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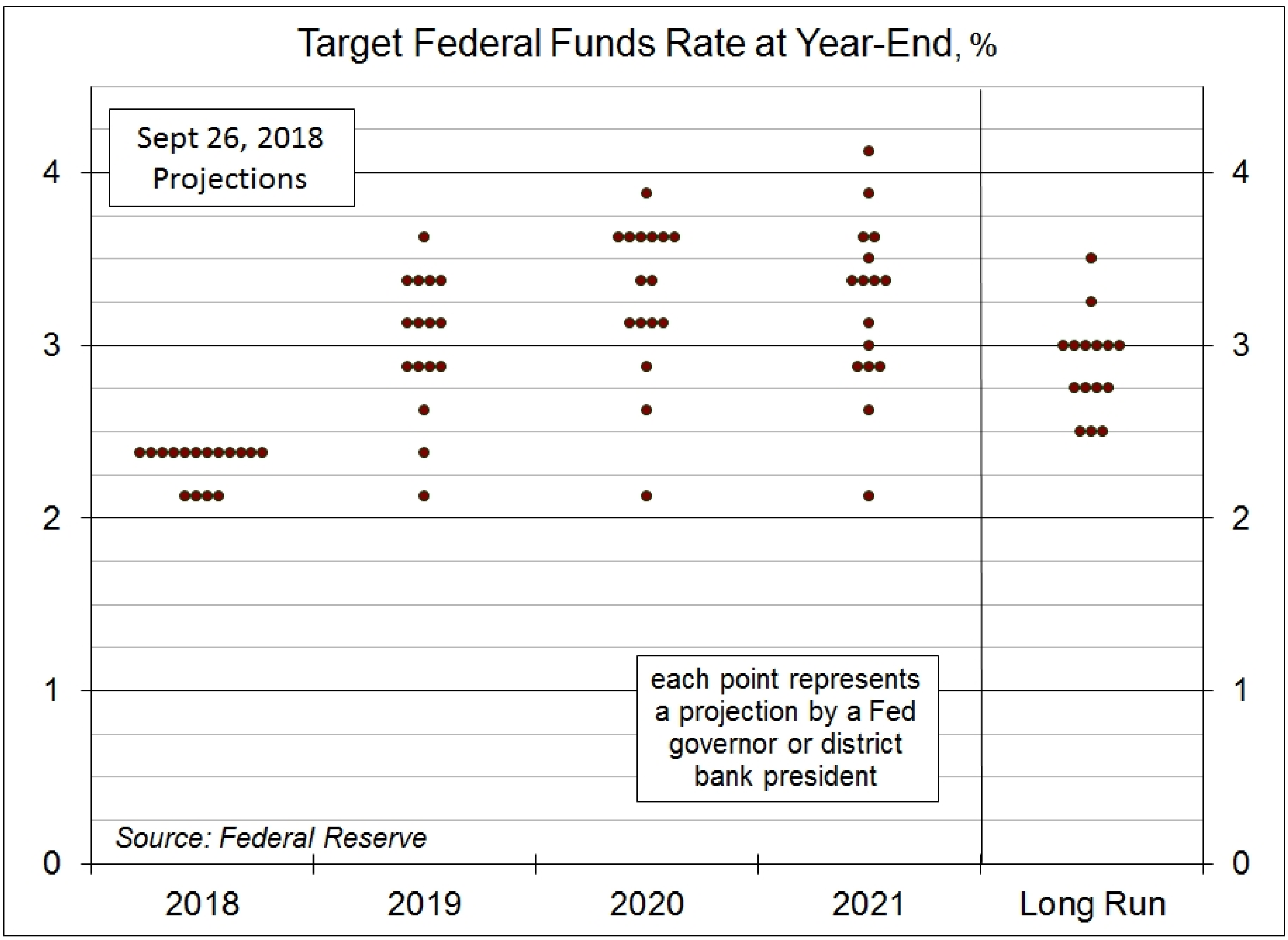
Weekly Economic Monitor -- Fed Policy Outlook

The Federal Open Market Committee is widely expected to raise short-term interest rates for the fourth time this year, although this outcome is not fully factored in (the federal funds futures market is pricing in about a 78% chance of a December 19 rate hike). As with every other Fed policy meeting, senior officials (the 5 Fed governors and 12 district bank presidents) will submit revised projections of growth, unemployment, and inflation. We'll also get a new dot plot, where the dots represent officials' estimates of the appropriate year-end federal funds target for each of the next few years. Fed Chairman Powell will conduct a post-meeting press conference.

