RAYMOND JAMES

Economic Research
Published by Raymond James & Associates

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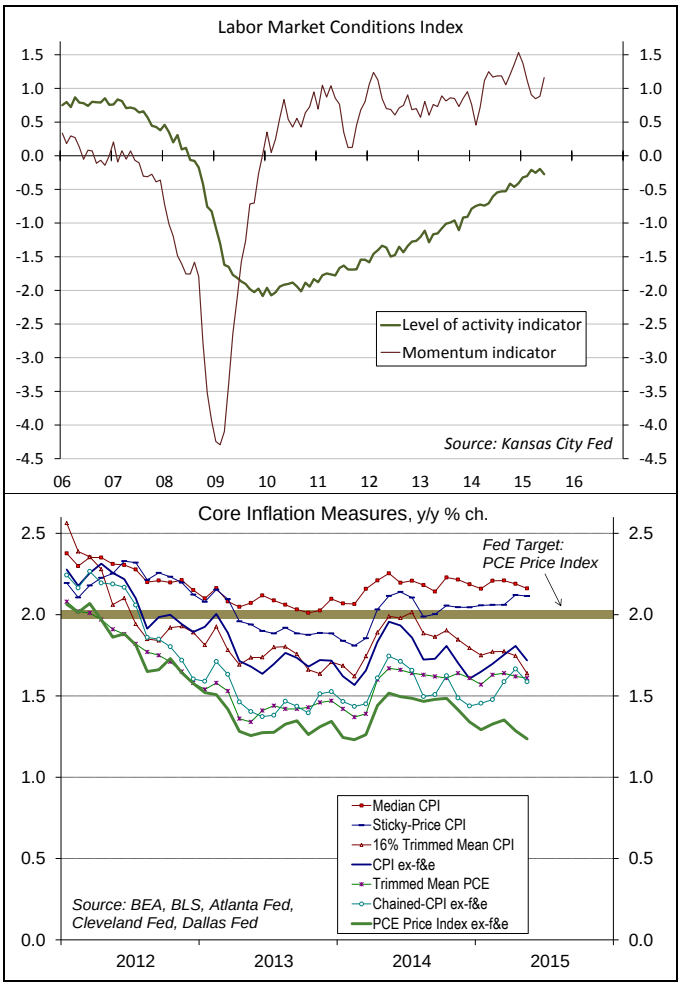
July 13 - 17, 2015

Weekly Economic Monitor

The View from the Fed

Federal Reserve Chair Janet Yellen will give her semiannual monetary policy testimony to Congress this week. In the past, this has been an important event for the financial markets. However, Fed communication is a lot more open these days. For example, we have the forecasts of senior Fed officials and the minutes of the June policy meeting in hand. However, there is still scope for financial market participants to learn a bit more.

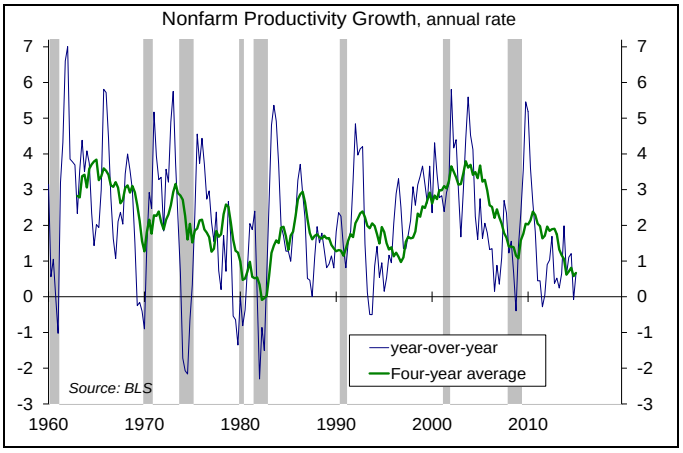
Over the last several months, Fed officials have made it clear that monetary policy decisions will depend critically on job market conditions and the inflation outlook. Job growth has remained strong. The unemployment rate has continued to decline and is now near levels that were once considered to be consistent with "full employment." However, that figure presents a false image due to shifts in labor force participation. Some of that is demographics, the aging of the population. The Kansas City Fed's Labor Market Conditions Index indicates that slack is being taken up, but considerable slack remains.



