LPL RESEARCH
WEEKLY ECONOMIC COMMENTARY

KEY TAKEAWAYS

The March 2017 Beige Book is consistent with our view that the Fed will raise rates later this month and two more times this year.

Based on our analysis, the March 2017 Beige Book continues to deliver a positive view of the U.S. economy.

Despite the elevated level of uncertainty surrounding U.S. policy, optimism on Main Street hit a two year-high in the March 2017 Beige Book.

March 6 2016

BEIGE BOOK: WINDOW ON MAIN STREET

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MARKET HAS NOW FULLY PRICED IN A MARCH RATE HIKE

In the last several weeks, the odds of a Federal Reserve (Fed) rate hike at the next Federal Open Market Committee (FOMC) meeting on March 14–15, 2017, have risen markedly. Using the federal funds futures market pricing as a guide, on February 15, 2017, the day Fed Chair Janet Yellen delivered the first leg of her semiannual Monetary Policy testimony to Congress, the odds of a 0.25% (25 basis point) rate hike at the March 14–15, 2017, FOMC meeting was just 44%. As of Monday morning, March 6, 2017, the odds of a Fed hike at the March meeting were 96%. A strong run of economic data, relatively hawkish comments from Fed officials (including Yellen herself in a speech on March 3, 2017), an easing of financial conditions, and relative calm in global financial markets have helped push the odds of a March hike to near 100%. Although the Fed doesn't state it outright, in recent memory, it likes to see a rate hike priced in by markets before actually raising rates. A March rate hike is both consistent with our view of two to three hikes in 2017 and the FOMC's "dot plots" from December 2016, which indicated that FOMC members (in aggregate) see three hikes in 2017. We will provide a full preview of the March 14–15, 2017, FOMC meeting in next week's *Weekly Economic Commentary* (March 13, 2017). This week, we'll discuss the latest Beige Book, one of the key inputs to the FOMC's decision-making process.

BEIGE BOOK SUGGESTS CONTINUED MODEST ECONOMIC GROWTH

The latest edition of the Fed's Beige Book was released Wednesday, March 1, 2017, and based on our analysis, it continues to deliver a positive view of the U.S. economy. The Beige Book is a qualitative assessment of the U.S. economy and each of the 12 Fed districts individually. The report is prepared eight times per year, ahead of each of the eight FOMC meetings. We believe the Beige Book is best interpreted by measuring how the key words change over time. The qualitative inputs for the March 2017 Beige Book were collected from early January 2017 through February 17, 2017. Thus, they captured Main Street's reaction to:

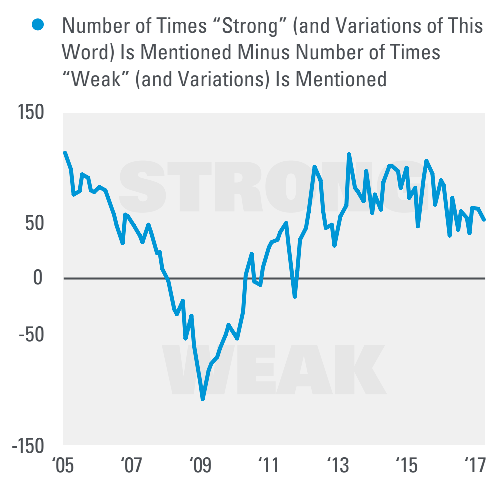
- The transition of the White House from President Obama to President Trump.
- New all-time highs in the U.S. equity markets and relatively calm financial markets at home and abroad.
- Better-than-expected economic data and rising odds of a Fed rate hike in March 2017.
- A solid set of earnings reports from S&P 500 companies for the fourth quarter of 2016 (reported in January and February 2017).

HOW THEY WORK
BEIGE BOOK AND BEIGE BOOK BAROMETER

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 1 of the 12 regional Fed 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 March 14–15, 2017.

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.

1 BEIGE BOOK BAROMETER CONTINUES TO SUGGEST POSITIVE ECONOMIC GROWTH IN THE U.S.



Source: LPL Research, Federal Reserve 03/06/17

SENTIMENT SNAPSHOT

We created our proprietary Beige Book Barometer (BBB) [Figure 1], to evaluate the sentiment behind the entire Beige Book collage of data. The BBB is a diffusion index measuring 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 advancing, it suggests that the economy is improving.

In March 2017, the barometer moved down to +53, after a +63 reading in January 2017, and a +64 reading in November 2016. All of the deterioration in the Beige Book in March 2017 versus January 2017's reading came outside the three Fed districts in the nation's oil patch (Minneapolis, Dallas, and Kansas City), as the increase in oil production and related activity boosted sentiment in those districts while things deteriorated a bit outside the oil patch.

Our Oil States Barometer (the barometer for the three Fed districts that include the top oil-producing states) moved from +8 in January 2017 to +9 in March 2017, just above the +8 reading seen, on average, in the Beige Books released since oil production began to move higher in summer 2016. Still, the +9 reading in March 2017 was well below the 20+ readings seen just prior to the peak in oil prices near $110 per barrel in mid-2014.

