Outlook and Market Review – Second Quarter 2013

Real GDP growth in the second quarter of 2013 was revised upward to 2.5% from the preliminary announcement of 1.7%. GDP growth in the first quarter was a lackluster 1.1%. The unemployment rate (U-3) fell to 7.3% in August but the key driving force behind the decline was a drop in the labor participation rate as potential workers dropped out of the labor market. The labor force participation rate fell to 63.2% in August, a new post-recession low, and the employment-to-population ratio fell to 58.6%. The broader measure of unemployment that adjusts for part time work and underemployment (U-6) fell to 13.7%.

Inflation remains low with the year-over-year increase in the CPI of 2%. Real wages remain flat suggesting slack in the labor market. Even so, consumer spending is outpacing GDP growth due to wealth effects from higher housing and equity prices. Corporations are in a position to invest if economic and regulatory uncertainty can be lifted. Net profit margins, measured as the ratio of after-tax profits to output, are twice the average level since World War II. Balance sheets are also generally strong, as businesses are flush with cash and debt loads are light.

Housing continues to rebound but at a slower pace due to higher interest rates. The benchmark rate for mortgages, the 10-year Treasury yield, is now 3% compared to less than 2% six months ago. Rates may continue to rise if the Fed begins tapering its $85 billion monthly purchases of securities later this year. The Treasury Department's estimate of the real rate of return from the TIPS auction is currently about 1.3%. With expected inflation of about 2% we might expect the ten-year Treasury to be 3.3% or higher in the near term. Oil prices are likely to remain high until uncertainty in the Middle East improves. The combined effects from higher oil prices, higher interest rates, flat wages, and mixed levels of confidence will provide headwinds for the remainder of 2013.

Analysts expect growth in the 2.2 to 2.4% range for the remainder of 2013 with momentum toward a 2.6% rate in 2014. This forecast seems optimistic in light of rising oil prices and Middle East tensions that will carry into the next year. Core inflation should remain below 2% with interest rates creeping up over the remainder of the year.

Fed Tapering - How Soon and How Much?

There are two opposing views on whether the Fed will begin pulling back on its $85 billion per month bond buying program in the next few months. On one hand, recent jobs reports have been discouraging. Even the steady job growth earlier in the year has been concentrated in low-wage, no-benefit, part-time positions. Favorable inflation numbers are a key reason why consumer confidence hasn't taken a bigger hit from the performance of the economy. With low inflation and below potential GDP growth there is room for further expansion from the Fed rather than

backing off on the stimulation. Interest rates have jumped by almost a full percent on just the suggestion that the Fed may begin to slowly reverse stimulation. The economy barely created replacement jobs after the FED applied $9-12 trillion in stimulus including the $3.2 trillion of debt they've bought. Equity and housing markets may well suffer reversals if tapering begins without a stronger set of economic fundamentals.

The alternative view that tapering is eminent rests on a combination of factors. The Fed has been expecting a pickup in economic growth to support continued hiring by businesses and reductions in unemployment. The upward revision of GDP to 2.5% for the second quarter suggests the recovery, though still not strong, remains remarkably resilient in the face of a host of challenges, including tax increases and sequestration. Economists had at one point expected growth to slow sharply in the middle of the year; instead, it appears to have accelerated. The improved growth figures and increased corporate profitability reinforce other signs that the economy is getting back on track. The Fed has already taken the monetary base from near $800 billion before the 2007 recession to more than $3.3 trillion now. With the economy healing and the benefits of its bond purchases fading, the Fed is eager to begin unwinding its easy-money policy. To further complicate matters, Chairman Bernanke is planning to step down early next year. He may want to leave with a neutral policy in place to provide a clean slate for his replacement.

There is no consensus, but odds appear to favor modest tapering (for example, a $10 billion reduction phased in with forward guidance for continued reductions over time) in the fourth quarter with a gradual path toward neutrality in 2014. Bernanke believes in early warning and disclosure of Fed policy to the extent possible, suggesting that his early signals of Fed tapering were sincere. Shocks in the Middle East could change this scenario.

The Dynamics of the Labor Market

The unemployment rate dipped to 7.3% in August but the labor market picture has not changed much over the last year. The three-month moving average of new hires has been about 4.3 million and separations have been about 4.2 million. The number of laid-off workers has held below the 2012 pace this year largely because the workforce is already lean from cost cutting over the last five years. New hiring is sluggish as labor-saving techniques are now in place.

Even with modest improvement in the labor market, GDP growth has been weak relative to employment growth. Historically, GDP growth is around 3% when the economy adds 180,000 to 200,000 jobs each month. Real GDP growth has been a full percent lower than what would be expected with the job gains the economy has generated.

