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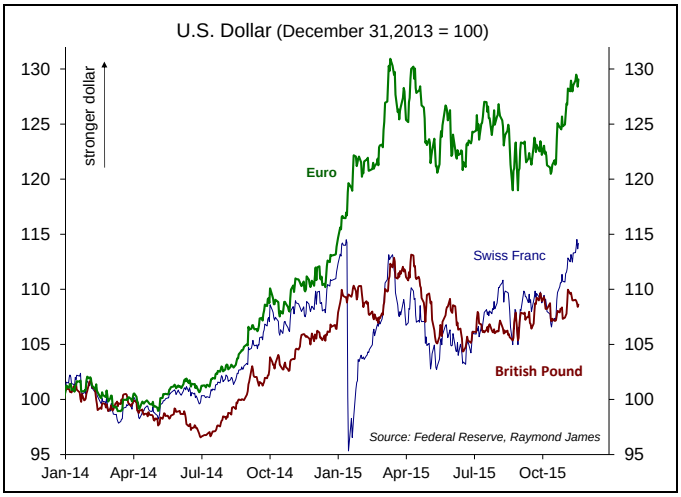
Weekly Economic Monitor

Forecasting Exchange Rates

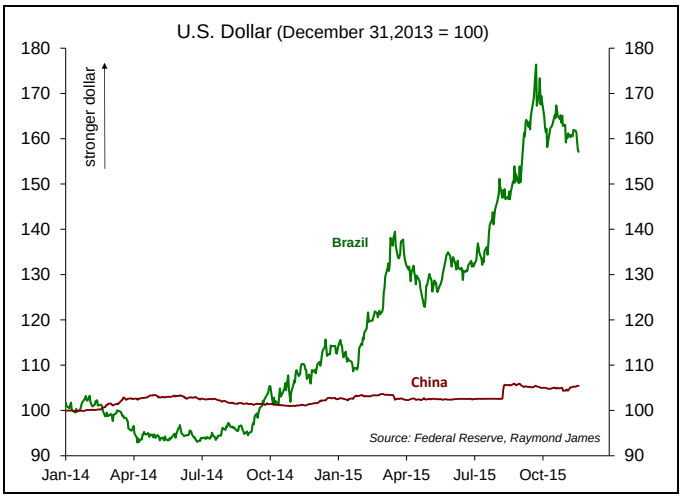
Currency forecasting is inherently difficult. Getting monetary policy right can help in the short-term, but beyond three months, you can't do any better than a random walk. That aside, the strong dollar (along with softer global economic growth) has played a major role in the slowdown in U.S. corporate profits this year. What can we expect for 2016?

First, some basics… The exchange rate of the dollar can be thought of as a price, dependent on supply and demand. There are trade flows and capital flows in and out of each country. Exchange rates will adjust to balance them (on net). One often hears complaints about the U.S. having to "borrow money" from the rest of the world. That is a function of the trade deficit, not the government's budget deficit. Net capital inflows merely balance the net trade outflows in goods and services. Capital flows can react quickly to exchange rate movements, while trade flows respond more slowly. Simply put, global capital can move rapidly, but import and export activity doesn't turn on a dime. This can lead to some "over-shooting" in exchange rates.

In most advanced economies, the exchange rate of the currency falls under the jurisdiction of the finance ministry (the Treasury Department in the U.S., the Eurogroup in Europe), not the central bank. However, finance ministries (in the advanced economies) have little ability to influence currencies beyond short-term interventions and jaw-boning. Central bankers can have a major influence on exchange rates in the short term, but that is not the goal of monetary policy. Rather, the central bank has to consider the impact of exchange rate movements on domestic growth and inflation. In general, policymakers are not much concerned about the level of the exchange rate. Rather, the speed of adjustment is what's important. Rapid movements in currency markets can be destabilizing.



