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Weekly Market Monitor

The Fed Policy Outlook: Connecting the Dots

Policywise, not much is expected out of this week's meeting of the Federal Open Market Committee. The FOMC is unlikely to provide a clear signal on the precise timing of the initial increase in short-term interest rates. However, there should be plenty of information in the Fed's revised economic projections and in Fed Chair Janet Yellen's press conference.

The split between the Fed's hawks and doves is widely overstated. Monetary policy decisions are generally arrived at through a broad consensus. Contrary to a recent op-ed in *The Wall Street Journal*, monetary policy is determined by the FOMC, not the Board of Governors. Recall that the FOMC sets the target range for the federal funds rate (the overnight lending rate). The Fed's Board of Governors sets the primary credit rate (the "discount rate," the rate the Fed charges banks for short-term borrowing) following a request by one or more district banks for a change (which may or may not be approved). The FOMC is made up of the five (normally seven) Fed governors, the president of the New York Fed, and four of the 11 other district banks (who rotate on and off each year). All 17 senior Fed officials participate at FOMC meetings, but only FOMC members get to vote on monetary policy. Still, the FOMC tends to be dominated by the board of governors and the governors tend to be dominated by the views of the Fed chair.

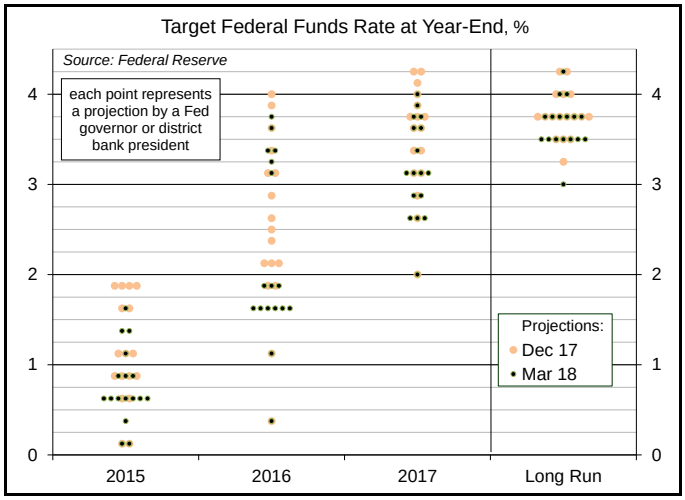
In their public speeches, senior Fed officials have clearly laid out the conditions that would lead to an initial rate hike, but also have listed a few caveats:

1) Officials want to see further improvement in the job market and they should expect that improvement to continue (however, judging how much slack remains and how rapidly that slack is being taken up are open questions, subject to different opinions);
2) Officials need to be "reasonably confident" that inflation will move back toward the 2% goal (the FOMC can hike well before reaching that goal, but the Fed's track record on forecasting inflation hasn't been good);
3) The timing of the first rate hike is much less important than the pace of tightening after the initial move (and that pace is expected to be very gradual);
4) Fed officials are aware of possible liquidity issues in the bond market, which could lead to excessive volatility in response to the Fed's initial move (further reinforcing expectations that the Fed will move slowly);
5) Fed officials are aware of possible adverse reactions in emerging economies (as we saw in 2013's taper tantrum – the FOMC will do what it has to do, but it also has to take into account the possible feedback from more unsettled reactions abroad).

The Labor Market Conditions Index, a composite of 24 indicators, suggests that slack is being taken up at a relatively rapid pace, but we still have a while to go before constraints hit. The May CPI report (due Thursday) is expected to show consumer price inflation at close to 0% over the last 12 months. Core inflation has remained low. Pipeline pressures are virtually nonexistent. The labor market is the widest channel for inflation pressure. Wage growth appears to have picked up, but not a lot and these figures are tentative. Moreover, Fed officials should be willing to tolerate a moderate pickup in wage growth.

In March, Fed officials lowered their GDP growth projections. Forecasts of the appropriate year-end level of the federal funds rate edged lower. The less aggressive Fed policy outlook contributed to a reversal in the dollar.

Janet Yellen has cautioned against reading too much into minor movements in the dots. Indeed, there is a huge amount of uncertainty in each individual dot (that is, forecast). Market estimates of the path of short-term interest rates, such as seen in the federal funds futures, are more gradual than the most dovish Fed official. Why is that? The Fed's forecasts reflect the most likely path seen by each Fed official. The market's forecast is a risk-adjusted expectation. The Fed's April survey of primary dealers showed that many expected that the Fed might be forced to return to the 0% lower bound after the initial hike.