There are many measures of "core" inflation. One can exclude food and energy. It's not that these don't matter. Rather, monthly changes in food and energy are often volatile and we are interested in the underlying trend. Trimmed measures exclude the highest and lowest price changes. The Atlanta Fed's sticky price index looks at prices of goods and services that change only gradually. Of these measures, the one the Fed focuses on (the PCE Price Index ex-f&e) is trending at the lowest level (that doesn't mean that the Fed is wrong).

More importantly, the Fed isn't worried about past inflation; the focus is on future inflation. The drop in energy prices and the strong dollar have put downward pressure on inflation over the last year, but as they stabilize, their impact on inflation will fade. In domestic production, there are no signs of the type of bottleneck pressures that would push prices higher. The labor market is the widest channel for inflation pressure. There are some signs that wage growth has picked up, but the pace has remained relatively lackluster. Average hourly earnings were reported to be flat in June, up just 2.0% from year ago.

Still, the Fed has to base policy on where the economy is expected to be many months down the road. Simply eyeballing the LMCI graph, it looks as if the labor market is on track to achieve some sense of normality in late 2016. The Fed is not going to wait until we get there to begin policy normalization. The best analogy is that while there is no pressing need for the Fed to hit the brakes, it does need to begin taking the foot off the accelerator in the not too distant future.



Yellen ended her July 10 speech on the economy by bringing up the issue of productivity growth, the most important factor in the long-term economic outlook. However, it's unclear why output per worker has slowed in recent years. A long-lasting low trend in productivity would have important implications for the standard of living, but also for wage growth (slower), interest rates (lower), and the federal budget deficit (wider).

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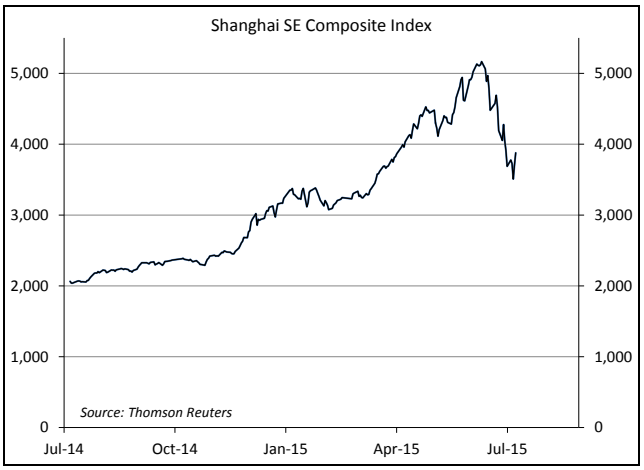
	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
6/12/15	0.02	0.10	0.28	0.74	1.12	1.75	2.39	3.10	1.128	1.559	123.23	1.231	5051.10	2094.11	17898.84
7/02/15	0.01	0.10	0.26	0.64	1.01	1.64	2.40	3.19	1.109	1.561	123.14	1.257	5009.21	2076.78	17730.11
7/10/15	0.02	0.09	0.26	0.65	1.03	1.66	2.41	3.20	1.113	1.550	122.79	1.268	4997.70	2076.58	17760.14

Recent Economic Data and Outlook

Concerns about Greece and China added to financial market volatility. Greek voters chose to reject requirements for a bailout deal, but the Greek government submitted a new plan that accepts more strenuous conditions (to get a larger bailout); and investors rejoiced. Chinese equities plunged despite government efforts to prop it up. The market rallied after the government severely limited sales by large shareholders; and everybody was happy with that. Really, you could not make this stuff up!



In her speech on the economic outlook, **Fed Chair Janet Yellen** said that she expects that *"it will be appropriate at some point later this year to take the first step to raise the federal funds rate and thus begin normalizing monetary policy."* However, she added that *"the course of the economy and inflation remains highly uncertain, and unanticipated developments could delay or accelerate this first step."* She stressed that monetary policy will remain very accommodative even after the first rate hike and that the pace of normalization should be gradual.

The **FOMC Minutes** from the June 16-17 policy meeting showed that *"meeting participants viewed the information received over the intermeeting period as indicating that economic activity was expanding moderately after little change in the first quarter of the year."* First quarter growth was restrained by temporary factors and projections of second half growth remained largely intact. Yet, *"while participants generally saw the risks to their projections of economic activity and the labor market as balanced, they gave a number of reasons to be cautious in assessing the outlook."* Officials cited concerns about Greece, China, and other emerging economies. While *"the ongoing rise in labor demand appeared to have begun to result in a firming of wage increases,"* those increases *"remain subdued."* Officials felt that stability in oil prices and exchange rates would reduce downward pressure on inflation. Only *"a couple"* of officials expressed concerns about a possible extended period of low inflation.

