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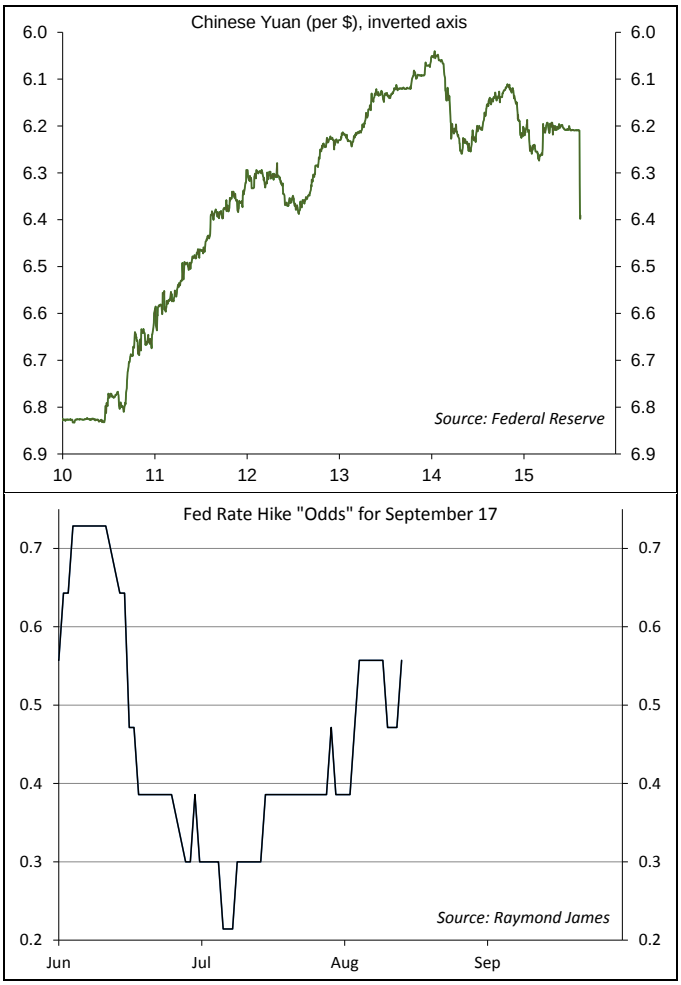
Weekly Market Monitor

China, the Fed, and Commodity Prices

The People's Bank of China, the country's central bank, moved to allow its exchange rate to be determined by market forces. After two sharp declines in the yuan, the PBOC apparently had had enough and declared that the currency adjustment was "basically completed." The news from China added to uncertainty about what the Fed will do in September. Concerns about the pace of global growth have put downward pressure on commodity prices, which may keep the Fed on hold.

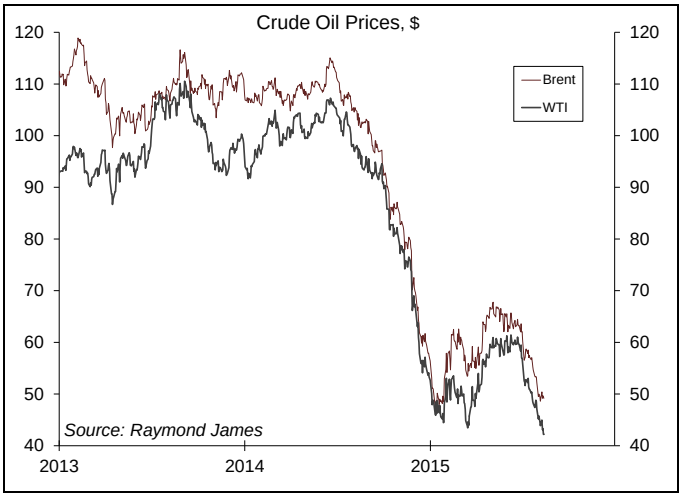
China's leadership wants the yuan to become one of the premier reserve currencies, but that means that the exchange rate will have to be set by the free market. The PBOC allows the currency to trade in a 2% range around a level announced before the market open. The PBOC said it would begin setting that level at the previous session's close (rather than picking it out of thin air). Investors took the currency down 1.9% after the news and the exchange rate dipped further in the following session, before the PBOC intervened to prop it back up.



