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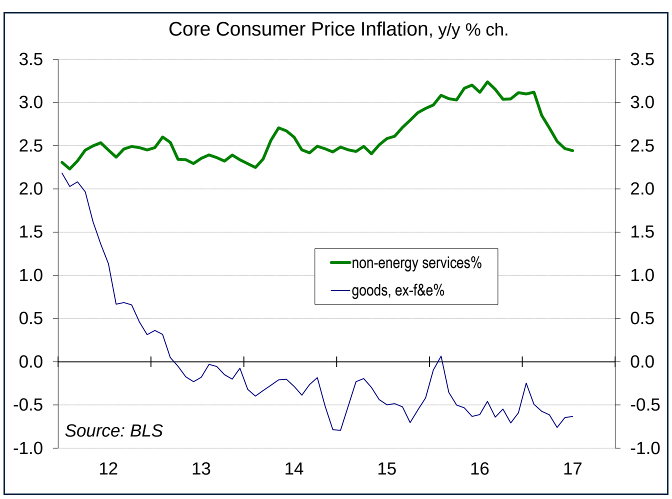
Weekly Economic Monitor

Fed Policy Outlook

The Federal Open Market Committee meets September 19-20 to set monetary policy. At this point, there is little suspense about what the Fed will do. Short-term interest rates should remain steady. The FOMC is widely expected to announce the start of the balance sheet unwinding (October), which will be a multi-year process. For investors, the bigger question is what the Fed is likely to do in the future. As with every other policy meeting, officials will update their projections of growth, unemployment, and inflation. We'll get a revised dot plot, reflecting expectations of where the federal funds target rate is headed in the quarters ahead. In her post-meeting press conference, Chair Yellen will almost certainly repeat the notion that monetary policy is *"data-dependent."*

Much of the recent discussion on monetary policy has centered on the low trend in inflation. Recall that the Fed has two policy goals: maximum sustainable employment and stable prices. The Fed interprets "stable prices" as a 2% inflation goal in the PCE Price Index. "Maximum sustainable employment" is less clear, equivalent to low unemployment, but exactly how low is an open question. A key Fed belief is that pushing unemployment too low would boost wage inflation, which would be passed along to higher consumer prices.

The PCE Price Index is made up of the same components of the Consumer Price Index, but the core PCE figure has trended somewhat below the core CPI. Monthly inflation figures can be quirky. They popped higher in January of this year, likely reflecting seasonal adjustment issues. The March data reflected a sharp drop in prices of wireless telecom services, which lowered the year-over-year inflation figure by about 0.2 percentage point. The Fed sees that as *"transitory."* The year-over-year increase will tick higher in March 2018 when the March 2017 drop in wireless telecom rolls off of the calculation.



Inflation measures the change in cost of a basket of goods and services over time. Prices of items in that basket do not rise at the same pace. Thus, individuals can experience significant differences in inflation depending on what is being purchased. Economists focus on figures excluding food and energy. That's not because food and energy don't matter. Fed policymakers do consider overall inflation. However, food and energy prices tend to be noisy, and we are interested in the underlying trend. Details over the last few years show a deflationary trend in core consumer goods. Shelter costs, which account for a large part of non-energy services, have risen faster than overall inflation. The price of a home reflects its value as an asset, but also the service it provides (shelter) – for homeowners, this is measured as the rental equivalent. Inflation in rents picked up in the last two years, but the pace has moderated some in recent months.

While Fed officials believe that recent low inflation is in part due to transitory factors, there is also a recognition that the transmission mechanism for inflation may have changed. The labor market is the widest channel for inflation pressure. Hence, with the unemployment rate at a historically low level, the limited wage pressure we've seen has been a puzzle. The decline in union membership in recent decades has reduced workers bargaining power, while a greater concentration of large firms and the wider use of the internet have increased the bargaining power of those purchasing labor.

