Weekly Economic Commentary

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

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Highlights

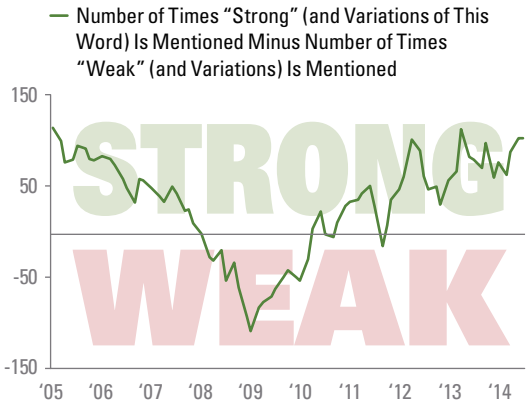
The latest edition of the Fed's Beige Book indicates that the negative headwinds that have held the U.S. economy back over the past seven years may be declining.

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 was mostly weather related.

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

We continue to expect that the U.S. economy (as measured by real GDP) may grow at 3.0% in 2014.

1 Beige Book Barometer Remains Near 10-Year High in July



Source: LPL Financial Research, Federal Reserve 07/16/14

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, July 16, 2014, ahead of the July 29–30, 2014 Federal Open Market Committee (FOMC) meeting, once again described the economy as increasing at either a "modest" or "moderate" pace, noting that "labor market conditions improved" but that "several Districts continued to report some difficulty finding workers for skilled positions." Aside from higher wages to attract talent for these skilled positions, the Beige Book noted that "wage pressures remained modest in most Districts" and that "price pressures were generally contained." The modest-to-moderate description of the overall economy has now been used in the last 10 Beige Books, and in 11 of the past 12 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 remained at +102 in July 2014, matching the June 2014 reading, but well above the +87 reading in April 2014 and the weather-impacted +62 reading in March 2014. At +102, the latest reading is the highest since the April 2013 Beige Book (+112). More importantly, the barometer remains above the October 2013 reading of +97, which was released just prior to the onset of the harsh winter weather that gripped much of the United States from December 2013 through most of the first quarter of 2014. The +102 reading on the Beige Book Barometer in July 2014 matches the second highest reading in the history of the data—only the +114 reading recorded in January 2005 was higher. 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—real gross domestic product (GDP) contracted at a 2.9% annualized rate in the first quarter of 2014—was mostly weather related. In addition, we found that the word "weak" or its variants appeared just 17 times in the July 2014 Beige Book, less than half the long-term average of 50 mentions, and the fewest since 2005. This suggests to us that the negative headwinds that have held the economy back over the past seven years may be abating.

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 early summer held the weather mentions to just nine 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. Looking back, weather was mentioned 35 times in the June 2014 Beige Book after 103 mentions in April and 119 in March 2014. To put the 119 mentions of weather in the March 2014 Beige Book in historical context, weather was mentioned only 48 times in the Beige Book released just after Superstorm Sandy hit the U.S. East Coast in October 2012. Weather was mentioned a total of 61 times in the three Beige Books released during the unusually cold and snowy winter of 2010–11. On balance, the 119 mentions of weather in the March 2014 Beige Book—along with 31 mentions of the word "cold," 24 of "snow," and 35 of "severe"—suggest that the weather's impact on the economy in the early part of 2014 was widespread and significant. This reinforces our view that the 2.9% drop in real GDP in the first quarter of 2014 was almost entirely weather related.

2 Beige Book Word Clouds

July 2014

June 2014

July 2013

Source: LPL Financial Research, Federal Reserve Beige Book 07/16/14, 06/04/14, and 07/19/13

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 July 29–30, 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 (July 16, 2014), the prior report (June 4, 2014), and the report from a year ago (July 17, 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.).

Looking ahead, we expect the improvement in the economic data to continue throughout the second half of 2014. We continue to expect that the U.S. economy, as measured by real GDP, may grow at 3.0% 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 may be 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 second quarter of 2014 is due out at the end of July 2014. Please see our recently published *Mid-Year Outlook 2014: The Investor's Almanac Field Notes* publication for details about our forecast for the second half of 2014.

Uncertainty Fading; Health Care Still a Concern; 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 nine times in the July 2014 edition of the Beige Book [Figure 3]. In both the April and June 2014 editions of the Beige Book, there were only 12 mentions of the words noted above, after 18 mentions in the March 2014 Beige Book and 26 mentions in the January 2014 Beige Book. 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.

3 Weather and Policy Uncertainty Have Faded as Restraints on Growth

	Weather	Shutdown/Fiscal/Sequester/Debt Ceiling/Uncertainty/Confidence	Affordable Care Act/ Health Care
07/2014	9	9	6
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 on Beige Book is fading	↓ Words surrounding government policy uncertainty are still trending lower	→ ACA/health care are fading now but likely to pick up later this year

Source: LPL Financial Research, Federal Reserve 07/16/14

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

	Optimism	Pessimism
2007	10	0
2009	9	5
2013	25	1
2014	28	0

Source: LPL Financial Research, Federal Reserve 07/16/14

(and health care in general) received just six mentions in both the July and June 2014 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 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, optimism on Main Street remains high. In the July 2014 Beige Book, the word optimism (or its related words) appears 24 times, whereas the word pessimism appeared just once. This is not the start of a new trend, however, as in the first five Beige Books this year, the word optimism has appeared, on average, 28 times. 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 five Beige Books of 2009, whereas the word pessimism appeared, on average, five 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 way overdone based on this metric. In the first five Beige Books of 2007, the word optimistic appeared, on average, just 10 times per Beige Book, a far cry from the 28 times per Beige Book in the first half of 2014. ■

IMPORTANT DISCLOSURES

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