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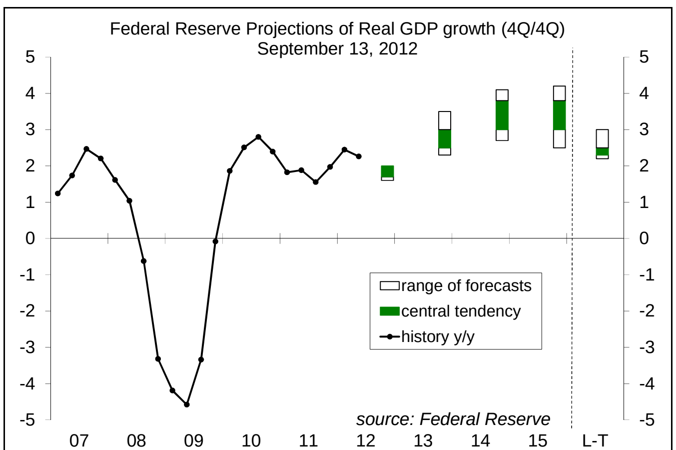
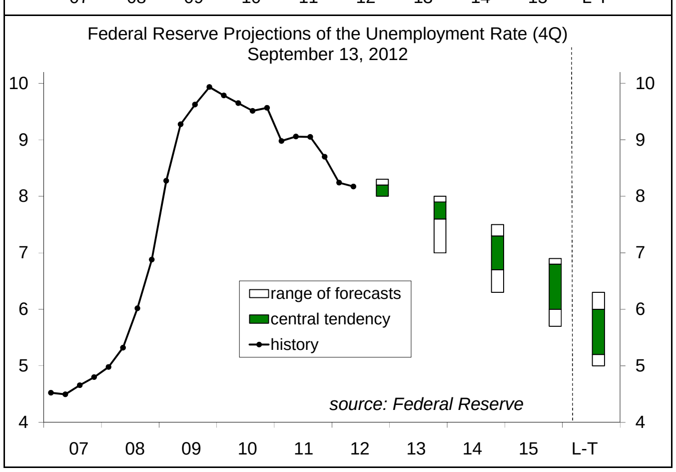
Weekly Market Monitor

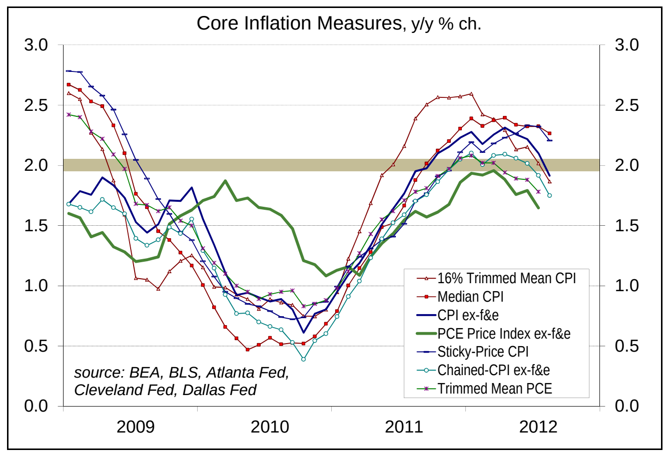
The Fed to the Rescue?

Citing concerns about the pace of improvement in the labor market, the Federal Open Market Committee extended and amplified its forward guidance and started a third round of large-scale asset purchases (what most people call "QE3"). The FOMC said that economic conditions are expected to warrant exceptionally low levels of the federal funds rate target through mid-2015 (vs. "late 2014" in the previous policy statement) and added that *"a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens."* The Fed's latest bond-buying program will be in mortgage-backed securities and, unlike the first two asset purchase programs, is open-ended ($40 billion per month, with no specified end date). In his press briefing after the FOMC meeting, Chairman Bernanke emphasized that the Fed wanted to see *"substantial"* improvement in the labor market, but declined to assign specific numbers to that. Bernanke also said that the Fed cannot do everything (including offsetting the negative impact of the fiscal cliff, should that occur), but it obliged to do what it can to support economic growth in the context of price stability.





