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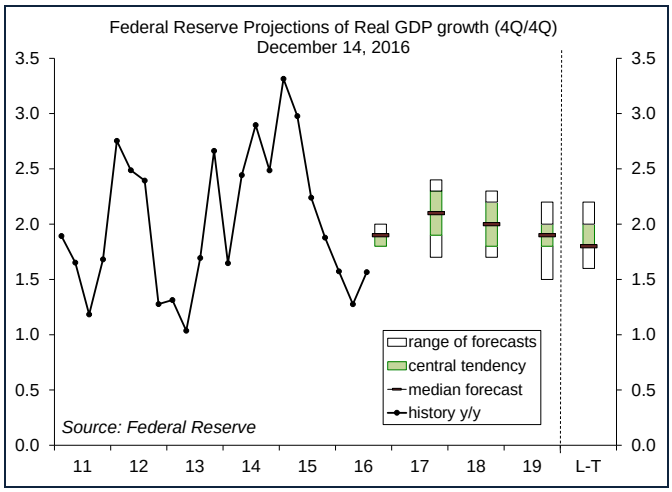
Weekly Economic Monitor

Rebel Yell(en)

Fed Chair Janet Yellen will present her monetary policy testimony to Congress on Tuesday and Wednesday. We may not learn much new regarding the pace of future rate increases (which will remain data-dependent) and she's certain to avoid getting into any discussion of fiscal policy. However, the Fed is now the chief supervisor of the financial system and, even if she is viewed as a lame duck (her term as Fed chair ends February 3, 2018), she ought to have a lot to say about financial regulation.

After some second-guessing in recent weeks, stock market participants remain generally enthusiastic. The Trump trade is back in gear. However, most economists are less enthusiastic. Expectations of near-term economic growth have been raised, but there are constraints ahead in the labor market, fiscal policy changes have to come through a contentious and difficult process, and there is a danger of a major mistake on global trade. It's uncertain how these two conflicting views will be resolved. Yellen may not provide much clarity, but it will interesting to hear the Fed's views on the outlook, as well as the risks and uncertainties. Remember, she's there to present the view of all Fed policymakers, not just to give her own opinions.

Fed officials did not formally update their economic projections at the recent policy meeting, so Yellen may simply rehash the mid-December outlook. At that meeting, some officials, but not all, incorporated fiscal stimulus into their forecasts. Most Fed officials see the economy as being near full employment. Hence, fiscal stimulus may not add much to the growth outlook. Still, Yellen should take note that the size, composition, and timing of fiscal stimulus is uncertain. The Fed is not going to base monetary policy decisions on what Congress might do. There's a strong belief that the central bank has the ability to wait to see what Congress does. There's little danger of the Fed falling behind the curve.



The Fed's economic outlook is likely to be a mixed bag. Job growth is expected to remain relatively strong in the near term, but will slow as labor market constraints become more binding. Wage growth, while uneven from month to month, is trending gradually higher. Yet, while nominal wage growth is gently moving up, inflation-adjusted wage growth has slowed significantly (reflecting the firming in gasoline prices). Hence, consumer spending growth ought to remain moderate – not weak, but not especially strong either. In contrast, beginning last summer, business fixed investment appeared to be emerging from a slow patch. The global economy, while not booming, is looking better. Thus, capital spending should add to overall economic growth in the near term. However, the consumer sector is a much larger part of the economy, so the upside prospects for growth are likely to be more limited than stock market participants seem to be anticipating.

The Fed has two goals, maximum sustainable employment and stable prices (in practice, this is taken to be low inflation – 2% per year in the PCE Price Index). Over the long term, these are often viewed as one goal. That is, keeping inflation low will lead to better job growth over time. Inflation is a monetary phenomenon, but its approach is visible through pressure in resource markets. The labor market is the widest channel for inflation pressure. Most Fed officials fear that wage inflation will be passed along in higher price inflation. However, that depends on the ability of firms to raise prices. Higher wage inflation could lead to a more efficient allocation of labor, boosting productivity growth. The Greenspan Fed took a risk in the late 1990s, allowing the unemployment rate to fall below a level many thought to be consistent with full employment. That period coincided with rapid technology change and a misallocation of capital (the dot-com bubble). It's hard to separate the effects (Fed policy vs. technology), but we saw major changes in the job market (a high level of job destruction and a high level of job creation, but net gains). It's unlikely that the Fed will repeat that experiment.

