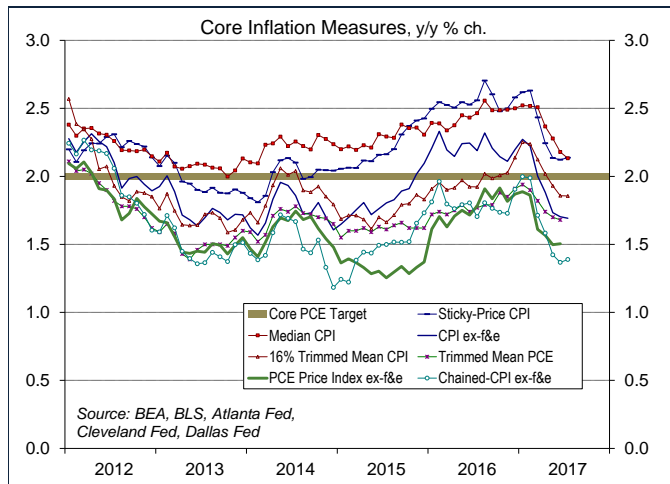


Weekly Economic Monitor

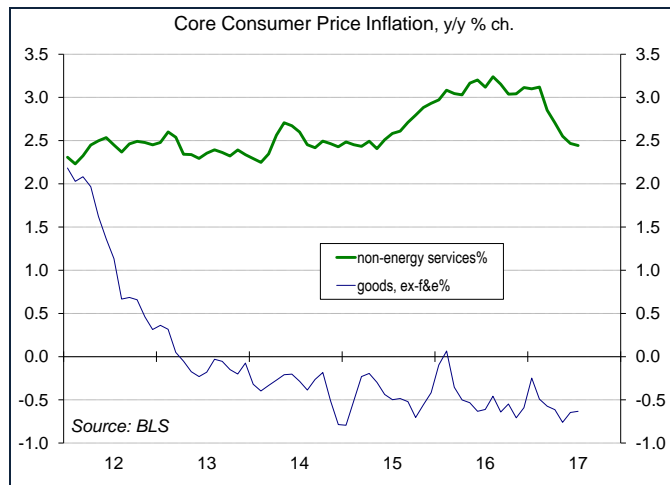
Inflation and Productivity

The July CPI data were a bit softer than anticipated, due partly to a drop in the price index for lodging away from home. Granted, if you exclude everything that went down, the CPI always looks higher, but the underlying trend is not far from the Fed's earlier expectations (of a gradual move toward the 2% goal). The Fed is more focused on future inflation than past inflation. How the new normal fits into the inflation outlook ought to be a primary consideration for Fed policy.

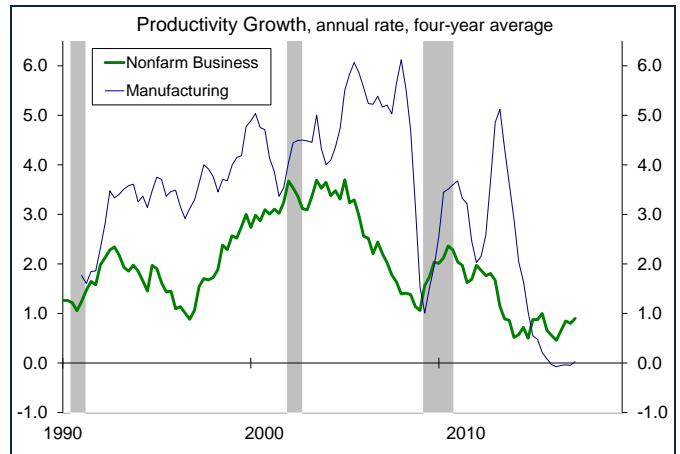
Inflation figures are often uneven over the course of a year. Higher numbers in January and February led to calls that the Fed had "fallen behind the curve." The more recent soft figures have led to calls that the Fed has overdone it. Go figure.