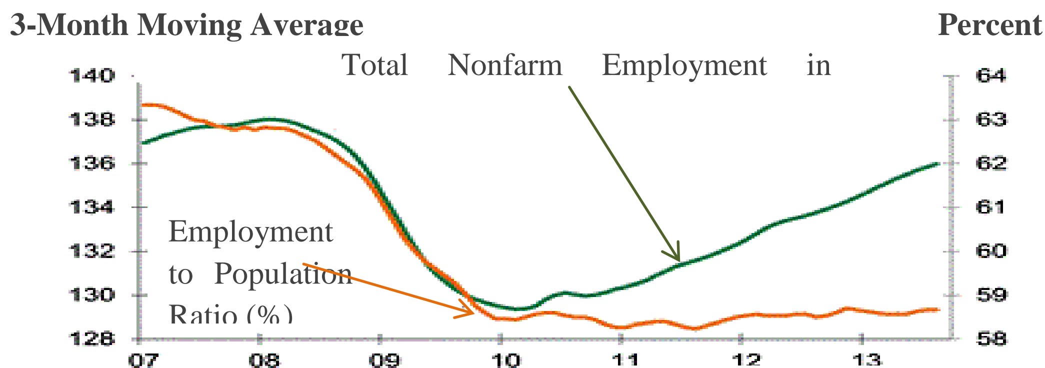
GDP growth performance has been weak relative to the improved labor market largely due to weak productivity growth. Business firms have been cautious since the recession and have delayed or abandoned investments in capital that increases labor productivity overall. Business profitability is high, cash balances are strong, and liquidity is ample but multiple sources of uncertainty have been building. Taxes, regulation, health care costs, environmental constraints,

and an inability of the government to control debt and budget issues have all played a role in holding back investment. Fed tapering and oil shocks from accelerated Middle East tensions are likely to add to the uncertainty in the short term.

Income growth has been disappointing but consumer spending has been supplemented by wealth effects linked to low interest rates. Real disposable income has lagged spending growth through most of the recovery and has averaged only 0.5% year-over-year in the first half of this year. But rising asset prices for housing and stocks along with improved access to credit have supported spending. Debt service burdens, the proportion of after-tax income households pay to remain current on obligations, were below early-1980s record lows in the fourth quarter of 2012 and have only inched up since then. The reduction in debt burdens is easing budget constraints and allowing more spending. It is not clear how fragile spending will be as interest rates edge up.

A key question for the economy moving forward is whether or not the labor force dynamic since the great recession is temporary or permanent. Lower participation rates mean a smaller share of the population is producing and contributing to growth. Both the quality and number of jobs must improve, but more of the population must be drawn into the labor force. Figure 1 below shows the declining pattern of the employment to population ratio.

Figure 1. Employment to Population Relationship



Source: Bureau of Labor Statistics

Since the recession the economy has been creating jobs at the rate of population growth. One view is that the participation rate will improve as better jobs are created. On the other hand, if a larger component of the population is content with a lower standard of living a smaller portion of the population will contribute to growth. Long term health of the economy requires expanding the tax base by lowering unemployment and increasing the labor participation rate.

The Federal Reserve Bank has a dual mandate to keep inflation low (below 2%) and achieve full employment. While the Fed has succeeded in achieving its low inflation mandate it is still well behind in achieving the second mandate of full employment. With no real help coming from fiscal policy in the near future the Fed will need to continue to find ways to stimulate economic activity even if tapering takes place. Other tools will need to come into play to keep markets

liquid and encourage investing. The Fed will need to monitor the dynamics of the labor market and not just the unemployment rate.

Third Quarter Survey of Professional Forecasters

Table 1 below shows the quarterly GDP, unemployment, and monthly payroll forecasts from the most recent Survey of Professional Forecasters conducted by the Philadelphia Federal Reserve Bank. The near term outlook for U.S. economic growth was revised downward for the remainder of 2013. The consensus GDP growth rate forecast, measured as the median annual rate forecast, fell to 2.2% for the third quarter and 2.3% for the fourth quarter of 2013. Forecasters revised GDP growth down from 2% to 1.5% for 2013 on an average annual basis over annual average basis. The GDP forecasts tend to reflect underlying assumptions that major shocks, such as escalated war in the Middle East, do not materialize and systemic risks holding back the U.S. economy continue.

Forecasters did not change their views much about the labor market or the rate of progress toward full employment. Quarterly unemployment is expected to decline very slowly from quarter to quarter. The average annual rate of unemployment (U-3) for 2013 is expected to be 7.5%, down only slightly from the prior forecast of 7.6%. Projections for average monthly nonfarm payroll employment are slightly higher overall but with little change.

Table 1. Quarterly GDP, Unemployment, and Payroll Forecasts from the Survey of Professional Forecasters (3Q 2013 through 3Q 2014)

	Real GDP (%)		Unemployment Rate (%)		Payrolls (000s per month)	
	Prior	New	Prior	New	Prior	New
2013:Q3	2.3	**2.2**	7.5	**7.4**	142.7	**169.4**
2013:Q4	2.7	**2.3**	7.4	**7.3**	173.3	**178.6**
2014:Q1	2.5	**2.7**	7.3	**7.2**	179.0	**171.2**
2014:Q2	3.2	**2.9**	7.2	**7.1**	184.9	**185.4**
2014:Q3	N.A.	2.9	N.A.	7.0	N.A.	**181.4**

Note: Red represents more pessimistic forecasts from prior estimates. Green represents more optimistic forecasts from prior estimates. Payroll estimates are computed as year-to-year changes in the annual-average level of nonfarm payroll employment, converted to a monthly percentage rate.

The longer term annual forecasts from the Professional Forecast Survey are provided in Table 2. In the longer term, forecasters expect real GDP growth of 2.6 percent in 2014 and 2.9 percent in 2015, before falling to 2.5 percent in 2016. It is significant that forecasters do not see the economy returning to a longer term average growth rate of 3.2% over the next three years. Unemployment is predicted to decline to an overall average of 7.1% in 2014. Forecasters expect employment gains to stay on a rather steady course of 183,800 per month on average in 2013 and 180,100 in 2014.