The decision to move toward a free market confused global financial market participants. The financial press described it as "a devaluation" and some viewed it as "the start of a currency war." Granted, China's currency has had a strong tie to the U.S. dollar, which has become harder for the country's exporters as the greenback has strengthened over the last year. However, the decision to intervene suggests that the PBOC had badly misjudged market forces and the likely reaction to the change. The U.S. market reaction to China's currency debacle (and to its recent stock market correction) seems way overdone. The more important issue is the slowing in China's economy.

The market odds of a September 17 rate hike from the Fed have varied considerably in recent weeks. Note that the market odds of a Fed move are not directly observable, because the FOMC will announce a target range for the federal funds rate rather than a specific level. However, if we assume that federal funds will trade around the midpoint of that range, we can use the federal funds futures market to calculate "odds" (I'll put quotes around that to emphasize the fuzziness of the estimate).

If the trend of improvement in the job market continues, we should be close to normal conditions in late 2016 or in early 2017. Policy is extraordinarily accommodative now and will still be very accommodative after the first few rate hikes, so the Fed would appear to be justified in beginning a gradual process of normalization. However, officials have indicated that they need to be *"reasonably confident"* that inflation will move toward the 2% goal. Lower commodity prices, lower import prices, and the lack of meaningful wage growth ought to give pause.



Most likely, the FOMC will err on the side of caution and delay. The Fed does not want the initial move to be a surprise for the markets. Fed Chair Yellen will not attend the Kansas City Fed's annual monetary policy symposium next week, but expect her to add a speech to calendar in the next few weeks.

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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
7/17/15	0.03	0.11	0.29	0.68	1.05	1.67	2.34	3.08	1.085	1.562	124.00	1.300	5210.14	2126.64	18086.45
8/07/15	0.06	0.23	0.38	0.73	1.08	1.59	2.28	2.68	1.096	1.547	124.27	1.312	5043.54	2077.57	17373.38
8/14/15	0.09	0.24	0.38	0.73	1.08	1.60	2.20	2.84	1.111	1.565	124.27	1.309	5048.24	2091.58	17477.54

Recent Economic Data and Outlook

In a move toward free markets, the People's Bank of China altered its exchange rate regime. That generated volatility in global financial markets. Confusion sent U.S. stock prices lower, and reduced bond yields. However, after a two-day decline, China's central bank acted to stabilize the exchange rate.

The **People's Bank of China** changed its exchange rate regime to better reflect market fundamentals (according to the PBOC), leading to devaluation in renminbi and setting off mass confusion in global financial markets. After two days of volatility, the PBOC had had enough. A spokesperson said the forex adjustment was "basically completed."

Retail Sales rose 0.6% in July, a bit better than expected (+2.4% y/y). Figures for May and June were revised higher (implying, all else equal, an upward revision to 2Q15 GDP growth). Ex-autos, sales rose 0.4% (+1.3% y/y). Auto sales rose 1.4% (+6.9% y/y). Sales of building materials rose 0.7% (+2.8% y/y). Sales of gasoline rose 0.4% (+3.2% before seasonal adjustment, -15.2% y/y). Ex-autos, building materials, and gasoline, sales rose 0.3%, but with upward revisions to May and June (+3.9% y/y). Sales at eating and drinking establishments rose 0.7% (+9.0% y/y, continuing the strong trend seen in the first half of 2015).

Business Inventories jumped 0.8% in June (+3.0% y/y), more than was assumed in the advance GDP report (implying an upward revision to the second quarter growth estimate, but also suggesting a possible inventory correction in 3Q15).

Industrial Production rose by 0.6% in July (+1.3% y/y), reflecting a 10.6% surge in autos (+9.0%). Seasonal adjustment is difficult in July, due to traditional plant retooling shutdowns, and it's not unusual to see large swings in July and August. Ex-autos, factory output rose 0.1% (+0.8% y/y).

The **Producer Price Index** rose 0.2% in July (-0.8% y/y). Food fell 0.1% (-2.8% y/y), while energy fell 0.6% (-17.6% y/y) and trade services rose 0.4% (+0.1% y/y). Ex-food, energy, and trade services, the PPI rose 0.2% (+0.9% y/y). Pipeline measures continued to indicate disinflationary pressures.

Import Prices fell 0.9% in July (-10.4% y/y), reflecting a 5.9% decline in petroleum (-43.4% y/y). Ex-food & fuels, import prices fell 0.3% (-2.6% y/y). Non-fuel industrial supplies and materials fell 0.8% (-7.7% y/y). Capital goods slipped 0.2% (-2.3% y/y). Autos were flat (-1.4% y/y). Prices of other consumer goods fell 0.3% (-1.1% y/y).

