LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

KEY TAKEAWAYS

The latest Beige Book suggests that the U.S. economy is still growing near its long-term trend.

However, Main Street's latest assessment suggests that the manufacturing sector continues to be affected by a stronger dollar, weaker energy prices, and a slowdown in EM economies.

Main Street has remained broadly optimistic, although pessimism is running high in the energy-producing regions.

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BEIGE BOOK: WINDOW ON MAIN STREET

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BEIGE BOOK SUGGESTS CONTINUED MODEST ECONOMIC GROWTH

The latest Beige Book suggests that the U.S. economy is still growing near its long-term trend, but that the drag from a stronger dollar and weaker energy prices, along with the slowdown in emerging market (EM) economies—most notably China, are still having a major impact on the manufacturing sector. In addition, our analysis of the Beige Book confirms that there has been some spillover of weakness from the energy and manufacturing sectors to other parts of the economy in recent months. Comments in the Beige Book also continue to indicate that some upward pressure on wages is beginning to emerge; but the wage pressures are not accelerating, which should keep the Federal Reserve (Fed) from raising interest rates aggressively this year.

Overall, the Beige Book described the economy as expanding at a "modest or moderate" pace in 7 of the 12 districts, a downshift from the 9 of 12 citing "modest or moderate growth" in the January 2016 Beige Book. In general, optimism regarding the economic outlook far outweighed pessimism throughout the Beige Book, as it has for the past two years or so, but pessimism is running high in the energy-producing regions of the U.S.

The Beige Book is a qualitative assessment of the U.S. economy and each of the 12 Fed districts individually. We believe the Beige Book is best interpreted by measuring how the descriptors change over time. The latest edition of the Fed's Beige Book was released Wednesday, March 2, 2016, ahead of the March 15–16, 2016 Federal Open Market Committee (FOMC) meeting, the second Fed policy meeting of 2016. The qualitative inputs for the March 2016 Beige Book were collected from early January 2016 through February 22, 2016. Thus, they captured Main Street's reaction to:

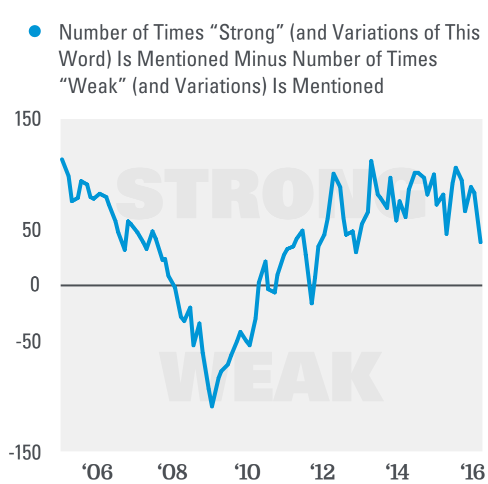
- A period of extreme volatility in U.S. and global financial markets
- Heightened fears of a U.S. and global recession
- Several 25%+ swings in oil prices
- The announcement by the Organization of the Oil Exporting Countries (OPEC) of an oil production "freeze"
- Another wave of capital spending cuts by U.S. energy-producing companies
- Economic and inflation data for December 2015, January 2016, and February 2016 that were mixed at best for the U.S. and generally much weaker than expected overseas, especially in Europe
- Increased discussion in the financial media about global deflation and negative interest rates

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 15 – 16, 2016.

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 THE DROP IN THE BEIGE BOOK BAROMETER TRACES, BUT DOESN'T MATCH, THE NEARLY 50% DROP IN OIL PRICES FROM JUNE 2015 TO EARLY 2016



Source: LPL Research, Federal Reserve Board 03/04/16

SENTIMENT SNAPSHOT

To evaluate the sentiment behind the entire Beige Book collage of data, we created our proprietary Beige Book Barometer (BBB) [Figure 1]. In March 2016, the barometer ticked down to just +39 — the lowest reading since November 2012 (+30), which came in the aftermath of Superstorm Sandy's impact on the East Coast. Notably, however, our BBB didn't turn negative as it did during the summer and fall of 2011, amid the debt downgrade and debt ceiling debacle in the U.S. and fears of a sovereign default in the Eurozone that roiled global economies and financial markets. This suggests that the underlying economy in early 2016 is in much better shape than it was in late 2011, and thus better able to withstand the financial market turmoil.

At +39, the BBB remains well below its mid-2015 peak (+106 in July 2015), which followed a 40% bounce in oil prices from March to June 2015. The +106 reading in July 2015 was the highest reading since April 2013, and the second-highest reading in over 10 years. The downshift in the BBB from +106 in July 2015 to +39 in March 2016 traces, but doesn't exactly match, the 50% drop in oil prices from June 2015 to early 2016. As we note in more detail below, however, most of the decline in the BBB since its 2015 peak has come in the non-energy-producing districts of the U.S, suggesting that there has been some spillover from lower oil prices to other parts of the economy and that the stronger dollar and economic weakness overseas are also acting as drags on the U.S. economy outside of the energy sector.

