

Weekly Market Monitor

Yellen Speaks, Do the Financial Markets Listen?

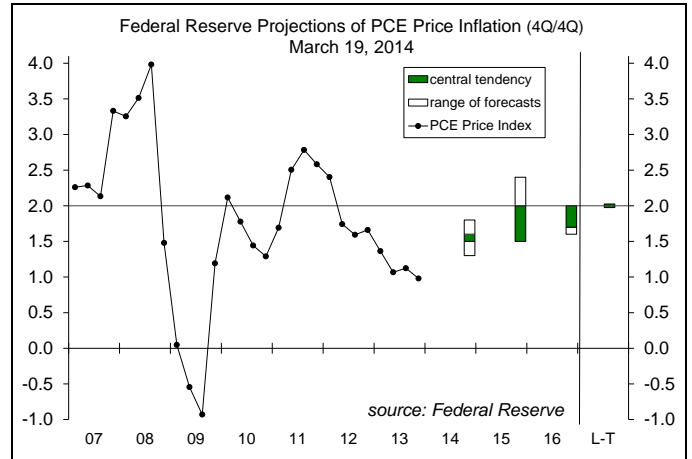
No surprise, the Federal Open Market Committee tapered the monthly rate of asset purchases by another \$10 billion and altered the language in its forward guidance on the federal funds rate. In its policy statement, the FOMC indicated that *“it likely will be appropriate to maintain the current target range for the federal funds rate for a considerable time after the asset purchase program ends.”* Moreover, the FOMC expects that conditions will warrant a below-normal level of the overnight lending rate even as employment and inflation near the Fed’s goals. As the FOMC statement noted, none of this reflects any change in the Fed’s policy intentions.

Former Fed Chair Ben Bernanke was exceptionally clear, but financial market participants often had a hard time understanding what he had to say. Janet Yellen was expected to be even clearer in her descriptions of the economy and monetary policy. Yet, there is a lot of nuance. For example, asked about the expected time between the end of QE3 and the first hike in short-term interest rates, Yellen responded:

“So, the language that we use in the statement is ‘considerable period.’ So, I, you know, this is the kind of term, it’s hard to define. But, you know, probably means something on the order of around six months or that type of thing. But, you know, it depends on what the statement is saying and it depends on what conditions are like. We need to see where the labor market is – how close are we to our full employment goal – that will be a complicated assessment not just based on a single statistic – and how rapidly are we moving toward it. Are we really close and moving fast? Or are we getting closer but moving very slowly? And then, what the statement emphasizes and this is the same language we used in December and January; we used the language ‘especially if inflation is running below our 2% objective.’ Inflation matters here, too, and our general principle tries to capture that notion. If we have a substantial shortfall in inflation – if inflation is persistently running below our 2% objective – that is a very good reason to hold the funds rate at its present range for longer.”

A bit rambly, to be sure (especially given the unedited false starts and “you knows”). She’s clearly thinking on the fly. However, her answer suggests that she and other Fed officials have spent a lot of time thinking about how monetary policy might evolve. The clear answer is that “it depends.” If the economic recovery proceeds as anticipated, inflation begins to move toward the 2% goal, and financial conditions remain stable, then the asset purchase program will end in 4Q14 and the first increase in the federal funds rate would likely come in 2Q15 (in April or in June). However, there are a lot of moving parts here. Yellen recognizes that monetary policy affects the economy with a lag and that the Fed has to be vigilant against putting too much inflation in the pipeline. However, that’s not a big concern right now. There’s also a danger for the economy if inflation continues to trend too low.

Fed officials expect that inflation will move gradually toward the 2% goal, but if not, the first rate hike would be pushed out.



While the markets have focused primarily on the trajectory of Fed asset purchases, the forward guidance on the overnight lending rate is just as important. In December 2012, the FOMC moved from a time-based directive to an economic directive. The establishment of thresholds for the unemployment rate (6.5%) and inflation (2.5%) was meant to give the financial markets more insight into how the Fed will determine the path of monetary policy. However, with inflation nearing the 6.5% threshold, this proved problematic. The Fed has now shifted back to a qualitative directive. That gives the Fed more flexibility, but it also has potential to add to market uncertainty. What constitutes sufficient improvement in the job market? What level of inflation is too low? The Fed has indicated that in determining how long to maintain the current 0-0.25% range for federal funds target it *“will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments.”* This may bring to mind Supreme Court Justice Potter Stewart’s definition of pornography – “I know it when I see it.” Monetary policy is set by a committee and different Fed officials have different opinions about the degree of slack in the economy.

