

Weekly Economic Commentary



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Beige Book: Window on Main Street

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Highlights

The latest Beige Book reflects a picture of the U.S. economy that has, thus far, been largely unaffected by current geopolitical headlines.

The latest Beige Book again described “modest to moderate economic growth” in the U.S. economy and employment expansion at a pace similar to that noted in the previous Beige Book (September 3, 2014).

Optimism regarding the economic outlook far outweighed pessimism, as it has for the past 18 months or so.

Over the past three Beige Books, the BBB has averaged +94, in-line with the highest readings over any three consecutive Beige Books since at least 2005, suggesting that global growth concerns have had little impact on the U.S. economy as of early October 2014.

How the Barometer Works

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.

See page 3 for “Beige Book: How It Works.”

No Signs of Global Growth Scare Impacting Main Street as Modest to Moderate Economic Growth Continues

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 Beige Book, released last Wednesday, October 15, 2014, ahead of the October 28–29, 2014, Federal Open Market Committee (FOMC) meeting, was timely, given the increasing concerns in global financial markets about a slowdown in global growth. The qualitative inputs for the October 2015 Beige Book were collected through October 6, 2014, and thus captured at least three weeks or so of the elevated market concerns around global growth centered around Europe, the rise of the Islamic State in Iraq and Syria (ISIS), the social unrest in Hong Kong, and the concerns about the spread of Ebola to the United States.

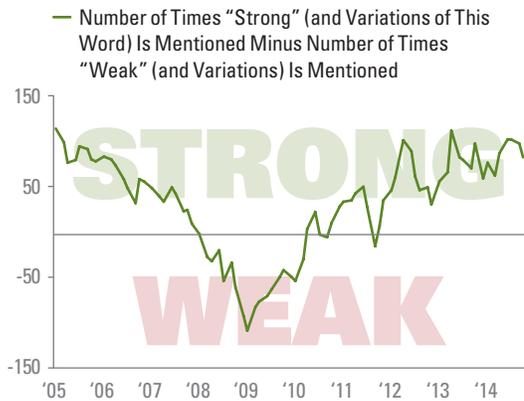
In our view, the latest Beige Book reflected a picture of the U.S. economy that was largely unaffected by any of the concerns noted above, and again described “modest to moderate economic growth (in the U.S. economy) at a pace similar to that noted in the previous Beige Book” (September 3, 2014) and that “employment continued to expand at about the same pace as that reported in the previous Beige Book.” However, as it has over the past year or so, the October 15, 2014, Beige Book noted that “some employers had difficulty finding qualified workers for certain positions” and that some reported “upward wage pressures for particular industries and occupations, such as skilled labor in construction and manufacturing.” In the past, these characterizations of labor markets have been a precursor to more prevalent economy-wide wage increases. In general, optimism regarding the economic outlook far outweighed pessimism, as it has for the past 18 months or so. The “modest to moderate” description of the overall economy has now been used in the last 12 Beige Books and in 13 of the past 14 dating back to March 2013.

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 October, the barometer ticked down to +82, down from a +97 reading in September and the +102 readings seen in both June and July. The +82



1 Beige Book Barometer Dips in October but Points to Solid U.S. Economic Growth



Source: LPL Financial Research, Federal Reserve 10/20/14

reading in October was well above the weather-impacted +62 reading in March earlier this year. Over the past three Beige Books, the BBB has averaged +94, in-line with the highest readings over any three consecutive Beige Books since at least 2005. In short, the October Beige Book did not confirm the financial markets' fear that the global growth scare had reached U.S. shores as of early October 2014.

The rebound in our Beige Book Barometer over the past several months is consistent with the Fed's view that the drop in economic activity in the first quarter of 2014—real gross domestic product (GDP) contracted at a 2.1% annualized rate for the quarter—was mostly weather related. The +94 reading on the BBB over the past three Beige Books is also consistent with the above-trend pace of GDP growth seen in the second quarter of 2014 and what is likely to be reported for the third quarter of 2014. (Third quarter GDP will be reported on October 30, 2014.) In addition, we found the word "weak" or its variants appeared just 16 times in the latest Beige Book and just 18 times, on average, in last 3 Beige Books (July, September, and October 2014), less than half of the long-term average of 50 mentions and the fewest since mid-2005. This suggests to us that the negative headwinds that have held the U.S. economy back over the past seven years may finally be abating, and as of early October 2014, the global growth concerns have had little impact on the U.S. economy.

2 Beige Book Word Clouds

October 2014



September 2014



October 2013



Source: LPL Financial Research, Federal Reserve Beige Book 10/15/14, 09/03/14, and 10/16/13



Beige Book: How It Works

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 one 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 October 28–29, 2014.

The word clouds or text clouds on page 2 are a visual format useful for quickly perceiving the most important words in a written document. They are culled from the Fed’s Beige Books published last week (October 15, 2014), the prior report (September 3, 2014), and the report from a year ago (October 16, 2013). In general, the more often a word appears in a speech, text, report, or other transcript, the larger that word appears in the word cloud. The word clouds show the top 50 words for each of the three Beige Books mentioned above. Similar words are grouped together and common words like “the,” “and,” “a,” and “is” are excluded, as are words that appear frequently in all Beige Books (federal, district, loan, level, activity, sales, conditions, firms, etc.).