The **U.S. Trade Deficit** widened to $41.9 billion in May, vs. $40.7 billion in April. Merchandise imports fell 5.1% from a year earlier, but were up 3.7% adjusting for inflation. Petroleum imports fell 45.8% y/y, down 2.6% adjusting for inflation. Non-oil imports rose 1.9% from a year ago, up 4.4% adjusting for inflation. Merchandise exports fell 7.0% y/y, down 0.5% adjusting for inflation. Net exports subtracted 1.9 percentage points from 1Q15 GDP growth, but appear unlikely to make much of a contribution either way in 2Q15.

The **ISM Non-Manufacturing Index** rose to 56.0 in June, vs. 55.7 in May and 57.8 in April. Details remained consistent with moderate growth overall. Business activity and new orders picked up slightly. Employment growth slowed. Input price pressures were modest. Comments from supply managers were mixed (generally strong, but with some references to Avian flu).

The May **Job Opening and Labor Turnover Survey** remained consistent with a very gradual pace of reduction in labor force underutilization. For the private sector, the hiring rate held steady at 3.9% (vs. 3.9% a year ago). The quit rate was unchanged at 2.2% (vs. 2.0% a year ago).

Economic Outlook (3Q15): Around a 3.0% annual rate, following about 2.5% in 2Q15.

Employment: The pace of job growth, while slower than in the second half of 2014, still appears to be relatively strong. Job losses are very limited. New hiring appears to have remained strong, especially for small and medium-sized firms.

Consumers: Strong job growth is supportive. Inflation-adjusted wages have been trending gradually lower since January, but are still up significantly from a year ago. Consumers are more optimistic about the economy, but generally remain judicious in how they spend their money.

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: An improving outlook, although the recovery has remained disappointing. Job growth is supportive and mortgage rates remain low. However, credit is still tight at 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 later this year, but the more important question is the pace of tightening after the initial hike (which is expected to be very gradual). Long-term rates should trend gradually higher.

