Weekly Economic Commentary

July 28, 2014

Midsummer Madness

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Highlights

Only nine times in over 14 years have the FOMC meeting, GDP report, ISM report, and the employment report—all often market-moving events—occurred in the same week.

Historically, these weeks have exhibited 20% more volatility than an average week over this time span, as measured by the S&P 500 Index.

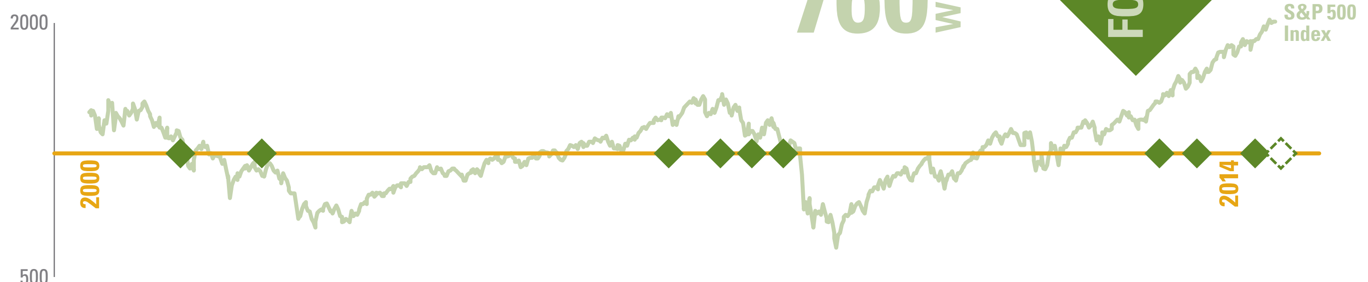
This week is unlikely to be just another boring mid-summer week for financial market participants.

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' (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 (July 28–August 1, 2014), all four of these key events are on the docket. How rare is this? In the 760 weeks between January 1, 2000, and July 28, 2014 (over 14 years), all four of these often market-moving events have occurred in the same week just nine times, most recently in the last week of April of 2014.

As an aside, all four would have also occurred the week of October 28–November 1, 2013, but the 16-day shutdown of the U.S. government prevented the release of the Q3 2013 GDP report and the October 2013 Employment Situation report that week.

1 Four Focal Points in the Same Week a Rarity

Only nine times since January 1, 2000, has the ISM, the jobs report, the GDP report, and the FOMC meeting all occurred in the same week. Historically, these weeks have exhibited **20% more volatility** than an average week over this time span.



Source: LPL Financial Research, Bloomberg 07/28/14

Past performance is no guarantee of future results.

The S&P 500 Index is unmanaged and cannot be directly invested in.

Historically, these weeks have exhibited 20% more volatility than an average week over this time span [Figure 1], and the VIX, a measure of equity market volatility, has been 4% higher. Add in the 150 S&P 500 companies expected to report earnings, and this week is unlikely to be just another boring midsummer week for financial market participants.

In addition to those four key events, markets will digest U.S. vehicle sales for July, pending home sales for June, home prices for May, and key data in Germany (inflation for July), Spain (Q2 GDP), China (Purchasing Managers' Index [PMI] for July) and Japan (housing starts and vehicle sales for July), along with a report on second quarter GDP in Taiwan.

FOMC in Focus: Tuesday, July 29 & Wednesday, July 30, 2014

- This is the fifth of eight FOMC meetings this year.
- We continue to expect the Fed to trim its bond purchases—also known as quantitative easing (QE)—by $10 billion per month this year, and to remain on pace to exit quantitative easing by the fourth quarter of 2014. The minutes of the June 17–18, 2014 FOMC meeting confirmed this path.
- We expect that the Fed will maintain its promise to keep rates low for a "considerable time" after QE ends.
- This meeting will not include a press conference from Fed Chair Janet Yellen, and the FOMC will not be releasing a new economic forecast at the conclusion of this 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 second quarter of 2014 will be released on Wednesday, July 30, 2014, the second day of the Fed's meeting.
- The statement released after the conclusion of the meeting will likely acknowledge the recent uptick in labor market indicators along with the lack of associated wage pressures.

Q2 GDP Wednesday, July 30, 2014

- The consensus of economists (as measured by Bloomberg News) is looking for a 3.0% annualized increase in real GDP for the second quarter of 2014, based on an expected rebound in economic growth in the second quarter after much more severe-than-usual winter weather impacted the nation during the first quarter of 2014.
- The second quarter GDP report may be more difficult than usual for markets to interpret. Every July, the government agency (BEA) that compiles the GDP data releases revised data on GDP and its components going back three years. These revisions have the potential to change the baseline for growth, making the meaning of the new data less clear for market participants.

