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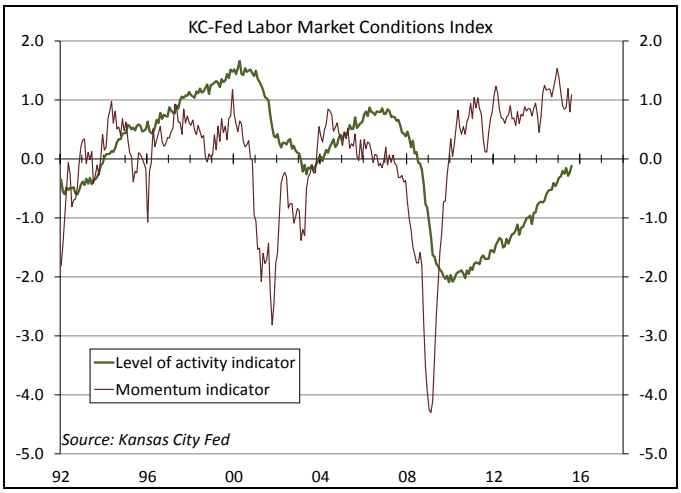
Weekly Economic Monitor

China, the Fed, and Bond Yields

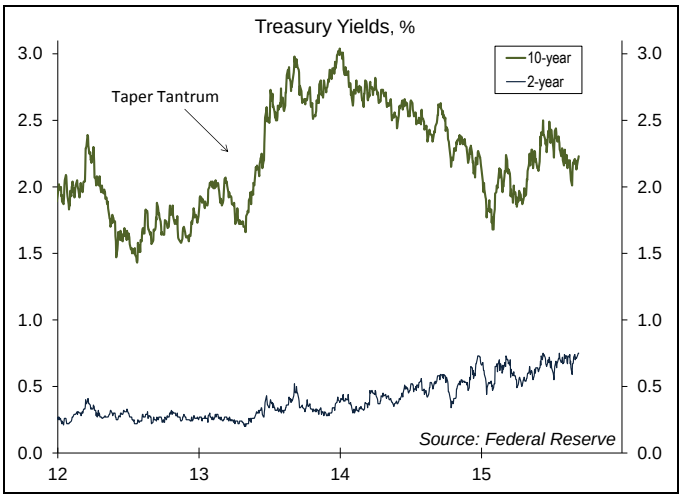
An initial increase in short-term interest rates is apparently still on the table at this week's Fed policy meeting, but it's more likely that we'll see a delay. That may not ease the stock market's concerns, as officials are expected to remain committed to raising rates at some point in the near future.

Fed arguments fall into four camps. The first believes that the economy has reached full employment and that the Fed is behind the curve. This is largely the same group of people who have been crying wolf on inflation the last few years. This time, they believe they are right. The second group sees more slack in the job market. The lackluster pace of wage growth suggests that the recovery has a lot more room to run before the Fed has to start reining it in. The third and fourth groups share a common belief – that is, that the timing of the initial move doesn't really matter much. Group 3: "so why not start raising rates now?" Group 4: "so why not delay for a little longer?"

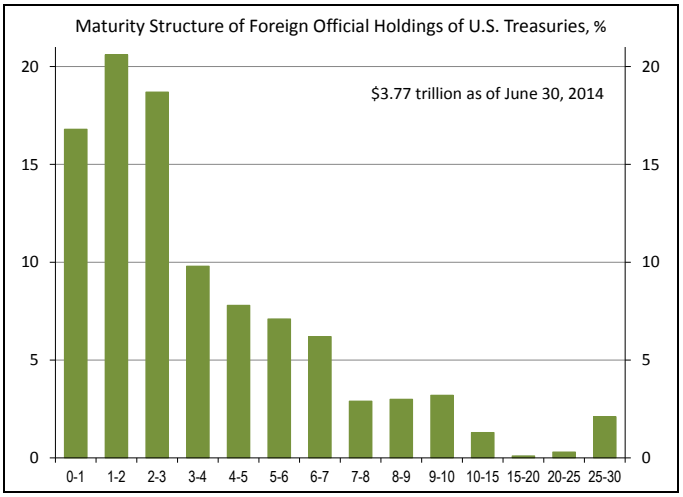


There is widespread agreement that short-term interest rates will have to be raised at some point and a consensus view that the pace of subsequent rate hikes is likely to be very gradual. The Fed has made public its normalization plans. The only question is the timing. We've seen a substantial reduction in the amount of slack in the labor market over the last couple of years. The Fed needs to set policy based on where the economy is expected to be 12 to 18 months from now, and there should be a lot less slack. The Fed doesn't have to be at neutral at that point, but it ought to be closer to neutral than it is now.