Over the last four quarters, U.S. merchandise exports fell 6.6%, but that decline largely reflects a drop in export prices. Merchandise exports fell 1.0% in inflation-adjusted terms – not a large decline. Merchandise imports fell 4.0% (3Q15-over-3Q14), but rose 5.4% adjusting for the drop in import prices. For services, exports rose 2.2% y/y, while imports rose 2.5%. Hence, the impact on GDP growth has been relatively limited (-0.7 percentage points from GDP growth over the last year). There may be some lag involved, so we may not want to write off concerns just yet. Moreover, the stronger dollar and softer global growth has had an impact on corporate profits.



On November 13, IMF Managing Director Christine Lagarde said she supported the staff's recommendation that the Chinese renminbi be included in the basket of currencies which make up the IMF's Special Drawing Rights (SDR). The IMF's Executive Board will take up the issue on November 30 and, if approved, the Chinese currency would be added on October 1, 2016. The Chinese currency is still highly manipulated, but for the IMF the criteria are that it be "freely usable" and "widely used." Some financial "newsletters" have suggested that this is a step in replacing the dollar as the premier reserve currency. However, these "newsletters" are simply selling gold (and this is only the latest excuse, among many, that they have put forth in the last several years). Still, there is a lot of downward pressure on the Chinese currency. Preventing it from falling comes with a cost.

The dollar's strength against the major currencies reflects relative monetary policy stances, but much of that is likely already baked in. The dollar's strength against the world's other currencies reflects concerns about growth in emerging economies. Growth in these economies should eventually pick up, but the pace may be more moderate than we've seen in the last decade or two. In any case, Federal Reserve policy is going to be based on what's happening with the domestic economy.

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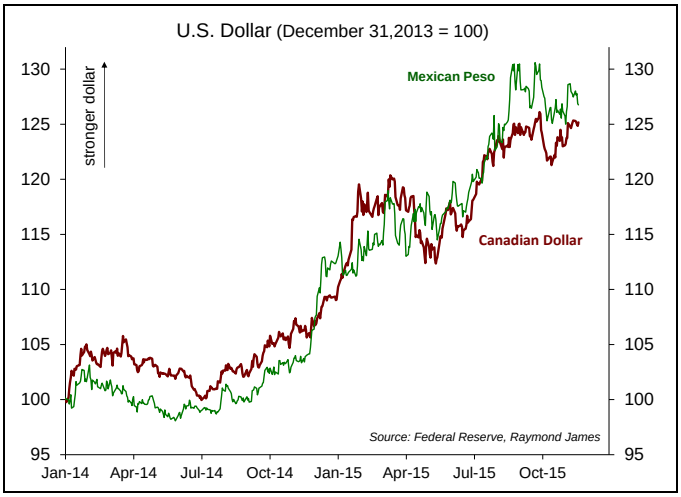
	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
10/23/15	0.01	0.13	0.24	0.66	0.94	1.43	2.09	2.90	1.102	1.534	121.20	1.317	5031.86	2075.15	17646.70
11/13/15	0.14	0.31	0.50	0.86	1.20	1.67	2.28	3.06	1.072	1.521	122.93	1.333	4984.62	2023.04	17483.01
11/20/15	0.10	0.31	0.48	0.92	1.24	1.69	2.26	3.02	1.064	1.519	122.89	1.334	5104.92	2089.17	17823.88

Recent Economic Data and Outlook

While the terrorist attacks in Paris were horrific, they are not expected to have more than a short-term impact on the European economy. FOMC minutes suggested that the central bank is on track to begin raising rates in December, although recent comments suggest that a decision has not yet been made. Economic data reports were mixed, but generally consistent with moderate growth in the near term.



The **FOMC Minutes** from the October 27-28 policy meeting showed that *"while no decision had been made, it may well become appropriate to initial the normalization process"* at the December 15-16 policy meeting. *"Some"* Fed officials felt that the conditions for raising rates had already been met in October, while *"most"* believed that *"these conditions could well be met by the time of the next meeting."* The one thing that Fed officials could agree on was that the pace of tightening after the first move would likely be *"gradual."*

The House approved (241-185) a Fed reform bill that would seriously weaken the central bank's ability to respond to economic downturns. Fortunately, cooler heads prevail in the Senate and the White House stands ready with a potential veto.

