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Scott J. Brown, Ph.D., (727) 567-2603, Scott.J.Brown@RaymondJames.com
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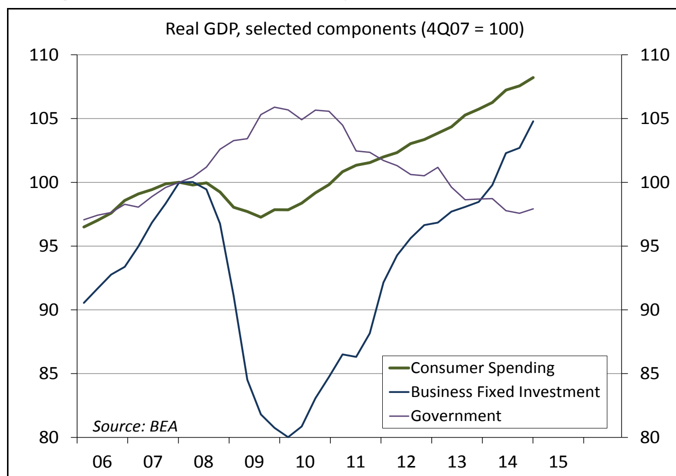
Economic Trends

The Fed Policy Outlook

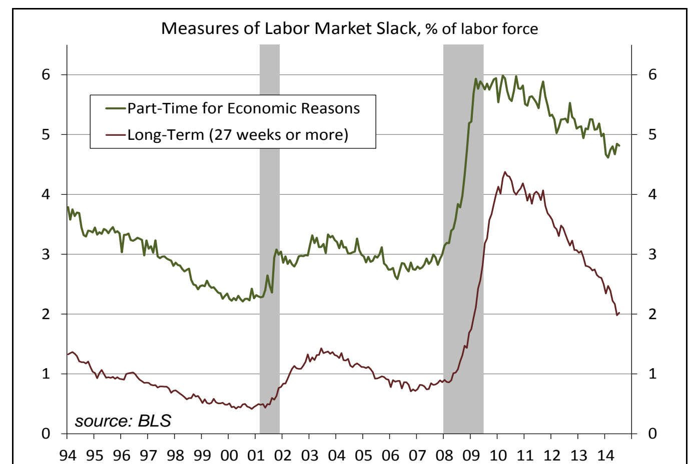
- *Real GDP growth is expected to expand at a moderately strong pace in the remainder of 2014, while inflation is likely to trend below the Federal Reserve's target.*
- *Economic weakness in Europe has put downward pressure on global bond yields. Geopolitical tensions are expected to remain an important factor for investors.*
- *The FOMC is on track to end its asset purchase program (QE3) after the October 29 policy meeting. The first increase in short-term interest rates will depend on the economic data, but rates are unlikely to be raised until around mid-2015. Officials are making progress on policy normalization plans.*

Real GDP rose at a 4.2% annual rate in the second estimate for 2Q14, vs. a -2.1% pace in 1Q14 (up 2.5% y/y). The increase reflected a sharp increase in inventory accumulation and a moderate rebound from the first quarter's bad weather. Domestic Final Sales (GDP less net exports and the change in inventories), a measure of underlying domestic demand, rose at a 3.1% annual rate, vs. +0.7% in 1Q14 (+2.2% y/y and a 1.9% average for the first half of this year).



Since bottoming in 2Q09, real GDP has averaged a 2.2% annual rate of growth over the last 20 quarters – not horrible, but not especially strong either. Over this time, consumer spending has averaged a 2.2% annual rate, supported by a gradual recovery in spending on motor vehicles. Business fixed investment averaged a 5.1% annual rate, somewhat stronger (+6.4%) over the last year. Homebuilding has risen at a 5.5% annual rate, but that's only a partial rebound from its sharp recessionary plunge and improvement has been meager (+0.8%) over the last year. What makes this recovery different from past rebounds is the decline in government (reflecting an unwinding of military effort, state and local budget constraints, and sequester cuts at the federal level).

The labor market data paint a mixed picture. Job growth has been relatively strong, with nonfarm payrolls up 2.6 million (+1.9%) for the 12 months ending in July. The unemployment rate has trended lower over the last several years (peaking at 10% in October 2009, down to 6.2% in July). Measures of short-term unemployment (weekly claims for unemployment benefits, the percentage of workers unemployed for 26 weeks or less) are at levels we would normally associate with a fully recovered job market. However, other measures (such as long-term unemployment, under-employment, and average wages) continue to suggest that there is a large amount of slack.



