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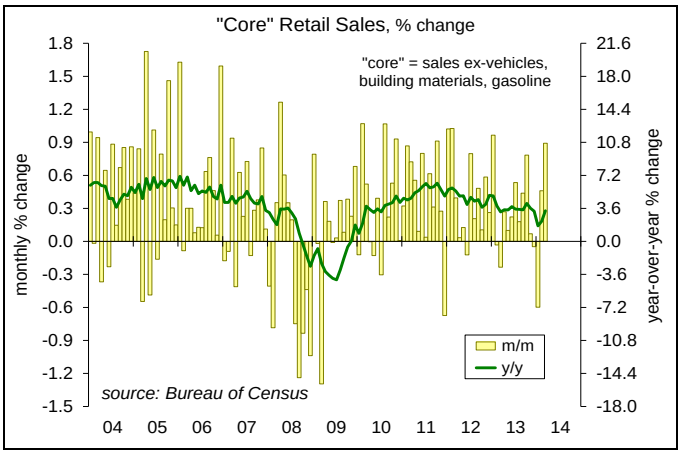
Monthly Economic Outlook

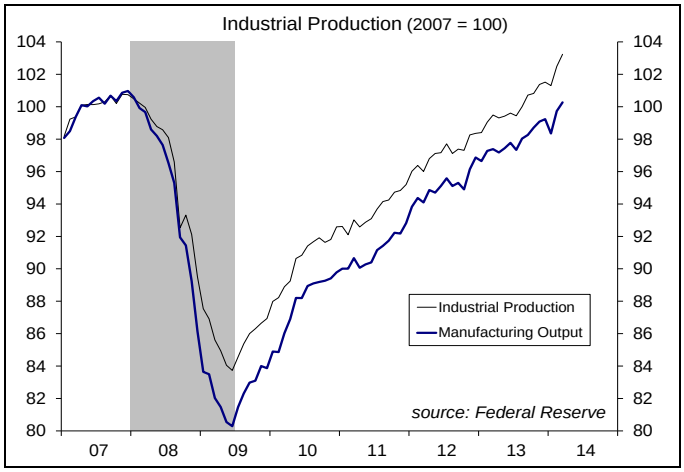
Spring Awakening?

- *Adverse weather had a negative effect on economic activity in the first quarter. We should see a rebound in most economic series in 2Q14. It will likely be difficult to gauge the underlying strength, but investors are likely to remain optimistic about growth prospects for the remainder of the year.*
- *Globally, the advanced economies are expected to improve, but growth in emerging economies may remain spotty. In the U.S., economic activity has varied across the income scale.*
- *Federal Reserve policymakers are expected to continue along the current taper path, reducing the monthly pace of asset purchases by $10 billion at each FOMC meeting. The Fed is not expected to begin raising short-term interest rates until about the middle of 2015 (and then only gradually).*

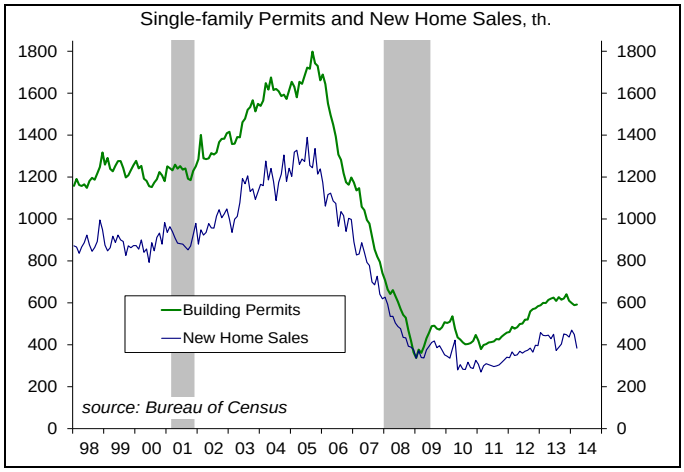
The advance estimate of 1Q14 GDP growth will be released on April 30 (coincidentally, the Federal Reserve will announce its latest policy decision that afternoon). The government will still be missing March data on inventories, foreign trade, and a few other components, but it's likely that the initial GDP estimate will come in at an annual rate of 0.4% to 1.4%. The GDP estimate will be revised, and revised again, but the story is unlikely to change much. Adverse weather should have had a negative impact on consumer spending and homebuilding. Inventories are expected to have slowed, subtracting from overall GDP growth. A wider trade deficit will also subtract. Government spending should rebound for the impact of the shutdown in 4Q13, adding to GDP growth.