FOMC members will likely want to see further evidence of a rebound in growth and then, beyond that, further evidence that growth will remain strong. This would put September as the most likely starting point (provided the data are in line with expectations), but the precise timing will depend on the data. The more important issue is the pace of tightening after the first move. In her speech of May 22, Fed Chair Yellen said that she expects that *"it will be several years before the federal funds rate would be back to its normal, longer-run level."*

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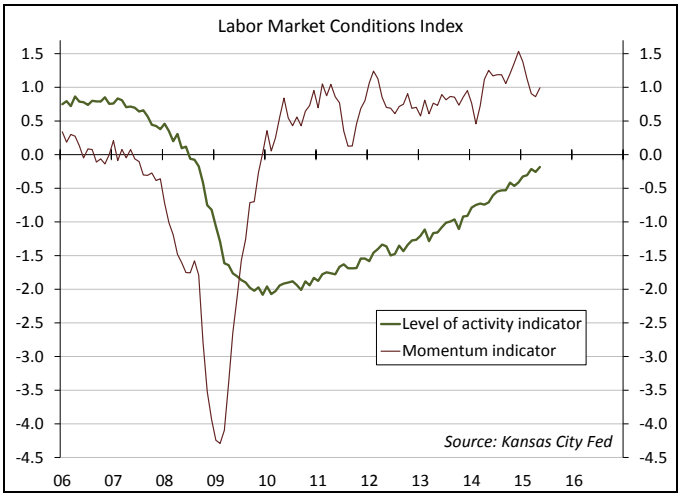
	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
3/15/15	0.02	0.09	0.23	0.55	0.90	1.46	2.14	2.93	1.143	1.577	119.36	1.201	5048.29	2122.73	18272.56
6/05/15	0.03	0.08	0.29	0.73	1.13	1.75	2.41	3.11	1.111	1.527	125.58	1.249	5068.46	2092.83	17849.46
6/12/15	0.01	0.10	0.26	0.73	1.13	1.74	2.39	3.10	1.126	1.556	123.37	1.231	5051.10	2094.12	17898.84

Recent Economic Data and Outlook

Retail sales posted a strong increase in May, as expected. However, upward revisions to March and April, along with quarterly data on services, paint a brighter consumer spending outlook. Financial markets remained volatile, reflecting concerns about Greece and the Fed.



Retail Sales rose 1.2% in May (+2.7% y/y), roughly in line with expectations. More importantly, March was revised to +1.5% (vs. +1.1%) and April was revised to +0.2% (vs. +0.0%). Ex-autos, sales rose 1.0% (+1.3% y/y). Gasoline sales rose 3.7% (-18.6% y/y). Ex-gasoline, retail sales rose 5.2% y/y (+4.3% ex-autos). Auto sales rose 2.0% (+8.2% y/y). Building materials rose 2.1% (+6.2% y/y). Core retail sales (which exclude autos, building materials, and gasoline) rose 0.6%, with upward revisions to March and April (+4.1% y/y). Sales at restaurants and bars edged up only 0.1% in May, but the total for the first five months of the year was up 8.9% from the same period in 2014.

Business Inventories rose 0.4% in April (+2.6% y/y). Retail inventories, the only new information in the release, rose 0.8% (autos +1.2%, non-autos +0.6%). Factory inventories (previously reported) rose 0.1%, while wholesale inventories rose by 0.4%. Business sales rose 0.6% in April (-2.3% y/y).

The **Quarterly Report on Services** suggested that consumer spending was stronger than estimated in the most recent GDP report (a -0.7% annual rate in the 2nd estimate, now expected to be revised to show a more modest decline).

The **Job Opening and Labor Turnover Survey** showed job openings rising to 5.4 million in April, a record high (the series began in December 2000). The hiring rate was 3.5%, same as a year ago. The quit rate edged down to 1.9% (from 2.0% in March), vs. 1.7% a year ago. The data are consistent with further improvement in job conditions, but also continued slack.