Table 2. Annual GDP, Unemployment, and Payroll Forecasts from the Survey of Professional Forecasters (2013 through 2016)

	Real GDP (%)		Unemployment Rate (%)		Payrolls (000s per month)	
	Prior	New	Prior	New	Prior	New
2013	2.0	**1.5**	7.6	**7.5**	169.8	**183.8**
2014	2.8	**2.6**	7.1	7.1	180.4	**180.1**
2015	3.0	**2.9**	6.6	6.6	N.A.	N.A.
2016	2.9	**2.5**	6.1	6.1	N.A.	N.A.

Note: Data are based on average annual projections. Red represents more pessimistic forecasts from prior estimates. Green represents more optimistic forecasts from prior estimates.

Forecasters see a tame inflation environment for the remainder of 2013. The headline and core components of the Consumer Price Index (CPI) and the broader Personal Consumption Expenditure Index (PCE) are expected to remain below the Fed's 2% target. Quarterly inflation forecasts from the survey appear in Table 3 below.

Table 3. Quarterly CPI and PCE Inflation Forecasts from the Survey of Professional Forecasters Survey (3Q 2013 through 3Q 2014)

	Headline CPI		Core CPI		Headline PCE		Core PCE	
	Prior	New	Prior	New	Prior	New	Prior	New
2013:Q3	2.0	2.0	2.0	**1.9**	1.8	**2.0**	1.6	**1.4**
2013:Q4	2.0	**1.7**	2.0	**1.9**	1.9	**1.7**	1.8	**1.5**
2014:Q1	2.0	**1.8**	2.0	2.0	1.9	**1.8**	1.9	**1.7**
2014:Q2	2.2	**1.9**	2.1	**2.0**	2.0	**1.8**	1.9	**1.7**
2014:Q3	N.A.	2.1	N.A.	2.0	N.A.	1.9	N.A.	1.8

Note: Percentages are annualized rates. Red represents more pessimistic forecasts from prior estimates. Green represents more optimistic forecasts from prior estimates.

Table 4 shows the long term inflation forecasts from the survey. Longer term forecasts were revised downward, consistent with an economy that is too weak to generate excess demand inflation. Forecasters see the status quo in structural issues that are holding back growth.

Table 4. Annual CPI and PCE Inflation Forecasts from the Survey of Professional Forecasters Survey (2013 through 2016)

	Headline CPI		Core CPI		Headline PCE		Core PCE	
	Prior	New	Prior	New	Prior	New	Prior	New
2013	1.7	**1.4**	2.0	**1.8**	1.4	**1.2**	1.5	**1.3**
2014	2.2	**2.0**	2.1	**2.0**	2.0	**1.8**	1.9	**1.8**
2015	2.3	**2.2**	2.1	2.1	2.0	2.0	1.9	1.9

Note: Data are based on average annual projections. Red represents more pessimistic forecasts from prior estimates. Green represents more optimistic forecasts from prior estimates.

The Natural Rate of Unemployment

The natural rate of unemployment represents a level of unemployment that will not improve with added economic activity. Structural unemployment linked to a lack of employable skills and frictional unemployment linked to movement between jobs are the two key components of the natural rate. There is considerable debate about the level of the natural rate of unemployment today for several key reasons. First, the natural rate represents a level of unemployment that can be obtained without excess demand inflation picking up. As the economy improves, movement of the unemployment rate to the natural rate will offer a leading indicator for inflation pressure. The natural rate of unemployment also represents a benchmark for the success of fiscal and monetary policies. The current unemployment rate looks much worse if the natural rate of unemployment is 4% than if it is 6%.

Table 5 below summarizes the history of forecaster estimates of the natural rate of unemployment from each third-quarter survey since 1996. The table illustrates the wide variation in forecasts in any given period as well as the variation over time. The consensus forecast of the natural rate of unemployment today is 6%. The lowest estimate in the survey is 4.75% and the highest is 7%.

Table 5. Natural Rate of Unemployment from the Survey of Professional Forecasters

Survey Date	Consensus Estimate (%)	Low (%)	High (%)
1996:Q3	5.65	5.00	6.00
1997:Q3	5.25	4.50	5.88
1998:Q3	5.30	4.50	5.80
1999:Q3	5.00	4.13	5.60
2000:Q3	4.50	4.00	5.00
2001:Q3	4.88	3.50	5.50
2002:Q3	5.10	3.80	5.50
2003:Q3	5.00	4.31	5.40
2004:Q3	5.00	4.00	5.50
2005:Q3	5.00	4.25	5.50
2006:Q3	4.95	4.00	5.50
2007:Q3	4.65	4.20	5.50
2008:Q3	5.00	4.00	5.50
2009:Q3	5.00	4.00	6.00
2010:Q3	5.78	4.50	6.80
2011:Q3	6.00	4.75	7.00
2012:Q3	6.00	4.75	7.00
2013:Q3	6.00	4.75	7.00

