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Weekly Economic Monitor

Market Worries, Real and Imagined

Financial market participants were beset with a number of worries in August. However, as a general theme, investors often worry about things they shouldn't worry about and don't worry about the things that they should worry about.

The drop in China's stock market is essentially an unwinding of a speculative bubble. As such, it's not necessarily a sign of weaker economic growth in China, nor will the market's decline lead to economic weakness. However, there are plenty of signs that the Chinese economy *has* slowed. That's the real worry. History has shown that preventing a bubble is problematic. Efforts to stop the bubble from collapsing are almost always futile, but policymakers should be prepared to deal with the unpleasant aftermath when it bursts.

China's "devaluation" has been described as an effort to spur exports, a first salvo in "a currency war." However, according to the People's Bank of China, the move was meant as a transition to a more market-based exchange regime. China's leadership wants the country to play a larger role in global finance and the yuan to be among the major currencies in the world. The IMF indicated that it would consider adding the yuan to its benchmark basket (along with the dollar, the euro, the pound, and the yen). However, to do that, the exchange rate would have to be determined by market forces instead of set at the whim of Chinese officials. After two sharp drops in the yuan against the dollar, the PBOC had had enough and declared that the currency adjustment was "essentially complete." The currency has depreciated by about 2.8% – not a huge move. A number of U.S. presidential candidates have railed against China's manipulation of its currency. However, the PBOC is acting to keep the yuan from *weakening*, not strengthening.

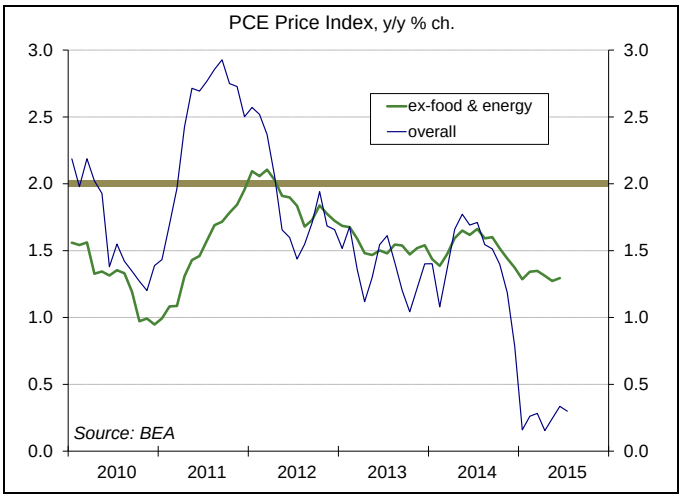
Again, the real worry about China is slower growth. The official economic figures (7% GDP growth) are suspect. While the country has grown rapidly is recent decades, it faces a tough transition to a better-balanced, demand-driven economy. In coming years, we're likely to see 4-6% growth, but it could be even lower if problems increase. The country needs more consumer spending. The collapse of housing and stock market bubbles, and a contraction in the country's shadow banking system make that a challenging goal in the near term. The ham-handed efforts to prop up the stock market and the PBOC's clumsy attempt to move to a new exchange rate regime haven't done much to instill confidence in the country's leadership.

The direct impact of China's slowdown on the U.S. economy should be small. However, one concern is that China's woes will lead to contagion to other nations. China accounts for a large percentage of exports from a number of "commodity countries."

The other major market worry is the Fed. Officials have made it clear that conditions are expected to warrant the first step in policy normalization – that is, an initial increase in short-term interest rates – by the end of this year. The stock market's fear of the Fed is not well-founded. It shouldn't really matter whether the Fed begins to raise rates in September, late October, or mid-December. The important thing is the pace of tightening beyond that first move. Officials have repeatedly indicated that conditions are expected to warrant a gradual pace of tightening.

Much of this appears to mirror the "taper tantrum" of 2013. Amid QE3, Fed officials began to talk about reducing the monthly pace of asset purchases. Markets freaked out. Bond yields rose. The Fed delayed its decision to start tapering, but when the Fed did begin to taper, long-term interest rates drifted lower, not higher. We may be seeing on over-reaction now in equities.

If not for August's financial market turmoil, the Federal Open Market Committee would very likely have begun rising short-term interest rates at the September 16-17 policy meeting. While apparently still on the table, a September move is a lot less likely now. The economy has made enough progress and is strong enough that it can easily withstand a small increase in rates.



