

April 20 2015

BEIGE BOOK: WINDOW ON MAIN STREET

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KEY TAKEAWAYS

The latest Beige Book suggests that the U.S. economy is still growing at a pace that is at or above its long-term trend, and that some upward pressure on wages is beginning to emerge.

Optimism regarding the economic outlook far outweighed pessimism throughout the Beige Book as it has for the past two years.

In April 2015, our BBB ticked down to +47 from +82 in March 2015 and +73 in January 2015; we believe recent weakness is transitory.

BEIGE BOOK SUGGESTS CONTINUED MODEST ECONOMIC GROWTH

The latest Beige Book suggests that the U.S. economy is still growing at a pace that is at or above its long-term trend, and that some upward pressure on wages is beginning to emerge despite headwinds that included the rising U.S. dollar, the West Coast port strikes, and the weather. Overall, the Beige Book described the economy as expanding at a “modest or moderate” pace in most districts. In general, optimism regarding the economic outlook far outweighed pessimism throughout the Beige Book, as it has for the past two years or so.

The Beige Book is a qualitative assessment of the U.S. economy and each of the 12 Federal Reserve (Fed) districts. We believe the Beige Book is best interpreted quantitatively by measuring how the descriptors change over time. The latest edition of the Fed’s Beige Book was released Wednesday, April 15, 2015, ahead of the April 28–29, 2015, Federal Open Market Committee (FOMC) meeting. The qualitative inputs for the April 2015 Beige Book were collected from late February 2015 through April 3, 2015; thus, they captured a period of:

- Increasing market concern around Greece
- A run of weaker than expected reports on the U.S. economy for February and March 2015
- Rising U.S. dollar
- Supply chain disruptions due to work stoppages and strikes at West Coast ports
- Some stability in oil prices
- Improving economic activity in the Eurozone, but renewed weakness in China
- Unusually cold and snowy weather in many parts of the eastern United States early in the period, giving way to more seasonal weather toward the end of the data collection period

SENTIMENT SNAPSHOT

To provide a snapshot of the sentiment behind the entire Beige Book collage of data, we created our proprietary Beige Book Barometer (BBB) [Figure 1]. In April 2015, the barometer ticked down to +47 from +82 in March 2015 and +73 in January 2015. The +47 reading in April 2015 was the lowest reading since late 2012, and the average reading of +67 over the past three Beige Books is the

HOW THEY WORK

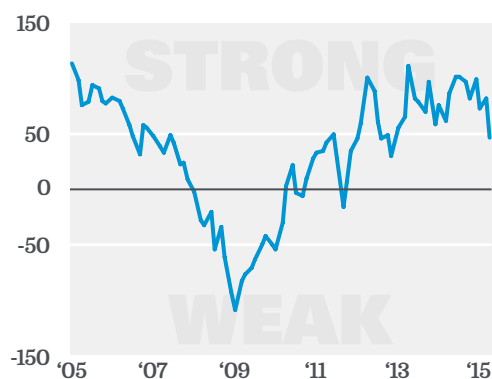
BEIGE BOOK AND BEIGE BOOK BAROMETER

The **Beige Book** compiles qualitative observations made by community bankers and business owners about economic (labor market, prices, wages, housing, nonresidential construction, tourism, manufacturing) and banking (loan demand, loan quality, lending conditions) conditions in each of the 12 Fed districts (Boston, New York, Philadelphia, Kansas City, etc.). This local color that makes up each Beige Book is compiled by 1 of the 12 regional Federal Reserve districts on a rotating basis—the report is much more “Main Street” than “Wall Street” focused. It provides an excellent window into economic activity around the nation using plain, everyday language. The report is prepared eight times per year, ahead of each of the eight Federal Open Market Committee (FOMC) meetings. The next FOMC meeting is April 28–29, 2015.

The **Beige Book Barometer** is a diffusion index that measures the number of times the word “strong” or its variations appear in the Beige Book less the number of times the word “weak” or its variations appear. When the Beige Book Barometer is declining, it suggests that the economy is deteriorating. When the Beige Book Barometer is rising, it suggests that the economy is improving.

1 WEATHER, PORT STRIKE, STRONG DOLLAR WEIGHED ON THE BAROMETER IN APRIL

- Number of Times “Strong” (and Variations of This Word) Is Mentioned Minus Number of Times “Weak” (and Variations) Is Mentioned



Source: LPL Research, Federal Reserve 04/17/15

lowest since early 2014. We’ll demonstrate below, however, why we believe the recent weakness may be transitory, not the start of a downshift in the economy. For perspective, our Beige Book Barometer averaged just +55 from 2011–13, when economic growth (as measured by inflation-adjusted gross domestic product [GDP]) was just 2.1%.

The word “weak” or its variants appeared 44 times in the latest Beige Book (versus 22 in March 2015), and much of the uptick can be attributed to a stronger dollar, the port slowdown, and bad weather. Despite the uptick in the number of weak words (44) in April 2015, the total was still below the long-term average of 50 mentions. This suggests to us that once the temporary impact of the above factors begins to fade, the Beige Book Barometer may rebound, reflecting the economy’s solid underlying momentum.