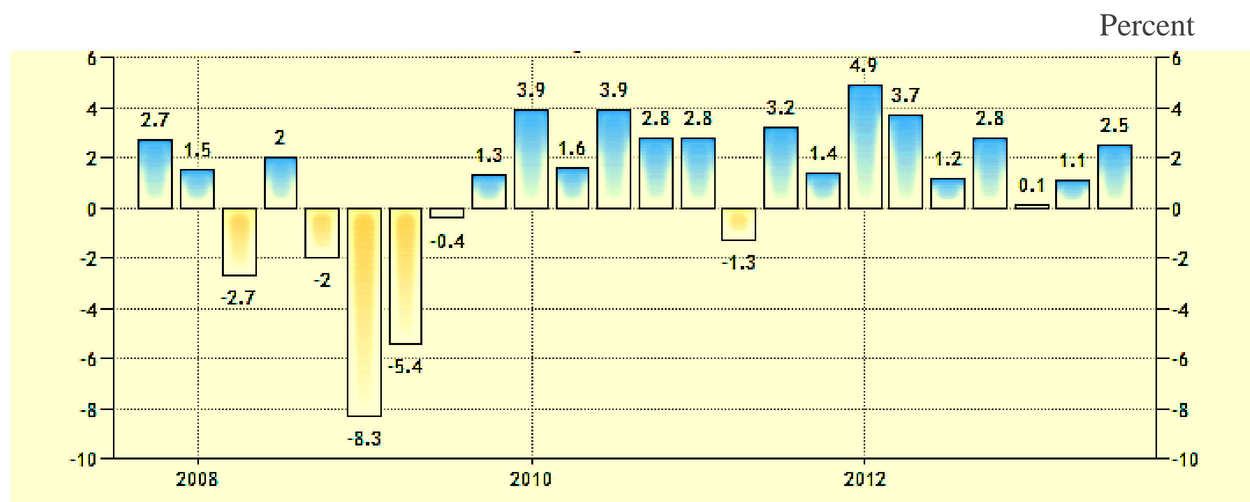
Summary of Recent Economic Data

GDP - *Forward-looking indicators of GDP are mixed. Rapid inventory accumulation will be a drag in the third quarter, but faster consumer spending and residential investment growth are expected. Overall, growth should remain moderate in the third quarter if there are no shocks from events in the Middle East. Analysts expect real GDP growth to be in the 2.2% to 2.4% range in the third quarter.*

- Real GDP in the second quarter had an unusually large revision. According to the Bureau of Economic Analysis' second estimate the economy grew at 2.5% in the second quarter compared to the initial estimate of 1.7%. While 2.5% is at best modest growth in a recovery, it more than doubled the 1.1% growth rate in the first quarter. Figure 2 below shows the quarterly GDP growth rates since the second quarter of 2008.

Figure 2. U. S. GDP Growth Rate (Percent Change in GDP)

Percent



Source: Bureau of Economic Analysis

- Higher second quarter growth was driven by faster gains in nonresidential investment, higher exports and reduced imports. Government was also less of a drag on the economy. Consumer spending slowed.

- Personal consumption expenditures increased 1.8 percent in the second quarter, compared with an increase of 2.3 percent in the first.

- Durable goods increased 6.1 percent, compared with an increase of 5.8 percent. Nondurable goods increased 1.8 percent, compared with an increase of 2.7 percent. Services increased 1.1 percent, compared with an increase of 1.5 percent.

- Nonresidential fixed investment increased 4.4 percent in the second quarter, in contrast to a decrease of 4.6 percent in the first. Nonresidential structures increased 16.1 percent, in contrast to a decrease of 25.7 percent.

- Federal government consumption expenditures and gross investment decreased 1.6 percent in the second quarter, compared with a decrease of 8.4 percent in the first. National defense decreased 0.6 percent, compared with a decrease of 11.2 percent. Nondefense decreased 3.2 percent, compared with a decrease of 3.6 percent. Real state and local government consumption expenditures and gross investment decreased 0.5 percent, compared with a decrease of 1.3 percent.

- The change in real private inventories added 0.59 percentage point to the second-quarter change in real GDP, after adding 0.93 percentage point to the first-quarter change. Private businesses increased inventories $62.6 billion in the second quarter, following increases of $42.2 billion in the first quarter and $7.3 billion in the fourth.

- Real final sales of domestic product (GDP less change in private inventories) increased 1.9 percent in the second quarter, compared with an increase of 0.2 percent in the first.

- Profits rose 3.9% in the second quarter (not annualized) after falling 1.3% in the first quarter.

Production – *The outlook for production is improving in the third quarter with a stronger ISM manufacturing index and continued demand for durable goods.*

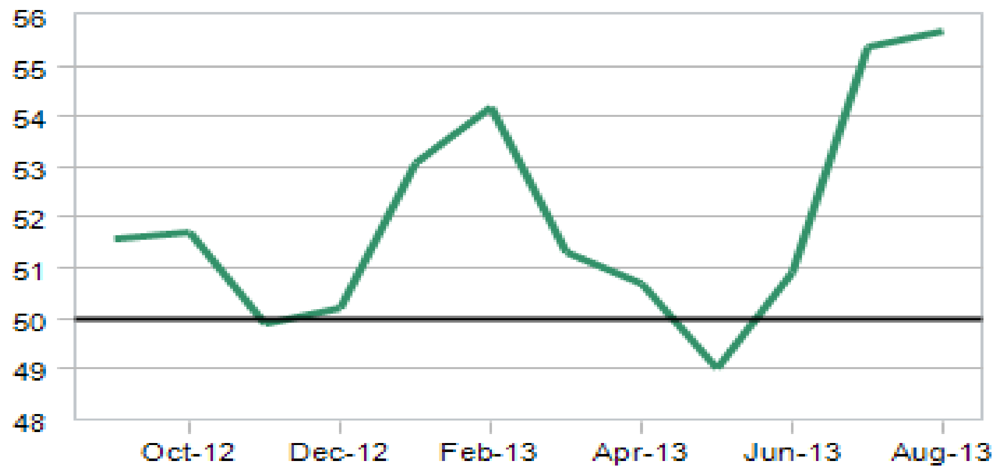
- Orders for manufactured goods fell 2.4% in July. The previously released figures for growth in durable goods orders were revised down slightly from a 7.3% to a 7.4% decline. Shipments of durable goods were unrevised, dipping 0.3%.