The financial crisis was due in part to the absence of a systemic regulator (no one overseeing the financial system as a whole). The Federal Reserve has that role now. Since the election, financial stocks have rallied on the expectation of a rollback of regulations. However, there's little evidence that regulation has been a major constraint on bank lending. On Friday, Daniel Tarullo, the key Fed governor on regulation and supervision, announced his resignation (effective April 5). President Trump will nominate his replacement (in addition to filling two currently vacant Fed governor slots and choosing Yellen's replacement as Fed chair). This week, expect Yellen to emphasize the importance of central bank independence and the Fed's critical role in regulating the financial system.

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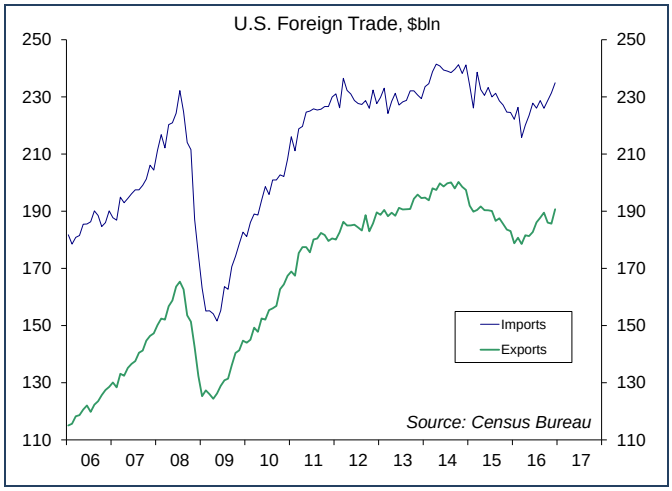
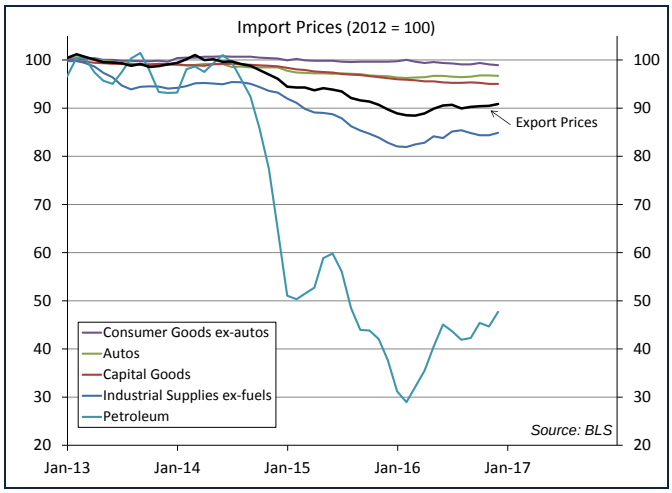
	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
1/13/17	0.53	0.61	0.82	1.21	1.48	1.90	2.40	2.99	1.063	1.220	115.03	1.313	5574.12	2274.64	19885.73
2/03/17	0.51	0.63	0.82	1.21	1.49	1.93	2.49	3.11	1.079	1.250	112.42	1.300	5666.77	2297.42	20071.46
2/10/17	0.54	0.65	0.80	1.19	1.47	1.89	2.41	3.01	1.064	1.249	113.34	1.309	5733.78	2316.10	20269.37

Recent Economic Data and Outlook

The economic data calendar was thin. Stock market participants were encouraged by prospects for tax cuts following comments from President Trump. The bond market was less confident that we'll see budget-busting fiscal policy anytime soon.