The financial press and market participants have had a hard time with the dot plot, typically focusing on the median of the dots, rather than on their range. The Fed is not on a preset path. Monetary policy decisions will remain data-dependent (specifically, this means what the incoming information tells us about the economic outlook). There is a considerable amount of uncertainty regarding each dot.



Over the current tightening cycle, the Fed has been seeking to normalize monetary policy. As the Fed gets closer to normal, the key issue is where the current federal funds rate is relatively to its long-term equilibrium. This natural rate is unknown, can change over time, and estimates will vary among the individual Fed officials. In late November, Fed Chairman Powell indicated that the current federal funds rate was near the bottom of the range of estimates for the long-term equilibrium rate. In the September dot plot, 12 of the 16 dots were evenly split on whether there would be two, three, our four rate hikes in 2019 (the median was three). That dispersion reflects different views regarding the economic outlook.

A lot has changed since the mid-September Federal Open Market Committee meeting. The stock market has declined. The leverage loan market has corrected. Bank credit, which had been getting easier even as the Fed raised short-term interest rates, appears to have tightened somewhat. The housing sector data have been soft. We're now seeing a broader impact from tariffs and signs of slower global growth. Inflation pressures, higher in the first half of 2018, have moderated. These should be yellow flags for the Fed. On the other hand, the job market has tightened further and wage growth has picked up, which should keep the Fed in tightening mode. U.S. economic growth is expected to slow next year, reflecting constraints in the labor market, but the expansion should continue. However, the list of concerns should lead to a more cautious Fed in 2019.

	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
11/16/18	2.36	2.50	2.68	2.81	2.85	2.90	3.08	3.33	1.140	1.284	112.76	1.317	7247.87	2736.27	25413.22
12/07/18	2.40	2.54	2.68	2.72	2.72	2.70	2.85	3.14	1.139	1.275	112.60	1.330	6969.25	2633.08	24388.95
12/14/18	2.41	2.55	2.68	2.74	2.73	2.74	2.89	3.15	1.130	1.256	113.36	1.337	6910.67	2599.96	24100.51

Data Recap – Investors were more focused on trade policy and Brexit uncertainty. Intraday volatility remained elevated. Stock market weakness kept downward pressure on long-term interest rates. The economic data reports were consistent with moderate economic growth and moderate inflation.

Retail Sales rose 0.2% in November (+4.2% y/y), held down by a 2.3% drop in gasoline sales (+8.2% y/y), with mixed revisions to September and October. Auto sales rose 0.2% (+1.4% y/y). Ex-autos, retail sales rose 0.2% (+4.9% y/y). Ex-autos, gasoline, and building materials, sales rose 0.6%, following a 0.7% gain in October (+4.6% y/y).

Industrial Production rose 0.6% in November (+3.9% y/y), boosted by a 2.5% increase in energy extraction (+16.7% y/y) and a 3.3% rise in the output of utilities (+4.3% y/y). Manufacturing output was flat (+2.2% y/y), following a 0.1% decline in October (revised from +0.3%). Auto production , which have been choppy in recent months, rose 0.3% (-9.1% before seasonal adjustment, +3.4% y/y). Ex-autos, factory output was flat (-0.9% before seasonal adjustment, +1.8% y/y). Oil and gas well drilling edged up 0.1% (+19.7% y/y, but down 4.6% since June). Sales at department stores rose 0.4% (-0.2% y/y), while sales for nonstore retailers (mail order and internet) jumped 2.3% (+10.8% y/y).

The **Consumer Price Index** was unchanged in November (+2.2% y/y), reflecting a 2.2% drop in energy prices (+3.1% y/y). Food rose 0.2% (+1.4% y/y), with a continued y/y split between food at home (+0.4% y/y) and food away from home (+2.6% y/y). Gasoline (4.3% of the overall CPI) fell 4.2% (-7.3% before seasonal adjustment, and +5.0% y/y). Ex-food & energy, the CPI rose 0.2% (+2.2% y/y). Ex-food, energy, and shelter, the CPI rose 0.1% in November, up 1.5% y/y (median forecast: +2.2%) – unchanged if you also exclude used vehicles (+1.5% y/y).