In his press briefing, Bernanke began by noting that the labor market outlook was *"still a grave concern."* Economic growth has been moderate, he said, *"but not fast enough to make significant progress in reducing the unemployment rate."* The Fed is not out of ammo. Bernanke said that *"if we do not see substantial improvement in the outlook for the labor market, we will continue the MBS purchases, undertake additional asset purchases, and employ our policy tools as appropriate until we do."* He did not provide specific guidelines, but said *"we will be looking for the sort of broad-based growth in jobs and economic activity that generally signal sustained improvement in labor market conditions and declining unemployment."* The conditional policy outlook is meant to reinforce consumer and business expectations of future policy, but the lack of specificity is likely to be a negative for the markets in the near term.



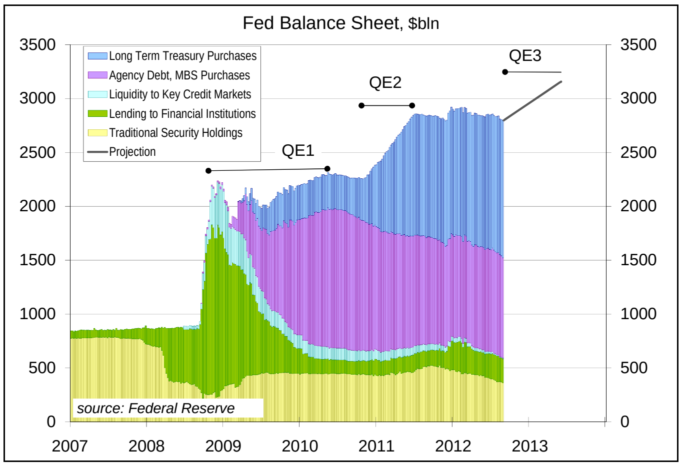
A number of economists have called for the Fed to push inflation above the 2% target to spur the recovery. Does QE3 and the amped-up forward guidance language indicate that the Fed will trade off higher inflation for lower unemployment? Not at all. The Fed remains committed to its 2% target for the PCE Price Index. Still, many market participants believe that the Fed is continuing to sow the seeds of substantially higher inflation down the line. Despite some pressure from higher food and energy prices in the short-term, inflation expectations remain well-anchored. In addition, measures of core consumer price inflation have been trending lower. Excluding fuels, import prices are trending down. Outside of food and energy, pipeline inflation pressures have generally moderated. Given huge slack in the job market, labor costs remain muted.

Critics have charged that we've had QE1, QE2, and Operation Twist, yet the economic recovery has remained disappointing. Bernanke countered that we still face a number of headwinds. The Fed cannot do everything. Fiscal policy, rather than helping, is set to remain a significant headwind for the economy. However, the Fed has to do what it can to support growth.

	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
8/17/12	0.09	0.14	0.18	0.29	0.42	0.80	1.81	2.93	1.232	1.570	79.50	0.988	3076.59	1418.16	13275.20
9/07/12	0.11	0.12	0.16	0.26	0.33	0.64	1.67	2.82	1.280	1.602	78.14	0.978	3136.42	1437.92	13306.64
9/14/12	0.10	0.11	0.16	0.25	0.36	0.72	1.87	3.09	1.312	1.623	78.37	0.971	3183.95	1465.76	13593.37

Recent Economic Data and Outlook

As expected, Fed policymakers extended and amplified their forward guidance and launched a third round of asset purchases. Stocks rallied, but Treasury market participants were upset that the program didn't include Treasuries and might lift inflation.



Citing concerns that "economic growth might not be strong enough to generate sustained improvement in the labor market," the **Federal Open Market Committee** extended its forward guidance, promising to maintain a highly accommodative stance of monetary policy "for a considerable time after the economic recovery strengthens," and embarked on a third round of asset purchases ("QE3"). The FOMC said economic conditions are expected to warrant exceptionally low levels of the federal funds rate through mid-2015 (vs. "late 2014" previously). Asset purchases will be in mortgage-backed securities and are open-ended ($40 billion per month).

