April 27 2015

A WEAK WEEK?

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KEY TAKEAWAYS

First quarter economic weakness will likely get plenty of attention this week, when the initial estimate of Q1 2015 GDP is expected to confirm tepid growth during the quarter.

We continue to expect that the FOMC will begin to raise rates in late 2015, when it is "reasonably confident" that inflation will move back to its 2% objective over the medium term.

Economic performance since the end of the recession has varied widely by state, with oil playing a key role.

Eight times per year, the outcome of the Federal Reserve's (Fed) Federal Open Market Committee (FOMC) meeting becomes the focal point for market participants. Four times each year, the Bureau of Economic Analysis's (BEA) first estimate of gross domestic product (GDP)—the first look at the health of the economy in the prior quarter—dominates the headlines. Similarly, at the start of each month, the Report on Business from the Institute for Supply Management (ISM) and the monthly labor market report from the U.S. Department of Labor are the centerpieces of any trading week. This week (April 27 to May 1, 2015), three of these four events are on the docket, with only the employment report for April 2015 (due out Friday, May 8) missing. So, while this week's economic events don't quite measure up to the weeks in which all of the "big four" economic events take place, which last occurred in the last week of July 2014 (see our July 27, 2014, *Weekly Economic Commentary*, "Midsummer Madness," for details), other events make the coming week as busy as any "big four" week.

This week, another 164 S&P 500 companies are scheduled to report their first quarter 2015 results. Also, key reports on the health of the U.S. economy in April 2015 are due out (vehicle sales, consumer sentiment, inflation expectations, the Dallas and Richmond Fed manufacturing indexes), which will help investors gauge whether the weakness in the economic data in Q1 2015 was temporary, as we expect, or the start of a new trend. Overseas, reports on Q1 2015 GDP in the U.K., Canada, Taiwan, and Spain will be released, and key central bank meetings are scheduled in Japan, Russia, Brazil, Sweden, and Mexico. Brazil may raise rates while the consensus expects both Sweden and Russia to cut rates.

Q1 2015 GDP IN FOCUS

WEDNESDAY, APRIL 29, 2015

- The consensus of economists (as measured by Bloomberg News) is looking for just a 1.0% annualized increase in real GDP for the first quarter of 2015 after the U.S. economy grew at an average of nearly 4% per quarter over the final three quarters of 2014.
- As was the case in Q1 2014, the weather is likely to have a big negative impact on Q1 2015 GDP. Much colder and snowier than usual weather gripped the eastern and southern U.S. in the first three months of 2015, likely impacting housing, consumer spending, and business capital spending on construction.

- The strength of the U.S. dollar (up 9% in Q1 2015 versus Q1 2014) likely negatively impacted U.S. export growth in Q1 2015, while the port strike likely held back inventory accumulation, some consumer spending, and some imports and exports as well.
- The worst of the cuts to energy-related capital spending hit in Q1 2015, likely substantially restraining the business capital spending component of GDP.
- Financial markets have become well acquainted with the impact of the "special factors" (bad weather, port strike, the strong dollar, and oil patch capital spending cuts) noted above, and as a result, should be well braced for a well-below trend Q1 2015 report. However, while markets may give the economy a free pass in Q1, it will expect a bounce back in growth in Q2.
- We continue to expect that real GDP will grow at 3.0%+ in 2015, as noted in our *Outlook 2015: In Transit* publication, published in November 2014.*

FOMC IN FOCUS

TUESDAY, APRIL 28, 2015, AND WEDNESDAY, APRIL 29, 2015

- This week's meeting is the third of eight FOMC meetings this year.
- As noted in our *Outlook 2015*, we continue to expect that the FOMC will begin to raise rates in late 2015. We also expect the FOMC will retain language in the statement that it will raise rates when it is "reasonably confident" than inflation will move back to its 2% objective in the medium term.

*As noted in the *Outlook 2015*, LPL Research expects GDP to expand at a rate of 3% or higher, which matches the average growth rate of the past 50 years. This is based on contributions from consumer spending, business capital spending, and housing, which are poised to advance at historically average or better growth rates in 2015. Net exports and the government sector should trail behind.

- This meeting will not include a press conference from Fed Chair Janet Yellen, and the FOMC will not release a new economic forecast at the conclusion of the meeting. In recent years, markets have been conditioned not to expect many changes to Fed policy at FOMC meetings that do not include press conferences and new forecasts from the FOMC.
- The GDP report for the first quarter of 2015 will be released on Wednesday, April 29, 2015, the second day of the Fed's meeting.
- The statement released after the conclusion of the meeting will likely acknowledge the recent softening of the economic data, but may also note that inflation has stabilized recently along with oil prices, and that overseas economies are improving. The statement may refer to one or more of the temporary factors (weather, dollar, port strike, oil capital spending) that weighed on growth in Q1.