If not for the recent global financial turbulence and concerns about growth in emerging economies, the Fed would almost certainly have begun raising rates this week. The direct impact of slower growth abroad on the U.S. economy should be relatively limited, but it depends on the magnitude. Consumers and businesses should benefit from the decrease in commodity prices (as we saw in the Asian financial crisis in the late 1990s). In 2013, the financial markets experienced a "taper tantrum" when the Fed began talking about reducing the monthly pace of asset purchases in QE3 ($85 billion at the time). Bond yields rose and emerging markets experienced volatility. The Fed ended up delaying the taper, but it did eventually taper.



As Fed tightening approaches, the bond market has been relatively calm. However, emerging economies have stumbled and experienced capital outflows. Strains may pick up and capital outflows may get worse if the Fed hikes. The Fed has to set policy based on the domestic economic outlook, but does consider possible feedback from the rest of the world.



Some fear that emerging economies, China especially, will dump Treasuries, putting upward pressure on bond yields. However, foreign central bank holdings of U.S. Treasuries are concentrated at the short-end of the yield curve. Long-term rates ought to move higher as the economy strengthens, but central bank selling should not be an issue.

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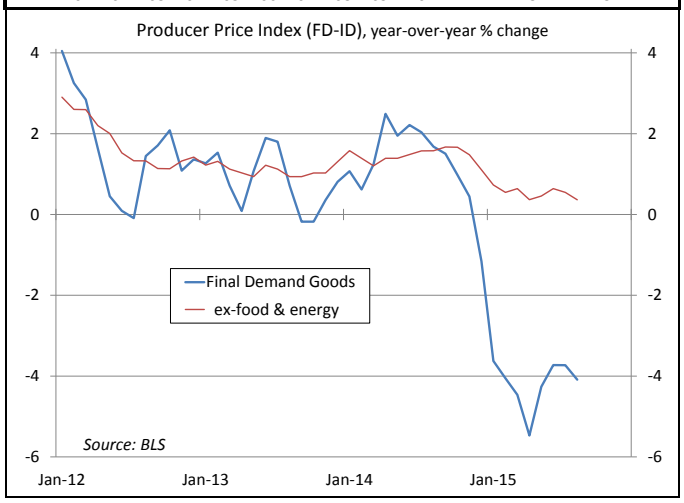
	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
8/14/15	0.09	0.25	0.41	0.73	1.08	1.61	2.20	2.84	1.111	1.563	124.27	1.308	5048.24	2091.54	17477.40
9/04/15	0.02	0.23	0.36	0.71	1.00	1.47	2.13	2.89	1.112	1.520	119.05	1.327	4683.92	1921.22	16102.38
9/11/15	0.03	0.24	0.37	0.71	1.03	1.51	2.19	2.96	1.134	1.543	120.55	1.325	4822.34	1961.05	16433.09

Recent Economic Data and Outlook

It was a quiet week for the economic data. Financial market participants remained obsessed with China and Fed policy.



The **Producer Price Index** was unchanged in August (-0.8% y/y), reflecting a 3.3% drop in energy (-19.6% y/y). Food rose 0.3% (-2.2% y/y), with eggs up 32.3% (+130.2% y/y). Wholesale gasoline prices fell 7.7% (-32.6% y/y). Ex-food & energy, the PPI rose 0.3% (+0.9%), reflecting a 0.9% rise in trade services (+1.6% y/y). Trade services measures margins, which are often distorted when prices are moving – more than half of the August increase was in margins on apparel. The new core PPI, which excludes food, energy, and trade services, edged up 0.1% (+0.7% y/y). Pipeline indicators showed deflation in goods, and mild inflation in services. The index for processed intermediate goods fell 0.6% (-4.1% y/y), -0.2% ex-food & energy (-3.6% y/y). The index for unprocessed intermediate goods fell 4.4% (-23.6% y/y), down 4.8% ex-food & energy (-16.4% y/y). The index for intermediate services rose 0.7% (+1.8% y/y).