The U.S. **Trade Deficit** narrowed to $44.3 billion in December (slightly smaller than what was assumed in the advance GDP report), down from $45.7 billion in November. Merchandise exports rose 3.9%% (+5.2% y/y). Merchandise imports rose 1.9% (+4.8% y/y), with petroleum imports down 0.3% (+14.1% y/y) and non-petroleum imports up 2.2% +4.2%y/y). Implicitly, import prices rose 0.4% +0.9% y/y), with petroleum up 8.9% (+13.9% y/y) and non-petroleum down 0.2% (+0.1% y/y).



Import Prices rose 0.4% in January (+3.7% y/y), reflecting a 5.2% rise in petroleum (+60.9% y/y). Ex-food & fuels, import prices slipped 0.1% (-0.1% y/y). Figures showed some pickup in inflation for imported raw materials, but general deflation in consumer goods and capital equipment.

The **Job Opening and Labor Turnover Survey** results for December showed relatively little change in hiring and quit rates over the last several months, consistent with moderate improvement in overall labor market conditions. Job layoffs and discharges are trending very low.

The University of Michigan's **Consumer Sentiment Index** fell to 95.7 in the mid-February estimate, down from 98.5 in January and 98.2 in December. Most of the decline was in expectations.

Economic Outlook (1Q17): 2.0-2.5% GDP growth.

Employment: The pace of job gains has slowed (still moderately strong), likely reflecting tighter job market conditions.

Consumers: Job growth and moderate wage increases are supportive for consumer spending, but real wage growth is slowing as lower gasoline prices fade. Higher rents and medical care have been a restraint for middle income households.

Manufacturing: Mixed across sectors, but relatively lackluster overall. A strong dollar makes it more difficult for U.S. exporters, but helps firms that import raw materials. Trade disputes could interrupt supply chains.

Housing/Construction: Job growth has remained supportive, but higher home prices and rising mortgage rates are a restraint for first-time buyers. Tax cuts are expected to help fuel the demand for vacation homes and second homes in 2017.

Prices: Ex-food & energy, the PCE Price Index has continued to trend below the Fed's 2% target. There is little inflation in consumer goods. Inflation in consumer services has been boosted by higher rents. Wage gains are moderate, but rising.

Interest Rates: The Fed remains in tightening mode, but is expected to proceed cautiously as it normalizes policy.