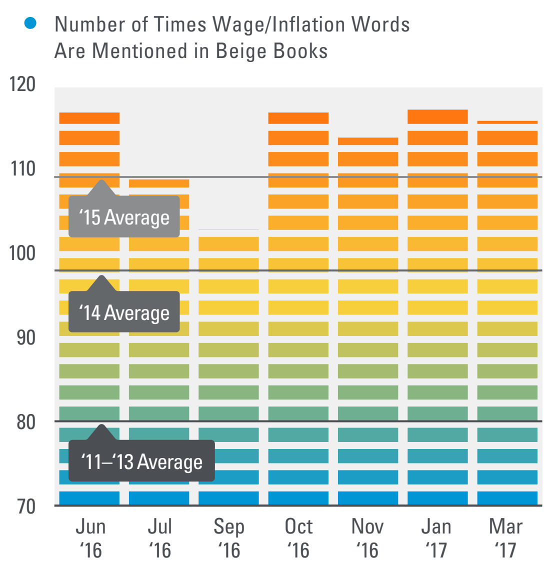
The somewhat disturbing news here is that the +44 reading on the barometer outside of the oil states in March 2017 was well below the +55 reading in January 2017 and below the +50 seen, on average, in 2016. In short, the rebound in oil production doesn't seem to have lifted sentiment outside of the oil-producing states in recent months.

WATCHING WAGES & INFLATION

As noted in our *Outlook 2017: Gauging Market Milestones* publication, our view is that the Fed will raise rates two to three times in 2017. The market has now fully priced in a 0.25% hike at the March 14–15, 2017, meeting. Still, market participants continue to monitor inflation and wages closely, as they gauge, not just when, but how far and how fast the Fed may raise rates this year and beyond. Each Beige Book provides an economy-wide assessment of wages and prices. On wages, the March 2017 Beige Book noted:

> In general, wages in most Districts rose modestly or moderately, with a few reporting some pickup in the pace of wage growth. A number of Districts noted that shortages of skilled workers—particularly engineers and IT workers—were driving up their wages, and there were also some reports of labor shortages in the leisure and hospitality, construction and manufacturing industries.

2 RISE IN WAGE AND PRICE PRESSURES EVIDENT IN OUR INFLATION BAROMETER



Source: LPL Research, Federal Reserve 01/06/17

In discussing price pressures, the March 2017 Beige Book said that:

> Pricing pressures were little changed from the prior report. Most Districts reported that selling prices were up modestly or moderately, though four indicated that prices had largely leveled off. Input prices were up modestly, on balance. Energy prices and farm prices were mixed but mostly steady, on balance, while prices for construction materials climbed in a number of Districts. Overall, businesses said they expected both input prices and selling prices to increase modestly in the months ahead.

We monitor wage pressures via the data in Figure 2, which show the recent trend in the number of wage/inflation words in the Beige Book. We counted the number of times the words "wage," "skilled," "shortage," "widespread," and "rising" appeared in recent editions of the Beige Book. In March 2017, these words appeared 116 times, similar to the 118 mentions in the January 2017 Beige Book and well above the 2016 low of 100 seen in January 2016.

By comparison, in the first half of 2016, these wage/inflation words appeared, on average, just 108 times per Beige Book. These words appeared, on average, 109 times per Beige Book in 2015. In all of 2014—when deflation, not inflation, was a concern—those words appeared an average of just 98 times per Beige Book. So, after a brief drift back toward deflation worries in the January 2016 edition (100 mentions), the Beige Books released over the latter half of 2016 and here in early 2017 show a noticeable pickup in the number of inflation words. For reference, during 2011–13, also a period when heightened risk of deflation was evident, inflation words appeared 80 times per Beige Book on average.

OPTIMISM STILL RULES

Despite the elevated level of uncertainty noted in the March 2017 Beige book, most of which was related to the lack of clarity around potential policy changes that may be enacted by President Trump and the Republican-controlled Congress in the coming months, optimism still reigns on Main Street. In the March 2017 Beige Book, the word "optimism" (or its related words) appeared 28 times, whereas the word "pessimism" didn't show up at all [Figure 3].

3 DESPITE POLICY UNCERTAINTY, OPTIMISM ON MAIN STREET IS ON THE RISE

	Mentions per Beige Book:	
	Optimism	Pessimism
Mar '17	28	0
Jan '17	26	0
Nov '16	14	2
Oct '16	14	1
Sep '16	15	1
Jul '16	10	2
Jun '16	17	2
'15–'16	21	1
'14	30	0
'13	25	1
'09	9	5
'07	10	1

Source: LPL Research, Federal Reserve 03/06/17

For full years, averages of all 8 Beige Books from that year are shown.

The 28 mentions of "optimism" in the March 2017 Beige Book were the most in any Beige Book since late 2014. For comparison, in the 16 Beige Books released in 2015 and 2016, optimism appeared, on average, 18 times per Beige Book, whereas the word "pessimism" has appeared a total of just 21 times, with over 70% (15 of 21) of those mentions coming in the Dallas and Kansas City districts and related to the outlook for the oil and gas sector.

As reassuring as it is to see that Main Street can remain optimistic despite the elevated levels of policy related uncertainty, the large number of optimistic comments in the Beige Book is not the start of a new trend. In the eight Beige Books released in 2014, the word "optimism" appeared, on average, 30 times. In 2013, "optimism" appeared, on average, 25 times per Beige Book. In the eight Beige Books released in 2009, during some of the worst of the financial crisis and Great Recession, the word "optimism" appeared, on average, just nine times.

Concerns that today's economic and market environment is similar to the onset of the Great Recession and the stock market peak in late 2007 also appear to be misplaced. In the eight Beige Books released in 2007, the word "optimism" appeared, on average, just 10 times per edition—a far cry from the 30 times per edition in the eight Beige Books released in 2014, the 21 times in 2015, and 19 in the eight Beige Books released in 2016 and here in early 2017. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

Any economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal and potential illiquidity of the investment in a falling market.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

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