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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 “modest or moderate” pace that is at or above its long-term trend, and that some upward pressure on wages is beginning to emerge.

Optimism on Main Street remains high despite the recent barrage of bad news on the economy.

Over the past three Beige Books, the BBB averaged +85, in-line with the +89 average reading in all of 2014.

BEIGE BOOK SUGGESTS CONTINUED MODEST ECONOMIC GROWTH

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, March 4, 2015, ahead of the March 17–18, 2015, Federal Open Market Committee (FOMC) meeting. The qualitative inputs for the March 2015 Beige Book were collected from early January 2015 through February 23, 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 December 2014 and early 2015
- Rising U.S. dollar
- Supply chain disruptions due to work stoppages and strikes at West Coast ports
- Ongoing cuts to energy sector capital spending
- A spike in layoffs in the energy sector
- Unusually cold and snowy weather in many parts of the eastern United States

Despite the headwinds noted above, 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. Overall, the Beige Book described the economy as expanding at a “modest or moderate” pace, and even the Boston district, which endured record cold temperatures and near record snowfall, noted that “business contacts were fairly upbeat this period, notwithstanding the severe weather.” In general, optimism regarding the economic outlook far outweighed pessimism throughout the Beige Book, as it has for the past 18 months or so.

As it has over the past year, the March 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. 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 three Beige Books (December 2014, January 2015, and March 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

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 March 17–18, 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 DESPITE AWFUL WEATHER, THE PORT STRIKE, AND STRONGER DOLLAR, OUR BEIGE BOOK BAROMETER TICKED HIGHER IN MARCH

- 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 03/06/15

long until Fed policymakers begin to take note of a faster pace of wage inflation in their monetary policy deliberations. Indeed, after the release of the stronger than expected February 2015 employment report on March 6, 2015, some market participants expect that the FOMC may remove its commitment to remain “patient” in keeping rates low. We’ll discuss our outlook for the March 17–18, 2015, FOMC meeting in the March 16, 2015, edition of the *Weekly Economic Commentary*.

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 March 2015, the barometer ticked up to +82, from +73 in January 2015. The barometer was +100 in December 2014. Over the past three Beige Books, the BBB averaged +85, in-line with the +89 average reading in all of 2014. 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 +85 reading on the BBB over the past 3 Beige Books is also consistent with the above-trend pace of GDP growth seen in the final three quarters of 2014, when the U.S. economy grew, on average, by 3.9%, well above the long-term average of around 3.0%. In addition, the word “weak” or its variants appeared just 22 times in the latest Beige Book and just under 19 times, on average, in the last 3 Beige Books (December 2014, January 2015, and March 2015), well under 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 that as of late February 2015, the global growth concerns around the drop in oil prices, deflation in Europe, a slowing Chinese economy, and the rising U.S. dollar may be overdone. In short, while the latest reading on our Beige Book Barometer was below the 100+ readings seen in mid-2014, temporary factors like the weather and the port strike—rather than

renewed global headwinds—are the likely culprits. In general, the Beige Book painted a much brighter picture of the U.S. economy than the string of lower than expected readings on the economic data released during January and February 2015.

COMMENTS ON OIL & ENERGY STILL ELEVATED

Oil and energy got a combined 50 mentions in the March 2015 Beige Book, below the 73 mentions in the January 2015 Beige Book but just above the 44–45 mentions per Beige Book in 2014 and in 2011–13 [Figure 2]. The summary comment on energy in the January 2015 Beige Book was: “Oil and natural gas drilling declined in the Cleveland, Minneapolis, Kansas City, and Dallas Districts. In contrast, the Richmond District reported that natural gas production was unchanged. The number of drilling rigs for oil and natural gas declined sharply in the Cleveland, Minneapolis, and Kansas City Districts. Oil and gas producers in the Cleveland, Kansas City, and Dallas Districts anticipate cuts in capital expenditures during 2015.”

In particular, contacts in the Kansas City District—which includes all or parts of key oil- and gas-producing states like Oklahoma, Texas, Colorado, Wyoming, and New Mexico—noted: “Energy activity in the District continued to slow and oil and gas producers attempted to reduce costs in January and early February as a result of low oil prices. The number of active oil and gas drilling rigs fell sharply through early February. Many producers reported large capital spending cuts and several announced layoffs. Future drilling activity was expected to fall, and to increasingly focus on core areas.”

Comments on the mining sector from the Minneapolis Fed District (which includes North Dakota) noted: “The energy and mining sectors contracted since the last report. Oil and gas exploration activity fell rapidly in response to lower prices; the number of active drilling rigs in North Dakota and Montana fell to 128 in mid-February compared with 179 at the beginning of the year.”

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.

UNCERTAINTY FADING FOR FISCAL POLICY & HEALTHCARE, BUT GLOBAL GROWTH & DROP IN OIL ARE STILL 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

2 BAD WEATHER AND OIL REPLACE UNCERTAINTY/ACA AS DRAGS ON GROWTH

	Shutdown/Fiscal/Debt Ceiling/ Uncertainty/Confidence	Affordable Care Act/Healthcare	Energy/Oil	Weather
March 2015	6	14	50	36
January 2015	13	7	73	11
2014 Average	12	13	44	80+ (Winter 2013–2014)
2011–2013 Avg.	31	11	45	14

Source: LPL Research, Federal Reserve Beige Book 03/06/15

6 times in the March 2015 edition of the Beige Book and just 13 times in January 2015 [Figure 2]. 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 has been replaced by uncertainty surrounding the drop in oil prices and what it might signal for global growth.

As we wrote in our *Outlook 2014: The Investor's Almanac*, we expected concerns over government policy to fade during the course of 2014, and that was largely the case. But as 2015 begins, policy-related uncertainty could make a comeback. Please see our *Outlook 2015: In Transit* for more details.

The Affordable Care Act (ACA), and healthcare in general, remained a consistent source of concern among respondents to the Beige Book, although the impact faded a bit recently. The ACA (and healthcare in general) received 14 mentions in the latest Beige Book, up from just 7 mentions in the January 2015 edition and similar to the 15 mentions in the December 2014 Beige Book. On average, the ACA/healthcare saw 16 mentions per Beige Book in 2013 and 13 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 and snowy/icy weather that descended on much of the eastern part of the country in January and February 2015 did not go unnoticed in the latest Beige Book. Indeed, weather was mentioned 36 times in the March 2015 Beige Book, and almost all the mentions were in a negative context. Although the cold and snow in January and February 2015 were debilitating, they did not have as big of an impact as the harsh winter weather in early 2014, which impacted a wider area of the country. In the first few Beige Books of 2014, weather was mentioned, on average, 80 times per Beige Book. The strong February 2015 employment report (released last Friday, March 6, 2015) saw little impact from harsher than usual winter weather,

consistent with the findings in the Beige Book. Still, even colder and more disruptive winter weather impacted the eastern U.S. in late February and early March 2015, so mentions of weather may again be elevated in the Beige Book released in mid-April.

Optimism on Main Street remains high despite the recent barrage of bad news on the economy, as noted in the first section of this week's commentary. In the March 2015 Beige Book, the word "optimism" (or its related words) appeared 24 times, whereas the word "pessimism" appeared just once. Not surprisingly, the pessimism was expressed by contacts in the energy sector. 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 3]. ■

3 OPTIMISM ON THE MAIN STREET ECONOMY IS RUNNING HIGH IN THE BEIGE BOOK

Mentions per Beige Book in:	Optimism	Pessimism
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 Beige Book 03/06/15

IMPORTANT DISCLOSURES

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