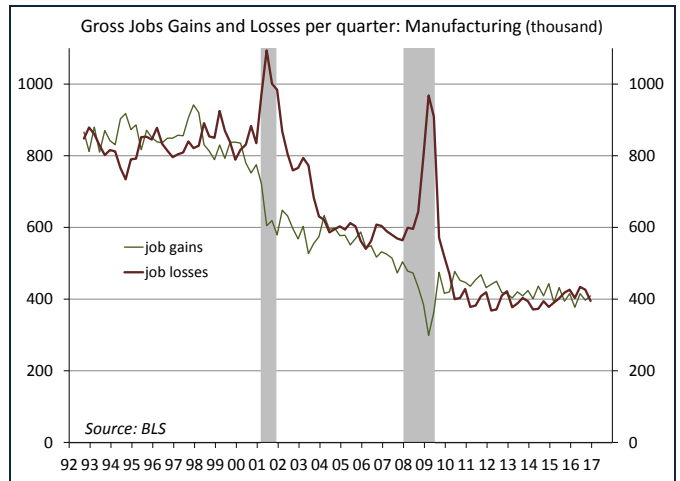
Diving into the details, one sees some odd things. Ex-food & energy, the price index for consumer goods (18.9% of the CPI) is still showing a trend of mild deflation (-0.6% y/y). Inflation in non-energy services, buoyed over the last year by rising rents, appears to have moderated somewhat.



Inflation in services is thought to be driven more by labor costs, but wage growth has been moderate. Note that there is a chicken-or-egg component here. Firms typically peg annual wage gains to the CPI. Firms generally complain that they can't find qualified workers. A simple solution would be to offer better wages, but that may mean paying more to those already on the payroll. One possible explanation for slow wage growth is the low trend in productivity. Quarterly figures bounce around, but the noise washes out over longer trends. Over the last four years, productivity growth has averaged 0.9% per year for nonfarm business and 0.0% for manufacturing.



The aging of the population means that there is less job hopping than in past decades. The turnover in factory jobs is half of what it was a couple of decades ago. The economy is less dynamic and there may not be much policy can do about that.

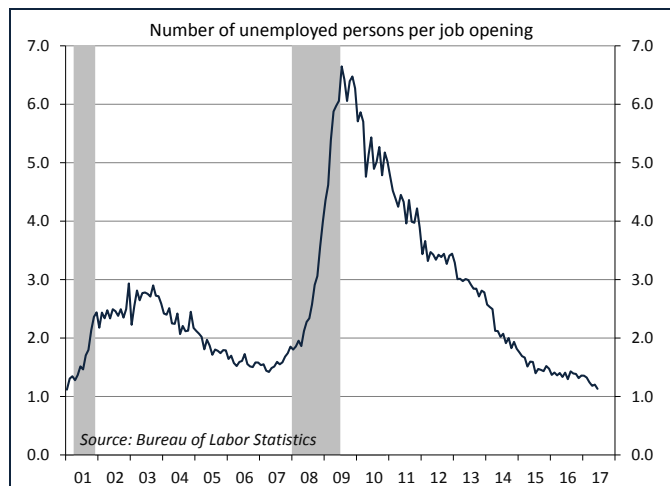


Given the demographic story, the new normal is characterized by slower economic growth, lower inflation, and lower interest rates. In the months ahead, Fed policymakers will wrestle with the questions of how slow and how low. They aren't alone. Other countries will be experiencing a similar challenge.

| | 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 |
| 7/14/17 | 1.16 | 1.10 | 1.22 | 1.36 | 1.50 | 1.81 | 2.24 | 2.81 | 1.166 | 1.297 | 111.18 | 1.255 | 6387.75 | 2472.54 | 21580.07 |
| 8/04/17 | 1.08 | 1.14 | 1.23 | 1.36 | 1.51 | 1.82 | 2.27 | 2.84 | 1.175 | 1.304 | 110.76 | 1.264 | 6351.56 | 2476.83 | 22092.81 |
| 8/11/17 | 1.04 | 1.14 | 1.20 | 1.29 | 1.44 | 1.74 | 2.19 | 2.78 | 1.182 | 1.301 | 109.09 | 1.268 | 6261.90 | 2441.35 | 21858.12 |

Recent Economic Data and Outlook

Tensions with North Korea were cited as a catalyst for equity market weakness, but stocks were likely due for a pullback (the market can't rise every day) and the market's timing relative to the news seemed a bit off. The economic data calendar was thin, with CPI figures surprising slightly to the downside.