WATCHING WAGES & INFLATION

Now that the Fed has initiated its first rate hike cycle since 2006, FOMC members and market participants, who are trying to gauge what the Fed may do next, will be watching inflation closely. Each Beige Book provides an economy-wide assessment of wages and prices. The March 2016 Beige Book noted that "wages generally increased as most districts experienced slight to strong wage growth," and that "labor market conditions continued to strengthen since the previous reporting period, with the majority of Districts reporting modest growth in the labor market."

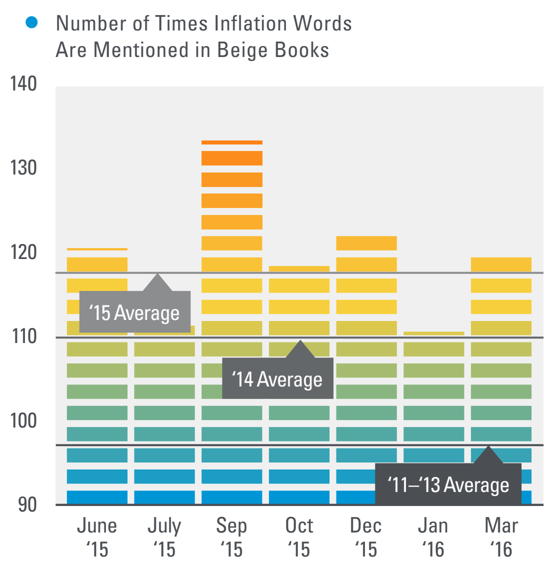
We monitor wage pressures via the data in Figure 2, which show the recent trend in the number of wage/inflation words in the Beige Book. We counted the number of times the words "wage," "skilled," "shortage," "widespread," and "rising" appeared in recent editions of the Beige Book. In March 2016, these words appeared 113 times, up from the 100 in January 2016, and above the 109 average seen in all 8 Beige Books in 2015. In all of 2014—when deflation, not inflation, was a concern—those words appeared, on average, just 98 times per Beige Book; so after a brief drift back toward deflation worries in the January 2016, the latest edition shows a 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, on average, 80 times per Beige Book.

COMMENTS ON OIL & ENERGY SPIKE AMID VOLATILE OIL PRICES

Oil and energy received a total of 87 mentions in the March 2016 Beige Book, the highest reading since at least the start of 2014. The last Beige Book that even came close to seeing as many mentions of oil was the April 2015 Beige Book, with 83 mentions. For context, energy and oil had only around 40–45 mentions per Beige Book in 2011–14 and 64 per Beige Book in 2015 [Figure 3]. Guidance from corporate management in the manufacturing sector, surveys of manufacturing activity, and data on manufacturing orders and shipments continue to be downbeat, although we note that oil has bounced 15–20% since data collection for this Beige Book wrapped up on February 22, 2016. If this bounce is sustained, it would likely lead to fewer mentions of oil and energy in the next few editions of the Beige Book.

So far in 2016, oil prices have averaged around $32 per barrel, more than 33% below the average price in 2015 ($49 per barrel), which, in turn, was 48% below the 2014 average price of $92 per barrel.

2 IN MARCH 2016, INFLATION WORDS WERE BACK ON THE RISE AFTER A DIP IN JANUARY



Source: LPL Research, Federal Reserve Board 03/04/16

3 ENERGY/OIL RECEIVED A TOTAL OF 87 MENTIONS, THE HIGHEST SINCE AT LEAST EARLY 2014

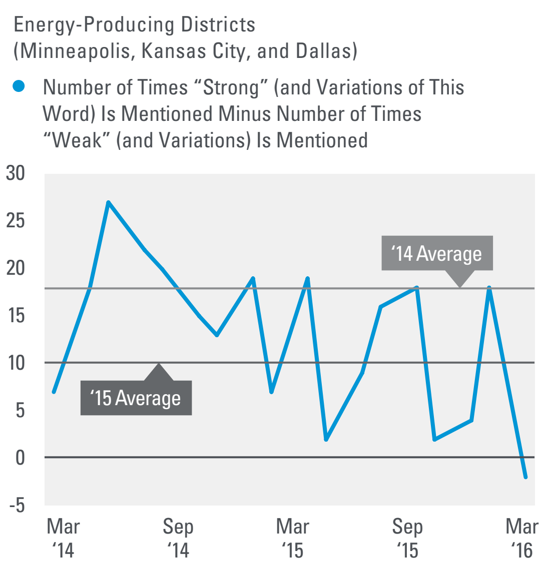
	Weather	China	Energy/ Oil	Strong Dollar
Mar '16	17	3	87	6
Jan '16	26	2	71	16
Dec '15	16	6	65	16
Oct '15	4	7	56	15
Sep '15	7	11	56	14
July '15	14	0	55	6
June '15	16	1	57	13
'15 Avg	22	4	64	13
'14 Avg	40	2	43	1
'11–'13 Avg	14	2	46	0

Source: LPL Research, Federal Reserve Board 03/04/16

To better gauge the impact of lower oil prices on the economy, we constructed a separate Beige Book Barometer [Figure 4] for the three Fed districts with the most energy-related economic activity (Minneapolis, Kansas City, and Dallas). During 2014, the Beige Book Barometer in the energy-related Fed districts averaged +18. In the 8 Beige Books released in 2015, the barometer in the energy-related districts was just +10, a clear deceleration in activity. In January 2016, the reading bounced back up to +18, but it cratered to -2 in the March 2016 Beige Book, reflecting the 20% drop in oil prices between mid-January 2016 and late February 2016 and the aforementioned announced capital expenditure cuts from U.S. energy producing companies. The -2 reading in March 2016 was the lowest since we began tracking this metric in early 2014.

