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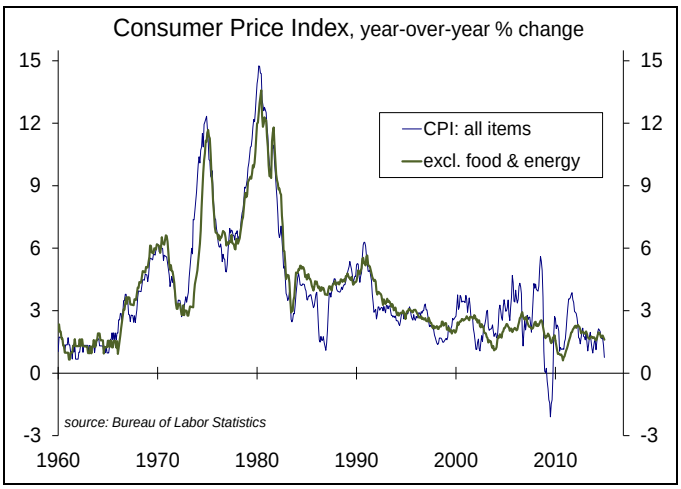
Weekly Market Monitor

Deflation, Low Inflation, and Monetary Policy

Central bank policymakers fear deflation more than anything. However, there is good deflation and there is bad deflation. Yet, even low inflation can create problems for an economy. Low inflation is expected to be a key factor in the ECB's decision to embark on quantitative easing and ought to have some influence on the timing of the Fed's initial rate hike.

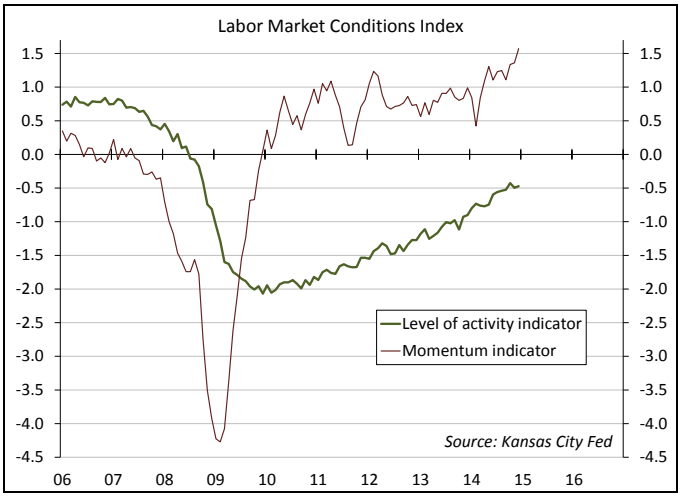
Deflation, a negative inflation rate or a general decline in the overall price level, is a scary prospect for monetary policymakers. Consumers will have little incentive to spend, as prices will be expected to fall the next month. Business will have little incentive to make capital expenditures, since they are less likely to realize a return on that investment. Debt becomes much more burdensome, as borrowers end up paying off the debt with dollars that are worth more. Yet, Japan's experience with deflation is that it need not be the death spiral that theory would suggest. During Ben Bernanke's tenure, first as Fed governor, then as chairman, the Fed went from *"making sure it doesn't happen here"* to being relatively complacent.

There are different types of deflation. Lower prices that are due to rapid productivity growth or falling commodity prices are nothing to fear (for example, falling gasoline prices make it easier to service debt). Deflation caused by weak demand is what we fear. It is due to slack in the economy and represents an underutilization of resources.