APRIL 2015 ISM IN FOCUS

FRIDAY, MAY 1, 2015

- The consensus forecast (as measured by Bloomberg News) is looking for a 52.0 reading from the ISM's Manufacturing Purchasing Managers' Index (PMI) for April 2015, after the 51.5 reading in March 2015. The April readings from the regional Federal Reserve Bank manufacturing surveys (Philadelphia Fed, Empire State, and Kansas City Fed) were mixed, at best, with two of the three decelerating versus their March 2015 readings, and similarly two of three coming in below consensus expectations.
- A reading above 50 on the ISM indicates that the manufacturing sector is expanding, a reading below 50 indicates that the manufacturing sector is contracting, and a reading of 42 or below indicates that the overall economy is in recession.

- The Markit PMI, released several weeks ahead of the ISM report, has been gaining acceptance among market participants as a good proxy for the ISM report and may, over time, diminish the market importance of the ISM report. While still a solid reading at 54.2, the preliminary Markit PMI reading for April 2015 was both below the consensus estimate (55.7) and below the March 2015 reading (also 55.7).
- Manufacturing activity got off to a slow start in 2015, impacted by all of the special factors noted above, and as those "temporary" factors lift, manufacturing activity is likely to rebound. Green shoots in the European economy, still low interest rates, cheap and plentiful supplies of energy, and plenty of cash on corporate balance sheets should all support manufacturing activity over the remainder of 2015.

STATE OF THE STATES

As noted above, the Q1 2015 GDP data for the United States is due out this Thursday, April 30, 2015, and market participants will be able to gauge how much the big drop in oil prices helped (and in some cases hurt) the economy nationwide since the peak in oil prices in mid-2014. We have written about the impact of falling oil prices on the labor market and the overall economy several times in the past six months, and focused on the state level impact to the labor market in the largest oil producing states in the *Weekly Economic Commentary*, "Drilling into the Labor Market," on January 12, 2015.

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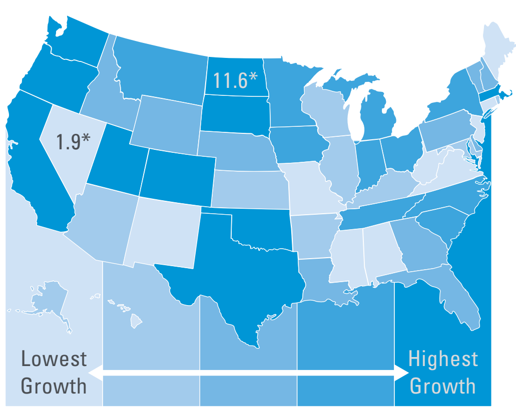
1 OIL-PRODUCING STATES AMONG BEST PERFORMERS SINCE END OF GREAT RECESSION

Wage and Salary Growth from the End of the Great Recession to the End of 2014, Annualized % Change



Source: LPL Research, Bureau of Economic Analysis 04/24/15

* Highest and lowest growth rates

Figure 1 details the performance of wage and salary growth from the end of the recession in Q2 2009 through the end of 2014, the latest data available for state level wage and salary data. We'll get a Q1 2015 reading on wages and salary incomes by state in late June 2015. The figure shows that since the end of the recession, top oil-producing states like North Dakota, Oklahoma, Texas, Colorado, and California rank in the top 10 states for income growth as well. Massachusetts, Oregon, Washington State, and Utah round out the top 10 states for income growth since the end of the recession. What do those non-oil states have in common?

Nearly 75% of the Massachusetts economy is tied to the export-heavy services area of the economy, where "good old American know-how" is boosting economic activity (see the *Weekly Economic Commentaries*, "Good Old American Know-How" from August 11 and August 18, 2014, for more details). Similarly, nearly two-thirds of economic output in Oregon and Washington State are linked to those export-heavy, good old American know-how sectors of the economy. While only 50% of both South Dakota and Idaho's economy are tied to those sectors, their proximity to oil-producing states like North Dakota and Colorado may be boosting their economies.

On the other end of the scale, only New Mexico, which has seen wage and salary growth of just 2% per year since the end of the recession, is also among the top 10 oil-producing states. The other states near the bottom of wage and salary growth are closely tied to the housing bust (Nevada, Hawaii, and to some extent Connecticut, Virginia, New Jersey), the relatively lackluster pace of hiring in the financial sector (Connecticut, New Jersey), the decline in coal prices (West Virginia), and low levels of state GDP dedicated to good old American know-how (Mississippi, Alabama).

Looking ahead, we expect the states that benefited the most from the oil boom to see their wage and salary growth fall out of the top 10 in the coming quarters, while those that have more diversified economies that are tied to the good old American know-how may continue to produce an above-average pace of wage and salary growth. We'll update this map at the end of June 2015 when the Q1 2015 state GDP data become available, and examine how well the oil-producing states fared in the nine months after the peak in oil prices in June 2015. ■

DEFINITIONS

The S&P 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Institute for Supply Management (ISM) index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

The Purchasing Managers Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries, and the employment environment.

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