In his press briefing, **Fed Chairman Bernanke** said that if the FOMC does not see "substantial improvement" in the labor market, it will "continue the MBS purchase program, undertake additional asset purchases, and employ our policy tools as appropriate until we do." Bernanke said that the Fed can't do everything, but is obliged to provide support where it can.

Retail Sales rose 0.9% in August (+4.7% y/y), boosted by increases in autos (+1.3%, up 10.7% y/y) and gasoline (+5.5%, up 2.5% y/y). Ex-autos, building materials, and gasoline, retail sales slipped 0.1%, after rising 0.8% in July.

Business Inventories rose 0.8% in July, up 5.4% y/y – a much faster pace in early 3Q12, but it's only one month.

Industrial Production fell 1.2% in August, held down partly by the impact of Hurricane Isaac (which led to a shutdown of oil and gas rigs, subtracting 0.3% from the total). Manufacturing output fell 0.7%. Auto production dropped 4.7%. Ex-autos, factory output slipped 0.4% (+2.7% y/y). Capacity utilization dropped a full percentage point, to 78.2% – 2.1 percentage points below the long-term average.

The **Consumer Price Index** rose 0.6% in August (+1.7% y/y), boosted by a 9.0% increase in gasoline (up 7.2% before seasonal adjustment and +1.8% y/y). Food rose 0.2% (+2.0% y/y), with no evidence of a significant drought effect (so far). Ex-food & energy, the CPI rose 0.1% (+0.132% before rounding, up 1.9% y/y). Ex-f&e, consumer goods fell 0.2% (+0.7% y/y).

Real Earnings fell 0.6% in August, up just 0.3% y/y.

The **Producer Price Index** jumped 1.7% in august (+2.0% y/y), reflecting higher prices of food (+0.9%) and energy (+6.4%). Ex-food & energy, the PPI rose 0.2% (+2.5% y/y). Drought effects were more apparent at the earlier stages in food production.

Import Prices rose 0.7% in August (-2.2% y/y), reflecting a 4.1% jump in petroleum (-6.4% y/y). Ex-fuels, import prices fell 0.2%, the third consecutive decline (-0.3% y/y).

The **U.S. Trade Deficit** was little changed at $42.0 billion in July, vs. $41.9 billion in June. Merchandise exports fell 1.5% (+3/3^ y/y), while imports fell 1.1% (oil down 6.5%, flat otherwise).

The Manpower, Inc. survey of **Net Hiring Intentions** held steady at 11% for 4Q12, vs. 8% a year ago.

The **Small Business Optimism Index** rose to 92.9 in August, vs. 91.2 in July, still relatively low by historical standards. Hiring plans improved to their highest level in four and a half years.

The **German Constitutional Court** ruled in favor of the European Stability Mechanism and the Fiscal Pact.

Economic Outlook (3Q12): +1.5% to +2.5% GDP growth.

Employment: Nonfarm payrolls have been a bit uneven in recent months, but the underlying trend appears to be disappointing. Job destruction remains relatively limited. New hiring may be restrained by a variety of uncertainties.

Consumers: A drop in gasoline prices (which peaked in early April) boosted consumer purchasing power into July). However, prices have risen in recent weeks, which is likely to restrain the pace of consumer spending growth in the near term.

Manufacturing: Sentiment figures have suggested mixed conditions across industries and regions, but generally weaker activity overall. New orders and production trends have been lackluster to moderate. Softer global growth won't help.

Housing/Construction: Home sales and residential construction activity are up significantly from a year ago. However, a full recovery in housing is still years away.

Prices: Gasoline prices have turned back up and the drought will further pressure food prices in the near term. Core inflation remains moderate. Inflation expectations are well anchored. There is no inflation pressure coming through the job market.

Interest Rates: Federal Reserve officials decided to extend the forward guidance (to mid-2015). Concerns about the job market led the Fed to initiate a further round of asset purchases ($40bln/mo in MBS, open-ended). Long-term interest rates are expected to remain low for a long time.

