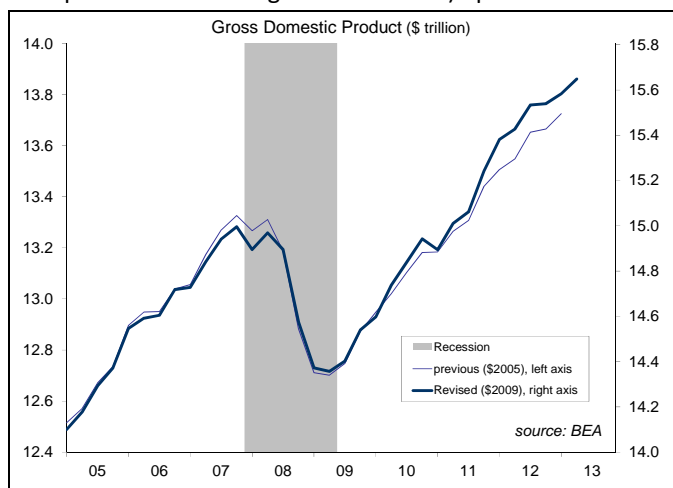


Monthly Economic Outlook

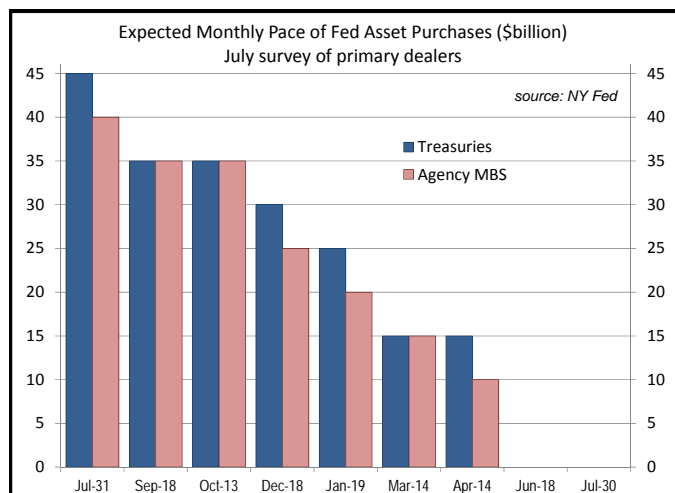
Tip-Toeing to Taper Town

- Recent economic data reports have been mixed, but consistent with moderate growth in 2H13.
- The Federal Reserve is widely expected to begin reducing its monthly pace of asset purchases by the end of the year. The decision when to start tapering will be data-dependent. Financial markets should have mostly factored in the tapering. Talk of tapering has led to capital outflows from emerging economies.
- The financial markets have focused too much on Fed tapering. A showdown over the federal budget and debt ceiling has the potential to be much more unsettling.

Real GDP rose at a 1.7% annual rate in the advance estimate for 2Q13 and recent component data suggest that this figure will be revised a bit higher. Annual benchmark revisions pushed the 1Q13 growth estimate down to a 1.1% pace (vs. +1.8%). The Bureau of Economic Analysis added capital expenditures on intellectual property products to the GDP figures. These additions and revisions to other components raised the level of nominal (current-dollar) GDP by a little over 3%. Even with the revisions, the pattern of real (constant-dollar) GDP through the recession and early recovery was not much different from previous estimates. Real GDP rose 1.4% over the last four quarters, with domestic final sales (GDP less net exports and the change in inventories) up 1.5%.



Despite the lackluster pace of GDP growth over the last year, job growth has remained moderately strong. Private-sector payrolls advanced by 161,000 in the initial estimate for July – a 181,000 pace over the last three months (and 193,000 per month over the last 12 months). Implicitly, productivity growth has slowed substantially. A continued low trend in productivity growth would have important implications for the economy. However, it's unclear why productivity might have slowed and whether this will be a long-term trend.