IMF Managing Director **Christine Lagarde** said she supported the staff's recommendation that the Chinese renminbi be included in the basket of currencies making up the IMF's Special Drawing Rights (SDR). The IMF's Executive Board will take up the issue when it meets on November 30 and, if approved, the Chinese currency would be added on October 1, 2016.

The **Consumer Price Index** rose 0.2% in October (+0.2% y/y). Food rose 0.1% (+1.6% y/y), while energy rose 0.3% (-17.1% y/y). Gasoline rose 0.4% (-3.9% before seasonal adjustment, and -27.8% y/y). Ex-food & energy the CPI rose 0.2% (+1.9% y/y). Shelter costs rose 0.3% (+3.2% y/y), with rent up 0.3% (+3.7% y/y). Ex-food, energy, and shelter, the CPI rose 0.2% (+1.0% y/y). Consumer goods ex-f&e fell 0.1% (-0.7% y/y).

Real Average Hourly Earnings rose 0.2% in October (+2.4% y/y).

Industrial Production fell 0.2% in October (+0.3% y/y), reflecting warm temperatures (the output of utilities fell 2.5%, down 1.5% from a year earlier) and further contraction in energy exploration (drilling oil and gas wells down 5.0%, -57.6% y/y). Manufacturing output rose 0.4% (+1.9% y/y), with autos up 0.7% (+10.9% y/y), and non-autos up 0.4% (+1.2% y/y).

Building Permits rose 4.1% (±1.5%) in October to a 1.150 million seasonally adjusted annual rate (+2.7% y/y). Single-family permits rose 2.4% (+9.0% y/y). **Housing Starts** fell 11.0% (±13.5%) to a 1.060 million pace (-1.8% y/y), with single-family starts down 2.4% (+2.4% y/y).

Homebuilder Sentiment fell back to 62 in November, from 65 in October (revised from 64), reflecting softening in both current and future sales perceptions. The traffic of potential buyers edged up slightly. Results were mixed across regions.

The Index of **Leading Economic Indicators** rose 0.6% in October, following 0.0% in July, -0.1% in August, and -0.1% in September.

The New York Fed's **Empire Manufacturing Index** edged up to -10.7 in November, vs. -11.4 in October and -14.7 in September. The Philly Fed's **Business Outlook Index** rose to 1.9 in November, from -4.5 in October and -6.0 in September.

Economic Outlook (4Q15): about a 2.0% to 2.5% annual rate.

Employment: The pace of job growth has moderated, but the trend remains relatively strong by historical standards.

Consumers: Job growth has been supportive. Wage growth is still lackluster, but may be picking up. The drop in gasoline prices has boosted consumer purchasing power, but the impact has varied across the income scale.

Manufacturing: Strength in autos, but flat otherwise -- partly reflecting the impact of the stronger dollar and slower global growth. Domestic orders have improved relative to 2Q15.

Housing/Construction: Home sales and construction activity are increasing, although builders continue to note supply constraints. Mortgage credit is getting somewhat easier.

Prices: Overall consumer price inflation has been very low, but should pick up after 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 (expected to be very gradual).