There's nothing magical about 0% inflation. Extended periods of low inflation can also cause problems. In the first half of 2014, The Federal Open Market Committee noted in its policy statements that *"the Committee recognizes that inflation persistently below its 2 percent objective could pose risks to economic performance, and it is monitoring inflation developments carefully for evidence that inflation will move back toward its objective over the medium term."*

The Fed's concern about low inflation seemed to disappear in the second half of 2014, as this phrase did not show up in the policy statement. That partly reflects confidence that economic slack is being taken up and the belief that inflation will eventually move toward the Fed's 2% goal. That outlook is largely based on the trajectory of the job market. On balance, the labor market data indicate improved momentum. In 2014, private-sector payrolls posted their largest gain since 1997, supported by hiring by small and medium-sized firms. Bank credit for these firms is still relatively tight, but has been gradually getting easier and optimism is on the rise. However, many labor market indicators, including lackluster growth in average hourly earnings, suggest that there is still ample slack.



The U.S. picture is a contrast to that of the euro area, which appears to face a more immediate threat of deflation, but as previously noted, even low inflation can create problems. With short-term interest rates at zero, quantitative easing is the only game in town for the ECB. This isn't an easy decision. Some members of the Governing Council will be strongly opposed. However, the risks of not doing QE are greater. QE should put more downward pressure on the euro, which will help exporters, but it should also boost inflation somewhat.

For the Federal Reserve, lower oil prices are a blessing. It's not the type of deflation that officials should worry about. It ought to support economic growth, which will eventually lead to a tightening up of resources. It gets back to the same old questions. How much slack is there in the labor market? How rapidly is that slack likely to be taken up in the months ahead? And will firms be able to pass higher labor costs along (in the form of higher prices)? None of this is currently clear, but the Fed has time to be patient and watch things develop. Officials have noted that they are watching financial market conditions. Unsettled conditions could keep the Fed on hold for a lot longer, but we ought to see market volatility begin to settle down.

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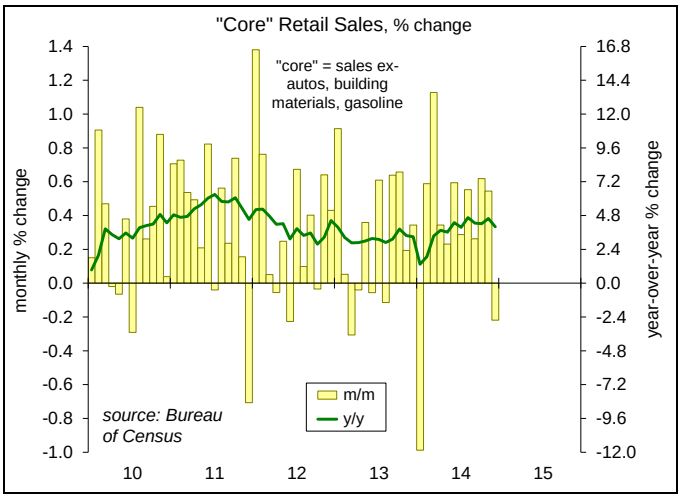
	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
12/19/14	0.04	0.11	0.26	0.67	1.10	1.66	2.17	2.77	1.224	1.561	119.56	1.163	4765.38	2070.65	17804.80
1/09/15	0.02	0.08	0.22	0.59	0.96	1.45	1.98	2.55	1.183	1.515	118.66	1.186	4664.71	2044.81	17737.37
1/16/15	0.02	0.07	0.16	0.48	0.81	1.29	1.83	2.45	1.156	1.515	117.60	1.196	4634.38	2019.36	17511.18

Recent Economic Data and Outlook

The economic data were mixed, but U.S. investors remained largely focused on the rest of the world. The Swiss National Bank's abandonment of its currency ceiling against the euro led to a sharp rise in the Swiss franc and generated significant turmoil in the foreign exchange markets (which U.S. investors interpreted as a sign of global financial instability).



The **Swiss National Bank** discontinued the currency ceiling against the euro, stating that the Swiss franc was less overvalued than when the ceiling went into effect. More likely, the SNB simply found it increasingly difficult to maintain the limit (in addition, the SNB noted the franc had been depreciating against the U.S. dollar). The SNB also lowered short-term interest rates further into negative territory.

The **European Court of Justice** granted conditional approval for the European Central Bank's Outright Monetary Transactions, paving the way for the ECB to undertake quantitative easing.