The **Consumer Price Index** rose 0.1% in July (median forecast: +0.2%), up 1.7% year-over-year. The index of food prices rose 0.2% (+1.1% y/y). Energy edged down 0.1% (+3.5% y/y), with gasoline unchanged (-2.3% before seasonal adjustment, +3.0% y/y). Ex-food & energy, the CPI rose 0.1% (median forecast: +0.2%), also up 1.7% from a year ago. Shelter costs were mixed. Owners' Equivalent Rent (24.5% of the CPI) rose 0.3% (+3.2% y/y), while rent (7.9% of the CPI) rose 0.2% (+3.8% y/y). Lodging away from home (1.0% of the CPI) fell 4.2%, following a 1.9% drop in June (-2.3% y/y) – otherwise, the headline CPI figures would have matched expectations. Ex-food & energy, the price index for consumer goods edged down 0.1% (-0.6% y/y), while non-energy services rose 0.2% (+2.4% y/y).

Real Average Hourly Earnings rose 0.2% in July, following gains of 0.3% in both May and June, up 0.7% year-over-year. Nominal (current-dollar) hourly earnings were already reported (in the July Employment Report) to have risen 0.3% (+2.5% y/y). For production workers, real average hourly earnings rose 0.2%, up 0.8% y/y. The pickup in real earnings should provide some support for consumer spending growth in the near term.

The **Producer Price Index** edged down 0.1% in July (+1.9% y/y), down 0.1% ex-food & energy (+1.8% y/y). Ex-food, energy, and trade services, the PPI was unchanged (+1.9% y/y). Ex-food & energy, the index for processed intermediate goods fell 0.3% (+3.0% y/y), while unprocessed intermediate goods rose 1.2%

(+9.9% y/y). Intermediate services fell 0.3% (+2.2% y/y). The index for construction rose 1.2% (+3.2% y/y).

Nonfarm Business Productivity rose at a 0.9% annual rate in 2Q17 (+1.2% y/y). Output rose 3.4% (+2.7% y/y), while hours rose 2.5% (+1.5% y/y). **Unit Labor Costs** rose at a 0.6% pace (-0.2% y/y). In manufacturing, productivity rose 2.5% (+1.0% y/y), leaving unit labor costs down 0.3% (+0.1% y/y). Over the last four year, productivity growth has averaged 0.9% per year, with unit labor costs at a 1.1% pace. In manufacturing, productivity growth has averaged 0.0% per year over the last four years, with unit labor costs averaging 1.8% per year.

The **Job Opening and Labor Market Turnover Survey** results for June continued to reflect a strengthening labor market. Job openings rose to 6.163 million (vs. 5.535 million a year earlier). For the private-sector, the hiring rate held steady at 4.1%, while the quit rate edged down to 2.4% (moderate by historical standards, but should be lower given the aging population).

The Index of **Small Business Optimism** rose to 105.2 in July, vs. 103.6 in June (it hit 105.9 in January). The business outlook remained strong, but earnings were still generally weak. Hiring intentions and capital spending plans remained moderately strong. Taxes, the quality of labor, and government regulations remained the chief concerns.

Economic Outlook (3Q17): around 2.0% GDP growth.

Employment: The trend in private-sector job growth has remained similar to that of 2016, but is expected to slow as the job market continues to tighten.

Consumers: Spending improved in the second quarter, but monthly figures suggest little momentum into 3Q17. Job gains have been supportive. Inflation adjusted wage growth, weak in the first few months of the year, appears to be picking up.

Manufacturing: Orders and production have remained mixed across sectors, but moderate overall. Better global growth and the rebound in energy exploration have helped, but motor vehicle sales appear to have passed their peak.

Housing/Construction: Job growth has been supportive, with some weather-related shift into the earlier part of the year. Higher home prices and rising building costs are restraints.

Prices: Core inflation has continued to trend below the Fed's 2% target, partly reflecting a "one-off" plunge in wireless telecom services. Wage pressures are moderate.