Inflation has remained low. The core PCE Price Index, the Fed's chief inflation gauge, rose 1.2% in the 12 months ending in July, a long way from the Fed's official goal of 2%. Inflation has been pushed lower in recent months by the drop in oil prices and the stronger dollar. Oil prices aren't going to fall forever and the dollar should stabilize – and inflation should move somewhat higher – but the near-term inflation outlook should allow the Fed to take its time before beginning to raise rates.

Still, the stock market need not worry about the Fed raising rates. A hike would signal that the recovery has progressed sufficiently and the Fed is confident that growth will continue.

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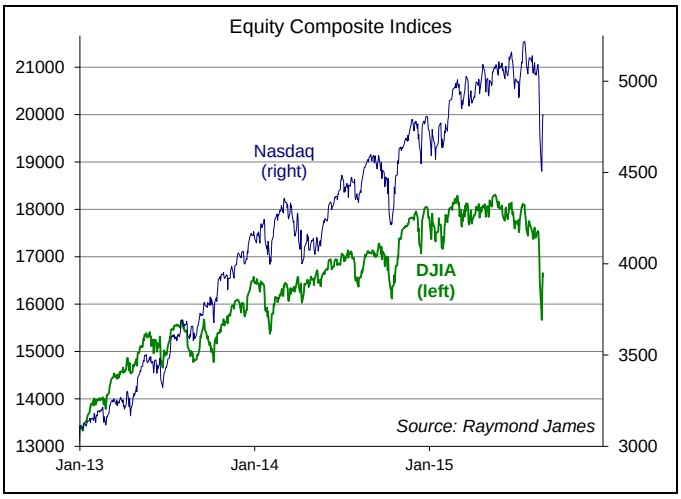
	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
7/31/15	0.08	0.14	0.33	0.67	1.00	1.54	2.20	2.92	1.103	1.563	123.94	1.305	5128.28	2103.84	17689.86
8/21/15	0.03	0.21	0.36	0.64	0.95	1.44	2.05	2.74	1.136	1.570	122.11	1.315	4706.04	1970.89	16459.75
8/28/15	0.06	0.24	0.37	0.72	1.03	1.52	2.19	2.91	1.119	1.540	121.44	1.321	4828.33	1988.79	16642.41

Recent Economic Data and Outlook

Worries about China and slower global economic growth sent stock markets lower, but the share prices regrouped following China's efforts to support its stock market and its economy. The estimate of second quarter GDP growth was revised higher than expected, but remember, that followed a soft 1Q15 (a 2.2% average for the first half of the year). Oil prices fell further on global growth concerns, but rebounded by the end of the week.



Real GDP rose at a 3.7% annual rate in the 2nd estimate for 2Q15 (vs. +2.3% in the advance estimate). Consumer spending rose at a 3.1% (vs. 2.9%), while business fixed investment rose 3.2% (vs. -0.6%). Inventories rose somewhat faster. State and local government spending rose at a 4.3% annual rate. Private final sales to domestic purchasers (GDP less inventories, foreign trade, and government) rose at a 3.3% annual rate (vs. +3.2% in the advance estimate), +3.4% y/y. Gross Domestic Income rose at a 0.6% annual rate (+2.2% y/y).

Personal Income rose 0.4% for the third consecutive month in July (+4.3% y/y). Wage and salary income rose 0.5% (+4.2% y/y). **Personal Spending** rose 0.3%, with upward revisions to figures for May and June (+3.5% y/y). Adjusting for inflation, spending rose 0.2% (+3.2% y/y). The **PCE Price Index** rose 0.1% (+0.084 before rounding), up 0.3% y/y. Ex food & energy, the index rose 0.1% (+0.072% before rounding), +1.2% y/y (further from the Fed's 2.0% inflation goal).

Durable Goods Orders rose 2.0% in July, following a 4.1% jump in June. Aircraft orders surged in June, but retreated only partially in July. Ex-transportation, orders rose 0.6%, following +1.0% in July. Orders for nondefense capital goods ex-aircraft rose 2.2%, following a 1.4% gain (revised from +0.7%) – the total for the first seven months of the year was down 3.4% relative to the same period in 2014.

The **Advance Trade Report** showed a narrowing in the goods deficit in July, largely reflecting a drop in imports of consumer goods. Exports edged higher.

New Home Sales rose 5.4% (±14.8%, not statistically different from zero), to a 507,000 seasonally adjusted annual rate (+25.8% ±22.6% y/y). Results were mixed across regions.

The **Pending Home Sales Index**, which measures signed contracts, rose 0.5% in July (-11.5% before seasonal adjustment), up 7.4% from a year ago. Results varied by region.