This Week:					*forecast*	last	last –1	comments
Monday	11/23	10:00	**Existing Home Sales, mln**	Oct	***5.50***	5.55	5.30	still strong
			% change		***-0.9***	+4.7	-5.0	some supply constraints
		1:00	Treasury Note Auction					$26 billion in 2-year notes
Tuesday	11/24	8:30	**Real GDP (2nd estimate)**	3Q15	***+2.0%***	+3.9%	+0.6%	+1.5% in the advance estimate
		8:30	Trade Balance in Goods, $b	Oct	***-63.2***	-58.6	-67.2	seen wider
		10:00	**Consumer Confidence**	Oct	***99.2***	97.6	102.6	likely to rebound somewhat
		1:00	Treasury FRN Auction					$13 billion in re-opened FRNs
		1:00	Treasury Note Auction					$35 billion in 5-year notes
Wednesday	11/25	8:30	Jobless Claims, th.	11/21	***272***	271	276	a low trend
		8:30	Personal Income	Oct	***+0.5%***	+0.1%	+0.4%	a rebound in aggregate wage income
			Personal Spending		***+0.3%***	+0.1%	+0.4%	a softer trend into 4Q15
			PCE Price Index ex-f&e		***+0.1%***	+0.1%	+0.1%	still a low trend
		8:30	**Durable Goods Orders**	Oct	***+1.1%***	-1.2%	-2.9%	expecting a rebound in aircraft orders
			ex-transportation		***+0.4%***	-0.3%	-0.9%	mixed, but moderate, otherwise
			nondef cap gds ex-aircraft		***+0.3%***	-0.1%	-1.4%	a soft trend into 4Q15
		10:00	**New Home Sales, mln**	Oct	***505***	468	529	likely to rebound (choppy data)
			% change		***+7.9***	-11.5	+5.2	watch for possible revisions
		10:00	Consumer Sentiment	Oct	***93.0***	90.0	87.2	93.1 at mid-month
		11:30	Treasury Note Auction					$29 billion in 7-year notes
Thursday	11/26		Thanksgiving Holiday					markets closed
Friday	11/27		no significant data					market close early
Next Week:								
Monday	11/30	9:45	Chicago PM Index	Nov	***54.0***	56.2	48.7	unusually choppy this year
		10:00	Pending Home Sales Index	Oct	***+2.0***	-2.3	-1.4	likely to rebound
Tuesday	12/01	10:00	**ISM Manf. Index**	Nov	***50.7***	50.1	50.2	still mixed
		tba	Motor Vehicle Sales, mln	Nov	***18.0***	18.1	18.1	still a brisk pace
			domestically built		***14.2***	14.1	14.4	some shift in the mix
Wednesday	12/02	8:15	**ADP Payroll Estimate, th.**	Nov	***+185***	+189	+190	a moderately strong trend
		10:00	BOC Policy Decision					no change
		2:00	**Fed Beige Book**					still "mixed" to "moderate"
Thursday	12/03	7:45	ECB Policy Decision					expecting more QE
		8:30	Jobless Claims, th.	11/28	***272***	***273***	276	a low trend
		10:00	**Yellen JEC Tesimony**					on the economic outlook
		10:00	Factory Orders	Oct	***NF***	-1.0	-2.1	likely to have improved
		10:00	**ISM Non-Manf. Index**	Nov	***58.2***	59.1	56.9	moderately strong
Friday	12/04	8:30	**Nonfarm Payrolls, th.**	Nov	***+185***	+271	+137	moderately strong
			private-sector		***+180***	+268	+149	but watch for revisions
			Unemployment Rate		***5.0***	5.0	5.1	seen steady
			employment/population		***59.3***	59.3	59.2	little changed over the last year
			Avg. Weekly Hours		***34.5***	34.5	34.5	seen steady
			Avg. Hourly Earnings		***+0.2***	+0.4	+0.0	a moderate trend (watch for revisions)
		8:30	Trade Balance, $bln	Oct	***-44.5***	-40.8	-48.0	seen wider, but somewhat choppy
			goods only		***-64.0***	-60.3	-67.6	not a huge drag on GDP growth

