

Weekly Economic Commentary

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Highlights

Over the past three Beige Books, the BBB has averaged +100, the highest reading over any three consecutive Beige Books since at least 2005.

The latest Beige Book indicates to us that the negative headwinds that have held the U.S. economy back over the past seven years may finally be abating.

Health care and the ACA have remained a consistent source of concern among Beige Book respondents, although the impact has faded a bit recently.

Despite the recent barrage of bad news on the geopolitical front, optimism on Main Street remains high.

Beige Book: Window on Main Street Modest-to-Moderate Economic Growth Continues

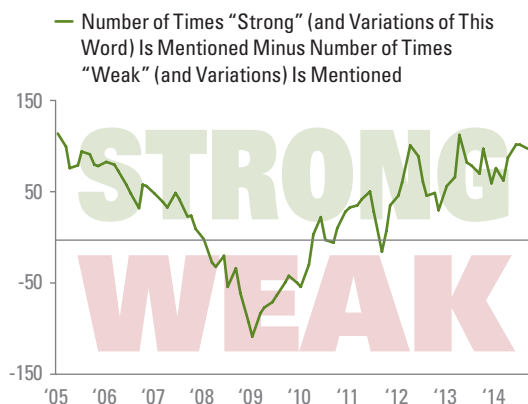
The Beige Book is a qualitative assessment of the U.S. economy and each of the 12 Federal Reserve (Fed) Districts. We believe the Beige Book is best interpreted quantitatively by measuring how the descriptors change over time. The latest edition of the Fed Beige Book, released last Wednesday, September 3, 2014, ahead of the September 16–17, 2014 Federal Open Market Committee (FOMC) meeting, once again described the economy as increasing at either a “modest” or “moderate” pace and noted that “trends in employment, wages, and prices were relatively unchanged” versus the July 2014 Beige Book. However, the report did say that “greater wage pressures [were] reported in sectors where shortages of skilled labor persisted.” This theme has been a common one in Beige Books this year, and in the past has been a precursor to more prevalent wage increases economy-wide. In general, optimism regarding the economic outlook far outweighed pessimism, as it has for the past 18 months or so. The modest-to-moderate description of the overall economy has now been used in the last 11 Beige Books and in 12 of the past 13 dating back to March 2013.

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]. The barometer ticked down to +97 in September 2014, from the +102 reading seen in both the June and July 2014 Beige Books. The +97 reading in September 2014 was well above the weather-impacted +62 reading in March 2014. Over the past three Beige Books, the BBB has averaged +100, the highest reading over any three consecutive Beige Books since at least 2005.

The rebound in our Beige Book Barometer over the past several months is consistent with the Fed’s view that the drop in economic activity in the first quarter of 2014—real gross domestic product (GDP) contracted at a 2.1% annualized rate for the quarter—was mostly weather related. The +100 reading on the BBB over the past three Beige Books is also consistent with the above-trend pace of GDP growth seen in the second quarter of 2014 and so far in the third quarter of 2014. In addition, we found that the word “weak” or its variants appeared, on average, just 22 times in the last three Beige Books (June, July, and September 2014), less than half 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.

1 Beige Book Barometer Remains Near 10-Year High



Source: LPL Financial Research, Federal Reserve 09/03/14



How the Barometer Works

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.

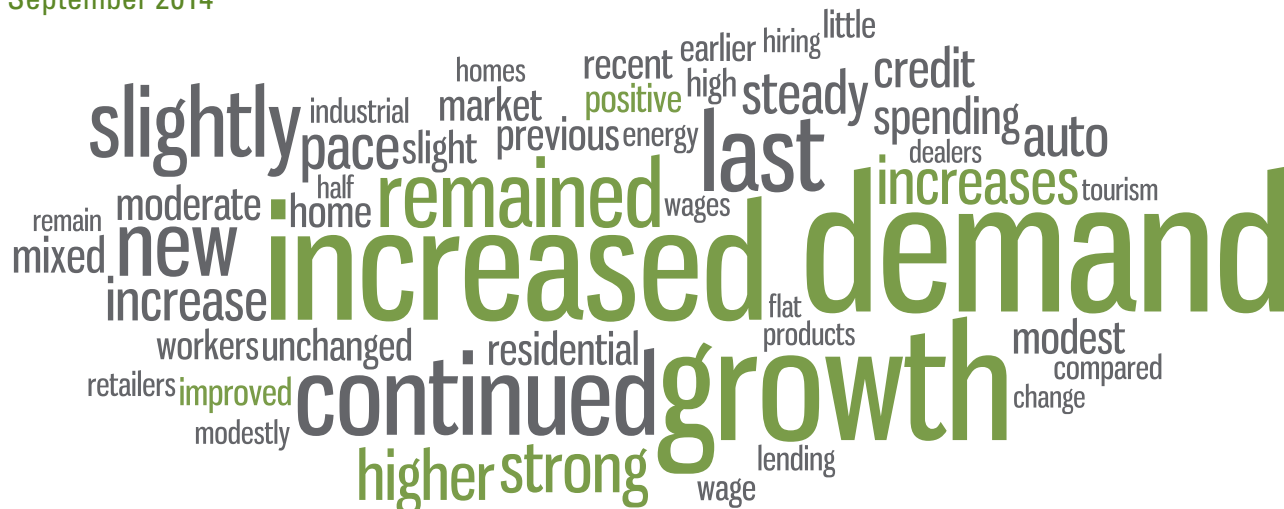
See page 3 for "Beige Book: How It Works."