As was the case in the Beige Books released in 2015 and in the January 2016 Beige Book, the March 2016 edition provided many comments from all 12 Fed districts about how lower fuel and energy prices were benefiting multiple industries. In short, comments on the impact of falling oil prices are consistent with our view that falling oil prices may be a net plus for the U.S. economy as a whole, but economies in certain states could see a significant impact from the additional slowdown in drilling activity that is likely to occur over the next six to nine months or so.

4 ECONOMIC ACTIVITY IN ENERGY-PRODUCING DISTRICTS DIPS TO ITS LOWEST READING SO FAR



Source: LPL Research, Federal Reserve Board 03/04/16

FADING CONCERNS/RISING CONCERNS

Uncertainty around fiscal policy and the Affordable Care Act has continued to fade as a concern; however, in some cases it has been replaced by uncertainty surrounding China, the drop in oil and other commodity prices, the stronger dollar, and the implications for global growth. Despite the widespread concern in financial markets around the potential impact the equity market and economic turmoil in China may have on the U.S. economy, Beige Book respondents remain largely unconcerned. China had just 3 mentions in the latest Beige Book, well below the 8 China mentions per Beige Book in the late summer and fall of 2015. China averaged only 2 mentions per Beige Book from 2011–14. As we noted in the *Weekly Economic Commentary, "China Challenge,"* while the Chinese economy has been slowing for more than 5 years, the news media and U.S. financial markets have only recently seemed to have taken note. All three of the mentions of China in the latest Beige Book were in a negative context.

The concerns about a stronger dollar eased substantially in the latest Beige Book, as the value of the U.S. dollar versus the currencies of its major trading partners generally moved lower over the first few months of 2016. There were only 6 mentions of "strong dollar" in the March 2016 Beige Book—down from 16 in January 2016 [Figure 3]. The 6 mentions in March 2016 were the fewest since the July 2015 report. To put these readings in context, the strong dollar was mentioned, on average, 13 times per Beige Book in 2015, but just once per Beige Book in 2014 and in the first few Beige Books of 2015, and got virtually no mentions in 2011–13. But since the big run-up in the dollar between late 2014 and early 2015, the dollar has received, on average, 20 mentions per Beige Book.

Although strong dollar concerns over the past 18 months have mainly come from manufacturers, retailers who cater to overseas customers and tourism contacts in areas that traditionally attract overseas tourists (New York, Florida, Nevada, and California) also cited the strong dollar as a drag on business in recent Beige Books. In the March 2016 Beige Book, contacts in the farm sector cited the strong dollar for weaker than anticipated exports of agricultural products.

OPTIMISM STILL RULES

Of the major transitory factors that impacted the economy and the Beige Book in early 2015 (dollar, oil, port strike, bad weather), only oil and the strong dollar remain as concerns, but there has clearly been some spillover from weaker oil into other parts of the economy. However, neither the dollar nor the other headlines has dampened optimism on the economy, which has picked up strength in the past year or so.

In the March 2016 Beige Book, the word "optimism" (or its related words) appeared 14 times, whereas the word "pessimism" appeared just 4 times [Figure 5].

In the 10 Beige Books released since early 2015, optimism appeared, on average, 22 times per Beige Book, while the word pessimism has appeared a total of just 12 times, with 8 of the 12 mentions coming in the Dallas and Kansas City districts, who were commenting on the outlook for the oil and gas sector.

As reassuring as it is to see that Main Street can remain optimistic despite the flow of bad news, the large number of optimistic comments in the Beige Book is not the start of a new trend: In the 8 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 8 Beige Books released in 2009, during some of the worst of the financial crisis and Great Recession, the word "optimism" appeared, on average, just 9 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 8 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 8 Beige Books released in all of 2014 and the 21 times per edition in 2015. ■

5 OPTIMISM CONTINUES TO RUN HIGH ON MAIN STREET

Mentions per Beige Book in:	Optimism	Pessimism
Mar '16	14	4
Jan '16	17	3
Dec '15	20	0
Oct '15	15	1
Sep '15	22	1
July '15	24	1
June '15	19	1
'15	21	1
'14	30	0
'13	25	1
'09	9	5
'07	10	1

Source: LPL Research, Federal Reserve Board 03/04/16

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.

Investing in foreign and emerging markets securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

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