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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 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 or so.

In June 2015, the barometer moved up to +92, the highest since late 2014.

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, indicating that some of the “transitory factors” that held the U.S. economy back in the first quarter of 2015 have faded 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 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, June 3, 2015, ahead of the June 16–17, 2015, Federal Open Market Committee (FOMC) meeting. The qualitative inputs for the June 2015 Beige Book were collected from early April 2015 through May 22, 2015; thus, they captured a period of:

- Increasing market concern around Greece
- A disappointing bounce back in the U.S. economic data for March and April following the disruptions of the first quarter (port strike, bad weather, strong dollar)
- Falling U.S. dollar (decline began in mid-April) that remains elevated relative to year ago levels
- Some stability in oil prices
- Improving economic activity in the Eurozone and Japan, but ongoing concern over weakness in China

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 June 2015, the barometer moved up to +92 from +47 in April 2015 and +82 in March 2015. The +92 reading in June 2015 was the highest reading since late 2014.

Much was made of the fact that the word “weak” or its variants appeared 52 times in the latest Beige Book (versus 44 in April 2015). Indeed, it was the highest number of weak words in the Beige Book since 2011, during the worst of the

HOW THEY WORK

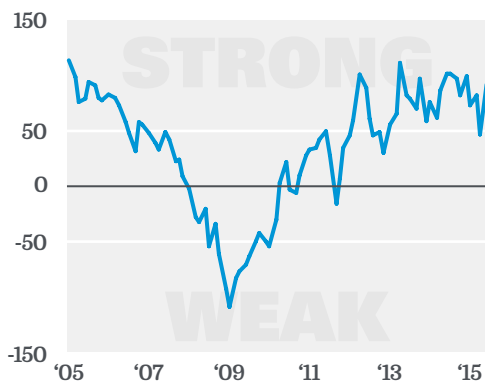
BEIGE BOOK AND BEIGE BOOK BAROMETER

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 Fed 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 June 16 – 17, 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 JUNE 2015 BAROMETER READING WAS THE HIGHEST READING SINCE LATE 2014

- 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 06/05/15

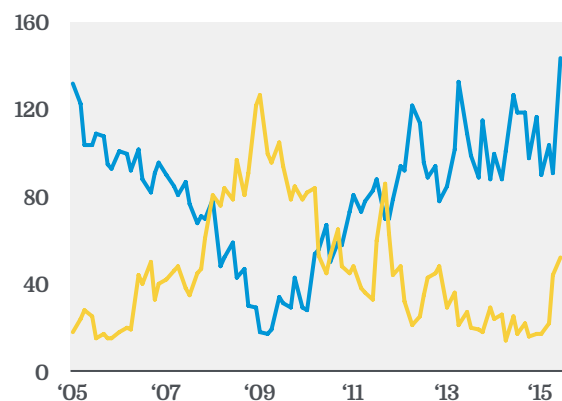
European debt crisis of that year and the aftermath of the U.S. debt downgrade and debt ceiling debacle. However, we point out that at 144, the number of strong words (strong, strength, and their variants) was the highest since at least 2005 [Figure 2]. This supports the Fed’s view that the weakness in the U.S. economic data in the first quarter was transitory.

WATCHING WAGES & INFLATION

As it has over the past year, the June 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 five Beige Books (December 2014, January 2015, March 2015, April 2015, and June 2015) contained several mentions of employers having difficulty attracting and retaining low-skilled workers, and retaining and compensating key workers.

2 WITH THE MOST STRONG WORDS SINCE 2005, THIS BEIGE BOOK SUPPORTS THAT Q1 2015 WEAKNESS WAS TRANSITORY

- Beige Book Mentions
- “Strong” Words
 - “Weak” Words

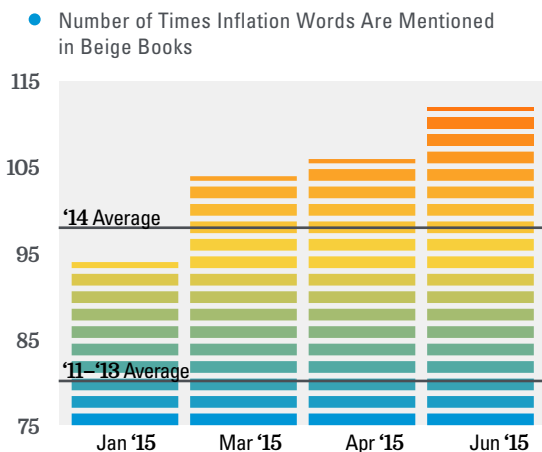


Source: LPL Research, Federal Reserve 06/05/15

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. Based on the minutes of the April 28–29 FOMC meeting, released in late May 2015, Fed officials are not yet worried about rising wages, and indeed, cannot come to general agreement that wages should even play a part in measuring inflation pressures in the economy.