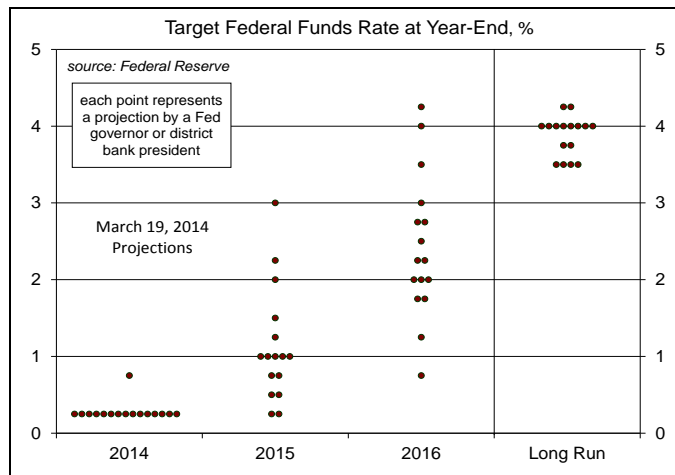
At the March policy meeting, the four Fed governors and 12 district bank presidents submitted updated projections of growth, unemployment, and inflation. While weather has been a factor behind recent softness in the economy, the outlook for the year as a whole hasn’t changed since December.

Fed officials also submitted projections of the federal funds rate. Only one expected a rate hike this year. All but two expected to raise rates sometime in 2015, but there was a wide range of views regarding exactly how much. More importantly, most expected below-normal rates at the end of 2016.

	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	
2/21/14	0.05	0.08	0.12	0.33	0.71	1.56	2.73	3.69	1.372	1.663	102.71	1.113	4263.41	1836.25	16103.30	
3/14/14	0.05	0.08	0.12	0.36	0.74	1.55	2.65	3.59	1.392	1.663	101.46	1.109	4245.40	1841.13	16065.67	
3/21/14	0.05	0.08	0.13	0.43	0.90	1.71	2.74	3.61	1.380	1.649	102.12	1.121	4276.79	1866.42	16299.94	

Recent Economic Data and Outlook

The financial markets were complacent about Putin's annexation of Crimea, but freaked out over a Yellen comment taken out of context. Nevertheless, some market participants had expected that it would be a lot longer before the Fed started to raise rates (2016?) and adjusted their views closer to the consensus (2Q15).



As expected, the **Federal Open Market Committee** reduced the monthly pace of asset purchases by another \$10 billion (beginning in April) to \$55 billion per month and abandoned the 6.5% unemployment rate threshold in its forward guidance on short-term interest rates. The assessment on when to begin raising the federal funds target rate *“will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments.”* The FOMC anticipates that *“even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run.”*

In the **Summary of Economic Projections**, Fed officials revised their forecasts of 2014 GDP growth to 2.8-3.0% (vs. December's 2.8-3.2%). Fourteen (of 16) Fed officials expect to begin raising the federal funds target rate by the end of 2015. Most expect that the funds target rate will still be well below normal in 4Q16.

In her first post-FOMC press conference, Fed Chair **Janet Yellen** stressed that the new forward guidance language did not represent a change in the Fed's policy outlook. Asked about how long it would be between the end of QE3 and the first hike in short-term rates, Yellen gave a nuanced answer (*“it depends,”* essentially), but market participants seized on the suggestion that it could be *“something on the order of around six months.”*

The **Consumer Price Index** rose 0.1% in February (+1.1% y/y). Food prices rose 0.4% (+1.4% y/y), partly reflecting drought conditions in California. Energy prices fell 0.5% (-2.5% y/y), with gasoline down 1.7% (up 1.1% before seasonal adjustment, -8.1% y/y). Ex-food & energy, the CPI rose 0.1% (+1.6% y/y).

Real Weekly Earnings were flat in February (+0.2% y/y).

Existing Home Sales edged down 0.4% in February, to a 4.60 million seasonally adjusted annual rate (-7.1% y/y). Results varied across regions (Northeast -11.3%, Midwest -3.8%, South +1.5%, West +5.9%). The National Association of Realtors noted weather, constrained inventory, restrictive mortgage lending standards, and decreased affordability relative to a year ago. Student debt was *“the biggest obstacle”* for younger buyers.

Building Permits jumped 7.7% in February, to a 1.018 million seasonally adjusted annual rate (+6.9% y/y). Single-family permits fell 1.8% (-2.0% y/y), mixed across regions. Multi-family permits (which tend to be volatile) surged 24.3% (+22.2% y/y). **Housing Starts** slipped 0.2%, to a 907,000 pace (-6.4% y/y).