The **Producer Price Index** rose 0.5% in May (-1.1% y/y), with 80% of the monthly increase due to higher energy costs. Food 0.8% (-3.3%), boosted partly by a 42.9% increase in eggs (a consequence of bird flu). Wholesale gasoline prices jumped 17.0% (+15.7% before seasonal adjustment, -31.3% y/y). Ex-food & energy, the PPI rose 0.1% (+0.6% y/y). The new core PPI, which excludes food, energy, and trade services, slipped 0.1% (+0.6% y/y). Higher energy prices were also a factor at the earlier stages of production, but pipeline pressures were generally mild (core processed intermediate goods down 3.0% y/y, core unprocessed intermediate goods down 14.0% y/y, intermediate services up 1.3% y/y).

Import Prices rose 1.3% in May (-9.6% y/y), reflecting a 12.7% rise in petroleum (-40.6% y/y). Ex-food & fuels, import prices were flat (-2.2% y/y). Ex-fuels, industrial supplies and materials slipped 0.1% (-6.4% y/y). Prices of imported capital goods fell 0.2% (-1.7% y/y). Autos edged down 0.1% (-2.0% y/y). Other consumer goods slipped 0.1% (-2.0% y/y).

The University of Michigan **Consumer Sentiment Index** rose to 94.6 in the mid-June reading, vs. 90.7 in May and 95.9 in April.

Hiring Intentions held steady for 3Q15. The latest survey by Manpower, Inc. showed that 24% of firms planned to increase payrolls (vs. 22% for 3Q14), while 4% planned cuts (vs. 4%). That works out to a seasonally adjusted net increase of 16%, vs. 16% for 2Q15 and 14% for 3Q14.

The Index of **Small Business Optimism** rose to 98.3 in May (the highest level this year), vs. 96.9 in April.

Negotiations between **Greece** and the IMF broke down.

Economic Outlook (2Q15): Around a 2.0% to 2.5% annual rate.

Employment: The pace of job growth appears to be relatively strong. Except for energy exploration, job losses are 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 moderate and less than anticipated.

Manufacturing: The strong dollar has been a constraint, but likely a transitory one (assuming the dollar stabilizes). 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 believe that conditions are likely to warrant an initial increase in short-term rates this year, but the more important question is the pace of tightening after the initial hike (which is likely to be very gradual).

This Week:					*forecast*	last	last –1	comments
Monday	6/15	8:30	Empire St Manf. Index	Jun	***5.4***	3.1	-1.2	moderate
		9:15	**Industrial Production**	May	***+0.3%***	-0.3%	-0.3%	moderate
			manufacturing output		***+0.4%***	0.0%	+0.3%	aggregate hours reported up 0.2%
			Capacity Utilization		***78.3%***	78.2%	78.6%	likely to edge a bit higher
			manufacturing		***78.3%***	78.0%	78.1%	no threat to the inflation outlook
		10:00	Homebuilder Sentiment	Jun	***56***	54	56	likely to improve
Tuesday	6/16	8:30	**Building Permits, mln**	May	***1.120***	1.140	1.038	single-family strength
			% change		***-1.8***	+9.8	-5.5	multi-family volatility
			Housing Starts		***1.105***	1.135	0.944	a strong trend into 2Q15
			% change		***-2.6***	+20.2	+4.9	but watch for revisions
Wednesday	6/17	2:00	**FOMC Policy Statement**					expecting minor changes in statement
		2:00	**Summary of Econ Proj.**					dots likely to be a bit lower
		2:30	**Yellen Press Briefing**					repeating recent themes
Thursday	6/18	8:30	Jobless Claims, th.	6/13	***278***	279	277	expecting little change
		8:30	**Consumer Price Index**	May	***+0.4%***	+0.1%	+0.2%	some increase in gasoline prices
			year-over-year		***-0.0%***	-0.2%	-0.1%	little changed from a year ago
			ex-food & energy		***+0.1%***	+0.3%	+0.2%	mild core inflation
			year-over-year		***+1.8%***	+1.8%	+1.8%	a low trend
		8:30	Real Hourly Earnings	May	***-0.2%***	0.0%	0.0%	nominal earnings rose 0.3%
		8:30	Current Account, $bln	1Q15	***-120.0***	-113.5	-98.9	seen wider
		10:00	Philadelphia Fed Index	Jun	***6.8***	6.7	7.5	moderate
		10:00	Leading Econ Indicators	May	***+0.3%***	+0.7%	+0.4%	mixed components, mostly higher
		1:00	TIPS Auction					re-opened 30-year TIPS
Friday	6/19		no significant data					quadruple witching
Next Week:								
Monday	6/22	10:00	**Existing Home Sales, mln**	May	***5.16***	5.04	5.21	seen rebounding from dip in April
			% change		***+2.4***	-3.3	+6.5	still some supply constraints
Tuesday	6/23	**8:30**	**Durable Goods Orders**	May	***-0.5%***	-1.0%	+5.1%	lower aircraft orders
			ex-transportation		***+0.8%***	-0.2%	+0.6%	seen higher
			core capital goods		***+0.6%***	-0.3%	+1.6%	uneven in recent months, likely to pick up
		9:45	Markit US Manf PMI (flash)	Jun	***NF***	54.0	54.1	moderate
		10:00	**New Home Sales, th.**	May	***520***	517	484	likely to remain strong
			% change		***+0.6***	+6.8	-10.0	but these figures tend to be erratic
		1:00	Treasury Note Auction					2-year notes
Wednesday	6/24	8:30	**Real GDP (3rd estimate)**	1Q15	***-0.1%***	+2.2%	+5.0	-0.7% in the advance estimate
		11:30	FRN Auction					re-opened 2-year FRNs
		1:00	Treasury Note Auction					5-year notes
Thursday	6/25	8:30	Jobless Claims, th.	6/20	***278***	***278***	279	a low trend
		8:30	Personal Income	May	***+0.4%***	+0.4%	0.0%	healthy wage growth
			Personal Spending		***+0.5%***	0.0%	+0.5%	seen higher (with ↑ revisions to Mar/Apr)
			PCE Price Index ex-f&e		***+0.1%***	+0.1%	+0.1%	mild core inflation
		1:00	Treasury Note Auction					7-year notes
Friday	6/26	10:00	UM Consumer Sentiment	Jun	***95.2***	90.7	95.9	94.6 at mid-month