The Conference Board's **Consumer Confidence Index** jumped to 101.3 in the initial estimate for August (based on data collected on or before August 13), vs. 91.0 in July and 99.8 in June. The same percentage described jobs as "plentiful" as described them as "hard to get" – the first non-negative reading since January 2008. Results were mixed across regions.

The University of Michigan's **Consumer Sentiment Index** fell to 91.1 in August, down from the mid-month reading of 92.1, 93.1 in July, and 96.1 in June. The report blamed the decline on the recent stock market volatility. That's still consistent with a strong pace of consumer spending growth.

The **Chicago Fed National Activity Index** rose to +0.34 in July, vs. -0.07 in June. The three-month average, at 0.00, was consistent with growth in national economic activity at its historical trend.

Economic Outlook (3Q15): about a 2.0-2.5% annual rate, likely held back by an inventory correction and a wider trade deficit.

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

Consumers: Average wage growth has remained lackluster, but strong job growth and lower gasoline prices have been supportive for spending. Credit is still relatively tight, but should become gradually easier over time.

Manufacturing: Mixed across industries, but orders and production have been generally soft in recent months. The stronger dollar and softer global growth 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	8/31	10:00	Chicago PM Index	Aug	***52.0***	54.7	49.4	more erratic than usual in recent months
Tuesday	9/01	9:45	Markit US Manf PMI (final)	Aug	***NF***	53.8	53.6	52.9 in flash estimate
		10:00	Construction Spending	Jul	***+1.4%***	+0.1%	+1.8%	led by gains in residential
		10:00	**ISM Manf Index**	Aug	***52.4***	52.7	53.5	moderate, mixed across industries
		tba	**Motor Vehicle Sales, mln**	Aug	***17.5***	17.5	17.0	a strong trend
			domestically built		***13.8***	13.9	13.2	but the pace may be levelling out
Wednesday	9/02	8:15	**ADP Payroll Estimate, th.**	Aug	***+200***	+185	+229	moderately strong
		8:30	Productivity (revised)	2Q15	***+2.8%***	-1.1%	-2.1%	+1.3% in the preliminary estimate
			Unit Labor Costs		***-1.0%***	+2.3%	+5.7%	+0.5% in the preliminary estimate
		10:00	Factory Orders	Jul	***+0.9%***	+2.2%	-1.1%	durable goods orders reported +2.0%
		2:00	**Fed Beige Book**					no significant wage or price pressures
Thursday	9/03	7:45	ECB Policy Decision					no change, steady course on QE
		8:30	Jobless Claims, th.	8/29	***272***	271	277	a low trend
		8:30	Trade Balance, $bln	Jul	***-39.4***	-43.8	-40.9	seen dropping back in July
			goods only		***-59.1***	-63.5	-60.6	narrower in the advance estimate
		10:00	**ISM Non-Manf. Index**	Aug	***58.6***	60.3	56.0	strong in July, may pull back a bit
Friday	9/04	8:30	**Nonfarm Payrolls, th.**	Aug	***220***	215	231	moderately strong
			private-sector		***215***	210	227	watch the three-month average
			Unemployment Rate		***5.2%***	5.3%	5.3%	likely to edge lower
			employment/population		***59.4%***	59.3%	59.3%	trending only gradually higher
			Avg. Weekly Hours		***34.5***	34.6	34.5	seen little changed (revisions?)
			Avg. Hourly Earnings		***+0.2%***	+0.2%	-0.0%	still a lackluster trend
Next Week:								
Monday	9/07		Labor Day Holiday					
Tuesday	9/08	9:00	Small Business Optimism	Aug	***NF***	95.4	94.1	expecting further improvement
		1:00	Treasury Note Auction					3-year notes
Wednesday	9/09	10:00	BOC Policy Decision					leaning toward another cut in rates
		10:00	JOLTS: hiring rate	Jul	***NF***	4.0%	4.0%	very gradual improvement
			JOLTS: quit rate		***NF***	2.2%	2.2%	still below "normal"
		1:00	Treasury Note Auction					re-opened 10-year notes
Thursday	9/10	7:00	BOE Policy Decision					contemplating tightening (at some point)
		8:30	Jobless Claims, th.	9/05	***271***	***272***	271	a low trend
		8:30	Import Prices	Aug	***NF***	-0.9%	0.0%	expecting another drop
			ex-food & fuels		***NF***	-0.3%	-0.1%	disinflation pressures
		1:00	Treasury Bond Auction					re-opened 30-year bonds
Friday	9/11	8:30	**Producer Price Index**	Aug	***-0.3%***	+0.2%	+0.4%	lower oil prices
			ex-food & energy		***+0.1%***	+0.3%	+0.3%	mild
			ex-f, e, trade services		***+0.1%***	+0.2%	+0.3%	low core inflation
		10:00	UM Consumer Sentiment	m-Sep	***NF***	91.9	93.1	any stock market impact?
		2:00	Treasury Budget, $bln		***NF***	-128.7	-147.9	some spending shifted into July

