15/15	0.02	0.08	0.21	0.54	0.90	1.46	2.14	2.93	1.145	1.573	119.32	1.202	5048.29	2122.72	18272.49

Recent Economic Data and Outlook

The economic data were generally disappointing, suggesting that the anticipated second quarter rebound in growth (following a weak first quarter) will fall far short of expectations. Bond yields rose again in Europe, putting some upward pressure on U.S. Treasury yields, but the softer U.S. data helped push yields back down. The euro continued to rebound against the dollar.



Retail Sales were disappointingly flat in April (+0.9% y/y), up just 0.1% ex-autos (unchanged from a year ago). Auto dealership sales fell 0.4% (less than was suggested by the drop in unit sales). Building materials rose 0.3%. Gasoline fell 0.7% (-22.0% y/y). Ex-autos, building materials, and gasoline, sales edged up 0.1% (+3.1% y/y). For the first four months of the year, unadjusted retail sales were up just 1.0% for the same period last year. Core retail sales rose 4.0% y/y, mixed across sectors. Sales at restaurants and bars were up 9.0% y/y, while sales at electronics and appliance stores fell 1.0% y/y.

Business Inventories rose 0.1% in March (+2.0% y/y), less than was assumed in the advance GDP report (implying, all else equal, a slight downward revision to the first quarter growth estimate). Business sales (factory shipments plus wholesale and retail sales) rose 0.4% in March (-2.1% y/y).

The UM **Consumer Sentiment Index** fell to 88.6 in the mid-May reading, vs. 95.9 in April and 93.0 in March.

Industrial Production fell 0.3% in April, partly reflecting a further decrease in the output of utilities and another sharp decline in oil and gas drilling. Manufacturing output was flat, although the March figure was revised slightly higher. Output of motor vehicles rose 1.3% (+7.2% y/y). Ex-autos, factory output slipped 0.1% (+2.0% y/y). The output of utilities slipped 1.3% (+0.1% y/y). Drilling of oil and gas wells sank 14.5% (-46.5% y/y), while energy extraction rose 0.5% (+9.3% y/y). Capacity utilization fell to 78.2% (from 78.6%), 1.9 percentage points below the long-term average.

The **Producer Price Index** fell 0.4% in April (-1.3% y/y), reflecting a 0.9% decline in food (-4.2% y/y) and a 2.9% decline in energy (-24.0 y/y). Ex-food & energy, the PPI fell 0.2% (+0.8% y/y). The new core PPI, which also excludes trade services, rose 0.1% (+0.7% y/y). Pipeline gauges showed disinflationary pressures.

Import Prices fell 0.3% in April (-10.7% y/y), down 0.4% excluding food and fuels (-2.2% y/y).

The Index of **Small Business Optimism** edged up to 96.9 in April, vs. 95.2 in March and 98.0 in February. The earnings trend remained weak. Respondents were negative on the general business outlook. Sales expectations were moderate. Hiring plans remained moderate. Job openings picked up.

The **Bureau of Economic Analysis** announced that will introduce some important new measures in July. One is simply an average of Gross Domestic Product and Gross Domestic Income (aggregate economic activity can be measured as output or as income, this gauge will split the difference). The other is Final Sales to Private Domestic Purchases (net exports, the change in inventories, and defense spending are often choppy, adding volatility to GDP growth – this new gauge, a measure of underlying private-sector demand, should be more stable).

Euro Area GDP rose 0.4% q/q (a 1.7% annual rate) in the flash estimate for the first quarter.

Economic Outlook (2Q15): Around a 1.0% to 1.5% annual rate.

Employment: The pace of job growth slowed, 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 boosted consumer purchasing power, but the pickup in spending has been less than anticipated.

Manufacturing: The strong 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: Sales appeared mixed at the start of the spring selling season. Rising prices and relatively tight credit appear to be constraining the lower end of the market.

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: Senior Fed officials have signaled that conditions are likely to warrant an initial increase in short-term rates this year, but indicate that the more important question is the pace of tightening after the initial hike (which is likely to be gradual).