The trend in real wages may be due to a number of factors. There could be pent-up demand for real wage reductions. That is, firms may have been generally unable to reduce nominal wages during the downturn, but they can reduce inflation-adjusted wages over time by giving more modest wage increases. There may be secular reasons, such as technological advances or fundamental changes to production. Or there may be long-lasting effects from the severe economic downturn. Another possible explanation is a mismatch in skills. If this were true, one would see much more rapid job growth and wage gains in some areas, and that's generally not true. Firms may be pickier in hiring workers. Often when someone says that they can't find enough skilled workers, they mean that they can't find workers *at the wage they're willing to pay*.

Assessments of the amount of slack in the labor market will play a significant role in the Federal Reserve's policy decisions. However, this isn't a simple task. Data reports often conflict with one another. Moreover, it's not a straight-forward transition from tighter labor markets to higher wage pressures. Labor force participation has declined significantly in recent years. We should see many of those who dropped out of the labor force return as the job market improves, but wage developments will play a key role in that.

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In her Jackson Hole speech, Fed Chair Janet Yellen gave a balanced assessment of the theories and evidence regarding the amount of slack in the job market (in contrast to expectations that she would be "dovish"). The consensus view in the market is that the first rate hike will likely come in 2Q15, but that depends. Given the substantial degree of labor market slack in recent years, *"the need for extraordinary accommodation is unambiguous."* However, Fed policymakers are *"naturally shifting to questions about the degree of remaining slack, how quickly that slack is taken up, and thereby to the question of under what conditions we should begin dialing back our extraordinary accommodation."* She repeated the notion that the Fed could raise short-term interest rates a bit sooner if the economy strengthens more than anticipated, or raise a little later if the economy disappoints, but as Yellen emphasized, there are dangers of raising rates too soon as well as too late. *"There is no simple recipe for appropriate policy in this context."*

The minutes of the July 29-30 Fed policy meeting showed that the hawkish view (those officials wanting to raise rates sooner rather) was a small minority. However, in the weeks and months ahead, quotes from the more hawkish Fed officials are likely to receive disproportionate attention in the financial press, possibly adding to financial market volatility. It's worth noting that many of those expressing concerns about the risk of higher inflation were the same ones harping about it three or four years ago. Consumer price inflation is likely to remain relatively mild for some time. The soft global economy should put a check on commodity prices and increased domestic production is likely to put downward pressure on energy prices. There's little to no inflation coming through imports (raw materials or finished goods), there's plenty of excess capacity in manufacturing (firms not struggling to keep up with demand), and there's no significant upward pressure in wages.

The minutes also showed that Fed officials have made progress on their plans for policy normalization. The federal funds target rate is expected to remain the main policy lever, but with a specified range, rather than a return to a specific level. The top of the range will most likely be the rate of interest on excess reserves held at the Fed (IOER), while the lower end should be defined by the overnight reverse repo rate. Most senior Fed officials expect to end the reinvestment of mortgage principal payments and maturing Treasuries after the first increase in short-term interest rates, at which point the size of the balance sheet would decrease naturally over time. Policymakers expect to present details of their normalization plans "well before" taking the first steps.

U.S. economic growth is expected to pick up in the second half of the year, but it's unclear whether that will be a little over 3% or a little less. While the pace of hiring has gradually improved, geopolitical tensions, if they escalate, could lead to more cautious business attitudes (leaving firms a little less likely to make capital expenditures or hire new workers). Conversely, geopolitical tensions have helped to push long-term interest rates lower in the U.S., which should be helpful for consumer spending and business fixed investment.

With the Fed's asset purchase program (QE3) winding down (expected to end after the October 28-29 policy meeting), many are still puzzled by the decline in U.S. bond yields. Soft first half GDP growth and an expectation of gradual Fed tightening have played a part, but Europe has also been a key factor. The euro area economy appears weak and inflation has trended at an uncomfortably low level. The European Central Bank is now poised to embark on its own asset purchase program. The prospect of a tightening Fed and an easing ECB puts downward pressure on the euro and European bond yields, and in turn, U.S. yields.