Figure 3 shows the recent trend in the number of “inflation words” in the Beige Book. We counted the number of times the words “wage,” “skilled,” “shortage,” “widespread,” and “rising,” appeared in recent editions of the Beige Book. In June 2015, these words appeared 112 times, up from 106 in April 2015 and 104 in March 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%.

3 MENTIONS OF “INFLATION WORDS” IN BEIGE BOOK CONTINUE TO RISE



Source: LPL Research, Federal Reserve Board 06/05/15

FEWER COMMENTS ON OIL & ENERGY THAN IN PAST BEIGE BOOKS

Oil and energy received a combined 32 mentions in the June 2015 Beige Book, below the 46, 50, and 73 mentions in the April, March, and January 2015 Beige Books, and even below the 44–45 mentions per Beige Book in 2014 and in 2011–13 [Figure 4]. This may suggest that the capital spending cuts, rig count reductions, and job cuts in the oil and gas sector in late 2014 and in the first few months of 2015 may be fading as drags on economic activity. The summary comment on the energy sector in the June 2015 Beige Book captures the situation in the oil and gas drilling sector well:

“Reports indicated that oil and natural gas drilling activity continued to decline in the Atlanta, Minneapolis, Kansas City, Dallas, and San Francisco Districts, while the Cleveland District said the number of rigs operating in the Marcellus and Utica shale regions leveled out in April after sharp declines in the first quarter.”

As was the case in the April 2015 Beige Book, the June 2015 Beige Book was also full of comments about how lower fuel and energy prices were

4 FEWER MENTIONS OF ENERGY/OIL, AND WEATHER IMPACT DECLINES SIGNIFICANTLY

	Uncertainty*	ACA/ Healthcare	Energy/ Oil	Weather
Jun '15	9	11	32	16
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 06/05/15

*Uncertainty/Confidence/Shutdown/Debt Ceiling/Fiscal

benefiting multiple industries throughout all 12 Fed districts. In short, comments 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 six to nine months or so. (Please see our *Weekly Economic Commentary*, “Drilling into the Labor Market,” January 12, 2015, for more details.)

FADING & 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 9 times in the June 2015 Beige Book, bringing the 2015 year-to-date average to 10 [Figure 4]. 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, and 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. Please see this week’s *Weekly Market Commentary*, “ACA Ruling Could Make Healthcare

Sector More Affordable” for details of the Supreme Court’s upcoming ruling on the ACA.

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—led to a whopping 71 mentions of weather in the April 2015 Beige Book, and almost all the mentions were in a negative context. Weather got only 16 mentions in the June 2015 edition, clearly indicating that weather faded as a drag on growth as spring got underway. 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.

OPTIMISM RULES

Of the major “transitory factors” that impacted the economy and the Beige Book in early 2015, only the strong dollar lingered (30 mentions in June 2015 versus 31 in April); however, neither the dollar nor the other headlines of the day were able to dampen the optimism on the economy that has picked up strength in the past year or so.

In the June 2015 Beige Book, the word “optimism” (or its related words) appeared 19 times, whereas the word “pessimism” appeared just once, referring to the outlook in the oil and gas sector in the Dallas Fed district. Over the first 4 Beige Books of 2015, optimism has appeared, on average, 22 times per Beige Book, while the word pessimism has appeared a total of just twice across all 4 Beige Books in 2015, with both mentions in the Dallas district commenting on the outlook for the oil and gas sector.

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 5]. ■

5 OPTIMISM CONTINUES TO RUN HIGH ON MAIN STREET

Mentions per Beige Book in:	Optimism	Pessimism
Jun 2015	19	1
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 06/05/15

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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