This Week:					*forecast*	last	last –1	comments
Monday	7/13	2:00	Treasury Budget, $bln	Jun	***+51.0***	+70.5	+116.5	June is a surplus month
Tuesday	7/14	8:30	Import Prices	Jun	***NF***	+1.3%	-0.2%	more modest pressure in oil
			ex-food & fuels		***NF***	0.0%	-0.3%	a low trend in recent months
		8:30	**Retail Sales**	Jun	***+0.3%***	+1.2%	+0.2%	vehicle sales fell back from strong May
			ex-autos		***+0.6%***	+1.0%	+0.1%	some push from higher gasoline prices
			ex-autos, bld mat, gasoline		***+0.5%***	+0.6%	+0.3%	moderately strong
		9:00	Small Business Optimism	Jun	***NF***	98.3	96.9	should be trending higher
		10:00	Business Inventories	May	***+0.3%***	+0.5%	+0.1%	likely to be a bit slower in 2Q15
Wednesday	7/15	8:30	**Producer Price Index**	Jun	***+0.3%***	+0.5%	-0.4%	some boost from food and gasoline
			ex-food & energy		***+0.1%***	+0.1%	-0.2%	mild (old) core inflation
			ex-f, e, trade services		***+0.2%***	-0.1%	+0.1%	mild (new) core inflation
		8:30	Empire St. Manf. Index	Jul	***+4.2***	-2.0	3.1	likely to pick up
		9:15	**Industrial Production**	Jun	***+0.1%***	-0.2%	-0.5%	soft
			manufacturing		***0.0%***	-0.2%	+0.1%	aggregate hours fell 0.2%
			Capacity Utilization		***78.0%***	78.1%	78.3%	no threat to the inflation outlook
			manufacturing		***77.6%***	77.8%	78.0%	well below the long-term trend
		10:00	**Yellen Mon Pol Testimony**					to House Financial Services Committee
		10:00	BOC Policy Decision		***0.75%***	0.75%	0.75%	a close call on whether to cut rates
		2:00	Fed Beige Book					still "mixed" to "moderate" across regions?
Thursday	7/16	7:45	ECB Policy Decision					Draghi on QE, Greece, etc.
		8:30	Jobless Claims, th.	7/11	***285***	297	282	still subject to seasonal distortions
		10:00	Philadelphia Fed Index	Jul	***14.0***	15.2	6.7	moderate
		10:00	Homebuilder Sentiment	Jul	***60***	59	54	trending higher
		2:30	**Yellen Monetary Policy**					to Senate Banking Committee
Friday	7/17	8:30	**Consumer Price Index**	Jun	***+0.3%***	+0.4%	+0.1%	some minor boost from gasoline
			year-over-year		***+0.2%***	+0.0%	-0.2%	still close to 0% y/y
			ex-food & energy		***+0.1%***	+0.1%	+0.3%	mild core inflation
			year-over-year		***+1.7%***	+1.7%	+1.8%	roughly steady
		8:30	Real Hourly Earnings	Jun	***-0.3%***	-0.1%	0.0%	nominal earnings were flat
		8:30	**Building Permit, mln**	Jun	***1.070***	1.250	1.140	multi-family pulled forward into May
			% change		***-14.4***	+9.6	+9.8	continued strength in single-family
			Housing Starts		***1.145***	1.036	1.165	volatility in multi-family
			% change		***+10.5***	-11.1	+22.1	choppy, but improving trend in single-fam
		10:00	UM Consumer Sentiment	m-Jul	***97.2***	96.1	90.7	likely to improve further
Next Week:								
Monday	7/20		no significant data					
Tuesday	7/21		Industrial Production					annual benchmark revisions
Wednesday	7/22	10:00	**Existing Home Sales, mln**	Jun	***5.40***	5.35	5.09	choppy in recent months
			% change		***+0.9***	+5.1	-2.3	but trending higher
Thursday	7/23	8:30	Jobless Claims, th.	7/18	***278***	***280***	285	still a bit noisy
		10:00	Leading Econ Indicators	Jun	***-0.2***	+0.7	+0.7	expecting a pullback in building permits
		1:00	TIPS Auction					re-opened 10-year TIPS
Friday	7/24	9:45	Markit US Manf Index (flash)	Jul	***NF***	53.6	54.0	moderate, not market-moving
		10:00	**New Home Sales, th.**	Jun	***550***	546	534	these figures are noisy
			% change		***+0.7***	+2.2	+8.1	but are likely to remain moderately strong

This Week…

Greece, again. Financial markets will begin the week by reacting to the EU's acceptance or rejection of Greece's proposal. The U.S. economic calendar picks up on Tuesday. Figures are likely to be mixed, but consistent with moderate growth. Fed Chair Yellen will present the central bank's outlook. While most of that will be a rehash of what we already know (following the Fed's June 17 Summary of Economic Projections and FOMC minutes), investors will be keen to hear what she has to say about Greece, China, and U.S. inflation (or lack thereof).

Monday

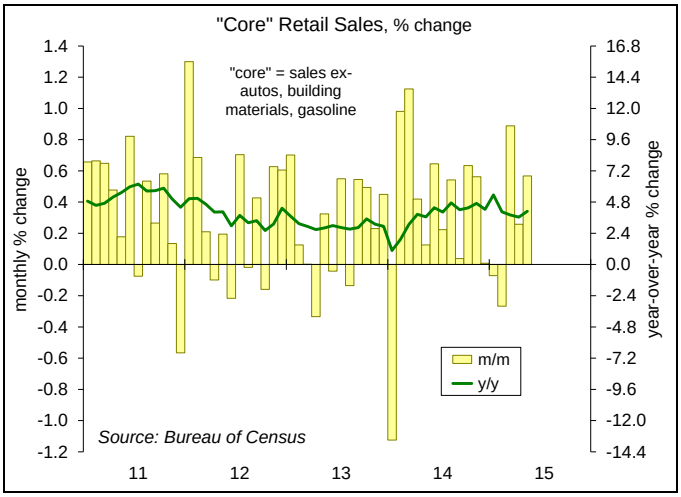
Greece – In its latest proposal, the country has conceded to demands for more austerity (which were rejected in the July 5 referendum) and requested more money. The EU finance ministers may reject that outright (not likely), leading to an exit from the euro, accept the plan as is (not likely), or demand further negotiations. Even if accepted, the proposal is not a realistic solution for Greece, but it ought to buy some time (in which case, we can go through this all over again at some point).