The **Fed's Beige Book** noted that economic activity expanded at a modest to moderate pace in most areas of the country. Payrolls "expanded moderately." Significant wage pressures were "largely limited to workers with specialized technical skills." Prices increased slightly, on balance, in most districts.

Industrial Production fell 0.1% in December (+4.9% y/y), held down by a 7.3% drop in the output of utilities (-5.4% y/y), which reflected warmer temperatures. Manufacturing output rose 0.3% (+5.2%), with mixed results across industries. Mining rose 2.2% (+11.1% y/y), as oil and gas drilling fell 1.9% (+5.3% y/y) and energy extraction jumped 2.8% (+14.0% y/y). Capacity utilization remained a bit below its long-term average, still well below a level that one would associate with inflation pressure.

Retail Sales fell 0.9% in December (+3.2% y/y), down 1.0% excluding autos (+1.9% y/y). Seasonal adjustment is difficult in December (sales rose 14.2% before adjustment) and it was still a relatively strong quarter (seasonal sales may have been pulled forward). Ex-autos, building materials, and gasoline, sales slipped 0.2% -- a 5.2% annual rate (vs. +5.0% in 3Q14).

Business Inventories rose 0.2% in November (+4.4% y/y), a somewhat slower pace than in 3Q14.

The **Consumer Price Index** fell 0.4% in December (+0.8% y/y, vs. +1.5% in 2013). Food rose 0.3% (+3.4% y/y). Gasoline prices fell 9.4% (-11.1% before seasonal adjustment, -21.0% y/y). Ex-food & energy, the CPI was flat (+1.6% y/y, vs. +1.7% in 2013).

Real Hourly Earnings edged up 0.1% in December (+1.0% y/y).

The **Producer Price Index** fell 0.3% in December (+1.1% y/y), held down largely due to a 14.5% drop in wholesale gasoline (-27.5% y/y). Ex-food and energy, the PPI rose 0.3%, boosted by a quirk in gasoline (as prices fall, margins increase, and higher margins show up in trade services). Ex-food, energy, & trade services (the new "core" PPI), the PPI rose 0.1% (+1.3% y/y).

Import Prices fell 2.5% in December (-5.5% y/y), reflecting a 16.6% drop in petroleum prices (-30.1% y/y). Ex-food & fuels, import prices edged down 0.1% (-0.2% y/y).

The Index of **Small Business Optimism** rose to 100.4 in December (the highest level since October 2006), vs. 98.2 in November and 96.1 in October. Sales expectations continued to pick up and hiring plans improved.

Economic Outlook (1Q15): Real GDP growth of 2.5-3.0%, following around 3.0% in 4Q14.

Employment: Job growth was very strong in 2014. Labor market slack is being taken up, but considerable slack remains.

Consumers: The underlying trend in nominal average wages has been lackluster, but lower gasoline prices will add to consumer purchasing power in the near term and wage growth should pick up later on as the job market tightens.

Manufacturing: Mixed. A stronger dollar and weakness in the global economy are expected to restrain exports, but domestic demand should strengthen in the months ahead.

Housing/Construction: Supply constraints have eased and affordability has improved. Look for a better balance in 2015 (less speculative buying, better consumer fundamentals).

Prices: The PCE Price Index, the Fed's chief inflation gauge, remains well below the Fed's 2% target on a y/y basis. Pipeline pressures appear mild. Wage pressures are limited. Inflation expectations remain well-anchored, but could decline.

Interest Rates: With the Fed's large-scale asset purchases (QE3) completed, short-term interest rates are expected to remain exceptionally low through the middle of 2015. The Fed's policy moves in 2015 will be dictated largely by job market conditions, but the Fed will also react to financial market conditions.