Interest Rates: The Fed remains in tightening mode, and is expected to continue raising short-term rates gradually. Balance sheet reduction is expected to start in October, initially gradual, but picking up over the course of a year.

| This Week: | | | | <i>forecast</i> | last | last -1 | comments | |
|------------|------|---------------------|--|-----------------|--------------|------------|----------|---|
| Monday | 8/14 | no significant data | | | | | | |
| Tuesday | 8/15 | 8:30 | Import Prices ex-food & fuels | Jul | NF | -0.2% | -0.1% | seen about steady |
| | | | | | NF | 0.0% | 0.0% | no pressure from import prices |
| | | 8:30 | Retail Sales ex-autos ex-autos, bld mat, gasoline | Jul | +0.4% | -0.2% | -0.1% | due for a pickup |
| | | | | | +0.3% | -0.2% | -0.3% | watch for revisions |
| | | | | | +0.4% | -0.2% | 0.0% | core rate likely to improve |
| | | 8:30 | Empire St. Manf. Index | Aug | NF | 9.8 | 19.8 | choppy, but a moderately strong trend |
| | | 10:00 | Business Inventories | Jun | +0.5% | +0.3% | -0.2% | seen higher |
| | | 10:00 | Homebuilder Sentiment | Aug | 64 | 64 | 66 | still strong, but off peak |
| Wednesday | 8/16 | 8:30 | Building Permits, mln % change | Jul | 1.270 | 1.275 | 1.168 | likely to remain strong |
| | | | | | -0.4 | +9.2 | -4.9 | strong single-family trend |
| | | | Housing Starts % change | | 1.225 | 1.215 | 1.122 | choppy |
| | | | | | +0.8 | +8.3 | -2.8 | watch for revisions |
| | | 2:00 | FOMC Minutes | | | | | pointing to Oct balance sheet unwind |
| Thursday | 8/17 | 8:30 | Jobless Claims, th. | 8/12 | 240 | 244 | 241 | a low trend |
| | | 8:30 | Philadelphia Fed Index | Aug | NF | 19.5 | 27.6 | choppy, likely to be moderately strong |
| | | 9:15 | Industrial Production Manufacturing Output | Jul | +0.4% | +0.4% | +0.1% | a moderate gain |
| | | | Capacity Utilization | | +0.3% | +0.2% | -0.4% | aggregate hours rose 0.2% |
| | | | | | 76.8% | 76.6% | 76.4% | no threat to the inflation outlook |
| | | 10:00 | Leading Econ. Indicators | Jul | +0.3% | +0.6% | +0.2% | components mostly positive |
| Friday | 8/18 | 10:00 | Adv. Qtrly Services | 2Q17 | | | | some implications for GDP revisions |
| | | 10:00 | UM Consumer Sentiment | m-Aug | 93.2 | 93.4 | 95.1 | watch the expectations component |
| Next Week: | | | | | | | | |
| Monday | 8/21 | no significant | | | | | | eclipse |
| Tuesday | 8/22 | no significant data | | | | | | Happy Birthday, Honor Blackman |
| Wednesday | 8/23 | 10:00 | New Home Sales, th. | Jul | 615 | 610 | 605 | choppy, but a moderately strong trend |
| | | | % change | | +0.8 | +0.8 | +4.9 | watch for possible revisions |
| | | 1:00 | FRN Auction | | | | | re-opened 2-year FRNs |
| Thursday | 8/24 | 8:30 | Jobless Claims, th. | 8/12 | 240 | 240 | 244 | a low trend |
| | | 10:00 | Existing Home Sales, mln | Jul | 5.56 | 5.52 | 5.62 | a relatively strong trend |
| | | | % change | | +0.7 | -1.8 | +1.1 | some supply constraints |
| | | 1:00 | TIPS Auction | | | | | re-opened 5-year TIPS |
| Friday | 8/25 | 8:30 | Durable Goods Orders ex-transportation nondef cap gds ex-aircraft | Jul | -6.0% | +6.4% | -0.0% | aircraft orders return to Earth |
| | | | | | -0.2% | +0.1% | +0.8% | a lackluster trend |
| | | | | | 0.0% | 0.0% | +0.8% | trend slowing |
| | | tbd | Yellen Jackson Hole Speech | | | | | date and time not officially released yet |

This Week...