- The ISM Non-Manufacturing Index grew to 56.0 in July, the best reading since February. New orders jumped seven points, to 57.7, the highest level since December

- Unfilled orders grew 0.4%, while inventories were up 0.2% in July. Revisions to core capital goods orders were negative, showing a 4% decrease rather than the previously reported 3.3% drop.

- The ISM manufacturing index edged slightly higher in August, increasing from 55.4 to 55.7. So far in the third quarter the index is well above its second quarter average of 50.2. The ISM index for the last year is provided in Figure 3 below.

Figure 3. ISM Purchasing Managers Index (Index > 50 is expansionary)



Labor Market and Employment - *The labor market is improving but the momentum is slowing. The unemployment rate (U-3) has declined to 7.3% but the labor force participation rate also declined as potential workers stopped looking for jobs. The U-6 unemployment rate was 13.7% in August.*

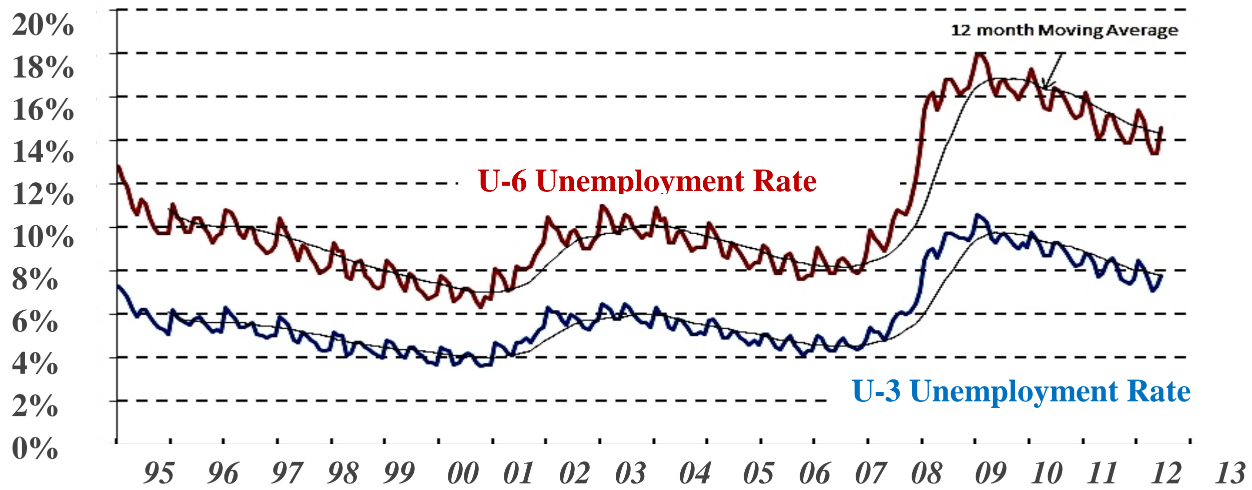
- The U-3 unemployment rate fell to 7.3% in August. The unemployment rate fell but the decline occurred because of a contraction of 312,000 in the labor force and a decline of 115,000 in household employment.

- The labor force participation rate fell again to 63.2%, a new post-recession low. The employment-to-population ratio fell to 58.6%.

- The U-6 unemployment rate fell to 13.7% in August.

- Figure 4 below shows the relationship between the traditional U-3 and U-6 unemployment rates since 1994. The U6 unemployment rate counts not only people without work seeking full-time employment (the more familiar U-3 rate), but also counts "marginally attached workers and those working part-time for economic reasons." Some of these part-time workers counted as employed by U-3 could be working as little as an hour a week. And the "marginally attached workers" include those who have gotten discouraged and stopped looking, but still want to work. The age considered for this calculation is 16 years and over

Figure 4. Comparison of U-6 versus U-3 from 1995 to Present



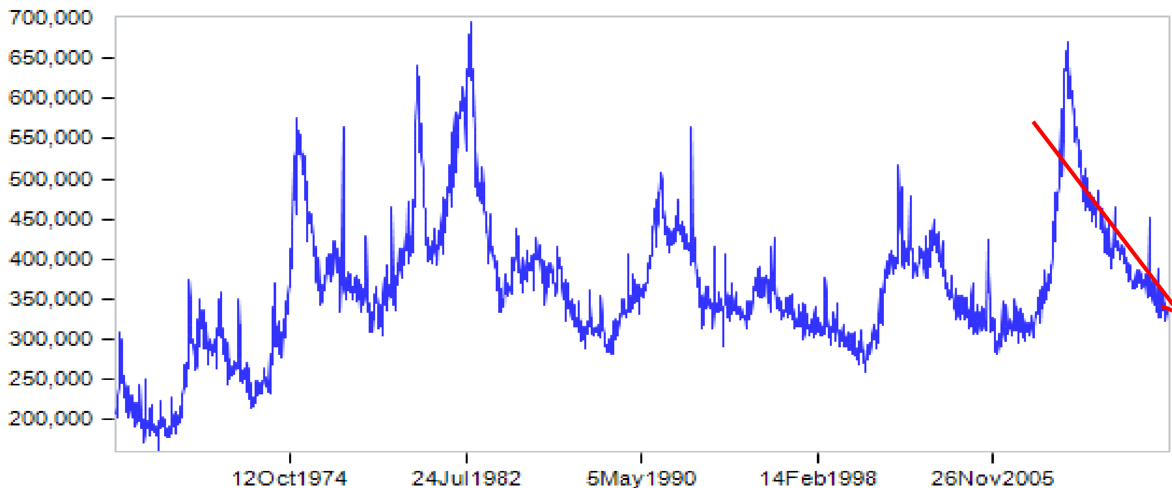
The spread between U-6 and U-3 is about 4% until 2009 when the spread increases to 6%.