WATCHING WAGES & INFLATION

As it has over the past year, the April 2015 Beige Book noted that employers were having a difficult time finding qualified workers for certain skilled positions, and some reported upward wage pressures for particular industries and occupations. The comment this time was a bit more emphatic, noting that “difficulty finding skilled workers was frequently reported.” In the past, these characterizations of labor markets have been a precursor to more prevalent economy-wide wage increases. Indeed, for the first time in this business cycle, the latest four Beige Books (December 2014, January 2015, March 2015, and April 2015) contained several mentions of employers having difficulty attracting and retaining low-skilled workers, and retaining and compensating key workers.

If this trend persists over the next few Beige Books, history suggests it may not be long until Fed policymakers begin to take note of a faster pace of wage inflation in their monetary policy deliberations. Indeed, the minutes of the March 17–18 FOMC meeting (released in early April 2015) noted that just 1 of the 17 participants in the meeting saw evidence of rising wage inflation, while “almost all” of the 17

participants expressed concern about weakness in overseas economies.

Figure 2 shows the recent trend in the number of “inflation words” in the Beige Book. We counted up the number of times the words “wage,” “skilled,” “shortage,” “widespread,” and “rising” appeared in recent editions of the Beige Book. In April 2015, these words appeared 106 times, up from 104 in March 2015 and 94 in January 2015. In all of 2014—when deflation, not inflation, was a concern—those words appeared, on average, 98 times per Beige Book. During 2011–13, also a period when heightened risk of deflation was evident, the “inflation words” appeared, on average, 80 times per Beige Book. We’ll continue to monitor this closely, as the FOMC has told markets that it will begin raising rates when it is “reasonably confident” that inflation will move back toward 2.0%.

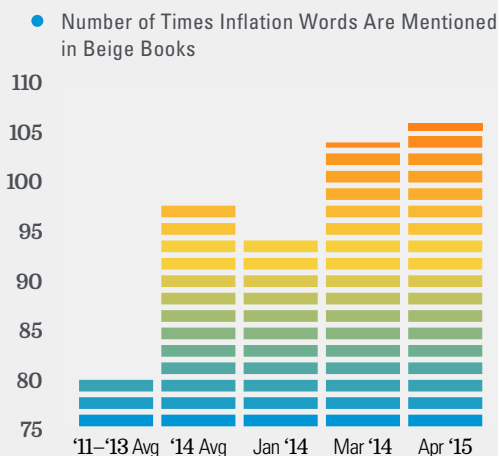
COMMENTS ON OIL & ENERGY STILL ELEVATED, BUT DOWN FROM LATE 2014 LEVELS

Oil and energy got a combined 46 mentions in the April 2015 Beige Book, below the 50 and 73

mentions in the March and January 2015 Beige Books, but right at the 44–45 mentions per Beige Book in 2014 and in 2011–13 [Figure 3]. This may suggest that the capital spending cuts, rig count reductions, and job cuts in the oil and gas sector in late 2014 may be fading as a drag on economic activity. The comments on the energy sector in the April 2015 Beige Book included:

- “While producers are optimistic about continued production growth in oil and gas, layoffs are occurring in the industry as well as in coal.”
- “The number of active drilling rigs fell in Cleveland, Minneapolis, Kansas City, and Dallas.”
- “Active drilling rigs in North Dakota and Montana reached their lowest levels in five years.”
- “However, despite the decline in permits and new investment, overall production in the oil and gas sector remains strong to increasing.”
- “Oil and gas producers in the Cleveland, Atlanta, and Dallas Districts anticipate cuts in 2015 capital expenditures.”
- “Layoffs were reported in the Cleveland, Atlanta, and Kansas City Districts.”

2 MENTIONS OF “INFLATION WORDS” IN BEIGE BOOK ARE RISING



Source: LPL Research, Federal Reserve Board 04/17/15

3 MENTIONS OF BAD WEATHER INCREASE AS OIL IMPACT FADES A BIT

	Uncertainty*	ACA/ Healthcare	Energy/ Oil	Weather
Apr '15	12	11	46	71
Mar '15	6	14	50	36
Jan '15	13	7	73	11
'14 Avg	12	13	44	80+ (Winter '13-'14)
'11-'13 Avg	31	11	45	14

Source: LPL Research, Federal Reserve Board 04/17/15

*Uncertainty/Confidence/Shutdown/Debt Ceiling/Fiscal

However, the latest Beige Book was also full of comments about how lower fuel and energy prices were benefiting multiple industries throughout all 12 Fed districts. In short, the comments in the latest Beige Book on the impact of falling oil prices are consistent with our view that while falling oil prices will be a net plus for the U.S. economy as a whole, economies in certain states could see significant impacts from the slowdown in drilling activity that is likely to occur over the next year or so. (Please see our *Weekly Economic Commentary*, “Drilling into the Labor Market,” from January 12, 2015, for more details.)