This Week:					*forecast*	last	last –1	comments
Monday	2/13		no significant economic data					Happy Birthday, Peter Tork
Tuesday	2/14	6:00	Small Business Optimism	Jan	***NF***	105.2	98.4	still enthusiastic
		8:30	**Producer Price Index**	Jan	***+0.2%***	+0.5%	-0.1%	moderate
			ex-food & energy		***+0.1%***	+0.5%	-0.2%	moderate
			ex-f, e, & trade services		***+0.1%***	+0.2%	+0.1%	moderate core inflation
		10:00	**Yellen Mon. Pol. Testimony**					to Senate Banking Committee
Wednesday	2/15	8:30	**Consumer Price Index**	Jan	***+0.3%***	+0.3%	+0.2%	some mild pressure in gasoline
			year-over-year		***+2.4%***	+2.1%	+1.7%	picking up
			ex-food & energy		***+0.2%***	+0.2%	+0.2%	moderate core inflation
			year-over-year		***+2.3%***	+2.2%	+2.1%	seen a little higher
		8:30	Real Hourly Earnings		***-0.0%***	+0.1%	-0.3%	nominal earnings rose 0.1%
		8:30	**Retail Sales**	Jan	***0.0%***	+0.6%	+0.2%	unit auto sales fell
			ex-autos		***+0.1%***	+0.2%	+0.3%	modest
			ex-autos, bld mat, gasoline		***+0.2%***	0.0%	+0.3%	lackluster core sales
		8:30	Empire St. Manf. Index	Feb	***NF***	6.5	7.6	choppy, but likely to be moderate
		9:15	**Industrial Production**	Jan	***+0.4%***	+0.8%	-0.7%	moderate
			Manufacturing Output		***+0.4%***	+0.2%	-0.1%	aggregate manufacturing hours rose 0.3%
			Capacity Utilization		***75.8%***	75.5%	74.9%	no bottleneck production pressures
		10:00	**Yellen Mon. Pol. Testimony**					to House Financial Services Committee
		10:00	Business Inventories	Dec	***+0.4%***	+0.8%	-0.1%	higher in 4Q16
		10:00	Homebuilder Sentiment	Feb	***66***	67	69	a little less enthusiastic?
Thursday	2/16	8:30	Jobless Claims, th.	2/11	***244***	234	246	some weather effects
		8:30	Building Permits, th.	Jan	***1.190***	1.228	1.212	mixed, but a moderate trend
			% change		***-3.1***	+1.3	-3.8	seasonal adjustment adds noise
			Housing Start		***1.200***	1.226	1.102	volatile and unreliable
			% change		***-2.1***	+11.3	-16.5	watch for revisions
		8:30	Philadelphia Fed Index	Feb	***NF***	23.6	19.7	strong in recent months
Friday	2/17	10:00	Leading Econ. Indicators	Jan	***+0.5%***	+0.5%	+0.1%	another strong gain
Next Week:								
Monday	2/20		Presidents Day Holiday					markets closed
Tuesday	2/21	1:00	Treasury Note Auction					2-year notes
Wednesday	2/22	10:00	Existing Home Sales, mln	Jan	***5.52***	5.49	5.65	subject to seasonal noise
			% change		***+0.5***	-2.8	+1.4	bigger test will come in spring
		11:30	FRN Auctions					2-year floating-rate notes
		1:00	Treasury Note Auction					5-year notes
		2:00	**Fed Beige Book**					focus on job market and inflation outlook
Thursday	2/23	8:30	Jobless Claims, th.	2/18	***250***	***244***	234	still trending low
		1:00	Treasury Note Auction					7-year notes
Friday	2/24	10:00	New Home Sales, th,	Jan	***555***	***536***	598	noisy, especially in January
			% change		***+3.5***	***-10.4***	+4.7	watch for revisions
		10:00	Consumer Sentiment	Feb	***95.5***	98.5	98.2	95.7 at mid-month

This Week…

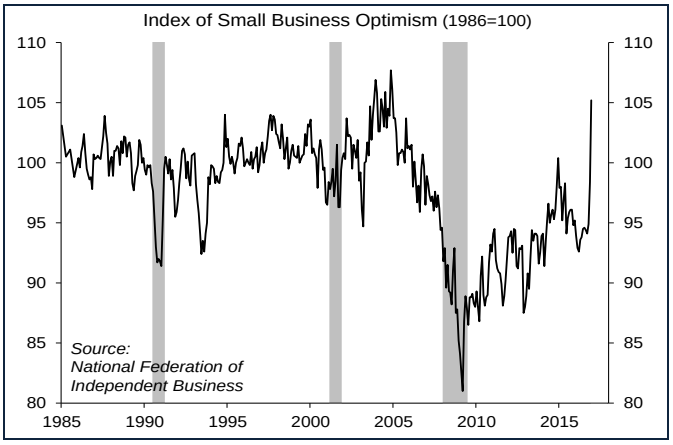
The economic data are subject to seasonal noise in January, so the mid-month figures should be looked upon skeptically. The focus for the markets will be on Yellen's monetary policy testimony (Tuesday and Wednesday). We may not learn much that is new (monetary policy will remain data-dependent) and she will steer clear of any discussion about fiscal policy. However, she should have a lot to say about financial regulation.

