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## BEIGE BOOK: WINDOW ON MAIN STREET

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## KEY TAKEAWAYS

The latest Beige Book reflected a picture of the U.S. economy that was largely unaffected by concerns over dropping oil prices, the 2014 holiday shopping season, global growth scares, and a rising U.S. dollar, although the drop in oil prices was noted as a negative in some districts.

The report described the economy as expanding at a “modest or moderate” pace, and in general, optimism regarding the economic outlook far outweighed pessimism, as it has for the past 18 months or so.

Over the past 3 Beige Books, the Beige Book Barometer (BBB) has averaged +85, in-line with the +89 average reading for all of 2014.

## BEIGE BOOK SUGGESTS THAT RECENT MARKET CONCERNS AROUND GLOBAL GROWTH MAY BE OVERDONE

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 last Wednesday, January 14, 2015, ahead of the January 27–28, 2015, Federal Open Market Committee (FOMC) meeting. The qualitative inputs for the January 2015 Beige Book were collected from mid-November 2014 through early January 2015; thus, they captured a period of increasing market concern due to the precipitous drop in oil prices, the 2014 holiday shopping season, deflation in the Eurozone, a slowing Chinese economy, and a rising U.S. dollar.

In our view, the latest Beige Book reflected a picture of the U.S. economy that was largely unaffected by any of the concerns described above, although the drop in oil prices was noted as a negative in the Dallas and Kansas City districts. (Please see the *Weekly Economic Commentary* from January 12, 2015, “Drilling into the Labor Market” for more details.) Overall, the Beige Book described the economy as expanding at a “modest or moderate” pace and noted “several districts expect somewhat faster growth over the coming months.” In general, optimism regarding the economic outlook far outweighed pessimism, as it has for the past 18 months or so.

As it has over the past year, the January 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 two Beige Books (December 2014 and January 2015) contained more than one mention of employers having difficulty attracting and retaining low-skilled workers, and retaining and compensating key workers. If this trend persists into 2015, 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.

## 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].

## HOW THEY WORK

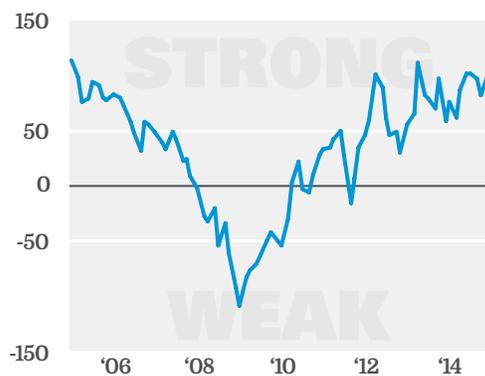
### BEIGE BOOK AND BEIGE BOOK BAROMETER

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 January 27–28, 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 BEIGE BOOK BAROMETER TICKS DOWN IN JANUARY BUT SUGGESTS SOLID GDP GROWTH

- Number of Times “Strong” (and Variations of This Word) Is Mentioned Minus Number of Times “Weak” (and Variations) Is Mentioned



Source: LPL Financial Research, Federal Reserve 01/14/15

In January 2015, the barometer ticked down to +73 from the +100 reading in December 2014 and the +82 reading in October 2014. Over the past 3 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 both the second and third quarters of 2014, when the U.S. economy grew, on average, by 4.8%, well above the long-term average of around 3.0%. In addition, the word “weak” or its variants appeared just 17 times in the latest Beige Book and just under 17 times, on average, in the last 3 Beige Books (October and December 2014 and January 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 as of early January 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 Beige Book did hint at some deceleration in the U.S. economy in late 2014, it did not support the financial markets’ worst fears around the health of the U.S. and global economies.

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## INCREASED COMMENTS ON OIL & ENERGY

Oil and energy got a combined 73 mentions in the January 2015 Beige Book, well 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: “Overall demand for energy-related products and services weakened somewhat, while the output of energy-related products increased.” However, the Beige Book also noted: “The Kansas City and Dallas districts reported that demand for oilfield services decreased,” and 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—expect the “district’s energy sector to slow further in response to lower energy prices.”

Comments from the Minneapolis Fed district (which includes North Dakota) on the mining sector noted that while oil and gas exploration activity decreased, one company “announced plans for four new diesel and natural gas processing plants in North Dakota.” On balance, 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.

**In our view, falling oil prices will be a net plus for the U.S. economy as a whole.**

### 2 UNCERTAINTY HAS FADED AS RESTRAINT ON GROWTH

	Shutdown/Fiscal/Debt Ceiling/ Uncertainty/Confidence	Affordable Care Act/Healthcare	Energy/Oil
January 2015	13	7	73
2014 Average	12	13	44
2011–2013 Average	31	11	45

Source: LPL Financial Research, Federal Reserve Beige Book 01/14/15

## UNCERTAINTY FADING FOR FISCAL POLICY & HEALTHCARE, BUT GLOBAL GROWTH AND 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 13 times in the January 2015 edition of the Beige Book [Figure 2]. In the 8 Beige Books released in 2014 (including the December edition), 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 they 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, with the next debt ceiling deadline (March 2015) on the horizon. 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 start of the enrollment

period for the second year of healthcare coverage under the ACA began on November 15, 2014, just outside the data collection period for the January 2015 Beige Book. The ACA (and healthcare in general) received just 7 mentions in the latest Beige Book, down from 15 mentions in the December 2014 Beige Book and fewer than 10 mentions in the Beige Books released in the late spring and summer of 2014. On average, the ACA/healthcare saw 16 mentions per Beige Book in 2013, and as many as 33 mentions in the October 2013 Beige Book, during the enrollment period that began on October 1, 2013, for coverage in calendar year 2014.

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

Mentions per Beige Book in:	Optimism	Pessimism
2015	21	0
2014	30	0
2013	25	1
2009	9	5
2007	10	1

Source: LPL Financial Research, Federal Reserve Beige Book 01/14/15

Optimism on Main Street remains high despite the recent barrage of news on the drop in oil prices—and its potential implications for global growth, the slowdown in Europe, and ongoing geopolitical tensions in the Middle East and elsewhere. In the January 2015 Beige Book, the word “optimism” (or its related words) appeared 21 times, whereas the word “pessimism” did not appear at all. However, this 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 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]. ■

#### IMPORTANT DISCLOSURES

The economic forecasts set forth in the presentation may not develop as predicted.

All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

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