Treasury reported a $149.2 billion **Budget Deficit** in July, boosted by a calendar quirk (August 1 fell on a weekend, shifting some spending ahead). With two months left in the fiscal calendar year, the deficit is on track to be less than 2.4% of GDP.

The Index of **Small Business Optimism** rose to 95.4 in July, vs. 94.1 in June and 98.3 in May. While there was only a partial rebound in the headline figure, most of the key components were back on track, consistent with moderate growth in the near term. The earnings trend weakened. Respondents were less negative on the general business outlook. Sales expectations were moderate. Hiring plans improved. Capital spending plans were little changed.

Nonfarm Productivity rose at a 1.3% annual rate in 2Q15 (+0.3% y/y). Unit labor costs rose at a 0.5% pace (+2.1% y/y). Note that these data are volatile (choppy and subject to large revisions).

The **Job Opening and Labor Turnover Survey** data (a Yellen favorite) were little changed in June. For the private sector, the hiring rate was 4.0% (vs. 3.9% a year ago), while the quit rate was unchanged at 2.2% (it was 2.0% a year ago).

Economic Outlook (3Q15): Around a 2.5% annual rate, expected to be held back by an inventory correction.

Employment: The pace of job growth has remained strong. Job losses are limited. New hiring appears robust.

Consumers: Average wage growth has generally remained lackluster, but strong job growth and lower gasoline prices have been supportive for spending.

Manufacturing: Mixed across industries, but generally soft in recent months. The stronger dollar has restrained exports.

Housing/Construction: Credit is still tight at the lower end of the market, but sales and construction activity are increasing.

Prices: Overall consumer price inflation has been very low, but should pick up as energy prices stabilize. There is downward price pressure in commodities and imports. Wage pressures are generally mild. Inflation expectations remain well-anchored.

Interest Rates: 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).

This Week:					*forecast*	last	last –1	comments
Monday	8/17	8:30	Empire St. Manf. Index	Aug	***5.0***	3.9	-2.0	choppy, but likely moderate
		10:00	Homebuilder Sentiment	Aug	***61***	60	60	may edge higher
Tuesday	8/18	8:30	**Building Permits, mln**	Jul	***1.145***	1.337	1.250	noise in multi-family
			% change		***-14.3***	+7.0	+9.6	continued strength in single-family
			Housing Starts		***1.215***	1.174	1.069	should improve
			% change		***+3.5***	+9.8	-10.2	watch for revisions
Wednesday	8/19	8:30	**Consumer Price Index**	Jul	***+0.2%***	+0.3%	+0.4%	moderate
			year-over-year		***+0.2%***	+0.1%	0.0%	still up mildly from a year ago
			ex-food & energy		***+0.2%***	+0.2%	+0.1%	mild core inflation
			year-over-year		***+1.9%***	+1.8%	+1.7%	still low
		8:30	Real Weekly Earnings	Jul	***+0.3%***	-0.3%	-0.2%	nominal earnings rose 0.5%
			Real Hourly Earnings		***0.0%***	-0.4%	-0.2%	nominal earnings rose 0.2%
		2:00	**FOMC Minutes**	7/29				more clues about the September meeting
Thursday	8/20	8:30	Jobless Claims, th.	8/15	***274***	274	269	seen little changed
		10:00	Philadelphia Fed Index	Aug	***7.5***	5.7	15.2	uneven, but likely moderate
		10:00	Existing Home Sales	Jul	***5.52***	5.49	5.32	strong
			% change		***+1.1***	+3.2	+4.5	supply has been an issue
		10:00	Leading Economic Indicators	Jul	***-0.1%***	+0.6%	+0.8%	building permits are the key factor
		1:00	TIPS Auction					$16 billion in re-opened 5-year TIPS
Friday	8/21		no significant data					ahhh, summertime!
Next Week:								
Monday	8/24	9:45	Markit US Manf PMI (flash)	Aug	***NF***	53.8	53.6	moderate
Tuesday	8/25	9:00	Case-Shiller Home Prices	Jun	***NF***	-0.2	-0.0	slowing
			year-over-year		***NF***	+4.9	+5.0	edging lower
		10:00	**New Home Sales, mln**	Jul	***520***	482	517	likely to rebound
			% change			-6.8	-1.1	but these figures are erratic
		10:00	Consumer Confidence Index	Aug	***93.2***	90.9	99.8	likely to partly rebound
		1:00	Treasury Note Auction					2-year notes
Wednesday	8/26	8:30	**Durable Goods Orders**	Jul	***-1.8***	+3.4	-2.2	aircraft unwound part of June spike
			ex-transportation		***+0.4***	+0.6	-0.3	moderate otherwise
			nondef cap gds ex-aircraft		***+0.5***	+0.7	-0.8	choppy, with a lackluster trend
		11:30	FRN Auction					re-opened floating rate notes
		1:00	Treasury Note Auction					5-year notes
Thursday	8/27	8:30	Jobless Claims, th.	8/22	***273***	***274***	274	a low trend
		8:30	**Real GDP (2nd estimate)**	2Q15	***+3.0%***	+0.6	+2.1	+2.3% in the advance estimate
		10:00	Pending Home Sales Index	Jul	***+1.0***	-1.8	+0.6	seen higher
		1:00	Treasury Note Auction					10-year notes
Friday	8/28	8:30	Adv. Trade Balance, $bln	Jul	***NF***	-63.5	-60.6	seen a bit narrower
		8:30	Personal Income	Jul	***+0.5***	+0.4	+0.4	moderate, led by wage income
			Personal Spending		***+0.4***	+0.2	+0.7	moderate
			PCE Price Index ex-f&e		***+0.1***	+0.1	+0.1	mild core inflation
		10:00	UM Consumer Sentiment	Aug	***93.2***	93.1	96.1	92.9 at mid-month