- The August unemployment report suggests that the labor market lost momentum going into the third quarter. U.S. employers added an average of 148,000 new jobs each month since June following a monthly average of 180,000 three months ago.

- More positive labor market data came from the initial jobless claims and the ADP and ISM surveys. Expected growth in new jobs is closer to 200,000 jobs a month.

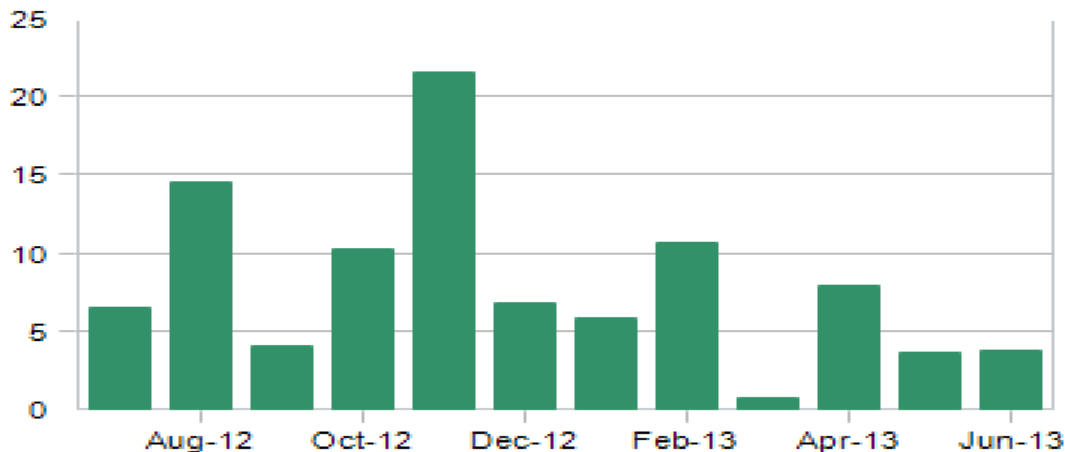
- Initial claims for unemployment insurance are volatile but are trending down as shown in Figure 5 below.

Figure 5. Unemployment Insurance Initial Claims (Seasonally Adjusted)



- The number of available jobs edged higher in June from 3.91 million in May to 3.94 million. Hiring declined from 4.49 million to 4.2 million, but separations also declined from 4.38 million to 4.08 million. As a result, net gains were unchanged in June. Figure 6 shows the pattern of job openings over the past year.

Figure 6. Total Nonfarm Job Openings (% Change one year ago)



- Payroll employment increased by 162,000 in July, below consensus estimates. Private payrolls grew by 161,000. Gains for May and June were revised down from 195,000 in both months to 176,000 and 188,000, respectively. The unemployment rate fell to a cyclical low of 7.3% in August, largely due to a contraction of the labor force rather than stronger hiring.

- Average weekly hours for all employees declined to 34.4 from 34.5 in June. For production workers, they declined to 33.6 from 33.7. Earnings also declined slightly, by 0.1% for all workers, and were flat for production workers. This follows the rather large gains of 0.4% and 0.3% in June. Aggregate hours slipped as well, by 0.1%.

- The number of workers employed part time for economic reasons increased slightly to 8.25 million, while the number of discouraged workers fell. The broadest measure of labor underutilization, the U-6 unemployment rate, fell to 13.7% from 14%. The number of workers out of a job more than half a year declined to 4.25 million, or 37% of all unemployed.

Personal Income and Wages- *Combined with modest wage gains and low unit labor costs, productivity data suggest the U.S. labor force is competitive and contributing little to inflationary pressures.*

- Personal income growth slumped in July, growing 0.1% after 0.3% in the prior two months. Wage income was a major contributor, falling 0.3%, the first decline in a year if the special case in January is discounted. Growth was led by rental and dividend income.

- Nominal hourly compensation rose 2.3% in the second quarter but real wages were flat.

- Unit labor costs were revised sharply lower in July to show no change. Unit labor costs have failed to advance for two quarters, proving the fourth quarter spike was temporary. The year-ago change in unit labor costs was 1.5%, well below the prerecession average and the inflation rate.

- Nominal consumer spending growth also slowed but continued as pent-up demand and wealth effects lifted expenditures. Nominal spending grew 0.1%, led by nondurable goods.

- Real spending was essentially unchanged, with growth in goods spending, especially nondurable goods, offsetting a decline in real service spending. Income was revised up modestly from January through May. The saving rate held steady at 4.4%.