- This time around, the GDP accounts will also undergo a "benchmark revision," which will extend as far back as 1999, to incorporate a change in the way international transactions (imports, exports, foreign holdings of U.S. securities, etc.) are handled in the GDP accounts. The revised data are based on new information from individuals, corporations, and businesses across the economy that was not available to the BEA initially.
- While the quarter-to-quarter wiggles of GDP growth may change — and perhaps show a deeper Great Recession and a slightly stronger recovery — the overall pattern is likely to stay the same.
- Consumer spending, housing (residential investment), and business investment in structures and business capital spending are likely to bounce back in Q2 after being severely impacted by poor weather in the first quarter. Trade (exports less imports) is likely to be a drag on growth in the second quarter, reflecting a stronger domestic economy and still sluggish overseas economies, notably in Europe.
- Government spending, which has been a drag on GDP growth in all but four quarters during the past five years, should be a plus for GDP in the second quarter, as federal, state, and local governments all add to growth after the government shutdown reduced spending in the fourth quarter of 2013.
- As noted in our *Mid-Year Outlook 2014: Investors Almanac Field Notes*, we continue to expect that U.S. economic growth may accelerate to about 3.0% in 2014, after growing at less than 2.0% in 2013. Growth in 2013 was stifled by tax increases and spending cuts that added a material drag to the economy. Getting beyond those drags, as well as solid business and consumer spending, should help to boost GDP this year.

July Employment Report in Focus: Friday, August 1, 2014

- The consensus (as measured by Bloomberg News) is that that the U.S. economy created a net 230,000 new jobs in July 2014, a slight deceleration in job creation from the 288,000 new jobs created in June 2014. After the economy created about 200,000 jobs per month in the 12 months ending in November 2013, severe winter weather in many parts of the nation led to a slowdown in job creation during the winter of 2013–14, when an average of just 151,000 jobs per month were created. In the recently completed second quarter of 2014, monthly job gains averaged 272,000 per month. These figures are derived from a survey of business establishments.
- The consensus of economists' forecasts suggests the unemployment rate (measured from a survey of households) may remain at 6.1% in July 2014, after starting the year at 6.6%. The labor force participation rate (the percentage of the population over 16 that has a job or is looking for work) is the wild card here. The overall participation rate plateaued in the 1990s, peaked at just over 67% in the early 2000s, and has been falling ever since (see *Weekly Economic Commentary: Labor Market Report Card*, dated March 31, 2014, for more details).

- The key in this report may be the pace of wage inflation, as measured by the year-over-year percent change in average hourly earnings. At just 2.0% year-over-year in June 2014, wages have not accelerated along with the recent uptick in job creation in the spring and early summer. In her recent testimony to Congress, Fed Chair Yellen noted that "..Significant slack remains in labor markets …corroborated by the continued slow pace of growth in most measures of hourly compensation." In our view, a sustained acceleration in wage growth may cause the Fed to act sooner rather than later to end QE and begin to raise rates, but for now, there have been few signs of such acceleration.
- Our view remains that the expected acceleration in the U.S. economy in the second half of the year will allow the labor market to routinely create 200,000 to 250,000 jobs per month and push the unemployment rate lower in the period ahead. But other measures of the health of the labor market — hiring rates, the quit rate, and the unemployment rate — and most importantly wages, still show that the labor market is not yet back to normal, and argue against the Fed taking aggressive action to reduce the monetary stimulus in the system anytime soon.

July ISM in Focus:
Friday, August 1, 2014

- The consensus forecast (as measured by Bloomberg News) is looking for a 56.0 reading on the ISM for July 2014, after the 55.3 reading in June 2014. The July readings on the regional Federal Reserve bank manufacturing surveys (Philadelphia Fed, Empire State, Richmond Fed, Kansas City Fed) have all accelerated from June and exceeded consensus expectations, and vehicle output in July is running at a seven-year-high.
- A reading above 50 on the ISM indicates that the manufacturing sector is expanding; a reading below 50 on the ISM indicates that the manufacturing sector is contracting, and an ISM reading at 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 importance to the markets of the ISM report. While still a solid reading at 56.3, the Markit PMI reading for July 2014 was both below consensus estimate (57.5) and below the June 2014 reading of 57.3.
- Over the course of 2014, we continue to expect the manufacturing sector will likely be boosted by the "onshoring" of jobs, the U.S. energy renaissance, which has brought relatively cheap and plentiful supplies of energy, and an improving pace of capital spending. At the same time, sluggishness in Europe — may continue to drag on the manufacturing sector in 2014. Please see our recent *Weekly Economic Commentary: Capital Spending Checkup,* dated May 27, 2014, for more details. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

The Federal Open Market Committee (FOMC), a committee within the Federal Reserve System, is charged under the United States law with overseeing the nation's open market operations (i.e., the Fed's buying and selling of United States Treasure securities).

Quantitative easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

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

The Standard & Poor's 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.

Markit is a leading, global financial information services company that provides independent data, valuations and trade processing across all asset classes in order to enhance transparency, reduce risk and improve operational efficiency. The Markit Purchasing Managers' IndexT (PMIT) is a composite index based on five of the individual indexes with the following weights: New Orders - 0.3, Output - 0.25, Employment - 0.2, Suppliers' Delivery Times - 0.15, Stocks of Items Purchased - 0.1, with the Delivery Times Index inverted so that it moves in a comparable direction.

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