	3Q13	4Q13	1Q14	2Q14	***3Q14***	***4Q14***	***1Q15***	***2Q15***	***3Q15***	***4Q15***	2013	**2014**	**2015**
GDP (↓ *contributions*)	4.5	3.5	-2.1	4.2	***2.8***	***2.7***	***2.8***	***2.8***	***2.7***	***2.6***	2.2	***2.1***	***2.9***
consumer durables	*0.4*	*0.4*	*0.2*	1.0	***0.4***	***0.5***	***0.5***	***0.5***	***0.4***	***0.4***	*0.5*	***0.5***	***0.5***
nondurables & services	*1.0*	*2.1*	*0.6*	0.7	***1.4***	***1.5***	***1.5***	***1.5***	***1.4***	***1.4***	*1.2*	***1.1***	***1.4***
bus. fixed investment	*0.6*	*0.7*	*-0.1*	1.0	***0.8***	***0.8***	***0.7***	***0.7***	***0.6***	***0.6***	*0.3*	***0.5***	***0.7***
residential investment	*0.3*	*-0.3*	*-0.2*	0.2	***0.6***	***0.3***	***0.3***	***0.2***	***0.2***	***0.2***	*0.3*	***0.1***	***0.3***
government	*0.0*	*-0.7*	*-0.2*	0.3	***0.2***	***0.2***	***0.2***	***0.2***	***0.2***	***0.2***	*-0.4*	***-0.1***	***0.2***
Domestic Final Sales	2.3	2.7	0.7	3.1	***3.4***	***3.4***	***3.1***	***3.1***	***2.8***	***2.8***	1.9	***2.2***	***3.1***
exports	*0.7*	*1.3*	*-1.3*	1.3	***0.2***	***0.2***	***0.3***	***0.4***	***0.4***	***0.4***	*0.4*	***0.3***	***0.4***
imports	*-0.1*	*-0.2*	*-0.4*	-1.7	***-0.2***	***-0.6***	***-0.6***	***-0.6***	***-0.6***	***-0.6***	*-0.2*	***-0.6***	***-0.6***
Final Sales	3.0	3.9	-1.0	2.8	***3.4***	***3.0***	***2.8***	***2.8***	***2.6***	***2.6***	1.8	***2.1***	***3.0***
ch. in bus. inventories	*1.5*	*-0.3*	*-1.2*	1.4	***-0.6***	***-0.2***	***0.0***	***0.0***	***0.0***	***0.0***	*0.0*	***0.0***	***0.0***
Unemployment, %	7.3	7.0	6.7	6.2	***6.0***	***5.8***	***5.6***	***5.5***	***5.4***	***5.3***	7.4	***6.2***	***5.5***
NF Payrolls, monthly, th.	172	198	190	272	***220***	***230***	***225***	***210***	***200***	***190***	194	***228***	***214***
Cons. Price Index (q/q)	2.2	1.1	1.9	3.0	***2.1***	***1.8***	***1.9***	***1.9***	***1.9***	***1.9***	1.5	***1.9***	***2.0***
excl. food & energy	1.8	1.6	1.6	2.5	***1.7***	***1.9***	***1.9***	***2.0***	***2.0***	***2.0***	1.8	***1.8***	***1.9***
PCE Price Index (q/q)	1.7	1.0	1.4	2.3	***1.9***	***1.7***	***1.8***	***1.8***	***1.8***	***1.8***	1.2	***1.6***	***1.8***
excl. food & energy	1.4	1.3	1.2	2.0	***1.7***	***1.7***	***1.8***	***1.8***	***1.9***	***1.9***	1.3	***1.5***	***1.8***
Fed Funds Rate, %	0.09	0.09	0.07	0.09	***0.09***	***0.14***	***0.20***	***0.24***	***0.70***	***1.22***	0.11	***0.10***	***0.59***
3-month T-Bill, (bond-eq.)	0.0	0.1	0.1	0.0	***0.0***	***0.1***	***0.2***	***0.2***	***0.7***	***1.2***	0.1	***0.0***	***0.6***
2-year Treasury Note	0.4	0.3	0.4	0.4	***0.5***	***0.8***	***1.1***	***1.4***	***1.9***	***2.3***	0.3	***0.5***	***1.7***
10-year Treasury Note	2.7	2.7	2.8	2.6	***2.5***	***2.8***	***3.1***	***3.3***	***3.5***	***3.6***	2.4	***2.7***	***3.4***

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