Retail sales figures were disappointing in May and June and investors ought to be looking at the July figures (due Tuesday) to gauge whether the consumer has been taking a break or is in more trouble than we think. The rest of the economic data calendar is not particularly market-moving – nothing to alter the overall economic picture or the Fed policy outlook. FOMC minutes (Wednesday afternoon) are unlikely to tell us much that we don't already know, but we should gain some insight into the amount of disagreement among Fed policymakers – and there's always a chance that the financial press (and in turn, the markets) will take something out of context.

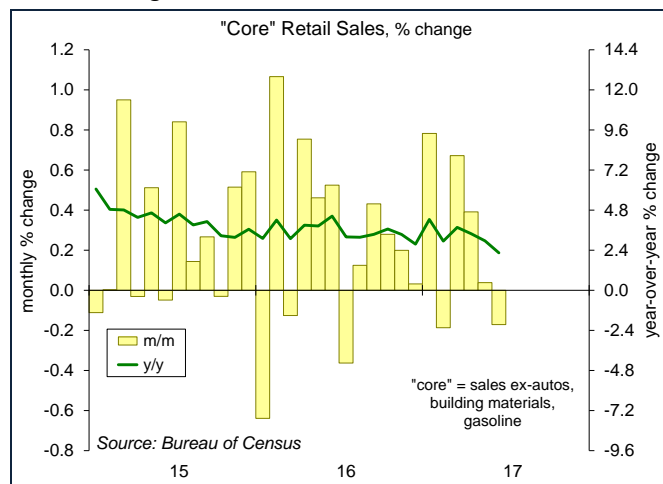
Monday

No significant data.

Tuesday

Import Prices (July) – Over the last several months, there has been no inflationary pressure in prices of imported supplies and raw materials. Inflation in imported finished goods (consumer items and capital equipment) has been roughly flat.

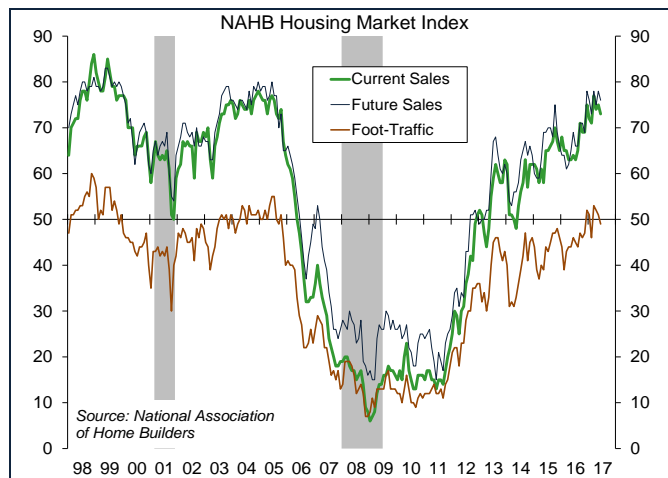
Retail Sales (July) – Monthly figures are notoriously uneven, which makes it difficult to discern a change in trend. However, a string of weak retail payroll numbers is usually a clear signal of trouble. Unit auto sales ticked up on a seasonally adjusted basis. Real wages have increased in the last three months.



Empire State Manufacturing Index (August) – This data are erratic, but the underlying trend should remain consistent with moderately strong growth in the region's factory sector.

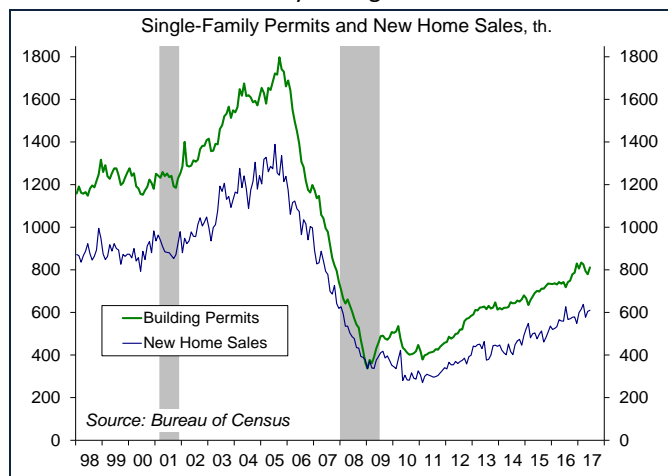
Business Inventories (June) – The only missing piece here is retail inventories, which were assumed to have risen about 0.6% in the advance GDP report.