Import Prices sank 1.8% in August (-11.4% y/y), led by a 14.2% drop in petroleum (-49.6% y/y). Ex-food & fuels, import prices fell 0.4% (-3.0% y/y). Ex-fuels, prices of industrial supplies and materials fell 1.8% (-9.5% y/y). Prices of imported capital goods slipped 0.2% (-2.3% y/y). Autos fell 0.2% (-1.6%). Price of other imported consumer goods edged down 0.1% (-1.2% y/y).

The **Job Opening and Labor Turnover Survey** showed a further increase in job openings in July to 3.9%, from 3.3% a year earlier), but relatively little change in hiring rates (3.9%, vs. 4.0%) or quit rates (2.1%, vs. 2.1%) over the last year.

The Index of **Small Business Optimism** edged up to 95.9 in August, vs. 95.4 in July and 94.1 in June. The earnings trend was a bit less weak. Respondents remained negative on the general business outlook. Sales expectations were moderate. Hiring plans improved. Capital spending plans were little changed.

Manpower, Inc.'s survey of **Hiring Intentions** showed further improvement. For 4Q15, 21% plan to add staff (vs. 19% a year ago), while 6% expect to reduce payrolls (vs. 7%).

The **Bank of Canada** maintained its target rate for the benchmark overnight lending rate at 0.5% and presented no bias to lower rates further in the month ahead. The BOC lowered rates in January and July.

The **Bank of England**'s Monetary Policy Committee voted 8-1 to keep short-term interest rates unchanged. The BOE noted that "all members agree that, given the likely persistence of the headwinds weighing on the economy, when [the] Bank Rate does begin to rise, it is expected to do so more gradually and to a lower level than in recent cycles," but it added that "this guidance is an expectation, not a promise."

Economic Outlook (3Q15): about a 2.5% annual rate, likely 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 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. Factory jobs fell in August, likely reflecting the impact of the stronger dollar and slower global growth. Domestic orders have improved.

Housing/Construction: Sales and construction activity are increasing. Mortgage credit is getting somewhat easier.

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).

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This Week:					*forecast*	last	last –1	comments
Monday	9/14		no significant data					
Tuesday	9/15	8:30	**Retail Sales**	Aug	***+0.6%***	+0.6%	0.0%	unit auto sales rose
			ex-autos		***+0.3%***	+0.4%	+0.4%	lower gasoline prices
			ex-autos, bld mat, gasoline		***+0.5%***	+0.3%	+0.2%	seen moderately strong
		8:30	Empire St. Manf. Index	Sep	***+3.5***	-14.9	+3.9	erratic, but likely moderate in August
		9:15	**Industrial Production**	Aug	***-0.3%***	+0.6%	+0.1%	likely lower
			Manufacturing Output		***-0.5%***	+0.9%	-0.3%	autos were likely overstated in July
			Capacity Utilization		***77.6%***	78.0%	77.7%	no threat to the inflation outlook
		10:00	Business Inventories	Jul	***-0.0%***	+0.6%	+0.3%	slower in 3Q15 (a drag on GDP growth)
Wednesday	9/16	8:30	**Consumer Price Index**	Aug	***+0.0%***	+0.1%	+0.3%	gasoline prices fell in August
			year-over-year		***+0.3%***	+0.2%	+0.1%	but they fell more a year ago
			ex-food & energy		***+0.1%***	+0.1%	+0.2%	mild core inflation
			year-over-year		***+1.8%***	+1.8%	+1.8%	steady
		8:30	Real Hourly Earnings	Aug	***+0.3%***	+0.1%	-0.4%	nominal hourly earnings rose 0.3%
			Real Weekly Earnings		***+0.6%***	+0.4%	-0.4%	nominal weekly earnings rose 0.6%
		10:00	Homebuilder Sentiment	Sep	***62***	61	60	may edge higher
Thursday	9/17	8:30	Jobless Claims, th.	9/12	***274***	275	281	holiday adjustment adds uncertainty
		8:30	**Building Permits, mln**	Aug	***1.170***	1.130	1.337	single-family expected to improve
			% change		***+3.5***	-15.5	-1.7	multi-family still volatile
			Housing Starts		***1.200***	1.206	1.204	seen a bit lower
			% change		***-0.5***	+0.2	+12.3	but watch for revisions
		10:00	Current Account, $bln	2Q15	***-115.0***	-113.3	-103.1	about 2.5% of GDP
		10:00	Philadelphia Fed Index	Sep	***6.5***	8.3	5.7	moderate
		2:00	**FOMC Policy Decision**		***0-0.25%***	0-0.25%	0-0.25%	no change just yet
		2:00	**Fed Summary of Econ Proj**					focus on the dot plot
		2:30	**Yellen Press Conference**					normalization still on track, seen gradual
Friday	9/18	10:00	Leading Econ Indicators	Aug	***+0.1%***	-0.2%	+0.6%	mixed components
		1:00	TIPS Auction					re-opened 10-year TIPS
Next Week:								
Monday	9/21	10:00	**Existing Home Sales, mln**	Aug	***5.54***	5.59	5.48	seen a bit lower
			% change		***-0.9***	+2.0	+3.0	but still a strong trend
Tuesday	9/22	1:00	Treasury Note Auction					2-year notes
Wednesday	9/23	9:45	Markit US Manf PMI (flash)	Sep	***NF***	53.0	53.8	moderate
		11:30	FRN Auction					re-opened 2-year floating-rate notes
		1:00	Treasury Note Auction					5-year notes
Thursday	9/24	8:30	Jobless Claims, th.	9/19	***273***	***274***	275	a low trend
		8:30	**Durable Goods Orders**	Aug	***-0.8%***	+2.2%	+4.1%	aircraft orders fell, autos distorted in July
			ex-transportation		***+0.6%***	+0.4%	+1.0%	a moderate trend following 1H15 softness
			nondef cap gds ex-aircraft		***+0.6%***	+2.1%	+1.5%	stronger in June and July
		10:00	**New Home Sales, th.**	Aug	***515***	507	481	seen somewhat higher
			% change		***+1.6***	+5.4	-7.7	but these figures are very quirky
		1:00	Treasury Note Auction					7-year notes
		5:00	**Yellen Speaks**					lecture at UMass Amherst
Friday	9/25	8:30	Real GDP (3rd estimate)	2Q15	***+3.8%***	+0.6%	+2.1%	+3.7% in the 2nd estimate
		10:00	UM Consumer Sentiment	Sep	***86.5***	91.9	93.1	85.7 at mid-month