The monthly data for the first quarter reflect a broad-based slowing, but also suggest stronger built-in gains for 2Q14. By most measures, the weather was worse than normal in December, January, February, and March, but especially so in the first two months of the year. Retails sales excluding autos, building materials, and gasoline were unchanged in 1Q14 (relative to 4Q13), but improvement in March implies a relatively strong gain in 2Q14 (+3.0% if sales were to simply remain at the March level in April, May, and June). Industrial production rose at a 4.4% annual rate in 1Q14, but that was boosted by increases in mining (a 9.5% pace) and utilities (a 17.9% pace). The output of utilities was boosted by colder than normal temperatures and we should see a sharp decrease in 2Q14. Manufacturing output rose at a 1.4% annual rate in 1Q14 (positive, but lackluster). The monthly arithmetic suggests a 3.4% annual rate assuming no change in April, May, and June. So, while estimates of 1Q14 GDP growth have been lowered, estimates for 2Q14 GDP growth have been raised.



Residential construction and sales were also restrained by the weather in 1Q14. These figures tend to be choppy, but the March data suggest that weakness is likely due to more than the weather. Higher mortgage rates (relative to a year ago) and higher home prices have reduced affordability. First-time homebuyers are having difficulty obtaining credit and high levels of student debt are a factor. Builders continue to note supply constraints (such as a lack of available lots on which to build), but remain somewhat optimistic that sales will improve.



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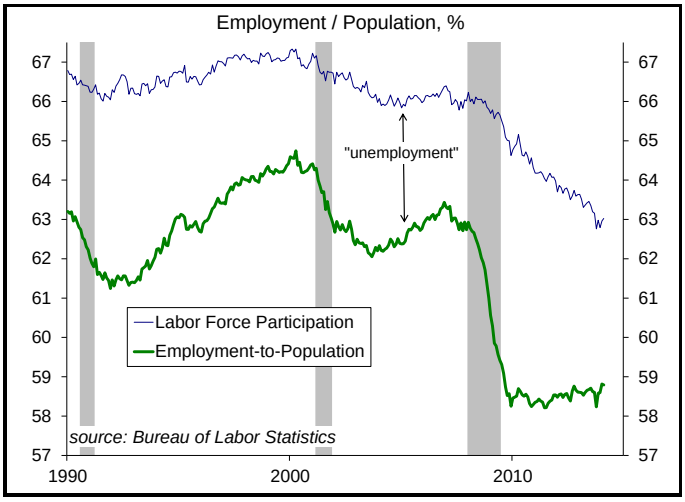
Fed Chair Janet Yellen recently spoke about the Fed's policy response to the Great Recession and provided some detail about the decision-making process going forward. Regarding the asset purchase program (QE3), the Fed is expected to continue along the current path of tapering $10 billion from the monthly pace of purchases at each policy meeting. It would take a major change in the economic outlook for the Fed to deviate from that path (note that the first quarter's adverse weather has not had a big impact on the economic outlook for 2014 as a whole).



In deciding when to raise short-term interest rates, the Fed will consider how far it is from its goals (maximum sustainable employment, 2% inflation), as well as financial conditions in general. The Fed will look to a wide range of labor market indicators beyond nonfarm payrolls and the unemployment rate: quit rates, hiring rates, labor force participation, long-term unemployment, and wage growth. These figures continue to suggest that there is a large amount of slack in job market.

Most Fed officials expect that inflation will trend at or below the 2% target over the next couple of years. In the short term, we should see higher food prices related to the drought in California, but that should be temporary. Import price increases have generally been mild for both raw materials and finished goods. Excess capacity in manufacturing should limit any inflation coming from production or bottleneck constraints. The labor market is the widest channel for inflation pressure. While there are reports of wage increases for certain skilled labor positions, average wages have not risen by much.

Median weekly earnings rose 2.7% in 1Q14 (vs. 1Q13), but only 1.2% adjusted for inflation. More worrisome, inflation-adjusted median wages were exactly the same as they were in 1Q05 – that is, no growth over the last decade. The continued slack in the labor market has restrained labor income, which implies less fuel for consumer spending growth, and a weaker economic recovery than would have occurred otherwise. Worries about a declining middle class should eventually ease as the labor market tightens and wage growth picks up, but that may still be some time away and the outlook would worsen if the economy were to stumble in the months ahead.

Yellen noted that Fed officials regularly ask themselves what could derail the recovery. These concerns are largely focused in financial conditions. The Fed often risks inflating new bubbles as it mops up the aftermath of the previous bubble. Some believe that the Fed traded the tech bubble for a housing bubble (although the Fed was raising rates in the housing bubble). The concern about possible financial bubbles was one factor in the decision to scale back the monthly pace of asset purchases. Credit spreads have narrowed, suggesting some risk that they might widen in an unorderly fashion in the months ahead. However, the Fed is unlikely to normalize monetary policy at a faster pace due to bubble concerns.