This Week:					forecast	last	last –1	comments
Monday	9/17	8:30	Empire St. Manf. Index	Sep	*-4.0*	-5.9	+7.4	still weak
Tuesday	9/18	8:30	Current Account, $bln	2Q12	*-125.6*	-137.3	-118.7	narrower
			% of GDP		*-3.2*	-3.5	-3.1	moderate
		10:00	Homebuilder Sentiment	Sep	*38*	37	35	trending higher
Wednesday	9/19	8:30	**Building Permits, th.**	Aug	*810*	811	760	an improving trend
			% change		*-0.1*	+6.7	-3.1	some volatility in multi-family
			Housing Starts		*770*	746	754	should trend higher
			% change		*+3.2*	-1.1	+6.8	a fair amount of noise month to month
		10:00	Existing Home Sales, mln	Aug	*4.52*	4.47	4.37	trending higher
			% change		*+1.1*	+2.3	-5.4	but may be limited by supply
Thursday	9/20	8:30	Jobless Claims	9/15	*370*	382	367	trend is likely to remain moderately low
		8:58	Markit US Manf Index (flash)	Sep	*NF*	51.5	51.4	lackluster growth, but still positive
		10:00	Philadelphia Fed Index	Sep	*-5.8*	-7.1	-12.9	still weak
		10:00	Leading Economic Indicators	Aug	*-0.1%*	+0.4%	-0.4%	components mixed, but mostly lower
		1:00	TIPS Auction					re-opened 10-year TIPS
Friday	9/21		no significant data					first day of autumn
Next Week:								
Monday	9/24		no significant data					
Tuesday	9/25	9:00	S&P/C-S Home Price Index	Jul	*NF*	+0.9%	+1.0%	trending higher in recent months
			year-over-year		*NF*	+0.5%	-0.5%	moving up
		10:00	**Consumer Confidence**	Sep	*63.0*	60.6	65.4	still relatively low
		1:00	Treasury Note Auction					2-year notes
Wednesday	9/26	10:00	**New Home Sales, th.**	Aug	*385*	372	359	some improvement is seen
			% change		*+3.5*	+3.6	-3.5	but watch for revisions
		1:00	Treasury Note Auction					5-year notes
Thursday	9/27	8:30	Jobless Claims	9/22	*370*	*370*	365	trend is likely to remain moderately low
		8:30	Real GDP (3rd estimate)	2Q12	*+1.7%*	+2.0%	+4.1%	+1.7% in the 2nd estimate
		8:30	**Durable Goods Orders**	Aug	*-5.5%*	+4.1%	+1.6%	Boeing orders: 260 in July, 1 in August
			ex-transportation		*-0.6%*	-0.6%	-2.2%	mixed, but mostly weaker
			nondef cap gds ex-aircraft		*-0.5%*	-4.0%	-2.7%	not a good trend
		10:00	Pending Home Sales Index	Aug	*+1.0%*	+2.4%	-1.4%	likely to trend gradually higher
		1:00	Treasury Note Auction					7-year notes
Friday	9/28	8:30	Personal Income	Aug	*+0.2%*	+0.3%	+0.3%	aggregate weekly payrolls were flat
			Personal Spending		*+0.3%*	+0.4%	0.0%	spending slowing
			PCE Price Index ex-f&e		*+0.1%*	+0.0%	+0.2%	below target, the core CPI rose 0.132%
		9:45	Chicago PM Index	Sep	*52.8*	53.0	53.7	little change expected
		9:55	Consumer Sentiment	Sep	*78.8*	74.3	72.3	79.2 at mid-month

This Week…

The economic calendar thins out considerably (relative to the important events of the last few weeks), with a focus on housing. Any surprises in the data could generate some market reactions, but aren't going to change the underlying picture.