Homebuilder Sentiment edged up to 47 on March, vs. 46 in February and 56 in January. The National Association of Home Builders cited *“poor weather and difficulties in finding lots and labor.”*

Industrial Production rose 0.6% in February, following a 0.2% decline in January (+2.8% y/y). The output of utilities slipped 0.2%, vs. +3.8% rise in January. Manufacturing output rose 0.8%, following a 0.8% decline in January (+1.6% y/y), reflecting a rebound in autos (+4.8%, vs. -5.2%).

The Index of **Leading Economic Indicators** rose 0.5% in February, reflecting positive contributions from the steep yield curve and the rebound in building permits.

Economic Outlook (1Q14): 1.0% to 2.0% GDP growth.

Employment: The pace of job growth has moderated in recent months, but adverse weather has been a constraint. Measures of job destruction remain low, while hiring is expected to improve in the spring and summer.

Consumers: Spending growth appears to have been dampened by poor weather. Wealth has increased, supporting spending. Average wage gains are barely keeping up with inflation.

Manufacturing: Recent data on new orders, production, and employment, while uneven, suggest moderate improvement in the factory sector. However, an inventory correction and global growth will be important concerns in the near term.

Housing/Construction: Higher mortgage rates and rising home prices have reduced housing affordability. Poor weather hasn't helped. Homebuilding activity is expected to improve, but supply constraints are likely to remain an issue.

Prices: The PCE Price Index, the Fed's chief inflation gauge, is trending well below the 2% goal, which would be a problem if that continues. Pipeline pressures have been modest. Wage gains are mild. Inflation expectations remain well-anchored.

Interest Rates: The tapering of asset purchases is *“not on a preset course,”* but Fed officials anticipate further reductions *“at a measure pace”* (-\$10 billion per FOMC meeting) – and it would take a significant change in the economic outlook for the Fed to deviate from the path. If the economy continues to evolve as the Fed anticipated, short-term interest rates are likely to be raised by the middle of 2015. Long-term interest rates should trend gradually higher, with some volatility along the way.

This Week:				<i>forecast</i>	last	last -1	comments		
Monday	3/24	8:30	Chicago Fed Nat Act Index	Feb	NF	-0.39	-0.03	some impact from the weather growth near its long-term trend	
			3-month average		NF	+0.10	+0.26		
		9:45	Markit US Manf PMI (flash)	Mar	NF	57.1	53.7	note time change for the release	
Tuesday	3/25	9:00	Case-Shiller Home Prices	Jan	+0.6%	+0.8%	+0.9%	seen higher, but more moderate should slow	
			year-over-year		+13.2%	+13.4%	+13.7%		
		10:00	New Home Sales, th.	Feb	455	468	427		some impact from the weather watch for revisions
			% change			+9.6	-3.8		
10:00	Consumer Confidence	Mar	79.5	78.1	79.4	should improve a bit			
		1:00	Treasury Note Auction				\$32 billion in 2-year notes		
Wednesday	3/26	8:30	Durable Goods Orders	Feb	+1.4%	-1.0%	-5.3%	expected a rebound in transportation watch for revisions choppy	
			ex-transportation		+0.3%	+1.1%	-1.8%		
			nondef cap gds ex-aircraft		+0.4%	+1.5%	-1.6%		
		11:30	FRN Auction				\$13 billion in re-opened 2-year FRNs		
		1:00	Treasury Note Auction				\$35 billion in 5-year notes		
Thursday	3/27	8:30	Jobless Claims, th.	3/22	323	320	315	a low trend	
		8:30	Real GDP (3 rd estimate)	4Q13	+2.6%	+4.1%	+2.5%	2 nd estimate: +2.4%, advance est.: +3.2%	
		10:00	Pending Home Sales Index	Feb	+0.5%	+0.1%	-5.8%	some weather impact, but likely to pick up	
		1:00	Treasury Note Auction				\$29 billion in 7-year notes		
Friday	3/28	8:30	Personal Income	Feb	+0.1%	+0.3%	0.0%	some impact from the weather moderate, but a better mix a mild trend in core inflation	
			Personal Spending		+0.3%	+0.4%	+0.1%		
			PCE Price Index ex-f&e		+0.1%	+0.1%	+0.1%		
		9:55	Consumer Sentiment	Mar	80.2	81.3	81.2		79.9 at mid-month
		12:00	Ind. Production Revisions						annual benchmark revisions
Next Week:									
Monday	3/31	9:45	Chicago PMI	Mar	61.5	59.8	59.6	some rebound from poor weather	
Tuesday	4/01	9:45	Markit US Manf. PMI (final)	Mar	NF	57.1	53.7	not market-moving	
		10:00	Construction Spending	Feb	-0.2%	+0.1%	+1.5%	watch for revisions	
		10:00	ISM Manf. Index	Mar	54.5	53.2	51.3	some rebound from poor weather	
		tba	Motor Vehicle Sales, mln domestically built	Mar	15.5 12.2	15.3 12.0	15.2 11.9	should pick up some pent-up demand	
Wednesday	4/02	8:15	ADP Payroll Estimate, th.	Mar	+190	+139	+127	likely to be moderately strong	
		10:00	Factory Orders	Feb	NF	-0.7%	-2.0%	likely to improve somewhat	
Thursday	4/03	8:30	Jobless Claims, th.	3/29	322	323	320	a low trend	
		8:30	Trade Balance, \$bln	Feb	-39.0	-39.1	-39.0	a minor impact from the Olympics	
			goods only		-58.5	-59.3	-58.7	seen a bit narrower	
		10:00	ISM Non-Manf. Index	Mar	53.8	51.6	54.0	should rebound	
Friday	4/04	8:30	Nonfarm Payrolls, th.	Mar	+185	+175	+162	likely to be moderately strong	
			private-sector		+185	+162	+145	little change in government jobs	
			Unemployment Rate		6.6%	6.7%	6.6%	trending lower	
			employment/population		58.9%	58.8%	58.8%	should edge higher	
			Avg. Weekly Hours		34.4	34.2	34.3	rebounding from weather effects	
			Avg. Hourly Earnings		+0.2%	+0.4%	+0.2%	modest-to-moderate wage inflation	