This Week…

The focus is expected to be on the FOMC minutes. There was no Yellen press conference after the July 28-29 meeting, so there's some chance that we may learn something new here. However, the financial markets are likely to be hypersensitive and we could see something taken out of context. The perceived market odds of a September move have bounced around 50% in the last week or two. However, the Fed will not want to surprise. Hence, we ought to see Chair Yellen speak at some point before the next meeting (note that she will not be attending the Kansas City Fed's annual monetary policy symposium later this month).

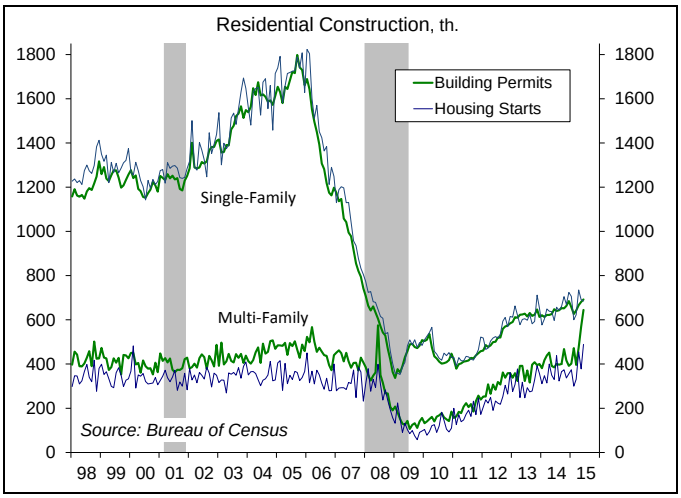
Monday

Empire State Manufacturing Index (August) – The headline figure is often volatile. Details should suggest moderate growth.

Homebuilder Sentiment (August) – The National Association of Home Builders' Housing Market Index picked up sharply in June and remained strong in July. We should see the headline figure improve a bit further in August. Strong job growth has been a supporting factor for housing.

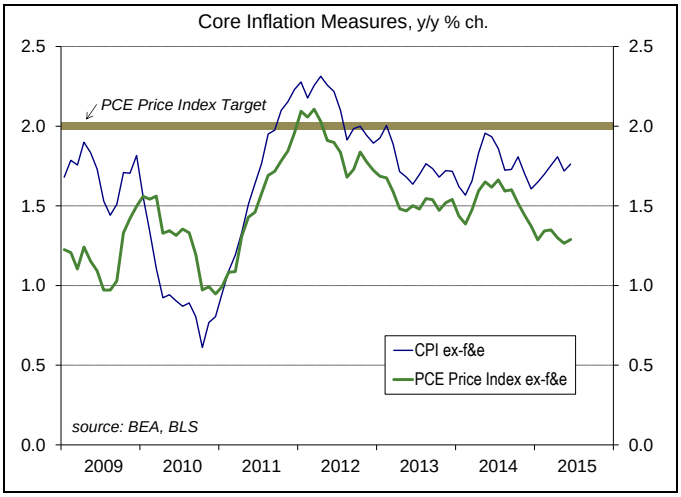
Tuesday

Building Permits, Housing Starts (July) – The multi-family sector data tend to be volatile even under normal conditions, but permits surged in May and June, reportedly as builders scrambled ahead of an expiring tax break. We should see some slowing in August. The financial markets may over-react to the noise in the data. Single-family permits are reported much more accurately than starts, and the trend has been improving in recent months (still well below levels associated with "normal" housing market conditions).