Real Hourly Earnings rose 0.3% in November (+0.8% y/y). For production workers, real earnings rose 0.3% (+1.0% y/y).

The **Producer Price Index** rose 0.1% in November (+2.5% y/y), as higher food and transportation costs offset lower energy costs. Food prices rose 1.3% (2.9% y/y). Wholesale gasoline prices fell 14.0% (-17.7% before seasonal adjustment, and -1.2% y/y). Trade services (which measure changes in margins received by wholesalers and retailers) rose 0.3% (+2.2% y/y). Transportation and warehousing services rose 1.2% (+6.2% y/y). Airline passenger services rose 2.3% (+4.8% y/y). Ex-food, energy, and trade services & energy, the PPI rose 0.3% (+2.8% y/y). Rail transportation (freight) rose 0.6% (+6.5% y/y), while truck transportation rose 1.0% (+7.0% y/y), and air transportation of freight rose 1.3% (+1.3% y/y). Pipeline inflation pressures were mixed. Ex-food & energy, unprocessed intermediate goods rose 3.3% y/y, with processed intermediate goods up 4.2% y/y. Intermediate services rose 3.1% y/y. Note that tariffs and taxes are not included directly in the PPI, but pricing decisions made in reaction to tariffs are included.

The **Import Price Index** sank 1.6% in November (+0.7% y/y), mostly reflecting a 12.1% drop in petroleum (+4.4% y/y). Note that these figures do not include tariffs. Ex-food & fuels, import prices slipped 0.2% (+0.4% y/y). Ex-fuels, prices of imported raw materials continued to fall (-0.4%), following a sharp rise earlier in the year (+2.1% y/y). Prices of imported capital goods slipped 0.1% (-0.2% y/y). Prices of imported autos and parts were flat (+0.3% y/y). Prices of imported consumer goods were unchanged (+0.4% y/y). Prices of agricultural exports rebounded 1.8% (-1.7% y/y).

Business Inventories rose 0.6% in October. Retail inventories, the only new information in the report, rose 0.8% (+4.0% y/y), with autos up 1.1% (+8.0% y/y) and non-autos up 0.7% (+1.8% y/y). It's only one month, but it likely like inventory growth in 4Q18 may be roughly the same as in 3Q18 (a sharp pickup in inventory growth added 2.3 percentage points to 3Q18 GDP growth).

Jobless Claims fell by 27,000 in the week ending December 8. It's not unusual to see volatility in these data during this time of year, due to difficulties in the seasonal adjustment. The four-week average was 224,750, still very low by historical standards.

The Index of **Small Business Optimism** fell to 104.8 in November, vs. 107.4 in October and 107.5 a year ago. The general business outlook softened. The earnings trend remained soft, but above normal. Hiring plans remained strong. Capital spending plans remained moderately strong.

The **European Central Bank** left short-term interest rates unchanged and, as expected, announced the end of its asset purchases. The ECB also enhanced its forward guidance on its reinvestment policy: "reinvesting, in full, the principal payments from maturing securities purchased for an extended period of time past the date when it starts raising the key ECB interest rates."

This Week – The Fed is expected to raise short-term interest rates for the fourth time this year, but the financial markets may not have that fully factored in. Investors will be interested in what the Fed signals about the pace in 2019. We will get revised economic projections from senior Fed officials, including a new dot plot (and the dots are likely to edge a little lower). The financial press and market participants tend to focus too much on the median of the dots, rather than their range.

Coming Events and Data Release

January 1	New Year's Day (markets closed)	January 9	FOMC Minutes (December 18-19)
January 3	ADP Payroll Estimate (Dec) ISM Manufacturing Index (December)	January 30	FOMC Policy Decision, press conf.
January 4	Employment Report (December)	March 20	FOMC Policy Decision, press conf.
January 7	ISM Non-Manufacturing Index (December) NCAA Football Championship	May 1	FOMC Policy Decision, press conf.
		June 19	FOMC Policy Decision, press conf.

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