This Week...

The economic data reports have some market-moving potential, but will not be critical to the overall outlook (the following week will be a different story). New home sales and durable goods figures are volatile even when weather isn't an issue. The Conference Board's report on consumer confidence will be the "fresh" economic data, possibly reflecting a rebound from poor weather (keep an eye on job perceptions). Personal spending figures will help fill in the GDP picture for 1Q14.

Monday

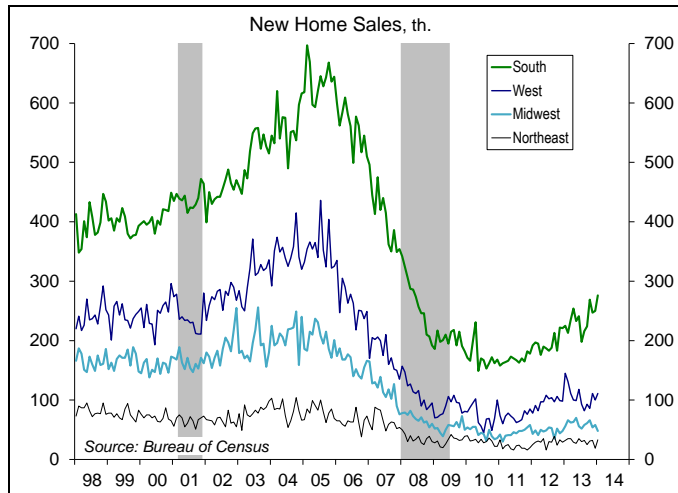
Chicago Fed National Activity Index (February) – The CFNAI, a composite of 85 economic indicators, is scaled to have a mean of 0 (representing trend growth) and a standard deviation of 1. The focus is on the three-month average, which is expected to decline, reflecting poor winter weather.

Markit U.S. Manufacturing PMI (March, flash estimate) – This gauge is relatively new and has not caught on among U.S. financial market participants. It's not a good predictor of the more-important ISM manufacturing survey, but it has tended to move in the same direction over time.

