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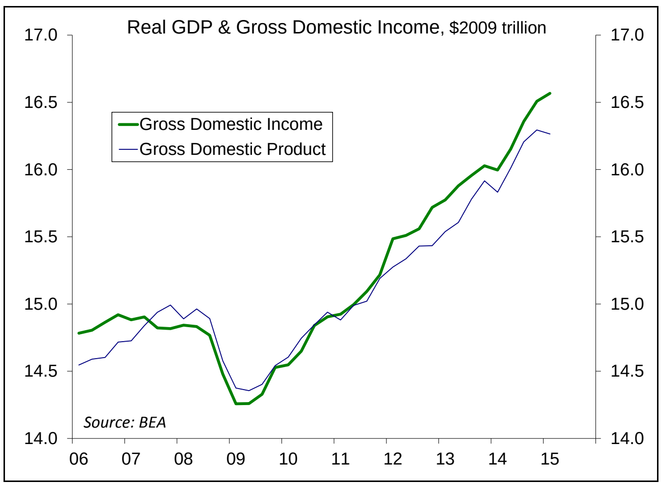
Monthly Economic Outlook

Fed on Track for Policy Normalization

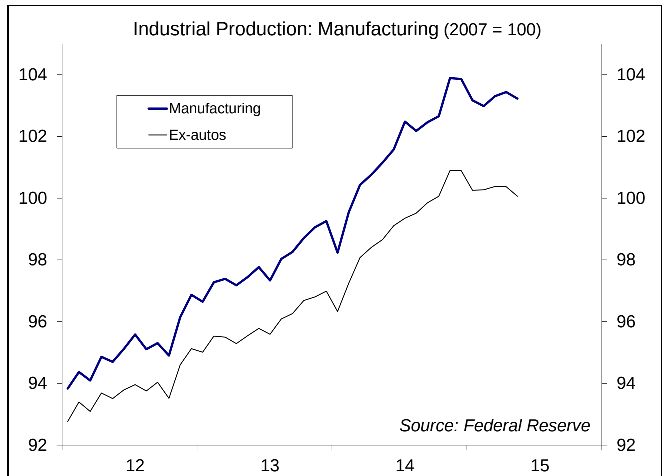
- *Economic data have been consistent with moderate growth in 2Q15, but with mixed strength across sectors.*
- *Excess slack in the labor market continues to be reduced, but full employment still appears to be many months away.*
- *Monetary policy will remain data-dependent. It's likely the Fed will begin raising short-term interest rates later this year, but the pace of tightening is likely to be very gradual.*

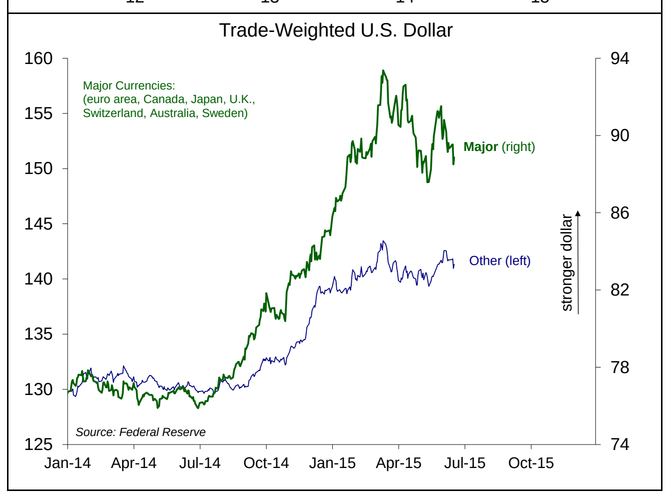
Real GDP fell at a 0.7% annual rate in the 2nd estimate for 1Q15 (down from +0.2% in the advance estimate). The third revision is expected to show a more modest decline (note annual benchmark revisions will arrive in late July). In general, financial market participants place far too much emphasis on the headline GDP figure and ignore most of the details. First quarter GDP growth was restrained by a sharp fall in net exports (a wider trade deficit). The more stable growth measures, such as Gross Domestic Income and Domestic Final Sales, were positive (+1.4% and +0.8%, respectively).



Recent economic data releases have been consistent with a moderate pace of growth in the second quarter, although activity appears to be mixed across sectors and generally disappointing (given the soft first quarter). The drop in gasoline prices was expected to fuel a sharp rise in consumer spending in the first half of 2015, but there is some evidence that consumers may have viewed the decline in gasoline prices as temporary, and therefore, less likely to spend the windfall. Yet, consumer spending has varied considerably across categories, suggesting a mixed response to the drop in gasoline prices. The retail sales figures through May showed that restaurant sales for the first five months of 2015 were up 8.9% relative to the same period in 2014. Auto sales rose 7.9% y/y. In contrast, sales at electronics and appliance stores were down 1.2% y/y. Department store sales fell 2.3% y/y.