This Week…

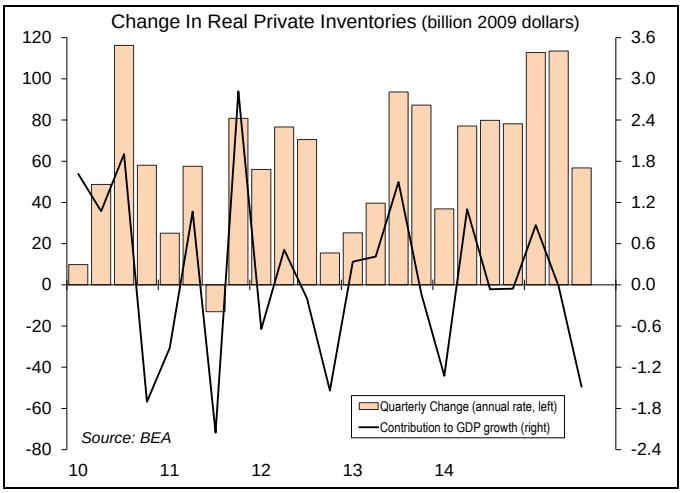
There are several economic data releases ahead of the Thanksgiving holiday, but none of the reports are expected to much alter the overall picture. Happy Thanksgiving!

Monday

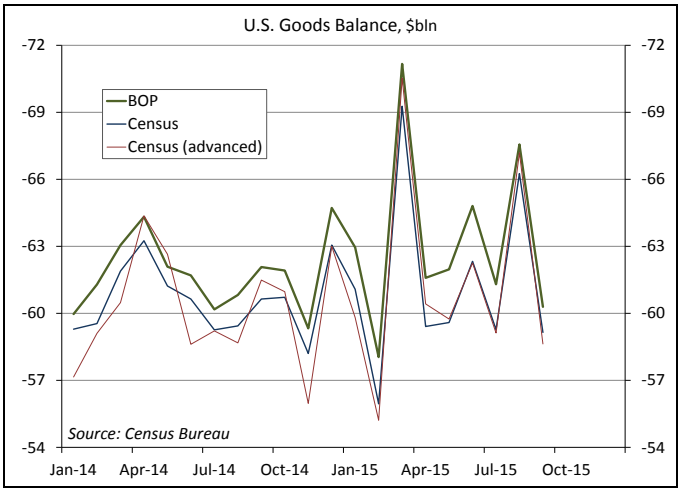
Existing Home Sales (October) – Choppy in recent months, sales are expected to have remained relatively strong in October.

Tuesday

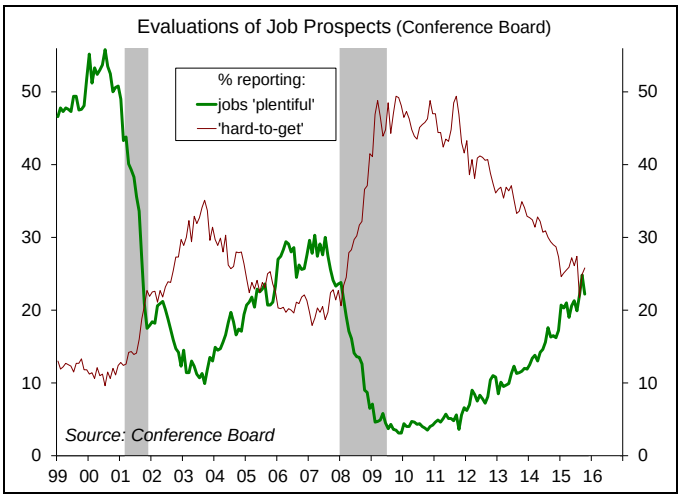
Real GDP (3Q15, 2nd estimate) – A slower pace of inventory growth subtracted 1.4 percentage points from GDP growth in the advance estimate of third quarter growth. However, September data showed that inventory growth did not slow as much as originally assumed. Other components exhibited either minor revisions or were close to what was expected.



Trade Balance (October) – The Census Bureau started the Advance International Trade in Goods report a few months ago (it's released about a week or so before the full monthly trade report). Monthly trade data can be choppy and port disruptions added noise earlier this year. Exports are down relative to a year ago, reflecting the impact of a strong dollar and slower global growth. However, imports are also down (the drop in import prices was larger than the increase in quantity), leaving the nominal trade deficit about where it was a year ago.