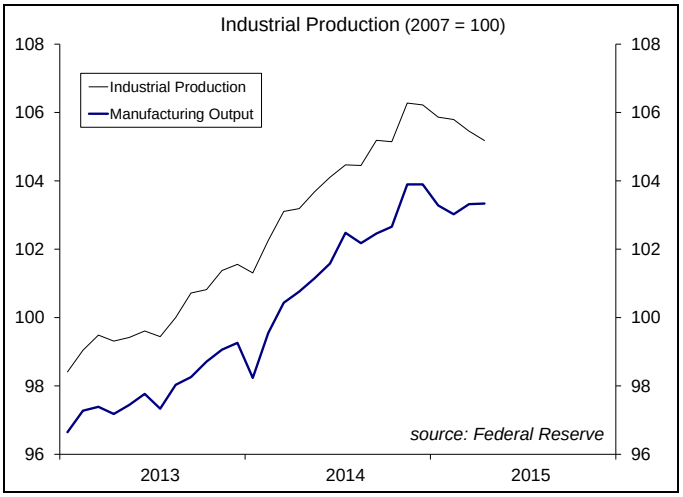
This Week…

The focus is on the Fed (policy statement, Summary of Economic Projections, and Yellen's press conference). Economic growth projections are expected to be somewhat lower than in March. The dots in the dot plot ought to drift down. Yellen is expected to repeat that the timing of the initial hike will depend on the data and subsequent moves will likely be very gradual.

Monday

Empire State Manufacturing Index (June) – Often erratic, the report is likely to be consistent with moderate growth.

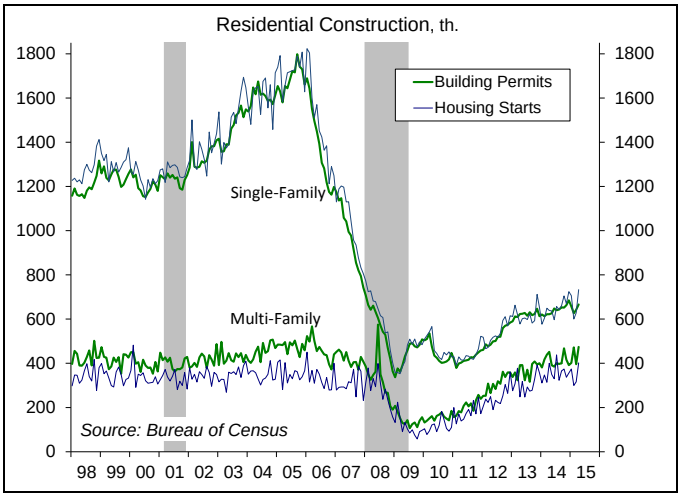
Industrial Production (May) – Following strength in 2014, factory output has been relatively lackluster this year. Results have varied across industries, partly reflecting the impact of a strong dollar. However, we should see the trend begin to pick up.