In our view, falling oil prices will be a net plus for the U.S. economy as a whole.

FADING CONCERNS; CURRENT CONCERNS

The uncertainty and lack of confidence around fiscal policy (fiscal cliff, debt ceiling, sequester, government shutdown) that dominated the Beige Book for most of 2013, and throughout 2011 and 2012 as well, is now clearly fading. These words were mentioned just 12 times in the April 2015 Beige Book, just 6 times in March 2015, and 13 times in January 2015, for a 2015 year-to-date average of 10 [Figure 3]. In the 8 Beige Books released in 2014, the words noted above were mentioned a total of 96 times, or around 12 mentions per Beige Book. In contrast, these words were mentioned 31 times, on average, in each of the 24 Beige Books released over the course of 2011–13. However, in some cases the uncertainty surrounding fiscal issues here and in Europe—mainly Greece—has been replaced by uncertainty surrounding the drop in oil prices and what it might signal for global growth.

The Affordable Care Act (ACA), and healthcare in general, remained a consistent source of concern among Beige Book respondents, although the impact has faded a bit recently. The ACA (and healthcare in general) received just 11 mentions in the latest

Beige Book, down from 14 in March 2015, but up from 7 mentions in the January 2015 edition. Thus far in 2015 this topic has received an average of 11 mentions per Beige Book, in-line with the number of mentions per Beige Book in 2014. The outcome of the current case before the Supreme Court on the legality of ACA subsidies may lead to a spike in mentions of the ACA/healthcare later this year.

The unusually cold, snowy, and icy weather that descended on much of the eastern part of the country in January and February 2015—and lingered well into March 2015—did not go unnoticed in the latest Beige Book. Indeed, weather was mentioned a whopping 71 times in the April 2015 Beige Book, and almost all the mentions were in a negative context. Weather got 36 mentions in the March 2015 edition, and those too, were mainly in a negative context. Although the cold and snow in the early part of 2015 were debilitating, they did not have as big an impact as the harsh winter weather in early 2014, which affected a wider area of the country. In the first few Beige Books of 2014, weather was mentioned, on average, 80 times per Beige Book.

There is also some evidence in the economic data released for March 2015 over the past few weeks (housing, retail sales, and industrial production) that the cold and snowy weather may have impacted the March data as well, something we pointed out when we last wrote about the Beige Book in late March 2015. With spring in full gear in most of the country, the mentions of weather are likely to all but disappear from the Beige Book due out in early June 2015.

OPTIMISM RULES

Although the weather, the port strike (16 mentions in April 2015 and 18 in March 2015), and the strong dollar (12 mentions in April 2015, 5 in March 2015, 2 in January 2015, and not once in all 8 Beige Books released in 2014) all clearly had an impact on Main Street’s view of near-term economic conditions in early 2015, they did little to dampen the optimism on the economy that has picked up strength in the past year or so.

In the April 2015 Beige Book, the word “optimism” (or its related words) appeared 23 times, whereas the word “pessimism” didn’t appear at all. Over the first 3 Beige Books of 2015, optimism has appeared on average 23 times per Beige Book, while the word pessimism has appeared a total of just 1 time across all 3 Beige Books in 2015.

As reassuring as it is to see that Main Street can remain optimistic despite the flow of bad news, the large number of optimistic comments in the Beige Book is not the start of a new trend: In the 8 Beige Books released in 2014, the word “optimism” appeared, on average, 30 times in each edition. In 2013, “optimism” appeared, on average, 25 times

per Beige Book. Looking back to the worst of the 2007–09 financial crisis and Great Recession, the word “optimism” appeared, on average, just 9 times in the 8 Beige Books released in 2009, whereas the word “pessimism” appeared, on average, 5 times.

Concerns that the economic and market environment we are in today is similar to the period just prior to the onset of the Great Recession and stock market peak in late 2007 also appear to be well overdone, based on this metric. In the 8 Beige Books released in 2007, the word “optimism” appeared, on average, just 10 times per edition—a far cry from the 30 times per edition in the 8 Beige Books released in 2014 [Figure 4]. ■

4 DESPITE DROP IN BAROMETER, OPTIMISM RUNNING HIGH ON MAIN STREET

Mentions per Beige Book in:	Optimism	Pessimism
Apr 2015	23	0
Mar 2015	24	1
Jan 2015	21	0
2014	30	0
2013	25	1
2009	9	5
2007	10	1

Source: LPL Research, Federal Reserve Board 04/17/15

IMPORTANT DISCLOSURES

The economic forecasts set forth in the presentation may not develop as predicted.

All performance referenced is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual.

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Commodity-linked investments may be more volatile and less liquid than the underlying instruments or measures, and their value may be affected by the performance of the overall commodities baskets, as well as weather, geopolitical events, and regulatory developments.

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