This Week…

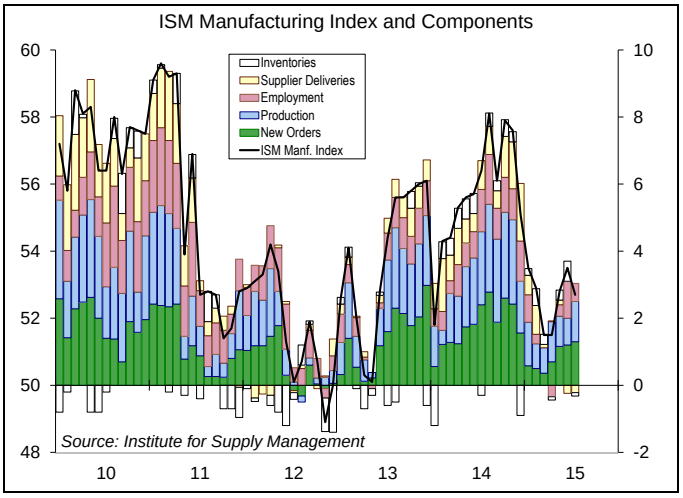
Investors' worries about China may be inclined to moderate, which would put a focus back on the U.S. economic data. The soft inflation outlook should lead Fed policymakers to delay the initial increase in short-term interest rates to beyond the mid-September FOMC meeting. Job growth is expected to have been moderately strong in the initial estimate for August.

Monday

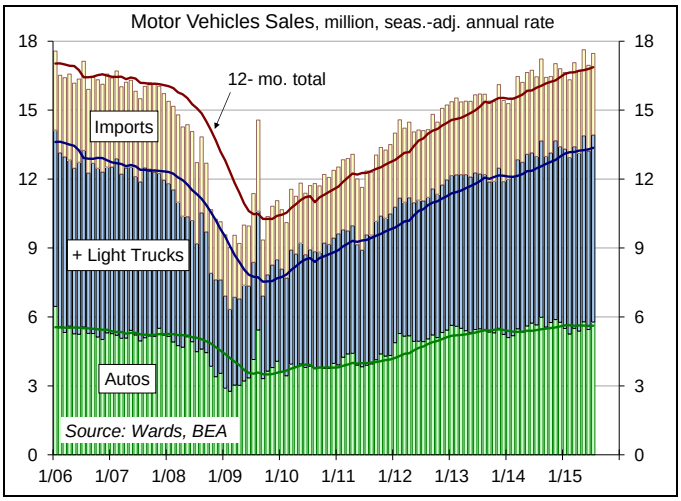
Chicago Purchasing Managers Index (August) – The ISM-Chicago data are more reflective of activity in durable goods. The headline figure has been unusually erratic in recent months.

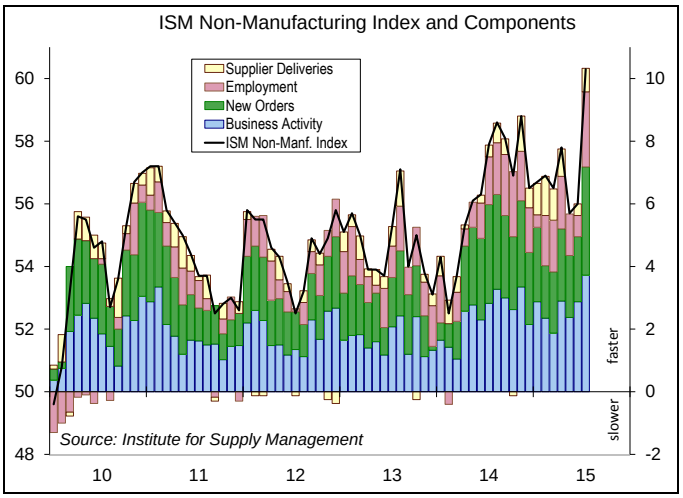
Tuesday

ISM Manufacturing Index (August) – The factory sector faces the prospect of slower global growth, but moderately strong growth at home. Results vary across industries, but we should see a general trend of improvement in the near term.



