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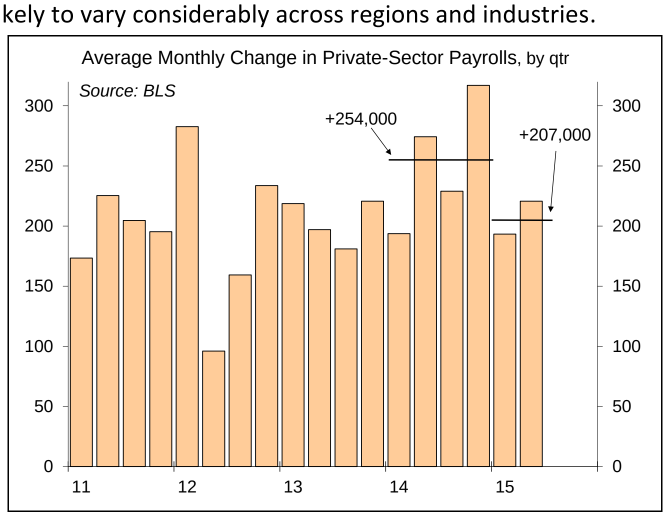
Monthly Economic Outlook

Second-, Third-, and Fourth-Guessing the Fed

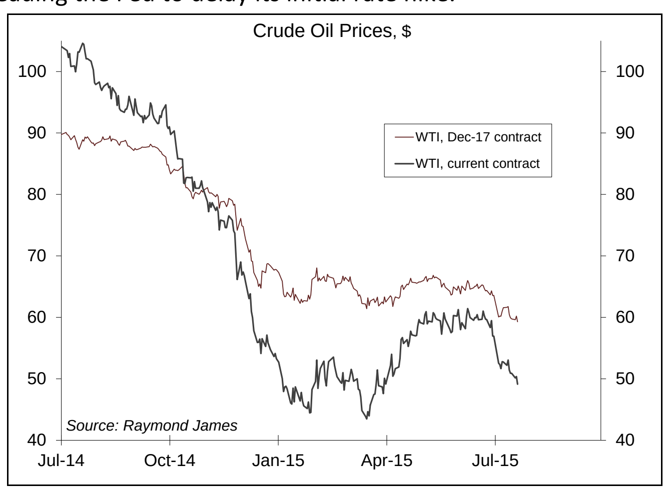
- *An agreement between Greece and the European Commission has reduced the odds of a near-term exit from the monetary union. However, the country's situation is unresolved and we are likely to see tensions heat up again at some point.*
- *Federal Reserve officials continue to signal that economic conditions are likely to warrant an initial increase in short-term interest rate this year, but they have also emphasized that the more important question is the pace of tightening beyond the first move – and that pace is expected to be gradual.*
- *While Greece is mostly off the table as a near-term risk, U.S. investors are likely to remain concerned about a variety of other issues, including the timing of Fed rate hikes and a possible longer-term slowdown in China.*

In her semiannual monetary policy testimony to Congress, Fed Chair Janet Yellen repeated that monetary policy will be data-dependent. The main drivers are estimates of the amount of slack in the labor market and the outlook for inflation. As Yellen noted, job growth slowed in the first half of 2015, but remained relatively strong. The economy added more than 3.0 million jobs in 2014. The pace for the first half of the year was about 2.5 million (annual rate). We need about 1.5 million per year to be consistent with the growth in the working age population. The unemployment rate fell to 5.3% in June (vs. 10% at the recessionary peak), but that understates the amount of slack in the job market. Long-term unemployment and involuntary part-time employment remain high, but both have improved substantially. Considering the broad range of labor market indicators and the current pace of improvement, one can reasonably expect that the labor market will be close to "normal" by late 2016 or early 2017. However, evaluations of the job market will evolve over time and perceptions are likely to vary considerably across regions and industries.