Homebuilder Sentiment (June) – Builder sentiment softened unexpectedly in May, but seems likely to rebound.

Tuesday

Building Permits, Housing Starts (May) – By some accounts, it looks as if the housing bust has been bigger than the boom. Given the strong job growth over the last year, the recovery in residential homebuilding has disappointed. Activity should be picking up a lot more. However, these figures can be erratic, reflecting a high degree of month-to-month volatility in the multi-family sector and a large amount of statistical noise in housing starts. Focus on single-family permits.



Wednesday

FOMC Policy Decision – The wording of the Fed policy statement should be little changed. Recall that in late April, the FOMC recognized the slower growth in the first quarter, but assigned that to "transitory factors." Officials were optimistic that economic activity would expand at a moderate pace, with the labor market continuing to move toward levels consistent with the dual mandate. This time, the FOMC is expected to recognize the improvement in the consumer spending outlook. Seemingly little noticed by the markets, recent policy statements have emphasized that the FOMC *"currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run."* In other words, subsequent rate increases are likely to be very gradual.

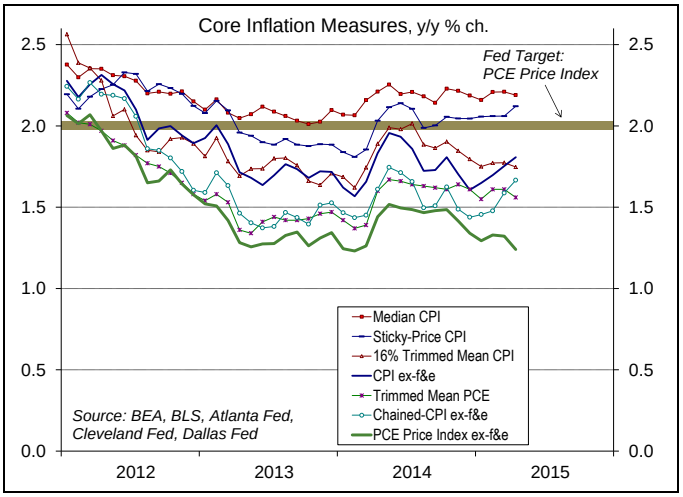
Fed Summary of Economic Projections – The five Fed governors and 12 district bank presidents will submit revised projections of growth, unemployment, and inflation for the next few years. In comparison to the April SEP, the forecasts of the appropriate year-end federal funds target rate (the "dots" in the dot plot) should drift a little lower.

Yellen Press Conference – This will be one opportunity for the Fed chair to expound on how the Fed sees the current economic situation and what will drive its decision to begin raising short-term interest rates. Perhaps more importantly, it will give Yellen a chance to further stress that the pace of policy tightening is likely to be very gradual.

Thursday

Jobless Claims (week ending June 13) – Claims will still be subject to some noise from the seasonal adjustment (reflecting the end of the school year). The underlying trend has remained low.

Consumer Price Index (May) – Higher gasoline prices should push the overall index higher. Note that the recent gasoline price rise *does not* reflect the start of the summer driving season (the seasonal adjustment looks for +0.2% in May, -0.8% in June, -1.1% in July, and -1.5% in August). Core inflation is expected to remain very low. Of the various measures of "core" inflation, the one that the Fed emphasizes is trending the lowest.



Real Earnings (May) – Nominal earnings (hourly and weekly) rose 0.3%, which should be less than the CPI increase in May.

Philadelphia Fed Index (June) – The headline figure is often choppy, but we're likely to see a moderate level for June.

Leading Economic Indicators (May) – Most components will make positive contributions in May.

Friday

No significant economic data.

Next Week …

We'll get another look at 1Q15 GDP growth (should be less negative or perhaps a little bit positive). May personal income and spending figures will help fill in the picture for 2Q15.

Coming Events and Data Releases

June 30	Consumer Confidence (June)
July 1	ISM Manufacturing Index (June)
July 2	Employment Report (June)
July 3	Independence Day Holiday (observed)
July 29	FOMC Policy Decision (no press conference)
July 30	Real GDP (2Q15 advance, benchmark revisions)
September 17	FOMC Policy Decision, Yellen press conference
October 28	FOMC Policy Decision (no press conference)
December 16	FOMC Policy Decision, Yellen press conference