Tuesday

Import Price (June) – Oil prices may add a little to the headline figure. Ex-food and fuels, import prices are likely to trend about flat, but are still generally lower than a year ago.

Retail Sales (June) – Unit motor vehicle sales fell back in June (May appears to have been boosted by the timing of the Memorial Day holiday), which should translate into a decline in

dealership sales. Gasoline prices rose somewhat (when they usually decline), adding to the total. Core retail sales are likely to have risen at a moderately strong pace. Keep an eye out for possible revisions to the figures for May.



Small Business Optimism Index (June) – The improved outlook for small business was a major factor in GDP (despite the 1Q15 decline, real GDP rose 2.9% y/y) and jobs (more than 2.9 million over the last 12 months). The June gauge is likely to be higher.

Wednesday

Producer Price Index (June) – Wholesale gasoline prices edged higher last month, counter to the normal seasonal pattern. Core inflation is likely to remain low, with no signs of pressure at the earlier stages of production.

Industrial Production (June) – Factory output should be mixed across sectors, but relatively flat overall. In the June jobs report, aggregate manufacturing hours edged down 0.2%. Note that the overall economy can still grow nicely even if the manufacturing sector is barely treading water.

Yellen Monetary Policy Testimony (House Financial Services Committee) – The Fed Chair will be speaking for all senior Fed officials, not just herself. Based on the published Fed projections and FOMC minutes, we already have a good idea of what she'll say. However, financial market participants will be looking for signs that the Fed will delay the initial increase in short-term rates. Specifically, how worried is the Fed about Greece, China, and the continued low trend in inflation?

Bank of Canada Policy Decision – Data suggest that the Canadian economy remains mixed, but soft overall. Following a mild first quarter contraction in real GDP, the second quarter is looking dicey. Recall that in January the BOC surprised with a 25-bp cut, which was billed as "insurance." This meeting is seen as a close call; economist surveys show even odds of another cut.

Fed Beige Book – Fed officials do not look solely to the economic data in setting monetary policy. They also consider anecdotal information. However, for financial markets participants, the Beige Book is largely seen as echoing the hard data. This latest read should be consistent with "mixed" to "moderate" growth, nothing to suggest a pressing need for the Fed to tighten policy.

Thursday

ECB Policy Decision – The European Central Bank's Governing Council is not expected to alter policy, but investors will want to hear what ECB President Draghi has to say in his post-meeting press conference. Expect a lot of questions about Greece.

Jobless Claims (week ending July 11) – Figures will remain subject to seasonal distortions in the near term, but the underlying trend is expected to remain low.

Homebuilder Sentiment (July) – The housing sector is expected to improve further in the near term.

Yellen Monetary Policy Testimony (Senate Banking Committee) – The written testimony will be the same as Wednesday's, but the Q&A should be different. The late timing should limit any possible reaction in the financial markets.

Friday

Consumer Price Index (June) – Retail gasoline prices rose a little over 2% last month. The seasonal adjustment expects a decline of 0.8%. Hence, we should see a small amount of upward pressure on the headline figure. Food prices may reflect some drought impact. Core inflation is likely to remain low.

Real Earnings (June) – The drop in gasoline prices sharply boosted real earnings into the early part of this year. Since January, real earnings have trended slightly lower (but year-over-year gains will remain significantly positive).

Building Permits, Housing Starts (June) – The June figures are likely to remain confusing to a lot of people. In May, an expiring tax break led to a surge in permits. That should unwind in June. There is a lot of statistical uncertainty in reported housing starts. Multi-family activity can be erratic. However, we should see continued strength in single-family permits.

UM Consumer Sentiment Index (mid-July) – The University of Michigan's figure popped higher in June, consistent with an improving consumer spending outlook.

Next Week …

The economic calendar thins out and, frankly, we could use a break. Things will heat up again in a couple of weeks, with the 2Q15 GDP release and the July jobs report. China, Greece, and the rest of the world may still be concerns for U.S. investors.

Coming Events and Data Releases

July 27	Durable Goods Orders (June)
July 29	FOMC Policy Decision (no press conference)
July 30	Real GDP (2Q15 advance, benchmark revisions)
July 31	Employment Cost Index (2Q15)
August 7	Employment Report (July)
September 7	Labor Day (markets closed)
September 17	FOMC Policy Decision, Yellen press conference
October 28	FOMC Policy Decision (no press conference)
December 16	FOMC Policy Decision, Yellen press conference