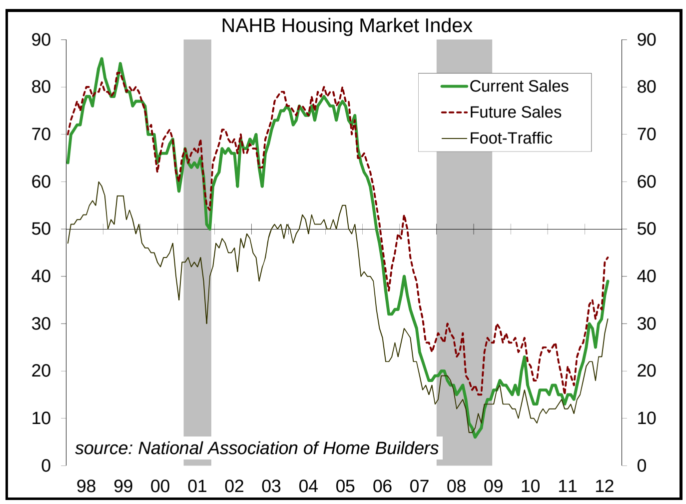
Monday

Empire State Manufacturing Index (September) – The New York Fed's factory sector survey took a turn for the worse in August, falling into negative territory. These figures tend to be volatile, but the details are likely to remain relatively weak in September.

Tuesday

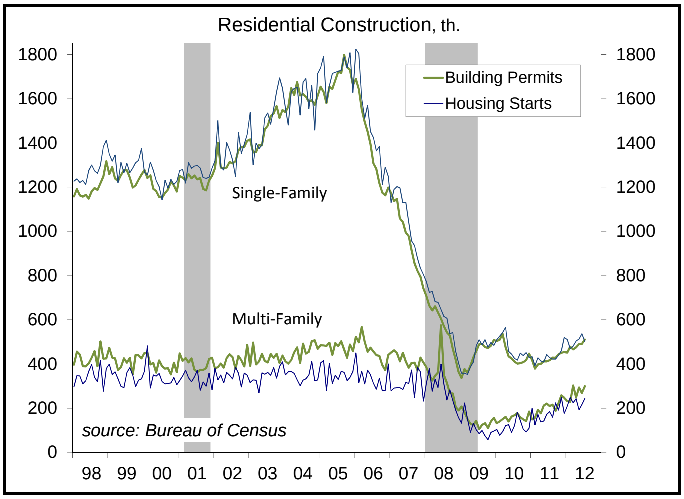
Current Account Deficit (2Q12) – The government's broadest measure of foreign trade should have narrowed in the second quarter, now at a moderate level relative to nominal GDP.

Homebuilder Sentiment (September) – The National Association of Home Builders' Housing Market Index has remained very low by historical standards, but the trend over the last few months is clearly higher. Expect further improvement in the short term.

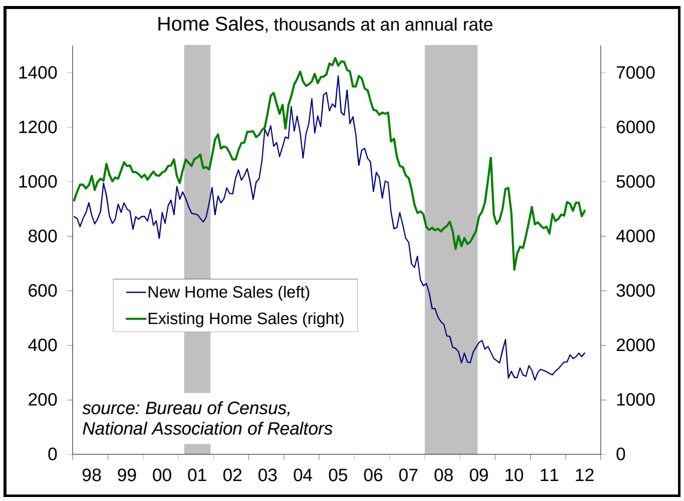


Wednesday

Building Permits, Housing Starts (August) – Single-family activity is expected to trend higher, but we may see some noise in the usually volatile multi-family sector.