	1Q13	2Q13	3Q13	4Q13	**1Q14**	***2Q14***	***3Q14***	***4Q14***	***1Q15***	***2Q15***	2013	**2014**	**2015**
GDP (↓ *contributions*)	1.1	2.5	4.1	2.6	***0.8***	***3.4***	***3.0***	***3.0***	***3.1***	***3.1***	1.9	***2.5***	***3.1***
consumer durables	*0.4*	*0.5*	*0.6*	*0.2*	***-0.1***	***0.6***	***0.4***	***0.4***	***0.4***	***0.4***	*0.5*	***0.3***	***0.4***
nondurables & services	*1.1*	*0.8*	*0.8*	*2.0*	***1.5***	***1.7***	***1.5***	***1.5***	***1.5***	***1.5***	*0.8*	***1.5***	***1.5***
bus. fixed investment	*-0.6*	*0.6*	*0.6*	*0.7*	***0.4***	***0.6***	***0.7***	***0.7***	***0.7***	***0.7***	*0.3*	***0.6***	***0.7***
residential investment	*0.3*	*0.4*	*0.3*	*-0.3*	***-0.2***	***0.7***	***0.4***	***0.3***	***0.3***	***0.3***	*0.3*	***0.2***	***0.3***
government	*-0.8*	*-0.1*	*0.1*	*-1.0*	***0.6***	***0.1***	***0.1***	***0.1***	***0.1***	***0.1***	*-0.4*	***0.0***	***0.1***
Domestic Final Sales	0.5	2.1	2.3	1.6	***2.3***	***3.7***	***3.0***	***3.0***	***3.0***	***3.0***	1.6	***2.6***	***3.0***
exports	*-0.2*	*1.0*	*0.5*	*1.2*	***-1.1***	***0.7***	***0.6***	***0.6***	***0.6***	***0.6***	*0.4*	***0.3***	***0.6***
imports	*-0.1*	*-1.1*	*-0.4*	*-0.2*	***0.1***	***-0.4***	***-0.5***	***-0.6***	***-0.6***	***-0.6***	*-0.2*	***-0.3***	***-0.5***
Final Sales	0.2	2.1	2.5	2.7	***1.3***	***4.0***	***3.1***	***3.1***	***3.1***	***3.0***	1.5	***2.5***	***3.0***
ch. in bus. inventories	*0.9*	*0.4*	*1.7*	*0.0*	***-0.5***	***-0.6***	***-0.1***	***0.0***	***0.0***	***0.0***	*0.2*	***0.0***	***0.0***
Unemployment, %	7.7	7.5	7.3	7.0	6.7	***6.5***	***6.3***	***6.1***	***5.9***	***5.8***	7.4	***6.4***	***5.7***
NF Payrolls, monthly, th.	206	201	172	198	178	***220***	***205***	***210***	***210***	***200***	182	***203***	***196***
Cons. Price Index (q/q)	1.2	0.4	2.2	1.1	1.9	***2.2***	***1.6***	***1.8***	***1.9***	***1.9***	1.5	***1.7***	***1.9***
excl. food & energy	2.0	1.4	1.8	1.6	1.6	***1.8***	***1.8***	***1.9***	***1.9***	***2.0***	1.8	***1.7***	***1.9***
PCE Price Index (q/q)	1.1	-0.1	1.9	1.1	***1.4***	***1.8***	***1.6***	***1.7***	***1.8***	***1.8***	1.1	***1.4***	***1.7***
excl. food & energy	1.4	0.6	1.4	1.3	***1.2***	***1.6***	***1.6***	***1.7***	***1.8***	***1.8***	1.2	***1.4***	***1.8***
Fed Funds Rate, %	0.14	0.12	0.09	0.09	0.07	***0.10***	***0.14***	***0.19***	***0.24***	***0.28***	0.11	***0.13***	***0.62***
3-month T-Bill, (bond-eq.)	0.1	0.1	0.0	0.1	0.1	***0.0***	***0.1***	***0.2***	***0.2***	***0.3***	0.1	***0.1***	***0.6***
2-year Treasury Note	0.3	0.3	0.4	0.3	0.4	***0.5***	***0.7***	***1.0***	***1.3***	***1.7***	0.3	***0.6***	***1.9***
10-year Treasury Note	2.0	2.0	2.7	2.7	2.8	***2.8***	***3.1***	***3.3***	***3.5***	***3.7***	2.4	***3.0***	***3.8***