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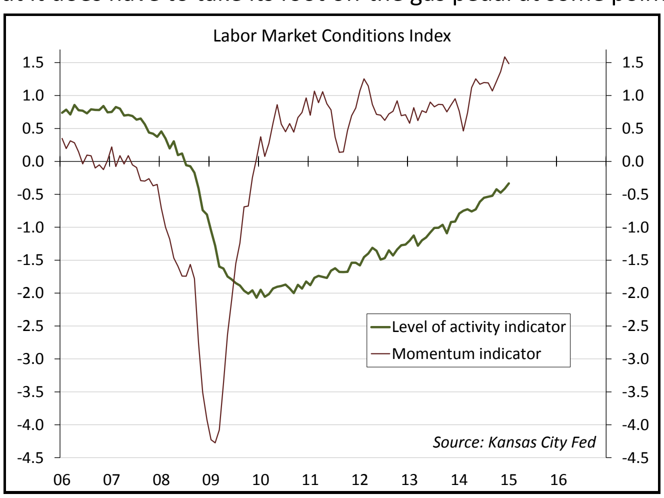
Monthly Economic Outlook

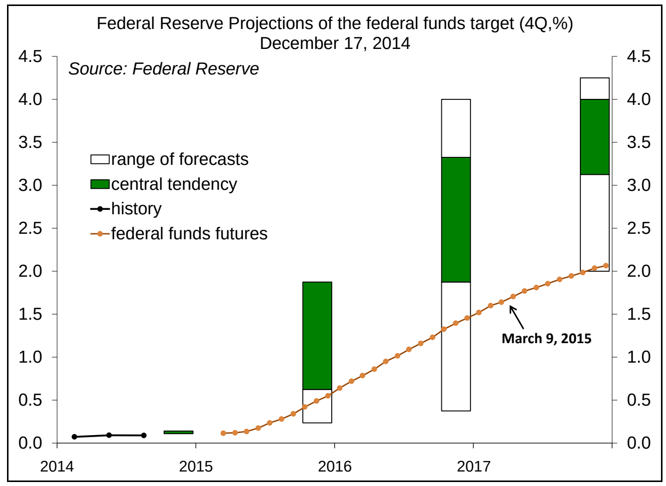
## The Fed, U.S. Dollar, and Markets

- *The Federal Open Market Committee is widely expected to alter its language in the March 18 policy statement, abandoning the view that it can "be patient" in deciding when to begin raising short-term interest rates. However, that does not mean that the Fed will raise rates anytime soon.*
- *The Fed will have to raise rates eventually. In contrast, other central banks are battling the possibility of deflation. Monetary policy is the major factor in short-term movements in exchange rates. The dollar is likely to strengthen further in the near term.*
- *The strong dollar is a plus for consumers, but a negative for exporters. There are two opposing forces at work on bonds: worries about the rest of the world, which are keeping yields down, and increasing domestic economic strength, which would normally be pushing bond yields higher.*

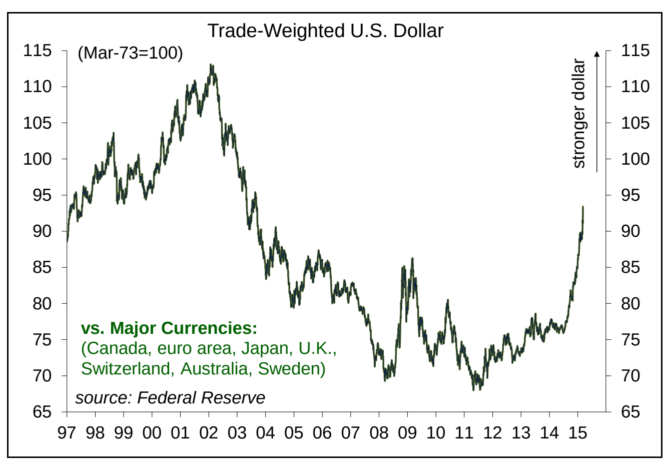
The Fed has well telegraphed its intentions to begin normalizing monetary policy, making public its plans (and tools) over the last several months. However, the timing of policy tightening is uncertain. Fed Chair Yellen has repeated many times that the lift-off decision will be data-dependent, with a primary focus on the job market. However, officials differ in their views as to how much slack remains in the labor market and how rapidly that slack will be taken up in the months ahead. Monetary policy works with a long and variable lag. Officials have to consider where the economy will be in 12 months or so. There's no need for the Fed to hit the brakes, but it does have to take its foot off the gas pedal at some point.




In a normal year, two million jobs added would be considered good. Nonfarm payrolls rose by 3.1 million in 2014, the largest gain since 1999 – and over the last four months, payrolls advanced at more than a 3.8 million annual rate. These figures are based on a statistical sample (the Bureau of Labor Statistics notes that a 90% confidence interval for the monthly change in payrolls is ±105,000). So, it's not unusual to see a string of above-trend figures. The unemployment rate fell to 5.5% in February, but that was partly due to lower labor force participation. The employment/population ratio has risen modestly higher over the last year. Looking at the wide range of labor market gauges (the Kansas City Fed's Labor Market Conditions Index provides a handy overview), slack is being taken up in the job market at a rapid pace. However, a large amount of slack remains. This slack may also be seen in the relatively lackluster growth in average hourly earnings.