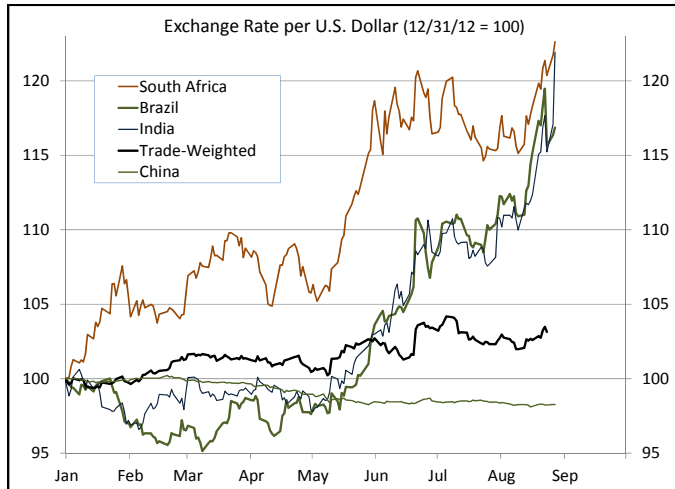


Prior to Fed policy meetings, the New York Fed surveys the primary dealers on issues related to the economy, the financial markets, and expectations for monetary policy (the primary dealers serve as trading counterparties of the NY Fed in its implementation of monetary policy). The July survey showed a median expectation of a gradual reduction in the pace of asset purchases beginning in September. Recent comments by Fed officials suggest that it will be a close call on whether to start tapering in September. Officials stress that the decision will depend on the economic data. The Fed will not react to any one data report, but the August Employment Report (due September 6) ought to play a key role in the decision.

Fed officials were initially puzzled by the financial market reaction to the talk of tapering. Tapering is not tightening. The Fed will still be adding policy accommodation as it slows the rate of asset purchases. Officials continue to emphasize that the federal funds target rate will remain near zero well into 2015. The Fed views this forward guidance as more important than the asset purchase program. Other major central banks have also used forward guidance to limit the increase in long-term interest rates. While financial markets may have misinterpreted the Fed's intentions, a reappraisal of risk was likely warranted. Indeed, at the July 30-31 policy meeting, Fed officials noted that recent developments "might have helped put the financial system on a more sustainable footing."

Long-term interest rates are normally going to trend gradually higher in an economic recovery. The key question is whether higher long-term rates will slow the pace of recovery (in which case, rates should back down somewhat). Recent data on new home sales and durable goods orders suggest that higher interest rates have had an impact. These two reports are generally unreliable (on a month-to-month basis), but they could help lead some Fed officials to favor a delay in tapering.

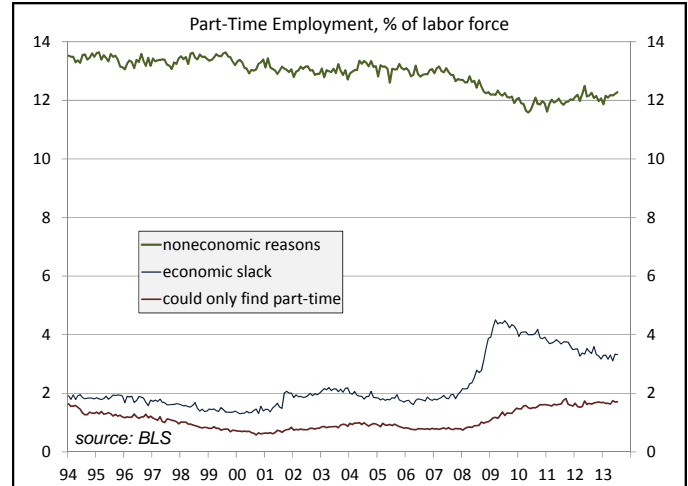
The Fed has continued to work on its exit plans. In June, policy makers indicated that there was no intent to sell mortgage-backed securities out of its portfolio (all else equal, this news should limit any increase in mortgage rates). In July, the Fed was considering the establishment of a reverse repo facility. In a reverse repo, the Fed lends assets on a short-term basis, draining reserves from the banking system. In the last few years, the Fed has regularly done reverse repos as a test of its ability to exit its highly accommodative policy. The creation of a facility to do reverse repos on a regular and large-scale basis widens this channel to drain reserves. The Fed may not need to drain reserves in such a hurry, but it's a smart move to set up the ability to do so, should it be needed down the line.