Inflation is driven by two factors: inflation expectations and a measure of the output gap. While the Fed has a 2% inflation goal, many see that as a ceiling in practice. Hence, inflation expectations would be a bit lower than 2%. Last week, Governor Brainard said that the policymakers should signal that *"we would be comfortable with inflation moving modestly above our target for a time."* On the output gap, officials suspect that low unemployment may not coincide with as much wage pressure as in the past, but officials are willing to wait for more information before coming to any conclusions. Hence, we're back to square one: future policy moves will be data-dependent.

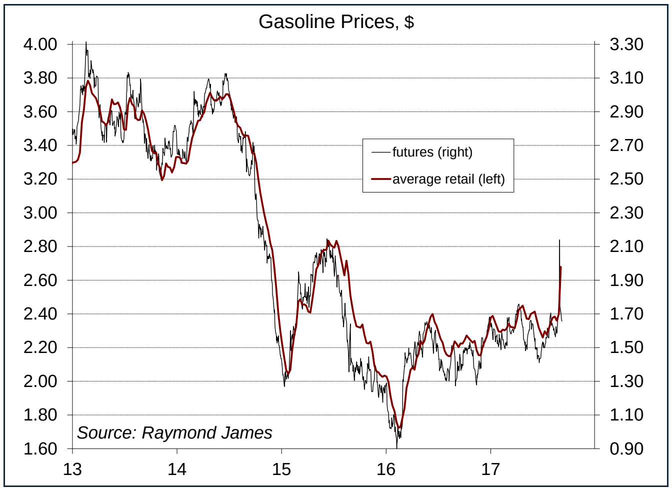
In her press conference following the June 13-14 policy meeting, Chair Yellen noted that the federal funds rate was probably not far from its equilibrium rate, which suggests that the Fed doesn't have far to go. However, she also said that the equilibrium federal funds rate is expected to rise as the economy strengthens – hence, an outlook of gradual rate hikes.

The balance sheet unwinding will start slowly, but the pace will pick up. While QE was an important policy tool amid a rock-bottom federal funds rate, the Fed views its removal as "background" and not as specific policy action. Of course, much of this could change depending on personnel changes on the Fed's Board of Governors, including the chair.

	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
8/11/17	1.03	1.14	1.21	1.30	1.43	1.74	2.19	2.79	1.181	1.299	109.06	1.269	6256.56	2441.32	21858.32
9/01/17	1.02	1.10	1.24	1.35	1.46	1.73	2.16	2.77	1.188	1.297	110.09	1.237	6435.33	2476.55	21987.56
9/08/17	1.05	1.14	1.21	1.27	1.38	1.64	2.06	2.68	1.203	1.320	107.77	1.214	6360.19	2461.43	21797.79

Recent Economic Data and Outlook

Market anxieties about North Korea and hurricanes (Harvey, Irma) remained elevated, but the deal on the budget and debt ceiling removed a key near-term uncertainty for investors.



In a surprise move, **President Trump** bypassed the Republican leadership and reached an agreement with Democratic leaders in Congress to provide Hurricane Harvey relief, fund the government, and avoid the debt ceiling through mid-December.

Federal Reserve Vice-Chair **Stanley Fischer** resigned *"effective on or around October 13,"* citing *"personal reasons."* It's been widely expected that Fischer would leave the Fed by early 2018. Meanwhile, the Senate Banking Committee advanced the nomination of **Randal Quarles**, who served in both Bush administrations and is President Trump's pick to serve as the Fed's Vice-Chair of Regulations. The Wall Street Journal reported that Trump was unlikely to nominate Gary Cohn, Director of the White House's National Economic Council, to replace Janet Yellen as Federal Reserve Chair.