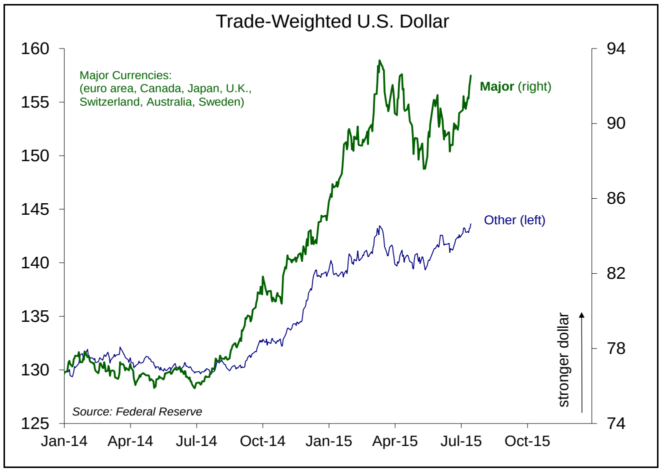


The pace of wage growth is an important signal of labor market slack. Wage growth should pick up as job conditions tighten. In recent years, that pace has been lackluster. There have been some tentative signs of a modest increase in recent months. However, average hourly earnings were flat in June (while May figures were revised lower), leaving the year-over-year gain at 2.0% (a pace little changed over the last several quarters). The Employment Cost Index, which includes benefits costs, is the preferred measure. The ECI ticked up to 2.6% for the year ending in March. Investors should pay close attention to the 2Q15 figure, due July 31, which could have a significant impact on the Fed policy outlook.

For many months, Fed officials have signaled that, as a condition to raise rates, they need to be *"reasonably confident"* that inflation will move back to the 2% goal (the PCE Price Index rose 0.2% in the 12 months ending in May, up 1.2% excluding food and energy). In her recent testimony, Chair Yellen downplayed the low inflation readings through the first half of the year. Fed policymakers see the drop in oil prices and the stronger dollar as *"transitory factors."* Indeed, oil prices and the dollar have been range-bound since mid-March. However, oil prices and the dollar are on the move again. The low trend in inflation may continue for a while longer, perhaps leading the Fed to delay its initial rate hike.



Exchange rates are influenced by many factors, ultimately driven by supply and demand (balancing trade and capital flows). In the short-run, it's largely about central bank policies. With the Fed (and the Bank of England) contemplating rate hikes, European Central Bank President Draghi signaling no curtailment of the asset purchase plans, and the Bank of Canada cutting rates, the dollar has strengthened recently. This, in turn, puts some downward pressure on import prices, likely prolonging the current low trend in consumer price inflation (and possibly delaying the Fed's initial hike).



Needless to say, the Fed's decision on when to begin raising rates may not be an easy one. The economy is far from fully recovered from the effects of the Great Recession, but it has made substantial progress. The risks are not symmetric. That is, if the Fed waits too long and inflation picks up, it can easily raise rates at a faster pace to get policy on a more appropriate path. However, if it raises rates too soon, and the economy stumbles, there would be a limited ability to counter that weakness. Note that there is no good argument for "reloading" (raising rates now so that it can lower them later if needed) — Fed officials have repeatedly dispelled this notion in the past. There is no pressing need for the Fed to hit the brakes here. However, with an eye to where the economy will be a year or more from now, the Fed should be justified in starting to lighten up on the gas pedal. Yet, the Fed also has to consider financial stability. As we saw in 2013's taper tantrum, over-reactions in the mortgage market and in emerging economies are possibilities. However, the Fed can hint strongly of a move and step back if the market response is unfavorable.

In other words, the Fed may use open-mouth operations and see how the markets react. It's a bit odd that as the Fed has become much more open in its communications in recent years, the markets have often struggled to correctly interpret the central bank's intentions. In recent months, Fed officials have gone out of their way to signal that the timing of the first move is not that important. The key is the pace of tightening over the next few years. However, financial participants are still overly preoccupied with the Fed's timing decision.

Global developments are likely to remain important issues for the markets in the months ahead. While Greece has agreed to conditions for a third bailout, some details still have to be worked out. The IMF has written that there is no viable long-term solution to Greece's situation without some write-down of the country's debt. However, German officials have signaled strong resistance to that notion. In the U.S., some states habitually receive much more in federal dollars than they send to Washington. Europe still has no fiscal union, which has long been a chief criticism of the monetary union. Tensions in Greece are almost certain to rise again in the months ahead.