Some blamed aggressive Fed policy for fueling bubbles in emerging economies. With the Fed's endgame in sight, capital has begun to flow out of these countries. Such capital outflows tend to be self-reinforcing. While this development won't be a factor in Fed policy decisions, investors should pay attention.

	3Q12	4Q12	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14	3Q14	4Q14	2012	2013	2014
GDP (↓ contributions)	2.8	0.1	1.1	1.7	2.1	2.5	2.8	2.9	3.0	3.0	2.8	1.5	2.7
consumer durables	0.6	0.7	0.4	0.5	0.3	0.3	0.3	0.3	0.3	0.3	0.5	0.5	0.3
nondurables & services	0.6	0.4	1.1	0.7	1.2	1.4	1.5	1.5	1.5	1.5	1.0	0.9	1.4
bus. fixed investment	0.0	1.1	-0.6	0.6	0.7	0.9	0.9	0.9	0.9	0.9	0.8	0.4	0.8
residential investment	0.4	0.5	0.3	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.4	0.3
government	0.7	-1.3	-0.8	-0.1	-0.4	-0.3	-0.1	0.0	0.0	0.1	-0.2	-0.4	-0.1
Domestic Final Sales	2.2	1.4	0.5	2.0	2.3	2.6	2.9	3.0	3.1	3.1	2.5	1.6	2.7
exports	0.1	0.2	-0.2	0.7	0.2	0.4	0.5	0.5	0.6	0.6	0.5	0.2	0.5
imports	-0.1	0.5	-0.1	-1.5	-0.4	-0.5	-0.6	-0.6	-0.7	-0.7	-0.4	-0.3	-0.6
Final Sales	2.2	2.2	0.2	1.3	2.1	2.5	2.8	2.9	3.0	3.0	2.4	1.5	2.6
ch. in bus. inventories	0.6	-2.0	0.9	0.4	0.0	0.1	0.0	0.0	0.0	0.0	0.2	0.0	0.1
Unemployment, %	8.0	7.8	7.7	7.5	7.4	7.3	7.1	7.0	6.9	6.8	8.1	7.5	7.0
NF Payrolls, monthly, th.	152	209	207	196	165	180	190	200	200	210	183	187	200
Cons. Price Index (q/q)	2.1	2.2	1.4	0.0	2.7	1.9	1.9	1.9	1.9	2.0	2.1	1.5	1.9
excl. food & energy	1.6	1.7	2.1	1.4	1.9	1.7	1.8	1.8	1.8	1.9	2.1	1.8	1.8
PCE Price Index (q/q)	1.7	1.6	1.1	0.0	2.4	1.8	1.8	1.8	1.8	1.9	1.8	1.3	1.8
excl. food & energy	1.4	1.3	1.4	0.8	1.8	1.6	1.6	1.7	1.7	1.7	1.8	1.4	1.6
Fed Funds Rate, %	0.15	0.16	0.14	0.12	0.09	0.10	0.12	0.16	0.20	0.22	0.14	0.11	0.18
3-month T-Bill, (bond-eq.)	0.1	0.1	0.1	0.1	0.0	0.1	0.1	0.1	0.2	0.2	0.1	0.1	0.1
2-year Treasury Note	0.3	0.3	0.3	0.3	0.3	0.4	0.5	0.7	0.9	1.1	0.3	0.3	0.8
10-year Treasury Note	1.6	1.7	2.0	2.0	2.7	2.6	2.8	3.0	3.2	3.5	1.8	2.3	3.1

There has been some anecdotal evidence that the Affordable Care Act has led to an increase in part-time employment. However, that's not apparent in the data. Most part-time employment is voluntary (students, those with health or child care issues, etc.). Involuntary part-time employment can be due to slackness in the economy or part-time may be the only thing available to these workers. Most involuntary part-time employment is due to weakness in demand.



Financial market participants have focused too much on Fed tapering. A stalemate over the federal budget and debt ceiling is a much bigger risk. The government's spending authority expires on September 30. Most likely, we will see a series of short-term Continuing Resolutions to authorize spending in the weeks ahead. Treasury has indicated that the debt ceiling will become binding in mid-October. Negotiations on spending and the debt ceiling are expected to be difficult. The Tea Party wing of the Republican Party has threatened to shut down the government unless Obamacare is defunded.