Fed Governor **Lael Brainard** noted that *"the approaching change to our reinvestment policy has been clearly communicated and is well anticipated."* Highlighting the Fed's internal debate on the impact of low inflation, she said *"I am concerned that the recent low readings for inflation may be driven by depressed underlying inflation, which would imply a more persistent shortfall in inflation from our objective."* In that case, "it would be prudent to raise the federal funds rate more gradually," but she added that *"we should have substantially more data in hand in the coming months that will help us make that assessment."*

The Fed's **Beige Book** noted that *"economic activity expanded at a modest to moderate pace across all twelve Federal Reserve districts in July and August."* Job growth *"slowed some,"* while most districts reported *"limited wage pressures."* Two districts (Dallas and San Francisco) indicated that *"labor shortages were pushing up wages."* Prices *"rose modestly overall."*

The **Bank of Canada** surprised the markets by raising short-term interest rates sooner than anticipated, citing "stronger-than-expected economic performance. Most economists (but not all) had expected an October move.

The **European Central Bank** left short-term interest rates steady and did not alter its asset purchase program. President Draghi said that the ECB will reconsider the QE program in the autumn.

The **ISM Non-Manufacturing Index** rose to 55.3 in August, vs. 53.0 in July. The key components (business activity, new orders, and employment) were somewhat stronger than in July, consistent with moderate growth in the overall economy. Input price pressures were moderate. Comments from supply managers were mixed.

Jobless Claims rose to 292,000 in the initial estimate for the week ending September 2 (a 62,000 increase over the prior week), reflecting the effects of Hurricane Harvey. The Labor Department noted a 51,000 rise in preliminary figures for Texas.

Factory Orders fell 3.3% in July, reflecting a 70.8% plunge in civilian aircraft orders (which had more than doubled in June). For nondefense capital goods, orders rose 1.0%, which shipments rose 1.2% (a good start to 3Q17).

The **U.S. Trade Deficit** was little changed in July, at $43.7 billion. Merchandise exports edged down, but were still higher than the 2Q average (up 5.2% from a year ago, reflecting improvement in the global economy). Imports fell slightly, partly reflecting lower petroleum prices (which were higher in August).

Economic Outlook (3Q17): around 2.5% GDP growth.

Employment: The trend in private-sector job growth has remained similar to that of 2016, but is expected to slow as the job market continues to tighten.

Consumers: Spending improved in 2Q17. Monthly figures suggest moderate momentum into 3Q17. Job gains have been supportive. Inflation-adjusted wage growth, weak in the first few months of the year, picked up in recent months.

Manufacturing: Orders and production have remained mixed across sectors, but moderate overall. Better global growth and the rebound in energy exploration have helped, but motor vehicle sales appear to have passed their peak.

Housing/Construction: Job growth has been supportive, with some weather-related shift into the earlier part of the year. Higher home prices and rising building costs are restraints.

Prices: Core inflation has continued to trend below the Fed's 2% target, partly reflecting a "one-off" plunge in wireless telecom services. Wage pressures are moderate.

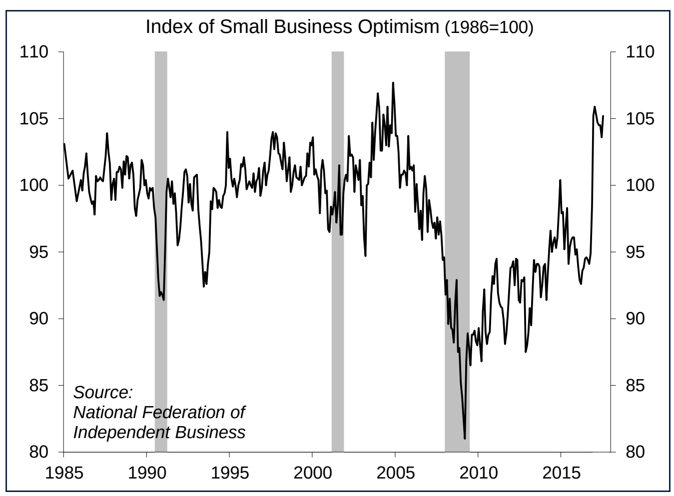
Interest Rates: The Fed remains in tightening mode, and is expected to continue raising short-term rates gradually. Balance sheet reduction is expected to start in October, initially gradual, but picking up over the course of a year.