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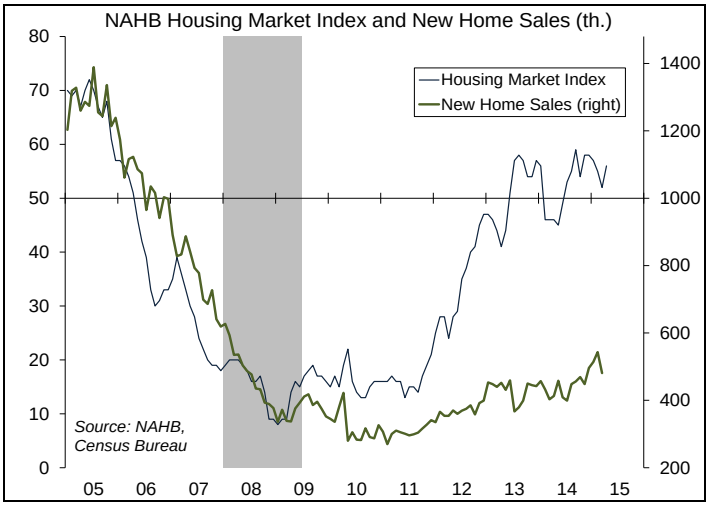
This Week:					*forecast*	last	last –1	comments
Monday	5/18	10:00	Homebuilder Sentiment	May	***58***	56	52	likely to improve further
Tuesday	5/19	8:30	**Building Permits, mln**	Apr	***1.085***	1.042	1.102	picking up
			% change		***+4.1***	-5.4	+4.0	single-family strengthening
			Housing Starts		***1.020***	.926	.908	likely to improve
			% change		***+10.2***	+2.0	-15.3	but watch for revisions
Wednesday	5/20	2:00	**FOMC Minutes**	4/29				perhaps a little more insight
Thursday	5/21	8:30	Jobless Claims, th.	5/16	***272***	264	265	can't go much lower
		9:45	Markit US Manf PMI (flash)	May	***NF***	54.1	55.7	not market-moving
		10:00	Philadelphia Fed Index	May	***7.0***	7.5	5.0	moderate
		10:00	Existing Home Sales	Apr	***5.30***	5.19	4.89	likely to have improved
			% change		***+2.1***	+6.1	+1.5	better weather may help
		10:00	Leading Economic Indicators	Apr	***+0.5%***	+0.2%	+0.1%	picking up
		1:00	TIPS Auction					$13 billion in re-opened 10-year TIPS
		1:00	Fed VC Fischer Speaks					*"Challenges for the Euro Area"*
Friday	5/22	8:30	**Consumer Price Index**	Apr	***+0.2%***	+0.2%	+0.2%	moderate
			year-over-year		***0.0%***	-0.1%	-0.0%	still flat y/y
			ex-food & energy		***+0.2%***	+0.2%	+0.2%	low core inflation
			year-over-year		***+1.8%***	+1.8%	+1.7%	trending higher than core PCE price index
		8:30	Real Hourly Earnings	Apr	***-0.1%***	+0.1%	-0.1%	nominal earnings rose 0.1%
		1:00	**Fed Chair Yellen Speaks**					*"U.S. Economic Outlook"*
Next Week:								
Monday	5/25		Memorial Day Holiday					markets closed
Tuesday	5/26	8:30	**Durable Goods Orders**	Apr	***-2.6%***	+4.4%	-1.4%	volatility in aircraft
			ex-transportation		***+0.4%***	+0.4%	-1.3%	likely to improve
			nondef cap gds ex-aircraft		***+0.3%***	+0.1%	-2.0%	turning the corner?
		9:00	Case-Shiller Home Prices	Mar	***+0.5%***	+0.4%	+0.5%	still rising
			year-over-year		***+4.6%***	+4.2%	+4.4%	moderate y/y
		10:00	**New Home Sales, th.**	Apr	***530***	481	543	seen higher, but these data are erratic
			% change		***+10.2***	-11.4	+5.6	watch for revisions
		10:00	**Consumer Confidence**	May	***98.0***	95.2	101.4	likely to bounce
		1:00	Treasury Note Auction					2-year notes
Wednesday	5/27	9:00	BOC Policy Decision					no change in rates or in inflation target
		11:30	Treasury FRN Auction					re-opened 2-year FRNs
		1:00	Treasury Note Auction					5-year notes
Thursday	5/28	8:30	Jobless Claims, th.	5/23	***270***	***272***	264	a remarkably low trend
		10:00	Pending Home Sales	Apr	***+1.5%***	+1.1%	+3.6%	trending higher
		1:00	Treasury Note Auction					7-year notes
Friday	5/29	8:30	**Real GDP (2nd estimate)**	1Q15	***-0.2%***	+2.2%	+5.0%	+0.2% in the advance estimate
		9:45	Chicago PM Index	May	***53.0***	52.3	46.3	rebounding from first quarter slump
		10:00	UM Consumer Sentiment	May	***92.4***	95.9	93.0	88.6 at mid-month

This Week…

The economic data reports have some potential to move the markets (provided we see a large enough surprise relative to expectations). However, the focus is likely to be on the Fed – specifically, how policymakers see the current situation. The FOMC minutes may help fill in that picture to some extent, but Fed speeches later in the week should provide more up-to-date views. Fed Vice Chair Fischer will speak about the euro area on Thursday, while Chair Yellen will address the U.S. outlook on Friday. Fischer's speech will likely address currency markets and long-term rates. Yellen is expected to note the transitory restraints on GDP growth in the first half of the year, but she will remain optimistic about a pickup in growth in the second half. The Fed is still on track for an initial rate hike later this year.

Monday

Homebuilder Sentiment (May) – The National Association of Home Builders' Housing Market Index is likely to continue trending higher. Strong job growth (over the last year) and low mortgage rates have been supportive.