The risks around the timing of the Fed's lift-off are not symmetric. That is, if the Fed raises rates too early and the economy stumbles, there would be limited scope for the Fed to stimulate (as rates are already low and nobody wants to launch another round of quantitative easing). If it raises rates too late and inflation picks up, the Fed can then raise rates more rapidly to get monetary policy back on course. Interestingly, market expectations of Fed tightening (federal funds futures) have been more dovish than the projections of most Fed officials (even after the strong February employment data).

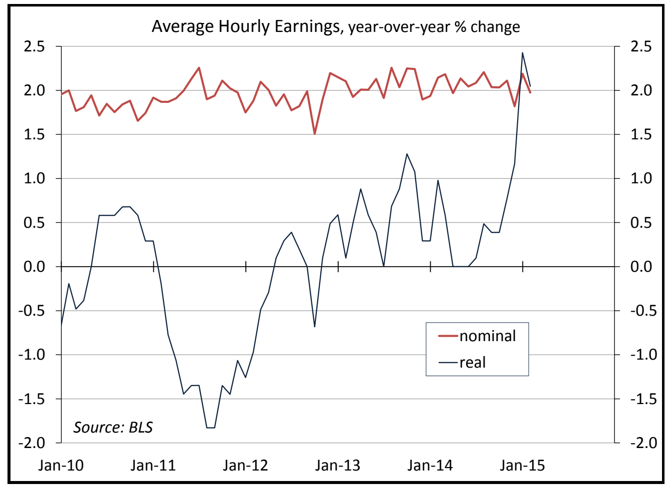


Exchange rates can be thought of as a price, which is dependent on supply and demand. There are a number of factors that influence exchange rates, including relative growth differentials and capital flows. In the short term, six months or so, it's largely about central bank policy. The U.S. Federal Reserve is considering when to begin raising rates. To battle the possibility of deflation, the European Central Bank has just expanded its asset purchase program (€60 billion per month expected through September 2016). With central bank policies diverging sharply, the dollar was naturally going to strengthen.

The stronger dollar has been a huge positive for the consumer. Notably, the drop in gasoline prices has freed up extra cash to fuel consumer spending growth. The impact of lower gasoline prices arrives with a lag (note that February is largely a transitional month, falling between January clearance promotions and the Easter shopping season). While gasoline prices rose in February, the drop from last summer should provide a significant boost to consumer spending this spring. The stronger dollar has also pushed prices lower for a wide range of commodities. Import prices are falling (raw materials, intermediate parts, and finished goods), putting downward pressure on consumer price inflation in the near term.

The strong dollar has not been kind to corporate earnings. Slower growth abroad has been a restraint on earnings growth. A strong dollar makes U.S. goods and services relatively more expensive (compared to their foreign counterparts) and any given amount of earnings in euros will be worth less in dollars.

Note that the exchange rate of the dollar is not the Fed's responsibility (the Treasury speaks for the dollar). However, the Fed does have to consider the growth and inflationary impact of the dollar. Fed officials are aware of the restraint for U.S. exporters, but see a net benefit to economic growth. However, the low inflation outlook may delay the Fed lift-off.




Average hourly earnings have continued to trend at a lackluster pace (+2.0% over the 12 months ending in February, vs. a pace of +3.5% or so for a "normal" job market). Until recently, wage growth has barely kept up with inflation. Consumer spending growth has come largely from job growth. The typical worker has not been getting ahead. The drop in gasoline prices changes that. Real average hourly earnings rose 2.4% y/y in January (with most of that improvement coming in just the last few months). The rise in real wages, combined with continued growth in jobs, should boost consumer spending sharply into the second quarter.

Market participants tend to put far too much weight on the headline GDP figures, which are subject to noise in inventories and foreign trade. Domestic Final Sales should reflect an improved economy in the next couple of quarters.

While improving domestic demand is helpful, market participants will likely remain anxious about global developments as well as the timing and pace of Fed tightening.