This Week:					*forecast*	last	last –1	comments
Monday	9/11	1:00	Treasury Note Auction					$24 billion in 3-year notes
Tuesday	9/12	6:00	Small Business Optimism	Aug	***NF***	105.2	103.6	still elevated
		1:00	Treasury Note Auction					$20 billion in re-opened 10-year notes
Wednesday	9/13	8:30	**Producer Price Index**	Aug	***+0.4%***	-0.1%	+0.1%	seasonal factors exaggerate gasoline rise
			ex-food & energy		***+0.1%***	-0.1%	+0.1%	mild old core
			ex-f, e, trade services		***+0.1%***	0.0%	+0.2%	mild new core
		1:00	Treasury Bond Auction					$12 billion in re-opened 30-year bonds
Thursday	9/14	7:00	BOE Policy Decision					no change
		8:30	Jobless Claims, th.	9/09	***340***	298	236	Harvey Impact
		8:30	**Consumer Price Index**	Aug	***+0.3%***	+0.1%	0.0%	seasonal adjustment adds to gasoline
			year-over-year		***+1.8%***	+1.7%	+1.6%	seen a bit higher
			ex-food & energy		***+0.1%***	+0.1%	+0.1%	mild core
			year-over-year		***+1.6%***	+1.7%	+1.7%	still low
		8:30	Real Hourly Earnings	Aug	***-0.2%***	+0.2%	+0.3%	nominal AHE rose 0.1%
Friday	9/15	8:30	**Retail Sales**	Aug	***0.0%***	+0.6%	+0.3%	likely moderate
			ex-autos		***+0.3%***	+0.5%	+0.1%	some boost from gasoline
			ex-autos, bld mat, gasoline		***+0.2%***	+0.5%	+0.1%	back-to-school
		8:30	Empire St. Manf. Index	Sep	***NF***	25.2	9.8	erratic
		9:15	**Industrial Production**	Aug	***+0.4%***	+0.2%	+0.4%	often seasonal noise in autos
			Manufacturing Output		***+0.6%***	-0.1%	+0.2%	aggregate hours rose 0.8%
			Capacity Utilization		***76.9%***	76.7	76.7%	still no threat to the inflation outlook
		10:00	Business Inventories	Jul	***+0.2%***	+0.5%	+0.3%	not market-moving
		10:00	UM Consumer Sentiment	m-Sep	***96.2***	96.8	93.4	roughly steady

Next Week:								
Monday	9/18	10:00	Homebuilder Sentiment	Sep	***66***	68	64	still elevated, but likely a bit softer
Tuesday	9/19	8:30	**Building Permits, mln**	Aug	***1.245***	1.230	1.275	moderate strength in single-family
			% change		***+1.2***	-3.5	+9.2	multi-fam is noisy
			Housing Starts		***1.190***	1.155	1.213	seen rebounding from soft July
			% change		***+3.0***	-4.8	+7.4	but watch for possible revisions
		8:30	Import Prices	Aug	***NF***	+0.1	-0.2	higher petroleum prices
			ex-food & fuels		***NF***	0.0	0.0	no inflation pressure in imports
Wednesday	9/20	10:00	Existing Home Sales, mln	Aug	***5.48***	5.44	5.51	a strong trend
			% change		***+0.7***	-1.3	-2.0	limited by supply constraints
		2:00	**FOMC Policy Decision**		***1-1.25%***	1-1.25%	1-1.25%	balance sheet unwind to start in Oct
		2:00	**Summary of Econ Proj.**					a new dot plot
		2:30	**Yellen Press Conference**					still data-dependent
Thursday	9/21	8:30	Jobless Claims, th.	9/16	***350***	***340***	236	Harvey Impact
		8:30	Philadelphia Fed Index	Sep	***NF***	18.9	19.5	erratic, but a moderately strong trend
		10:00	Leading Econ Indicators	Aug	***+0.3***	+0.3	+0.6	most components will add
		1:00	TIPS Auction					re-opened 10-year TIPS
Friday	9/22		no significant data					