China's stock market correction is not necessarily going to have much of an impact on the country's economy. However, a slowing in growth has already been a concern. In her Congressional testimony, Yellen noted that *"China continues to grapple with the challenges posed by high debt, weak property markets, and volatile financial conditions."* China can be added to the list of concerns about emerging economies in general. These economies are expected to account for most of the growth in the global economy over the next couple of decades, but have stumbled in the last year or so. Yet, Yellen also noted that *"economic growth abroad could also pick up more quickly than observers generally anticipate, providing additional support for U.S. economic activity."*

	1Q14	2Q14	3Q14	4Q14	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	2014	2015	2016
GDP (↓ *contributions*)	-2.1	4.6	5.0	2.2	-0.7	2.5	2.9	2.8	2.7	2.7	2.4	2.3	2.7
consumer durables	0.2	1.0	0.7	0.5	0.1	0.4	0.4	0.4	0.4	0.4	0.5	0.4	0.4
nondurables & services	0.6	0.8	1.5	2.5	1.2	1.4	1.5	1.4	1.4	1.4	1.2	1.6	1.4
bus. fixed investment	-0.1	1.2	1.1	0.6	-0.4	0.3	0.7	0.6	0.6	0.6	0.6	0.4	0.6
residential investment	-0.2	0.3	0.1	0.1	0.2	0.4	0.4	0.3	0.2	0.2	0.1	0.3	0.3
government	-0.2	0.3	0.8	-0.4	-0.2	0.3	0.2	0.2	0.2	0.2	0.0	0.1	0.2
Domestic Final Sales	0.7	3.4	4.1	3.3	0.8	2.9	3.3	3.0	2.8	2.8	2.3	2.8	2.9
exports	-1.3	1.4	0.6	0.6	-1.0	0.5	0.5	0.5	0.5	0.5	0.4	0.3	0.5
imports	-0.4	-1.8	0.2	-1.6	-0.9	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.9	-0.6
Final Sales	-1.0	3.2	5.0	2.3	-1.1	2.8	3.1	2.8	2.7	2.7	2.2	2.7	2.8
ch. in bus. inventories	-1.2	1.4	0.0	-0.1	0.3	-0.4	-0.2	0.0	0.0	0.0	0.1	0.1	0.0
Unemployment, %	6.7	6.2	6.1	5.8	5.6	5.4	5.2	5.1	5.0	4.8	6.2	5.3	4.8
NF Payrolls, monthly, th.	193	284	237	324	195	221	200	190	190	190	254	202	186
Cons. Price Index (q/q)	2.1	3.0	1.2	-0.9	-3.1	3.0	2.6	1.8	1.9	1.9	1.6	0.4	2.0
excl. food & energy	1.8	2.4	1.4	1.5	1.7	2.5	1.9	1.8	1.8	1.9	1.7	1.8	1.9
PCE Price Index (q/q)	1.4	2.3	1.2	-0.4	-2.0	2.1	2.2	1.6	1.7	1.7	1.3	0.5	1.8
excl. food & energy	1.2	2.0	1.4	1.1	0.8	1.7	1.6	1.6	1.7	1.7	1.4	1.3	1.7
Fed Funds Rate, %	0.07	0.09	0.09	0.10	0.11	0.13	0.17	0.38	0.42	0.65	0.09	0.20	0.79
3-month T-Bill, (bond-eq.)	0.1	0.0	0.0	0.0	0.0	0.0	0.1	0.3	0.4	0.6	0.0	0.1	0.8
2-year Treasury Note	0.4	0.4	0.5	0.5	0.6	0.6	0.7	1.4	2.0	2.3	0.5	0.8	2.3
10-year Treasury Note	2.8	2.6	2.5	2.3	2.0	2.2	2.5	2.6	2.9	3.0	2.5	2.3	3.1