This Week…

The economic data reports (retail sales, industrial production) are the undercard and could generate some interest from the crowd (that is, the markets), but the Fed is clearly the main event. The Fed policy statement, the revised economic projections, and Yellen's press conference will be a lot to take in in a short amount of time, but we should come away with a clearer picture of how the Fed sees things. Market expectations are not solid heading into the FOMC meeting, which means that we're likely to see some reaction no matter what.

Monday

No significant data.

Tuesday

Retail Sales (August) – Unit auto sales were up last month, although that doesn't always translate into a rise in the retail numbers. Lower gasoline prices should put some downward pressure on the headline numbers. Core sales are likely to be moderately strong, fueled by gains in aggregate income.

Industrial Production (August) – Results are likely to remain mixed across industries. The strong dollar has pressured the export sector, but that should be largely offset by increased domestic demand. Note that auto output appeared to be a bit exaggerated in July (due to seasonal adjustment issues), so we ought to see a partial correction in August.

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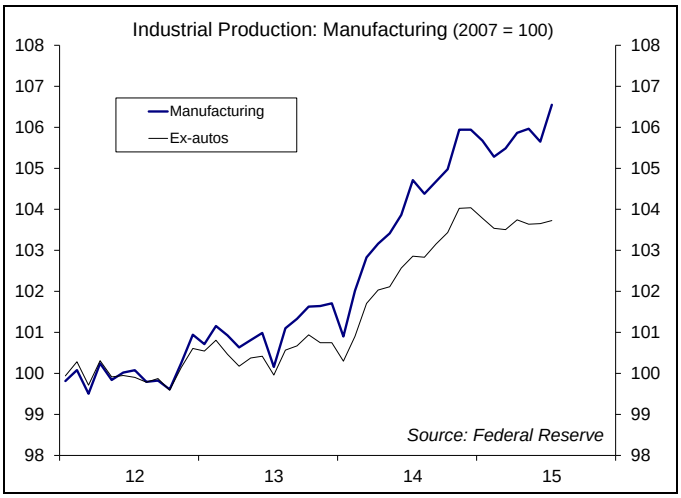
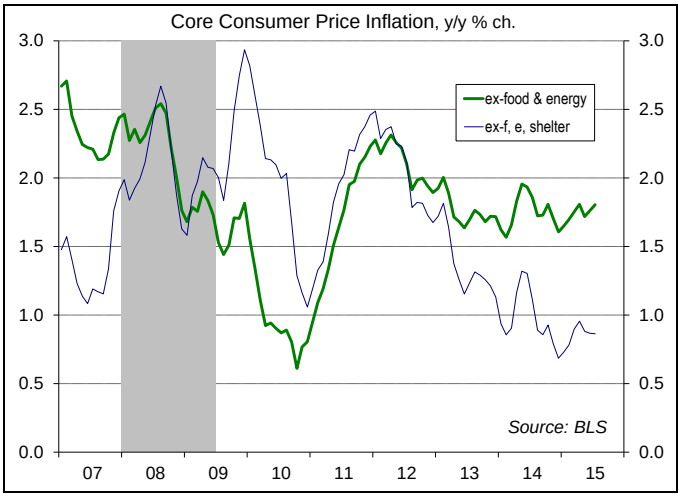