This Week…

The important economic reports (August CPI and retail sales) will arrive late in the week. Higher gasoline prices are expected to have played a part in lifting consumer price inflation, as well as retail sales (although unit vehicle sales were reported lower), but keep an eye on core retail sales (a likely harbinger of the holiday shopping season). While the markets may react to any surprises in the data, attention will likely be focused ahead to the Fed's policy meeting (September 19-20).



Monday

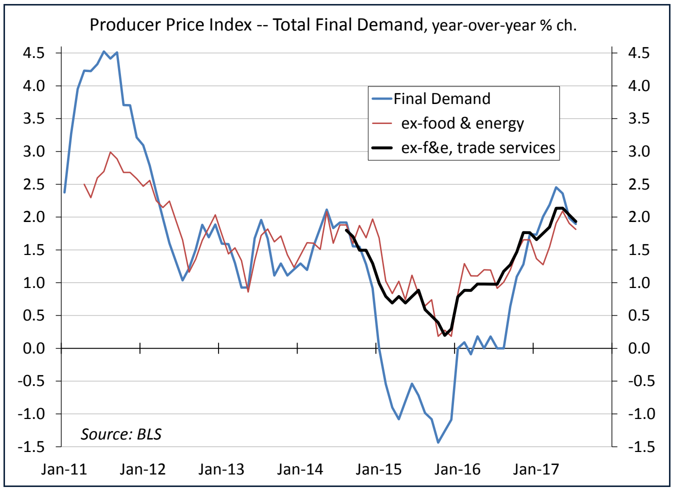
No significant data.

Tuesday

Small Business Optimism (August) – The headline figure is likely to remain elevated.

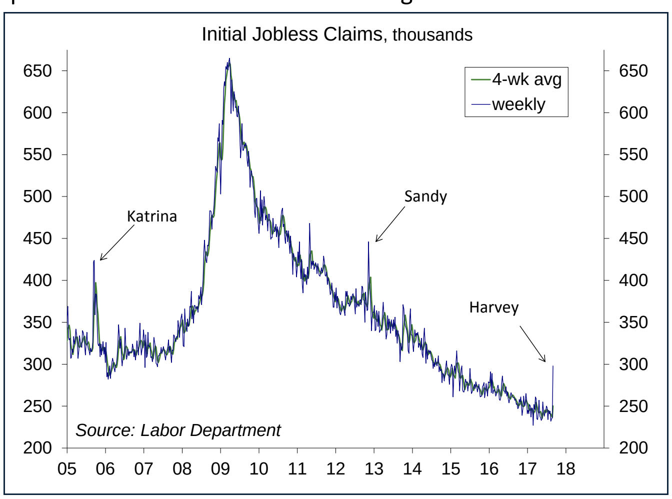
Wednesday

Producer Price Index (August) – Wholesale gasoline prices rose somewhat ahead of Harvey, while the seasonal adjustment anticipates a decline. Core inflation should remain mild.