- Consumer credit outstanding advanced in July because of increases in non-revolving balances. Consumers are taking advantage of persistently low interest rates to finance spending on big-ticket items such as education and vehicles. Furthermore, pent-up demand is also benefiting auto sales, which have held near 16 million units (SAAR) over the past several months.

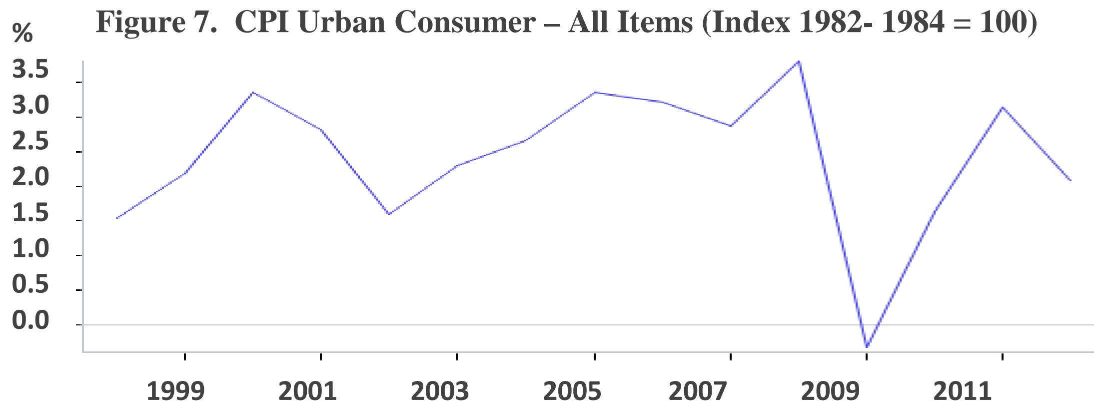
- Revolving credit trended lower in July. Revolving credit has been up and down throughout the recovery, portraying consumers' caution. Consumers are shying away from racking up higher-interest revolving debt, made up mostly of credit card usage. Weak income growth and lackluster labor market improvements are likely dampening the effects of increasing stock and housing markets.

Inflation – *Inflation remains low and well within the bounds set by the Fed. Over the past 12-months the CPI increased about 2%.*

- The **Consumer Price Indexes (CPI)** measures monthly changes in the prices paid by urban consumers for a representative basket of goods and services. On a seasonally adjusted basis, the Consumer Price Index for All Urban Consumers increased 0.2 percent in July after increasing 0.5 percent in June. The index for all items less food and energy (Core CPI) rose 0.2 percent in July, the same increase as in June.

- Over the last 12 months, the all items index increased 2.0 % before seasonal adjustment. The year-over-year percentage change in the CPI for the past 15 years is shown in Figure 7 below.

Figure 7. CPI Urban Consumer – All Items (Index 1982- 1984 = 100)



- The 12-month inflation rate based on the personal consumption expenditure index was 1.4% in June compared to 1.3% in May. The PCE index inflation rate was 1.65% for last year. This is very low inflation compared to the long term average annual rate of 3.55%.

- The Trimmed Mean PCE inflation rate is an alternative measure of core inflation in the price index for personal consumption expenditures (PCE). The Trimmed mean excludes outliers in the calculation and is constructed by staff at the Dallas Fed, using data from the Bureau of Economic Analysis (BEA). Comparisons of the PCE, core PCE, and trimmed mean PCE are shown in Table 6 below.

Table 6. Comparisons of PCE, Core PCE, and Trimmed PCE (February – July 2013)

	Feb-13	Mar-13	Apr-13	May-13	Jun-13	Jul-13
PCE	1.5	1.2	0.9	1.1	1.3	1.4
PCE excluding food & energy	1.5	1.4	1.2	1.2	1.2	1.2
Trimmed Mean PCE	1.6	1.5	1.3	1.3	1.3	1.4

Data represent annual percentage change

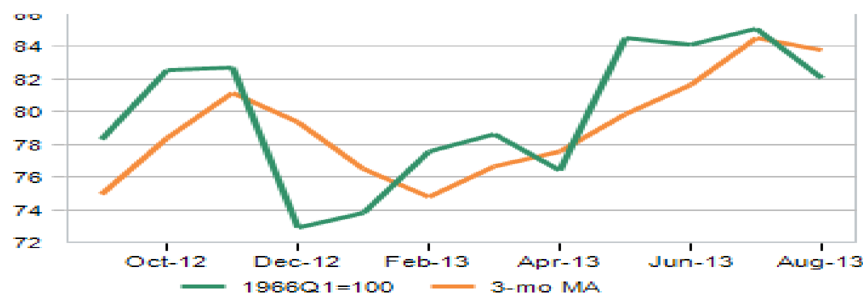
- Crude oil continues to trade at just less than $110 a barrel, up 24% from April and returning to heights reached only briefly in early 2011 and 2012. If tension in the Middle East escalates, the price of oil could stimulate higher overall inflation.

- Globally, input prices for both services and manufacturing (as measured by the JPMorgan Global Manufacturing & Services PMI) increased to a reading of 55.4, versus 52.4 in June, suggesting price pressures are easing upward in the supply chain.

Sentiment and Confidence – *confidence in the economy is fragile but improving over time. Confidence stalled in the most recent months but may pick up later in the year if there are no additional shocks. Higher interest rates have taken some of the momentum out of key sectors.*

- The University of Michigan Consumer Confidence Index fell slightly in August. The top-line measure was 82.1, down 3 points from the prior month but 2.1 points above August's reading. Figure 8 below shows the index pattern over the last year.