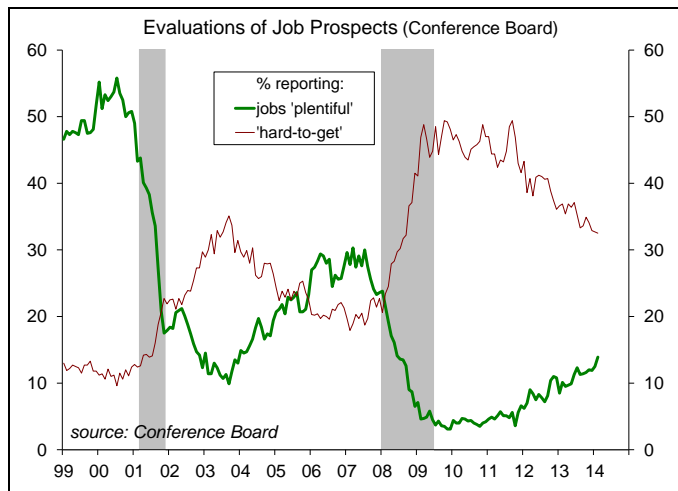
Tuesday

Case-Shiller Home Price Index (January) – The increase in home prices has helped lift many homeowners back above water on their mortgages. However, it's also priced a lot of potential homebuyers out of the market. The pace of increase is likely to slow in the near term, which wouldn't be a bad thing.

New Home Sales (February) – The data reflect initial transactions (a down payment or a signed contract). Weather may have been an ongoing issue, but most new home sales (about four-fifths) are in the South and the West.



Consumer Confidence (March) – The Conference Board's measure includes a more direct weighting of the labor market. Perceptions of job availability are still depressed, but have become gradually less so. That's consistent with the view that we have made progress, but we still have a very long way to go for a full recovery in the job market.



Wednesday

Durable Goods Orders (February) – Transportation orders fell in December and January, but should rebound to some degree in February. Ex-transportation, orders have been uneven in recent months and mixed (but generally soft) across sectors.

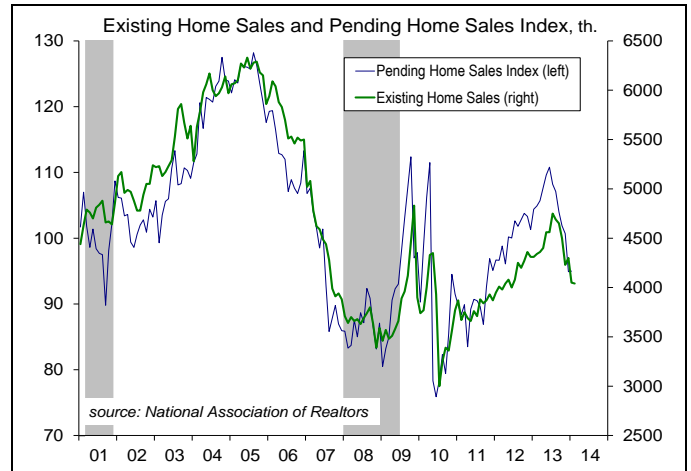
Thursday

Jobless Claims (week ending March 22) – Except for some noise around Easter, seasonal distortions tend to be minor in March and April. The underlying trend has remained relatively low.

Real GDP (4Q13, 3rd estimate) – The 3rd estimate of fourth quarter growth is expected to be revised slightly higher. Normally, there's very little difference between the 2nd and 3rd estimate. We saw an exception to that rule three months ago, when the estimate of 3Q13 GDP was revised sharply higher.

Pending Home Sales (February) – Existing home sales figures from the National Association of Realtors measure closings and tend to lag actual activity. The Pending Home Sales Index is

meant to get ahead of that. The PHSI tends to lead existing home sales by a month, but there's a fair amount of variation between the two.



Friday

Personal Income and Spending (February) – The newly expanded PPI Report (now with services) received relatively little fanfare last month, but is a major expansion in the coverage of inflation pressures. Those inflation pressures have been relatively mild in recent months and are unlikely to heat up anytime soon.

Consumer Sentiment (March) – Down in the mid-month reading, the University of Michigan survey is likely to show a rebound in the full-month assessment.

Next Week ...

Spring – a young man's fancy turns to love the ~~NCAA Tournament~~ fresh economic data. The ISM Manufacturing Index should matter a lot for the markets, but the employment report will be more important to the outlooks for the economy and Federal Reserve policy. Weather is likely to remain an issue in the economic data – but not because the weather was bad; rather, some strength in the data for March and April will merely reflect a recovery from the weather's effects on January and February. In short, much of the economic data are likely to be distorted, but now in the other direction.

Coming Events and Data Releases

April 7	NCAA Tournament Championship
April 9	FOMC Minutes (March 18-19)
April 14	Retail Sales (March)
April 15	Consumer Price Index (March)
April 16	Building Permits, Housing Starts (March) Industrial Production (March) Fed Beige Book
April 18	Good Friday Holiday (markets closed)
April 30	Real GDP (1Q14, advance estimate) FOMC Policy Decision (no press conference)
May 2	Employment Report (April)
June 18	FOMC Policy Decision, Yellen Press Conference