Monday

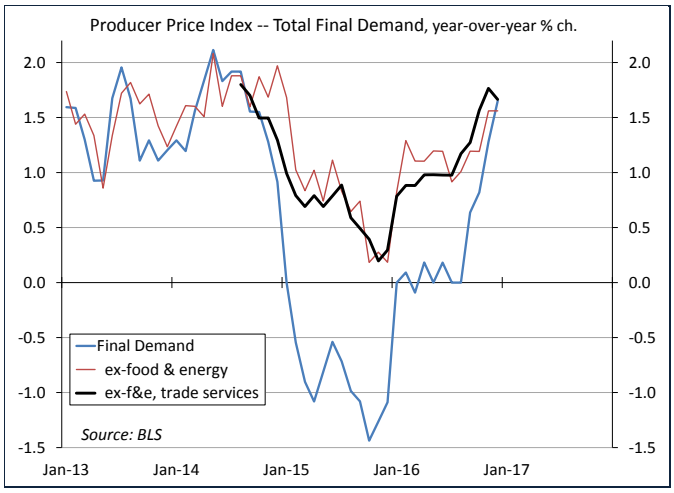
No significant data.

Tuesday

Small Business Optimism Index (January) – The headline figure popped sharply higher in December (to the highest level since 2004), driven by a bright business outlook.



Producer Price Index (January) – Benchmark revisions (released Friday) shifted the recent monthly figures around a bit. Pipeline pressures have picked up, but are not especially strong.



Yellen Monetary Policy Testimony (Senate Banking Committee) – The Fed chair's semi-annual monetary policy testimony is typically a big deal for the financial markets. Market participants will be looking for clues as to where the Fed will raise rates again in March, May, or June. At this point, she likely does not know. The Fed's decisions will depend on the job market data and the outlook for inflation. Some may try to pin her down on fiscal policy, but she will have none of that. However, expect some comments about Dodd-Frank and the importance of financial regulation in general.

Wednesday

Consumer Price Index (January) – Annual benchmark revisions will be released on Monday, but shouldn't change the overall picture of consumer prices. Gasoline prices rose in January, but only a little more than they usually do (so only a minor boost to the headline CPI figure). Core inflation should remain moderate, but firms often try to push price increases through at the start of the year, so we could see a surprise.

Real Hourly Earnings (January) – Nominal average hourly earnings were reported to have risen just 0.1% in January, but that figure appears to have been biased lower due to anticipated changes in tax rates (December income in finance was likely shifted into January).

Retail Sales (January) – It's hard to get excited about January retail sales figures. Prior to seasonal adjustment, sales fall sharply following the holiday shopping season. Keep an eye out for possible revisions to the December data. Note that continued job growth will remain supportive for consumer spending growth, but while nominal wage growth is trending moderately higher, inflation-adjusted wage growth has slowed (as gasoline prices have firmed up in recent months).

Industrial Production (January) – Temperatures could affect the headline figure (which often reflects swings in the output of utilities). Aggregate manufacturing hours (from the January employment report) were reported to have risen 0.3%, which means the factory output should be moderately higher. Much of the strength over the last several months has been in autos, where sales (and production) are expected to flatten. Orders for capital goods have been improving, which ought to help.

Yellen Testimony (House Financial Services Committee) – The Fed Chair will repeat her written testimony, but there's always a chance that something new will come up in the Q&A. There are 60 House members on this committee, so Yellen typically spends a lot of time here (that doesn't mean that we'll hear any illuminating lines of questioning).

Thursday

Jobless Claims (week ending February 11) – Still subject to seasonal adjustment quirks, claims are likely to have been restrained by poor weather last week.

Building Permits, Housing Starts (January) – Should we care much about January figures on residential construction? The bigger test will come in the next few months.

Friday

Leading Economic Indicators (January) – The Conference Board's figure is a published formula and most of the components are known. Hence, we see very few surprises. A steep yield curve, strong ISM new orders, lower jobless claims, and rising consumer expectations will propel the headline figure higher again. The drop in building permits is the only drag.

Next Week …

Monday is a holiday. The economic calendar is thin.

Coming Events and Data Releases

February 20	Presidents Day (markets closed)
February 27	Durable Goods Orders (January)
February 28	Real GDP (4Q16, 2nd estimate)
March 1	ISM Manufacturing Index (January)
March 3	ISM Non-Manufacturing Index (January)
March 10	Employment Report (February)
March 15	FOMC Policy Decision, Yellen press conference
May 3	FOMC Policy Decision (no press conference)
June 14	FOMC Policy Decision, Yellen press conference