This Week:					*forecast*	last	last –1	comments
Monday	1/19		MLK, Jr. Holiday					markets closed
Tuesday	1/20	10:00	Homebuilder Sentiment	Jan	***59***	57	58	lower gasoline prices should help
		21:00	State of the Union Address					what's on the agenda?
Wednesday	1/21	8:30	**Building Permits, th.**	Dec	***1065***	1052	1092	seen a bit higher
			% change		***+1.2***	-3.7	+5.9	the bigger test comes in the spring
			Housing Starts		***1050***	1028	1045	likely to rebound
			% change		***+2.1***	-1.6	+1.7	watch for revisions
		10:00	BOC Policy Decision					no change
Thursday	1/22	7:45	**ECB Policy Decisions**					QE is widely anticipated, but how much?
		8:30	Jobless Claims, th.	1/17	***300***	316	297	still subject to seasonal noise
		1:00	TIPS Auction					10-year TIPS
Friday	1/23	9:45	Markit US Manf PMI (flash)	Jan	***NF***	53.9	54.8	trended lower in 4Q14
		10:00	**Existing Home Sales, mln**	Dec	***5.12***	4.93	5.25	likely to rebound somewhat
			% change		***+3.9***	-6.1	+1.4	low mortgage rates should help
		10:00	Leading Economic Indicators	Dec	***+0.6%***	+0.6%	+0.6%	will include annual benchmark revisions
Next Week:								
Sunday	1/25		**Greek Elections**					less austerity, more debt forgiveness
Monday	1/26		no significant data					markets to react to Greek results
Tuesday	1/27	8:30	**Durable Goods Orders**	Dec	***+1.0%***	-0.9%	+0.3%	some upside in aircraft (noisy data)
			ex-transportation		***+0.5%***	-0.7%	-1.2%	breaking a weak trend
			nondef cap gds ex-aircraft		***+0.3%***	-0.5%	-1.8%	mixed, a soft trend
		9:00	Case-Shiller Home Prices	Nov	***+0.6%***	+0.7%	+0.2%	national index improving
			year-over-year		***+4.5%***	+4.6%	+4.8%	a moderate pace
		10:00	**New Home Sales, th.**	Dec	***450***	438	445	seen higher
			% change		***+2.7***	-1.6	-2.2	but these figures are volatile
		10:00	**Consumer Confidence**	Jan	***95.2***	92.6	91.0	likely to pick up
		11:30	FRN Auction					Floating-Rate Notes
		1:00	Treasury Note Auction					2-year notes
Wednesday	1/28	1:00	Treasury Note Auction					5-year notes
		2:00	**FOMC Policy Statement**					nothing new
Thursday	1/29	8:30	Jobless Claims, th.	1/24	***302***	***300***	316	some pickup in seasonal layoffs
		10:00	Pending Home Sales Index	Dec	***+1.2%***	+0.8%	-1.2%	likely to improve
		1:00	Treasury Note Auction					7-year notes
Friday	1/30	8:30	**Real GDP (advance est.)**	4Q14	***+2.8%***	+5.0%	+4.6%	some drag from inventories
		8:30	Employment Cost Index	4Q14	***+0.5%***	+0.7%	+0.7%	moderate
		9:45	Chicago PM Index	Jan	***57.8***	58.3	60.8	moderately strong
		9:55	UM Consumer Sentiment	Jan	***98.8***	93.6	88.8	98.2 at mid-month