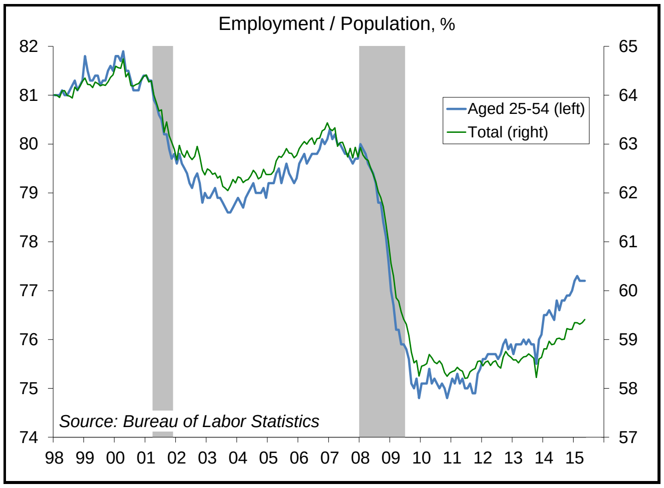
Manufacturing activity has been mixed, but generally lackluster in recent months, partly reflecting a lingering impact of the strong dollar. In the first five months of 2015, orders for core capital goods (nondefense, excluding aircraft) were down 2.6%, relative to the same period in 2014. Monthly figures can be volatile, but the trend in orders may be stabilizing. Shipments of core capital goods appear to be rising modestly. The strong dollar has likely been a factor, but the greenback has been largely range-bound in the last few months. If that continues, the exchange rate impact should fade.



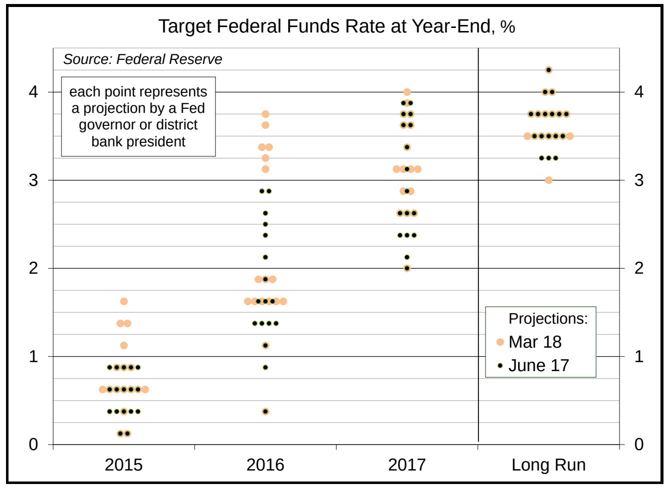


Job growth, although not quite as robust as in the second half of 2014, has been relatively strong in recent months; well ahead of the pace that would be consistent with trend growth in the labor force (1% annual growth in the labor force is equivalent to a monthly payroll gain of 120,000). Such a pace, while not sustainable over the long run, is necessary to reduce the labor market slack generated from the recession. In turn, strong job growth should help support consumer spending growth and recovery in the housing sector.

Gauging the amount of slack in the economy isn't easy. Fed officials look at a wide range of labor market indicators, including labor force participation rates, involuntary part-time employment, quit rates, and wage growth. Moreover, since monetary policy affects the economy with a lag, officials face an even greater task in trying to gauge how much slack will remain in the job market a year or so ahead. Currently, there's no pressing need for the Fed to hit the brakes, but it does have to begin taking the foot off the accelerator at some point.



In mid-June, all but two of the 17 senior Fed officials expect that conditions will warrant an initial hike later this year. However, Chair Yellen indicated that the timing of the first hike in short-term interest rates is much less important than the pace of tightening beyond that first move. As with the timing of the initial move, the pace will be data dependent. Yellen indicated that the Fed will not adopt a mechanical approach to raising rates, but the dots in the dot plot are consistent with 25 basis points per quarter (or every other FOMC meeting).



The Fed could raise rates faster, if economic conditions improve more than anticipated, or slow the pace, if the economy stumbles. The key factors will be labor market conditions and the inflation outlook. When the Fed does begin to raise rates, it should come as no surprise to U.S. financial markets. However, policymakers will be sensitive to financial stability issues. For example, there could be some liquidity problems in the bond market or an especially adverse reaction in emerging economies. These concerns should be consistent with the gradual policy outlook. More importantly, as Yellen stressed in her press conference, *"the stance of monetary policy will likely remain highly accommodative for quite some time after the initial increase in the federal funds rate."*

Looking ahead, growth is expected to pick up in 2H15, as restraints fade further. We may face another unnecessary showdown over the federal debt ceiling in the early autumn. A possible long-term slowdown in productivity growth is a concern. However, the overall outlook remains optimistic.

	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	***2.3***	***2.9***	***2.8***	***2.7***	***2.7***	2.4	***2.1***	***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*	***1.5***	***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*	***0.2***	***0.2***
government	*-0.2*	0.3	0.8	*-0.4*	-0.2	***0.2***	***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	***2.8***	***3.3***	***2.9***	***2.8***	***2.8***	2.3	***2.7***	***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*	***0.2***	***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*	***-0.8***	***-0.6***
Final Sales	-1.0	3.2	5.0	2.3	-1.1	***2.7***	***3.1***	***2.7***	***2.6***	***2.7***	2.2	***2.6***	***2.7***
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*	***0.0***	***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	184	***210***	***200***	***190***	***190***	***190***	254	***208***	***183***
Cons. Price Index (q/q)	2.1	3.0	1.2	-0.9	-3.1	***2.7***	***2.2***	***1.8***	***1.9***	***1.9***	1.6	***0.2***	***2.0***
excl. food & energy	1.8	2.4	1.4	1.5	1.7	***2.4***	***1.8***	***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	***1.8***	***1.8***	***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***	***1.7***
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***	***0.7***	0.0	***0.1***	***0.8***
2-year Treasury Note	0.4	0.4	0.5	0.5	0.6	***0.6***	***1.1***	***1.5***	***2.1***	***2.3***	0.5	***1.0***	***2.4***
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***