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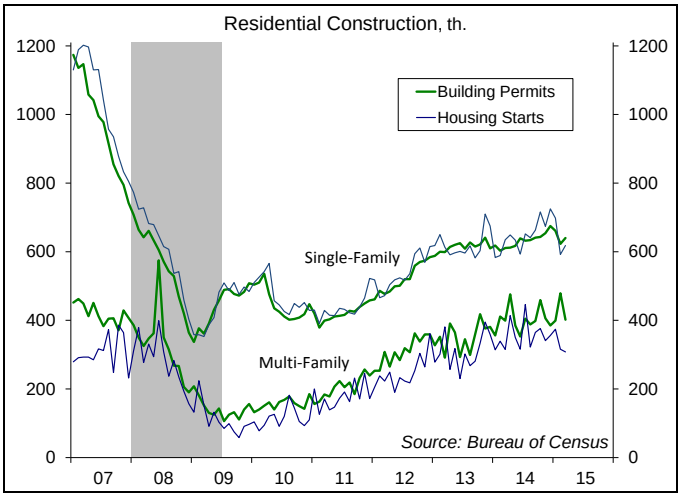
Tuesday

Building Permits, Housing Starts (April) – Construction figures are choppy, but the underlying trend of improvement has disappointed. We should see a pickup in the April data.



Wednesday

FOMC Minutes (April 28-29) – In its April 29 policy statement, the Federal Open Market Committee recognized that "economic growth slowed during the winter months, in part reflecting transitory factors." However, while the 1Q15 slowdown was seen as temporary, there may have been some concern about a more extended period of lackluster growth. How concerned were officials about soft business fixed investment and the impact of a strong dollar? We may get some answers here. However, more information is now available. Yellen's speech (on Friday) should provide a more up-to-date assessment.

Thursday

Jobless Claims (week ending May 16) – How much lower can the trend in claims go? Probably not much, the recent level suggests that we are close to base frictional levels. That is, there's always some seasonal job churning under the surface, and we're not seeing much in job losses beyond that.

Philadelphia Fed Index (May) – The Philly Fed's manufacturing survey results are often choppy, but the May results should be consistent with moderate growth in the region's factory sector.

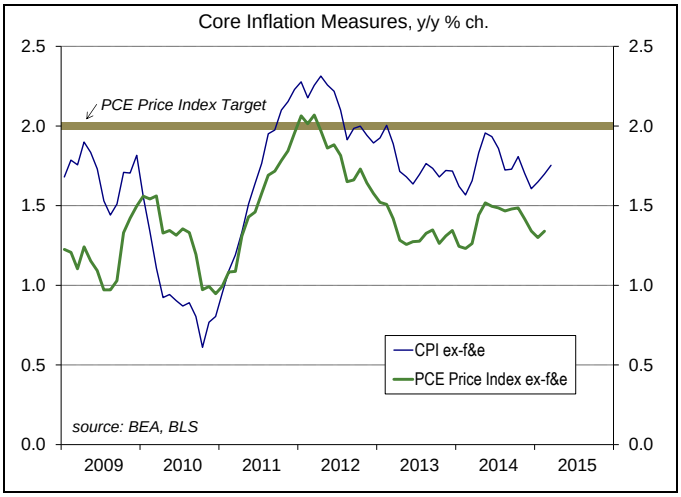
Existing Home Sales (April) – Existing home sales rebounded in March, from weather-related softness in February. Further improvement is expected for April.

Leading Economic Indicators (April) – Most of the ten components should make positive contributions, the largest from the slope of the yield curve.

Fed Governor Stanley Fischer speaks ("Past, Present, and Future Challenges for the Euro Area") – Certainly, the Fed has no control over monetary policy in the euro area. However, developments there have clear consequences here. Most notably, the rise in European bond yields is seen as the key driver of the recent increase in yields of U.S. long-term Treasuries. A recent shift in monetary policy expectations has led to a softening in the dollar. Fischer should address the key points.

Friday

Consumer Price Index (April) – Gasoline prices were flat or slightly higher relative to March, while the seasonal adjustment anticipates an increase of 1.6%. Hence, gasoline should not be a big factor. Core inflation is expected to remain relatively low (+0.1% or +0.2%, depending on the rounding error).



Real Earnings (April) – Nominal earnings (hourly and weekly) rose 0.1%, which should be offset by inflation (still up significantly on a year-over-year basis).

Fed Chair Janet Yellen speaks ("U.S. Economic Outlook") – It's been two months since the Federal Open Market Committee released economic projections. Yellen isn't going to update those figures here, but we should get a lot more background color on the key issues facing the economy. Instilling optimism is part of the job, but Yellen should note the temporary nature of recent restraints and demonstrate confidence that the economy will be sufficiently strong to warrant an initial interest rate increase by the end of the year. More importantly, she should stress that the pace of policy tightening beyond that first rate move is likely to be very gradual.

Next Week …

Monday's a holiday. Investors will return to face some key economic reports (the May Conference Board Consumer Confidence Index and April durable goods figures on Tuesday, and the second look at first quarter GDP growth on Friday).

Coming Events and Data Releases

June 1	ISM Manufacturing Index (May)
June 3	ECB Policy Decision
June 5	Employment Report (May)
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

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