This Week…

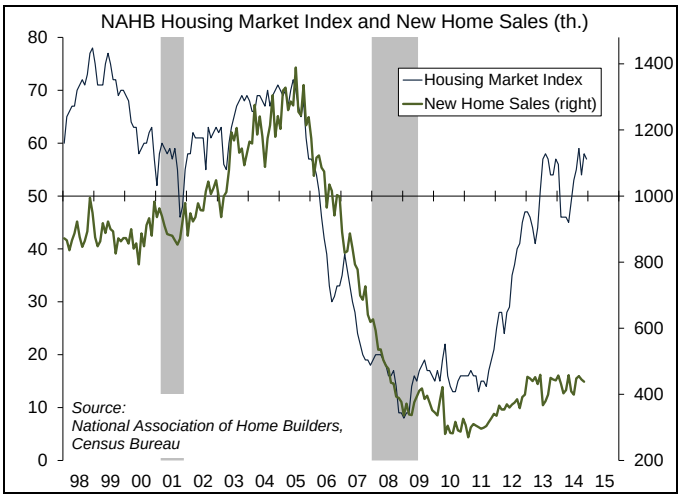
The focus will be on the ECB's policy announcement on Thursday morning. Quantitative easing is widely anticipated and should be factored in. ECB President Draghi's post-meeting press conference may be important. Global investors will then look ahead to the Sunday's election in Greece. The U.S. economic data shouldn't be market-moving. Home sales and construction activity for December don't matter much – the bigger test will come in the spring. The President's State of the Union Address is also of little importance to the markets.

Monday

Martin Luther King, Jr. Holiday – Markets closed.

Tuesday

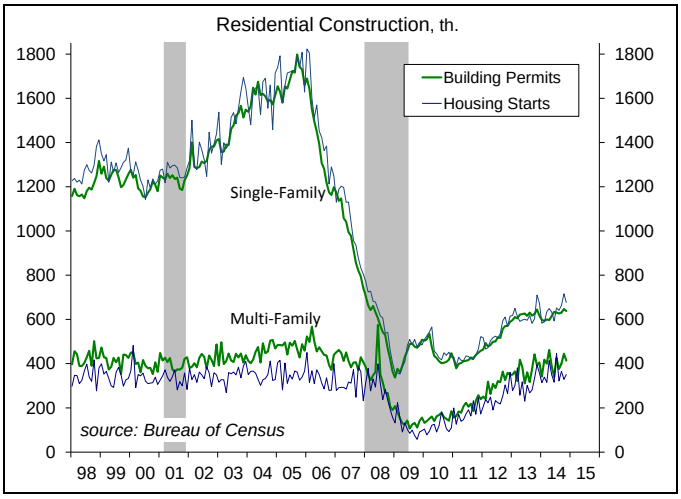
Homebuilder Sentiment (January) – The drop in gasoline prices and the decline in mortgage rates have boosted affordability, which should show up indirectly in homebuilder sentiment readings this month. Strong job growth and easier credit are also important factors in the near term.



State of the Union Address – With Republicans controlling both chambers of Congress, President Obama will have limited ability to get things done in his final two years in office. However, that won't stop him from laying out an agenda.

Wednesday

Building Permits, Housing Starts (December) – Supply constraints have decreased, but December is not a make-or-break month for construction activity. Seasonal adjustment could exaggerate the impact of relatively mild weather.

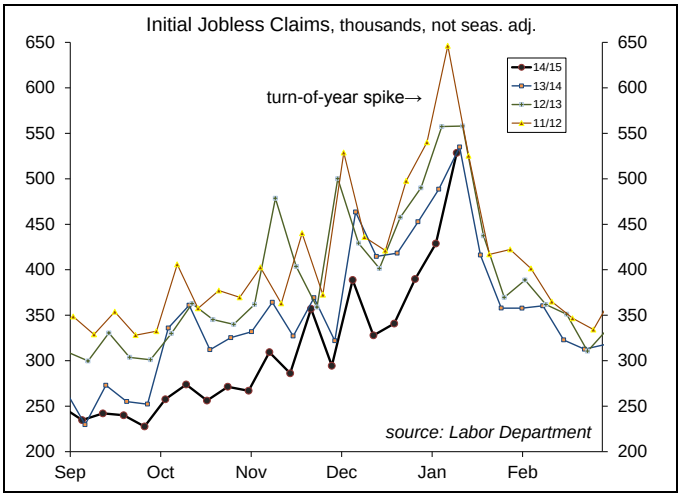


Bank of Canada Policy Decision – Canada's economy is being hit by different forces. The drop in oil prices is hurting energy production. A weaker Canadian dollar helps the manufacturing sector, but also makes U.S. imports more expensive. Monetary policy is expected to remain on hold for the foreseeable future.