Wednesday

Consumer Price Index (July) – Retail gasoline prices fell about 1% last month. The seasonal adjustment anticipates a decline of 1.1% (gasoline prices normally trend lower between May and December). Food prices are likely to have risen moderately, but we may see some drought effects. Ex-food & energy, the CPI is likely to post a mild increase.

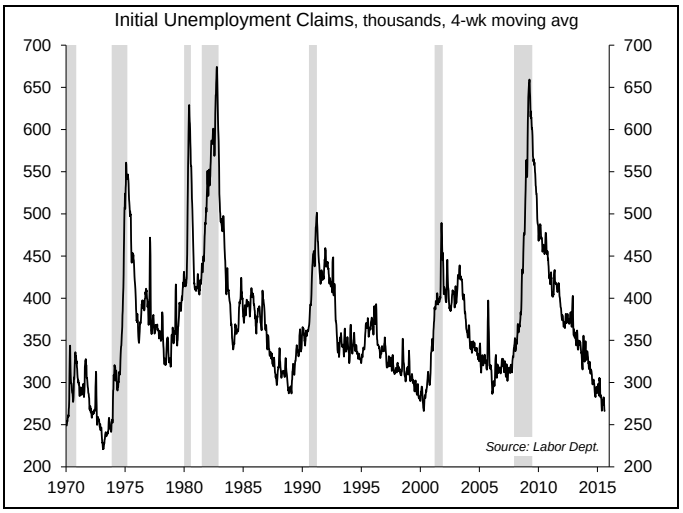


Real Earnings (July) – Nominal (current-dollar) hourly earnings rose 0.2% last month, which should roughly match the increase in the CPI. Real hourly earnings have been trending flat since the start of the year, but are still up nicely from a year ago (thanks to the drop in gasoline prices).

FOMC Minutes (July 28-29) – These minutes should provide a little more insight into the Fed's decision-making process and illustrate the range of views on the appropriate timing and pace of tightening. However, there's some chance that the financial markets will take something out of context.

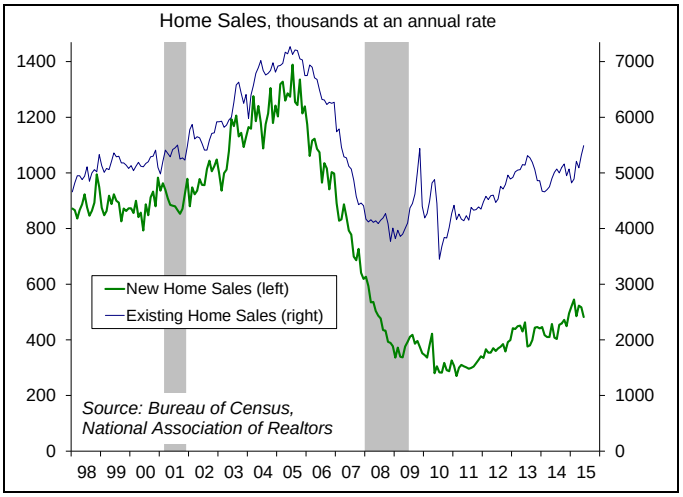
Thursday

Jobless Claims (week ending August 15) – The normal seasonal noise from July has faded and the underlying trend has remained low. The four-week average hit its lowest level since 1973 (an impressive feat, in that the job market is nearly twice as large as it was in late 1973).



Philadelphia Fed Index (August) – Expecting a moderate level.

Existing Home Sales (July) – Sales appear to have recovered from the financial crisis (not so for new home sales).



Friday

No significant economic data reports.

Next Week …

The economic calendar thins out, with the revised GDP estimate being the likely highlight. The KC-Fed's annual monetary policy symposium (sans Yellen) kicks off on Thursday evening.

Coming Events and Data Releases

September 1	ISM Manufacturing Index (August)
September 2	Fed Beige Book
September 3	ECB Policy Decision
September 4	Employment Report (August)
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