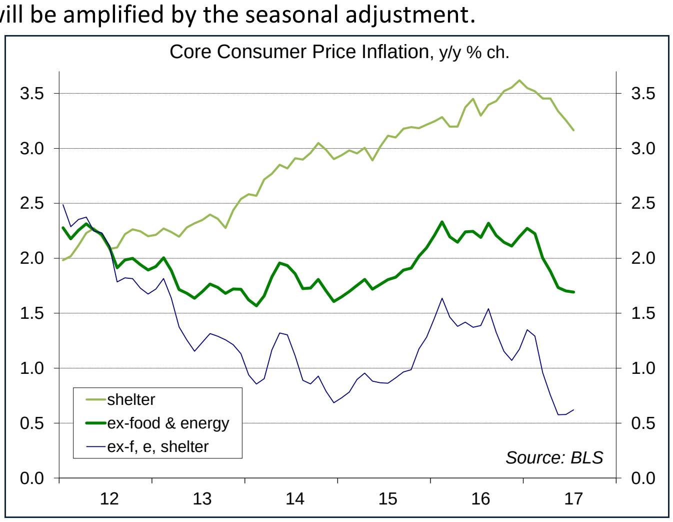


Thursday

Jobless Claims (week ending September 9) – Hurricane Harvey is expected to further boost the claims figures in the near term.

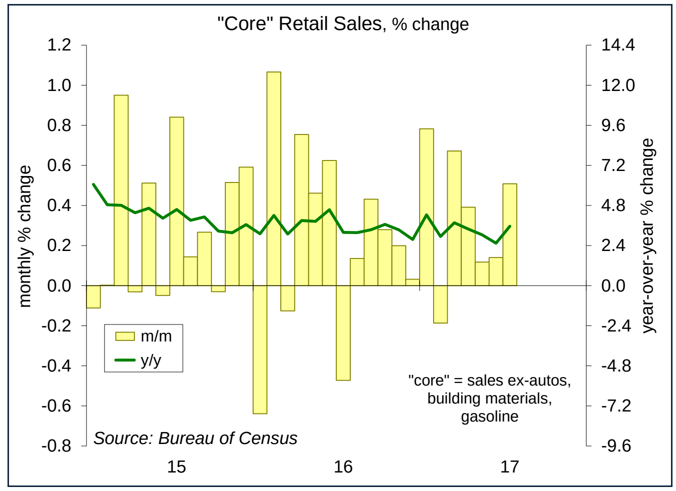


Consumer Price Index (August) – The increase in gasoline prices will be amplified by the seasonal adjustment.

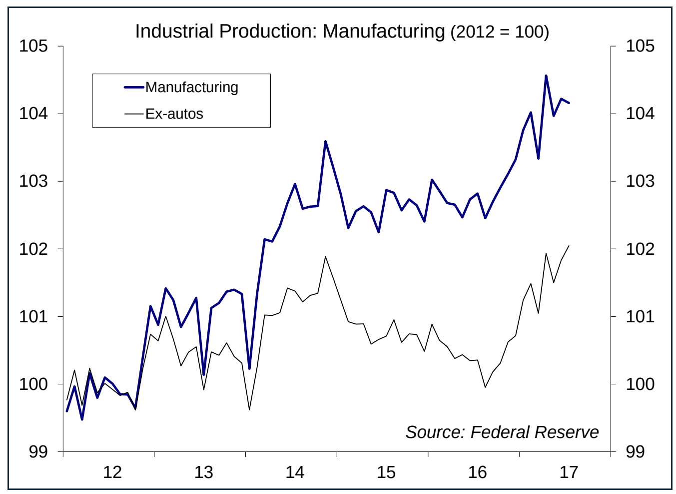


Friday

Retail Sales (August) – Unit auto sales fell. Gasoline prices rose. Core sales are likely to have risen moderately.



Industrial Production (August) – Aggregate hours rose, which should translate into a decent gain in factory output. Much of the post-election strength has been in energy and exports.



Next Week ...

The Federal Open Market Committee is widely expected to leave short-term interest rates unchanged and announce the start of the balance sheet unwinding. Markets will also digest new Fed forecasts (including a new dot plot) and any new information in Chair Yellen's post-meeting press conference.

Coming Events and Data Releases

September 26	Consumer Confidence (September) Yellen Speech (NABE Conference)
September 27	Durable Goods Orders (August)
October 2	ISM Manufacturing Index (September)
October 6	Employment Report (September)
November 1	FOMC Policy Decision (no press conf.)
December 13	FOMC Policy Decision, Yellen press conf.