Weather was a big driver of the weakness in the Beige Book in the winter of 2013–14, but the arrival of more “normal” weather this spring and summer held the weather mentions to just six in the latest Beige Book, the fewest mentions since the December 2013 Beige Book, which preceded the onset of the harsh winter of 2013–14. In the four Beige Books released over the winter of 2013–14, weather was mentioned, on average, 62 times in each. Over the last three Beige Books (June, July, and September 2014), weather was mentioned, on average, just 16 times per report. This further reinforces our view that the 2.1% drop in real GDP in the first quarter of 2014 was almost entirely weather related.

Looking ahead, we expect the improvement in the economic data to continue throughout the second half of 2014 and into 2015. We continue to expect that the U.S. economy, as measured by real GDP, may grow at 3.0%

2 Beige Book Word Clouds

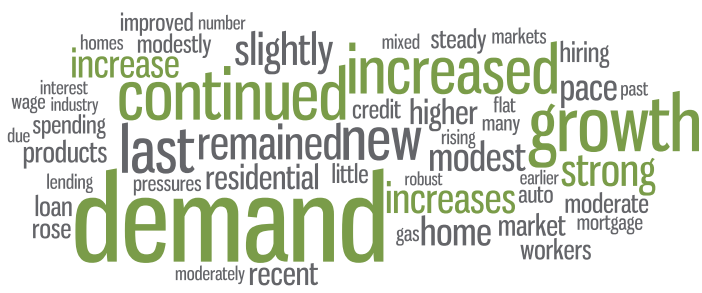
September 2014



July 2014



September 2013



Source: LPL Financial Research, Federal Reserve Beige Book 09/03/14, 07/16/14, and 09/04/13



Beige Book: How It Works

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 one 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 September 16–17, 2014.

The word clouds or text clouds on page 2 are a visual format useful for quickly perceiving the most important words in a written document. They are culled from the Fed’s Beige Books published last week (September 5, 2014), the prior report (July 16, 2014), and the report from a year ago (September 4, 2013). In general, the more often a word appears in a speech, text, report, or other transcript, the larger that word appears in the word cloud. The word clouds show the top 50 words for each of the three Beige Books mentioned above. Similar words are grouped together and common words like “the,” “and,” “a,” and “is” are excluded, as are words that appear frequently in all Beige Books (federal, district, loan, level, activity, sales, conditions, firms, etc.).

in 2014—accelerating from the sub-2.0% growth rate of 2013—based on the drags from 2013 reversing (tax hikes, government spending cuts, Europe recession) and a modest improvement in business spending. The data released thus far for the second and third quarters of 2014 suggest that the economy is likely expanding at a pace well above its long-term average, a snapback from the weather-induced weakness in the first quarter of 2014. The GDP report for the third quarter of 2014 is due out at the end of October 2014. Please see our recent *Mid-Year Outlook 2014* publication for details about our forecast for the second half of 2014.

Uncertainty Fading, Health Care Still a Concern, and Optimism Way Up

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 is now clearly fading, as these words were used just 13 times in the September 2014 edition of the Beige Book [Figure 3]. In the six Beige Books released so far in 2014 (including the September edition) the words noted above were mentioned a total of 64 times, or 10 mentions per Beige Book. In contrast, these words were mentioned 65 times, on average, in each of the eight Beige Books released in 2013. As we wrote in our *Outlook 2014: The Investor’s Almanac*, we continue to expect concerns over government policy to fade over the course of this year; but as 2014 winds down and 2015 begins, this policy-related uncertainty could make a comeback, with the end of the 2014–15 fiscal year (September 30, 2014) and the next debt ceiling deadline (March 15, 2015) on the horizon.

3 Weather and Policy Uncertainty Have Faded as Restraints on Growth

	Weather	Shutdown/Fiscal/Sequester/Debt Ceiling/Uncertainty/Confidence	Affordable Care Act/Health Care
09/2014	6	13	3
07/2014	9	9	2
06/2014	35	12	6
04/2014	103	12	17
03/2014	119	18	22
2013 Avg.	112 (14 per Beige Book)	520 (65 per Beige Book)	178 (22 per Beige Book)
	Weather impact has completely faded	Words surrounding government policy are still trending lower but may increase in coming months	ACA/health care fading but may pick up later this year

Source: LPL Financial Research, Federal Reserve 09/03/14

Good weather or bad, the Affordable Care Act (ACA), and health care in general, has remained a consistent source of concern among respondents to the Beige Book, although the impact has faded a bit recently. The ACA



4 Optimism on the Main Street Economy Is Running High in the Beige Book

1st Six Beige Books of	Optimism	Pessimism
2007	10	1
2009	9	4
2013	25	1
2014	29	0

Source: LPL Financial Research, Federal Reserve 09/03/14

(and health care in general) received fewer than 10 mentions in recent Beige Books, down from 17 mentions in the April 2014 Beige Book and 22 in the March 2014 edition. On average, the ACA/health care saw 22 mentions per Beige Book in 2013. We continue to expect this topic to appear frequently in the Beige Book in the quarters ahead, as businesses and consumers adjust to the rollout of the legislation. The midterm congressional elections (November 4, 2014) and the approach of the start of the open enrollment period for 2015 (November 15, 2014) may cause an uptick in concern around health care in the Beige Book.

Despite the recent barrage of bad news on the geopolitical front (Ukraine, Gaza, Europe, Iraq, and Syria), optimism on Main Street remains high. In the September 2014 Beige Book, the word “optimism” (or its related words) appeared 31 times, whereas the word “pessimism” did not appear at all. This is not the start of a new trend, however, as in the six Beige Books this year, the word “optimism” has appeared, on average, 29 times in each edition. In the similar period 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 nine times in the first six Beige Books of 2009, whereas the word “pessimism” appeared, on average, four 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 overdue, based on this metric. In the first six Beige Books of 2007, the word “optimism” appeared, on average, just 10 times per edition—a far cry from the 29 times per edition in the first six Beige Books of 2014. ■

IMPORTANT DISCLOSURES

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

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