Thursday

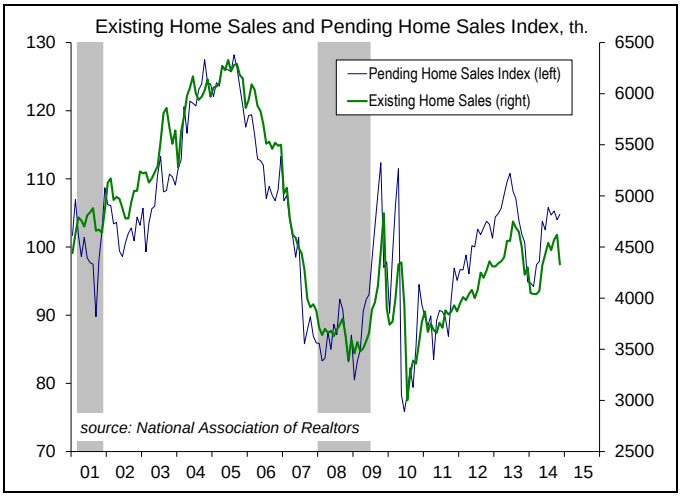
ECB Policy Meeting – The Governing Council's decision on quantitative easing is not going to be unanimous, but President Draghi should be able to muster enough votes. QE is far from perfect, but with fiscal policy ruled out, it is the only game in town. Yet, even if the ECB pulls the trigger on QE, there are a number of questions to be answered (how big and for how long, a set amount or open-ended?). Draghi often drops an interesting tidbit or two in the post-meeting press conference, which you can watch live on the Internet.

Jobless Claims (week ending January 17) – Unadjusted claims may pick up, reflecting job cuts in energy production. Note that strong seasonal hiring in November and December typically results in somewhat elevated seasonal layoffs in January.

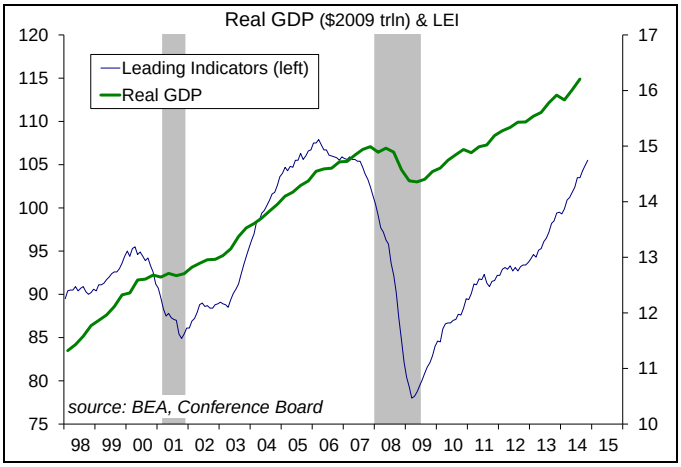


Friday

Existing Home Sales (December) – Sales were softer than expected in November (the Pending Home Sales Index had held up well). Affordability improved in 2014. Easier mortgage credit, low mortgage rates, and lower gasoline should help in 2015, but we'll have to wait until spring to really see.



Leading Economic Indicators (December) – Components were mostly positive in December (little chance of recession).



Next Week …

Markets will react to Greek election results. The FOMC meeting is expected to be a non-event. GDP growth is likely to have been moderately strong in the advance estimate for 4Q14.

Coming Events and Data Releases

February 1	Super Bowl XLIX
February 2	ISM Manufacturing Index (January)
February 6	Employment Report (January)
February 12	Retail Sales (January)
February 16	Presidents Day (markets closed)
March 18	FOMC Policy Decision, Yellen press conference
April 29	FOMC Policy Decision (no press conference)
June 17	FOMC Policy Decision, Yellen press conference