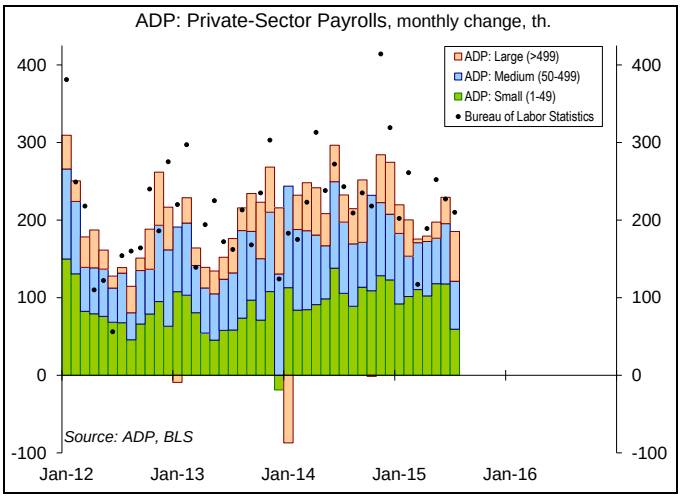
Motor Vehicle Sales (August) – Sales are expected to have remained strong, but the pace may flatten in the months ahead.





Wednesday

ADP Payroll Estimate (August) – The ADP figure isn't a good predictor of the official BLS data, but we've often seen the financial markets respond to a surprise (relative to the consensus). Much of the step-up in job growth over the last year has been concentrated among small and medium-sized firms, although that trend was interrupted in July.



Fed Beige Book – When setting monetary policy, Federal Reserve officials consider a wide range of information beyond the regular economic data reports. The Beige Book, the summary of anecdotal conditions across the 12 Fed districts, is part of that. Recent reports have continued to suggest modest-to-moderate growth with no appreciable pressure in wages or prices.

Thursday

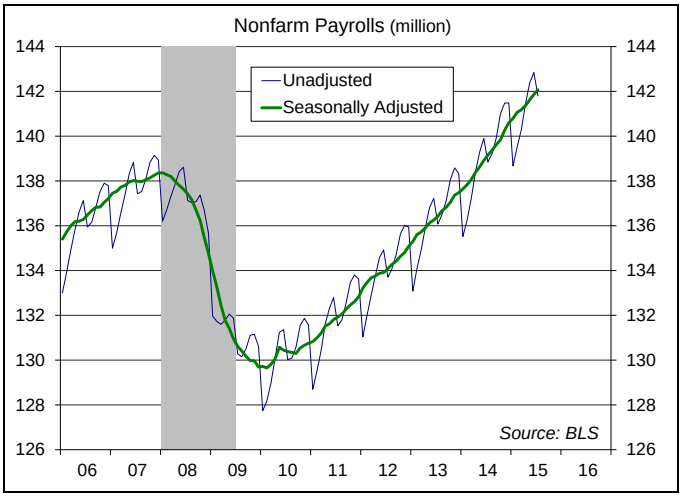
ECB Policy Meeting – The ECB's Governing Council is widely expected to leave policy unchanged. Investors will want to tune in to ECB President Draghi's post-meeting press conference, to get updates on Greece and the overall economic outlook.

Jobless Claims (week ending August 29) – Seen steady.

ISM Non-Manufacturing Index (August) – The headline figure jumped sharply in July, which means we're likely to see some pullback in August. Still, the component ought to remain consistent with moderately strong growth in the near term.

Friday

Employment Report (August) – Seasonal adjustment should be less of an issue in August, although we should see gains in education as the school year gets underway. There's a fair amount of noise in the monthly payroll figure. One should focus on the three-month average. The unemployment rate is likely to edge a bit lower, but the employment/population ratio is trending only gradually higher.



Next Week …

Monday's a holiday and there isn't much economic data.

Coming Events and Data Releases

September 15	Retail Sales (August) Industrial Production (August)
September 16	Consumer Price Index (August)
September 17	FOMC Policy Decision, Yellen press conference
October 12	Columbus Day (bond market closed)
October 28	FOMC Policy Decision (no press conference)
December 16	FOMC Policy Decision, Yellen press conference
January 27	FOMC Policy Decision (no press conference)
March 16	FOMC Policy Decision, Yellen press conference