Business Inventories (July) – Inventory growth was rapid in the first half of the year, but is likely to slow in 3Q15. Remember, inventory growth contributes to the level of GDP, so the change in inventory growth contributes to GDP growth. In other words, slower inventory growth would subtract from 3Q15 GDP growth (which is a good reason to focus on Domestic Final Sales as a better measure of underlying demand).

Wednesday

Consumer Price Index (August) – Retail gasoline prices fell about 5% last month, while the seasonal adjustment anticipates a decline of 1.5%. That should leave the headline CPI figure at close to flat versus July. Core inflation should remain relatively low, but note that rising shelter costs have kept the trend from falling much over the last year



Real Hourly Earnings (August) – Nominal hourly earnings were reported to have risen 0.3%. Inflation should be about flat.

Homebuilder Sentiment (September) – Sentiment has been improving in recent months, reflecting the impact of strong job growth and relatively low mortgage rates.

Thursday

Jobless Claims (week ending September 12) – Adjustments for the Labor Day holiday can add noise, but the underlying trend here has remained remarkably low in recent weeks.

Building Permits, Housing Start (August) – Single-family permits, the key figure in the report, should pick up after an unexpected pullback in July. The financial markets typically place more emphasis on starts, which are noisy. Go figure.

FOMC Policy Decision – Fed officials may talk about raising rates, but the Federal Open Market Committee is likely to delay the initial increase in short-term interest rates. The policy statement will be quickly scanned for signals of what's ahead.

Fed Summary of Economic Projections (SEP) – Senior Fed officials (the five governors and 12 district bank presidents) will submit revised forecasts of GDP growth (4Q/4Q), the unemployment rate (4Q average), and PCE Price Inflation (4Q/4Q). These have been displayed as a "central tendency" range, with the three highest and three lowest forecasts excluded. These ranges can be fairly large, and it's unclear whether forecasts may be bunched near the top or bottom of the listed range. From now on, the Fed will also provide a median forecast. The median should then become the headline forecast, the figures that the markets will focus on. The SEP also includes the infamous "dot plot" – the projections of each Fed official of the appropriate year-end federal funds target rate. Note that not all of the dots represent voting policymakers and there is a fair amount of uncertainty around each individual dot. However, the dots should give us a general idea of where policy is headed.

Yellen Press Conference – The Fed chair will provide further color on the FOMC policy decision and the Fed's updated projections. She will also take questions from the financial press.

Friday

Leading Economic Indicators (August) – Components were mixed last month. Stock prices, jobless claims, and ISM new orders will subtract, but the yield curve will add.

Next Week …

With all of the Fed news behind us, it's smooth sailing from here. Right? Greece votes on September 20. Looking ahead, the U.S. Congress needs to come up with a Continuing Resolution to fund the government beyond September and to raise the federal debt ceiling by early December.

Coming Events and Data Releases

September 29	Consumer Confidence (September)
October 1	ISM Manufacturing Index (September)
October 2	Employment Report (September)
October 8	FOMC Minutes (September 16-17)
October 12	Columbus Day (bond market closed)
October 28	FOMC Policy Decision (no press conference)
October 29	Real GDP (3Q15, advance estimate)
December 16	FOMC Policy Decision, Yellen press conference
January 27	FOMC Policy Decision (no press conference)
March 16	FOMC Policy Decision, Yellen press conference

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