| | 1Q14 | 2Q14 | 3Q14 | 4Q14 | **1Q15** | **2Q15** | **3Q15** | **4Q15** | **1Q16** | **2Q16** | 2014 | **2015** | **2016** |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| GDP (↓ *contributions*) | -2.1 | 4.6 | 5.0 | 2.2 | ***1.9*** | ***3.0*** | ***2.9*** | ***2.7*** | ***2.6*** | ***2.6*** | 2.4 | ***2.9*** | ***2.7*** |
| *consumer durables* | *0.2* | 1.0 | 0.7 | *0.4* | ***0.2*** | ***0.5*** | ***0.4*** | ***0.4*** | ***0.4*** | ***0.4*** | *0.5* | ***0.4*** | ***0.4*** |
| *nondurables & services* | *0.6* | 0.8 | 1.5 | *2.4* | ***1.6*** | ***1.8*** | ***1.5*** | ***1.4*** | ***1.4*** | ***1.4*** | *1.2* | ***1.7*** | ***1.4*** |
| *bus. fixed investment* | *-0.1* | 1.2 | 1.1 | *0.6* | ***0.3*** | ***0.7*** | ***0.8*** | ***0.6*** | ***0.6*** | ***0.6*** | *0.6* | ***0.7*** | ***0.7*** |
| *residential investment* | *-0.2* | 0.3 | 0.1 | *0.1* | ***0.4*** | ***0.5*** | ***0.3*** | ***0.3*** | ***0.2*** | ***0.2*** | *0.1* | ***0.3*** | ***0.2*** |
| *government* | *-0.2* | 0.3 | 0.8 | *-0.3* | ***0.3*** | ***0.3*** | ***0.3*** | ***0.2*** | ***0.2*** | ***0.2*** | *0.0* | ***0.2*** | ***0.2*** |
| Domestic Final Sales | 0.7 | 3.4 | 4.1 | 3.2 | ***2.8*** | ***3.9*** | ***3.4*** | ***2.9*** | ***2.8*** | ***2.7*** | 2.3 | ***3.4*** | ***2.9*** |
| *exports* | *-1.3* | 1.4 | 0.6 | *0.4* | ***-0.8*** | ***0.1*** | ***0.3*** | ***0.4*** | ***0.4*** | ***0.4*** | *0.4* | ***0.1*** | ***0.4*** |
| *imports* | *-0.4* | -1.8 | 0.2 | *-1.6* | ***0.2*** | ***-0.7*** | ***-0.7*** | ***-0.6*** | ***-0.6*** | ***-0.6*** | *-0.6* | ***-0.6*** | ***-0.6*** |
| Final Sales | -1.0 | 3.2 | 5.0 | 2.1 | ***2.2*** | ***3.3*** | ***3.0*** | ***2.6*** | ***2.6*** | ***2.6*** | 2.2 | ***3.3*** | ***2.7*** |
| *ch. in bus. inventories* | *-1.2* | 1.4 | 0.0 | *0.1* | ***-0.2*** | ***-0.2*** | ***0.0*** | ***0.0*** | ***0.0*** | ***0.0*** | *0.1* | ***0.0*** | ***0.0*** |
| Unemployment, % | 6.7 | 6.2 | 6.1 | 5.8 | ***5.5*** | ***5.3*** | ***5.1*** | ***4.9*** | ***4.8*** | ***4.7*** | 6.2 | ***5.3*** | ***4.7*** |
| NF Payrolls, monthly, th. | 193 | 284 | 237 | 324 | ***260*** | ***240*** | ***220*** | ***210*** | ***200*** | ***190*** | 260 | ***235*** | ***190*** |
| Cons. Price Index (q/q) | 2.1 | 3.0 | 1.2 | -0.9 | ***-2.7*** | ***1.9*** | ***1.8*** | ***1.8*** | ***1.9*** | ***1.9*** | 1.6 | ***0.1*** | ***1.9*** |
| excl. food & energy | 1.8 | 2.4 | 1.4 | 1.5 | ***1.5*** | ***1.6*** | ***1.8*** | ***1.8*** | ***1.9*** | ***1.9*** | 1.7 | ***1.6*** | ***1.8*** |
| PCE Price Index (q/q) | 1.4 | 2.3 | 1.2 | -0.4 | ***-1.7*** | ***1.7*** | ***1.6*** | ***1.6*** | ***1.7*** | ***1.7*** | 1.3 | ***0.4*** | ***1.7*** |
| excl. food & energy | 1.2 | 2.0 | 1.4 | 1.1 | ***0.8*** | ***1.5*** | ***1.6*** | ***1.6*** | ***1.7*** | ***1.7*** | 1.4 | ***1.3*** | ***1.6*** |
| Fed Funds Rate, % | 0.07 | 0.09 | 0.09 | 0.10 | ***0.11*** | ***0.16*** | ***0.23*** | ***0.68*** | ***1.14*** | ***1.64*** | 0.09 | ***0.30*** | ***1.89*** |
| 3-month T-Bill, (bond-eq.) | 0.1 | 0.0 | 0.0 | 0.0 | ***0.0*** | ***0.1*** | ***0.3*** | ***0.8*** | ***1.2*** | ***1.7*** | 0.0 | ***0.3*** | ***1.9*** |
| 2-year Treasury Note | 0.4 | 0.4 | 0.5 | 0.5 | ***0.6*** | ***1.1*** | ***1.5*** | ***1.9*** | ***2.3*** | ***2.5*** | 0.5 | ***1.3*** | ***2.5*** |
| 10-year Treasury Note | 2.8 | 2.6 | 2.5 | 2.3 | ***2.0*** | ***2.5*** | ***2.6*** | ***2.8*** | ***3.0*** | ***3.1*** | 2.5 | ***2.5*** | ***3.2*** |