Figure 8. University of Michigan Consumer Confidence Index



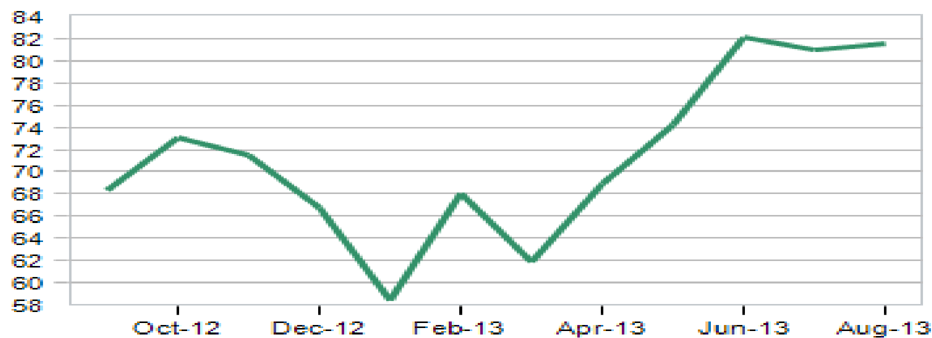
- The one-year inflation expectation in the University of Michigan survey dipped slightly in August while the five-year inflation gauge rose from July.

- The Bloomberg Consumer Comfort Index has been volatile and well below the benchmark since the recession began. The path of the index shows very slow improvement. Consumers are pessimistic about the state of the economy, personal finances, and the overall buying climate. Views on personal finances turned negative for the first time in four months. The Bloomberg Index is shown in Figure 9.

Figure 9. Bloomberg Consumer Comfort Index

- The Conference Board's Consumer Confidence Index posted an unexpected increase in August. Durable goods orders fell sharply in July and new-home sales plunged as mortgage rates increased. The Conference Board Index is shown in the figure below. Confidence improved in the second quarter but has flattened out in July and August.

Figure 10. Consumer Confidence Index (1985 = 100)



- The Conference Board survey showed plans to buy a home fell nearly 2 percentage points in August to the lowest since February. Higher mortgage rates were likely one of the factors. Plans to buy an existing home logged the biggest decline, suggesting that lean supply could also be an issue. The combination of lean supply and rising mortgage rates is bad for the housing market.

- The Conference Board index of leading indicators rose 0.6% in July. Financial components provided a notable lift to the index. The spread between 10-year Treasuries and the fed funds rate widened to 2.49 percentage points, the widest this year. The S&P 500 rebounded from last month's decline to advance 3.1% in July. A dip in average weekly manufacturing hours held back a stronger gain in the index. The year-ago rate accelerated to 3.1% in July, the highest since February 2012 and consistent with expectation that growth will strengthen appreciably early next year.

U. S. International Trade – *Export led growth is not on the immediate horizon as U.S. exports remain very sensitive to the economic growth of the rest of the world.*

- The U.S. foreign trade deficit widened in July to $39.1 billion from $34.5 billion in June. Nominal exports declined 0.6% to $189.4 billion from $190.5 billion in June, while nominal imports rose 1.6% to $228.6 billion from $225.1 billion in the prior month.

Global Economic Outlook – *Data released over the past week suggest that the global economy is improving.*

- Global growth increased only slightly from an annualized rate of 2½ percent in the second half of 2012 to 2¾ percent in the first quarter of 2013. The underperformance was due to growth disappointments in major emerging market economies, the recession in the euro area, low demand, and slow expansion by the U.S. economy. By contrast, growth was stronger than expected in Japan, driven by consumption and net exports that

were helped by the 20 percent depreciation of the yen (in real effective terms) since late 2012.

- Global growth is projected to remain subdued at slightly above 3 percent in 2013, the same as in 2012. Downside risks to global growth include emerging market vulnerability to slowing credit and tighter financial conditions if capital flows reverse due to U.S. unwinding expansionary monetary policy.

- Financial market volatility increased globally in May and June after a period of calm since last summer. Longer-term interest rates and financial market volatility have risen in advanced economies. Peripheral euro area sovereign spreads have widened again after a period of sustained declines. Emerging market economies have generally been hit hardest, as recent increases in advanced economy interest rates and asset price volatility, combined with weaker domestic activity (see below) have led to some capital outflows, equity price declines, rising local yields, and currency depreciation.

- China's manufacturing sector returned to growth last month. Chinese State Council announced that it wouldn't allow growth in China to slow to an unreasonable level as it works to reorient the country away from fixed-asset investment and toward domestic consumption.

- Overall, the Eurozone is rebounding. The Composite Purchasing Managers Index (which covers both manufacturing and services) increased to 50.5, its best level in two years. An index over 50 indicates growth in the Eurozone is in place for the first time since January. Europe's manufacturing sector has been contracting since late 2011 with budget austerity and financial turmoil. Lower government borrowing costs and stabilization in the bond market have helped turn things around.

- Greece is also on the upswing. The Greek Manufacturing Purchasing Managers Index is rebounding even though it remains below the benchmark of 50. Employment and new orders are contracting at their slowest pace since January 2010.

- The U.K. is improving. The July Manufacturing PMI reached a 28-month high and construction activity is increasing. United Kingdom is likely to have its best GDP growth in 14 years.