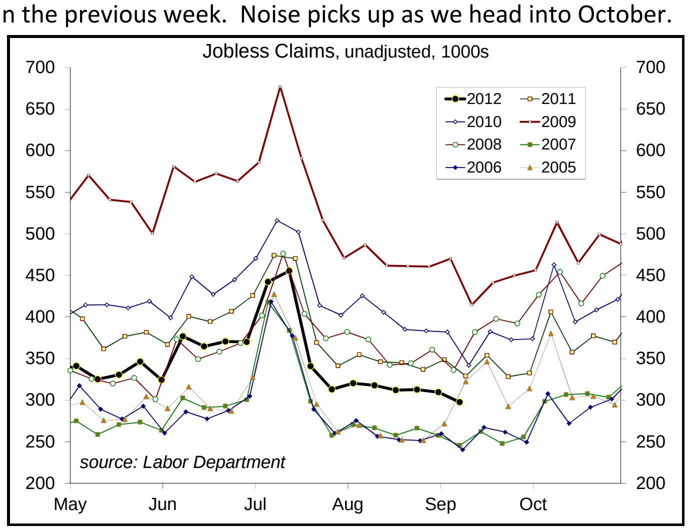


Existing Home Sales (August) – Sales have been limited in recent months by a reported lack of supply in some markets. Sales are likely to have improved last month, helped by low mortgage rates. Note that existing home sales don't add directly to GDP.



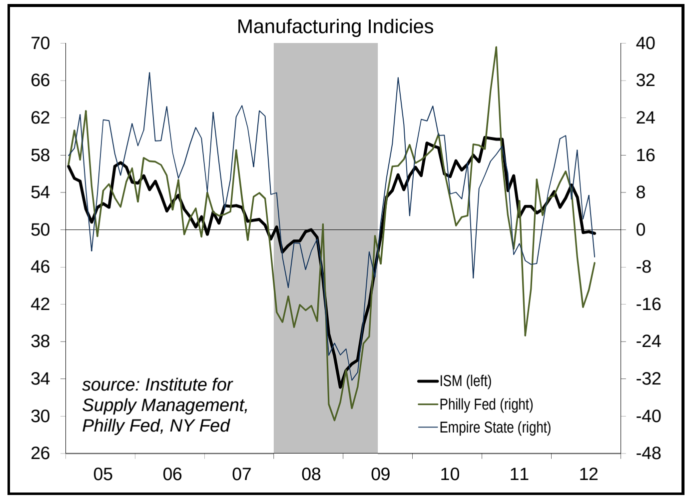
Thursday

Jobless Claims (week ending September 15) – Adjustments for the Labor Day holiday often add noise to the data for the first half of September. Tropical Storm Isaac boosted claims by about 9,000 in the previous week. Noise picks up as we head into October.



Markit US Manufacturing PMI (September, flash) – This index is relatively new and has yet to catch on among U.S. market participants, but could garner some attention if we get a surprise. The index was positive, but lackluster in August.

Philadelphia Fed Index (September) – The two major regional Fed manufacturing surveys tend to be erratic (much less smooth than the ISM index). The headline figure is likely to be less weak in September, but still below the breakeven level.



Leading Economic Indicators (August) – Components of the LEI were mixed. Positive contributions from the yield curve and higher stock prices will not offset negative contributions from ISM new orders, lower consumer expectations, a shorter factory workweek, and a rise in jobless claims.

Friday

No significant economic data.

Next Week …

The lighter march of data will continue. With the Fed's stated emphasis on labor market conditions, other reports are likely to be less critical for the financial markets. Looking ahead, the October employment data will be more important than usual.

Coming Events and Data Releases

October 3	1st Presidential Debate (Denver)
October 5	Employment Report (September)
October 11	Vice Presidential Debate (Danville, KY)
October 16	2nd Presidential Debate (Hempstead, NY)
October 22	3rd Presidential Debate (Boca Raton, FL)
October 24	FOMC Policy Decision (no press briefing)
October 27	Real GDP (3Q12, advance)
November 2	Employment Report (October)
November 6	Election Day
December 12	FOMC Policy Decision Bernanke Press Briefing