Weather was a big driver of the weakness in the Beige Book in the winter of 2013–14, but the arrival of more “normal” weather this spring and summer held the weather mentions to just five in the latest Beige Book, the fewest mentions since the December 2013 Beige Book, which preceded the onset of the harsh winter of 2013–14. In the 4 Beige Books released over the winter of 2013–14, weather was mentioned, on average, 62 times in each. Over the last three Beige Books (July, September, and October 2014), weather was mentioned, on average, just seven times per report. This further reinforces our view that the 2.1% drop in real GDP in the first quarter of 2014 was almost entirely weather related.

We expect the improvement in the economic data to continue throughout the second half of 2014 and into 2015. We continue to expect the U.S. economy, as measured by real GDP, may grow at 3.0% in 2014—accelerating from the sub-2.0% growth rate of 2013—based on the drags from 2013 reversing (tax hikes, government spending cuts, European recession) and a modest improvement in business spending. The data released thus far for the second and third quarters of 2014 suggest the economy is likely expanding at a pace well above its long-term average, a snapback from the weather-induced weakness in the first quarter of 2014. The GDP report for the third quarter of 2014 is due out at the end of October 2014. Please see our *Mid-Year Outlook 2014* publication for details about our forecast for the second half of 2014.

Uncertainty Fading, Healthcare Still a Concern, and Optimism Way Up, but Few Signs of a Global Growth Scare

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 is now clearly fading, and despite the hand-wringing in the financial markets and in the media, these words were used just three times in the October 2014 edition of the Beige Book [Figure 3]. In the 7 Beige

3 Weather and Policy Uncertainty Have Faded as Restraints on Growth

	Weather	Shutdown/Fiscal/Sequester/Debt Ceiling/Uncertainty/Confidence	Affordable Care Act/Healthcare
10/2014	5	3	14
09/2014	6	13	3
07/2014	9	9	2
06/2014	35	12	6
04/2014	103	12	17
03/2014	119	18	22
2013 Avg.	112 (14 per Beige Book)	520 (65 per Beige Book)	178 (22 per Beige Book)
	Weather impact has completely faded	Words surrounding government policy are still trending lower but may increase in coming months	ACA/healthcare fading but may pick up later this year

Source: LPL Financial Research, Federal Reserve 10/20/14



Books released so far in 2014 (including the October edition), the words noted above were mentioned a total of 67 times, or around 10 mentions per Beige Book. In contrast, these words were mentioned 65 times, on average, in each of the 8 Beige Books released in 2013. As we wrote in our *Outlook 2014: The Investor's Almanac*, we continue to expect concerns over government policy to fade over the course of this year; but as 2014 winds down and 2015 begins, this policy-related uncertainty could make a comeback, with the upcoming Congressional midterm elections (November 4, 2014) and the next debt ceiling deadline (March 15, 2015) on the horizon.

Good weather or bad, the Affordable Care Act (ACA), and healthcare in general, has remained a consistent source of concern among respondents to the Beige Book, although the impact has faded a bit recently. The ACA (and healthcare in general) received 14 mentions in the latest Beige Book, and fewer than 10 mentions in the Beige Books released in the late spring and summer of 2014, down from 17 mentions in the April 2014 Beige Book and 22 in the March 2014 edition. On average, the ACA/healthcare saw 22 mentions per Beige Book in 2013. We continue to expect this topic to appear frequently in the Beige Book in the quarters ahead, as businesses and consumers adjust to the rollout of the legislation. The midterm congressional elections (November 4, 2014) and the approach of the start of the health insurance open enrollment period for 2015 (November 15, 2014) may cause an uptick in concern around healthcare in the Beige Book.

Optimism on Main Street remains high despite the recent barrage of bad news on the geopolitical front (Ebola, Europe, Hong Kong protests, Iraq, Syria, Islamic State militants, economic slowdown in China). In the October 2014 Beige Book, the word “optimism” (or its related words) appeared 32 times, whereas the word “pessimism” did not appear at all. However, this is not the start of a new trend; as in the 7 Beige Books this year, the word “optimism” has appeared, on average, 29 times in each edition. In the similar period 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 nine times in the first seven Beige Books of 2009, whereas the word “pessimism” appeared, on average, four 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 in late 2007 also appear to be well overdone, based on this metric. In the first 7 Beige Books of 2007, the word “optimism” appeared, on average, just 10 times per edition—a far cry from the 29 times per edition in the first 7 Beige Books of 2014 [Figure 4]. ■

4 Optimism on the Main Street Economy Is Running High in the Beige Book

First 7 Beige Books of:	Optimism	Pessimism
2007	10	1
2009	9	4
2013	25	1
2014	29	0

Source: LPL Financial Research, Federal Reserve 10/20/14



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