Consumer Confidence (November) – Labor market perceptions play a more direct role in the Conference Board's measure. Those perceptions have improved, but remain relatively soft by historical standards. Some pickup is anticipated for November.

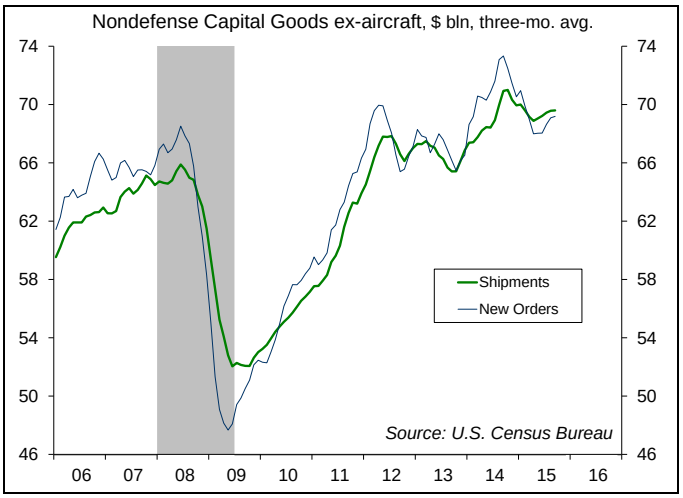


Wednesday

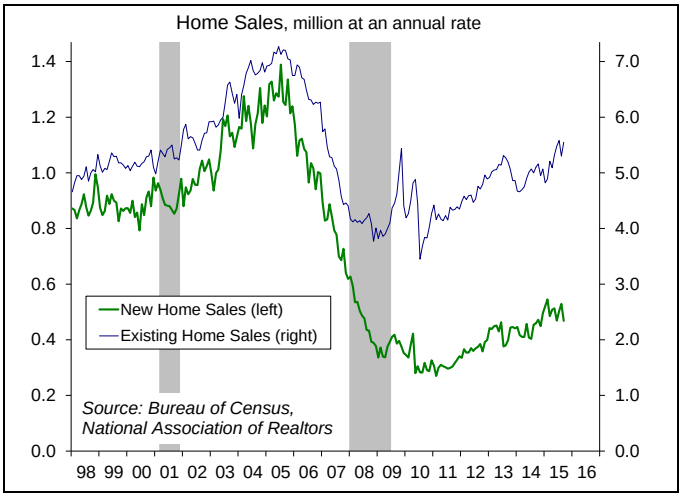
Jobless Claims (week ending November 21) – Still subject to seasonal noise, but the underlying trend has remained low.

Personal Income and Spending (October) – Income growth should pick up, reflecting a rebound in aggregate wages. Spending growth was likely mixed, but relatively lackluster overall.

Durable Goods Orders (October) – Boeing reported an increase in aircraft orders, but these don't always show through to the government figures. Ex-transportation, orders are likely to have remained mixed across industries. Orders for nondefense capital goods ex-aircraft are likely to remain at a soft trend.



New Home Sales (October) – These data are choppy, but we should see a general trend of improvement .



Thursday

Thanksgiving Holiday – Markets closed.

Friday

No significant economic data. Markets close early

Next Week …

The economic calendar has plenty of fresh figures. The ISM surveys and Friday's Employment Report would normally be the highlights, but financial market participants will be more interested in what happens on Thursday – the European Central Bank's Governing Council is expected to expand its asset purchase program, while Fed Chair Janet Yellen with testify before the Joint Economic Committee of Congress.

Coming Events and Data Releases

December 11	Retail Sales (November)
December 16	FOMC Policy Decision, Yellen press conference
January 8	Employment Report (December)
January 27	FOMC Policy Decision (no press conference)
March 16	FOMC Policy Decision, Yellen press conference