Homebuilder Sentiment (August) – There's a fair amount of noise in the monthly figures, but August results should remain relatively strong by historical standards.



Wednesday

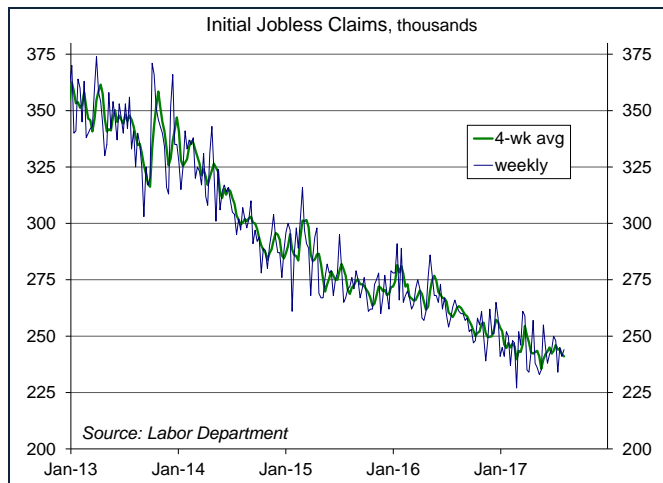
Building Permits, Housing Starts (July) – Housing starts are volatile and reported with a huge amount of uncertainty. Single-family permits are more accurate, and should remain consistent with a moderately strong trend in the near term.



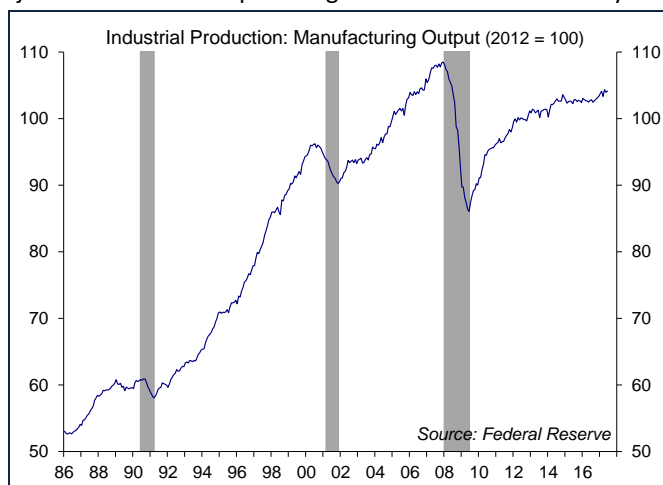
FOMC Minutes (July 25-26) – The Fed has already laid out its plan to begin unwinding the balance sheet. While no official start date has been announced, officials have dropped strong hints that it will start in October. Expect to hear some discussion of that in the minutes from the late-July policy meeting. In addition, officials will likely differ in their views on inflation.

Thursday

Jobless Claims (week ending August 12) – The underlying trend has remained low, consistent with further improvement in overall labor market conditions.



Industrial Production (July) – Recent improvement has been partly related to the recovery in energy exploration. Seasonal adjustment in auto output can generate some noise in July.



Leading Economic Indicators (July) – Another increase.

Friday

Quarterly Services (2Q17, advance) – This report will have some implications for possible GDP revisions.

Next Week ...

A light week until Friday, when we'll get durable goods orders. Yellen is expected to speak at the KC-Fed's monetary policy symposium in Jackson Hole.

Coming Events and Data Releases

| | |
|--------------|---|
| August 30 | Real GDP (2Q17, 2 nd estimate) |
| September 1 | Employment Report (August) |
| September 4 | Labor Day Holiday (markets closed) |
| September 7 | NFL Season Begins |
| September 20 | FOMC Policy Decision, Yellen press conf. |
| November 1 | FOMC Policy Decision (no press conf.) |
| December 13 | FOMC Policy Decision, Yellen press conf. |