Economics: QE3 Taper on Autopilot Amid Higher "Dot Plot" Altitude

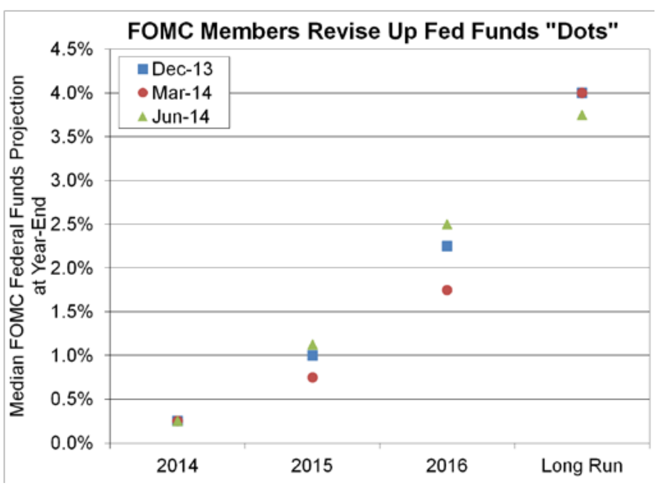
This week's economic data releases provided further evidence of firming economic conditions in the current quarter following a dismal start to the year. The nearly five-year long recovery in industrial output marches on, boosted by the manufacturing sector. After a setback in January 2014, manufacturing output increased at a 7.8 percent annual rate over the prior four months, approaching its December 2007 peak. The steadily declining trend in jobless claims offers hope for another healthy increase in June payroll employment, while a strengthening index of leading indicators suggests that the rebound in economic activity expected for the current quarter is likely to extend into the second half of this year. The Federal Reserve Open Market Committee (FOMC) offered few surprises on Wednesday, as it reduced its monthly purchases of Treasury debt and MBS by $5 billion each for the fifth consecutive meeting. However, as the unemployment rate continues its descent amid increased inflation pressure, FOMC members have revised up their projections of the fed funds rate. Its "dot plot," which indicates current expectations among FOMC members about future levels of the fed funds rate, showed that members expect a higher policy rate at the end of 2015 and in 2016 compared with prior forecasts. Markets appeared to take the statement in stride, as a small rally in bonds on Wednesday afternoon was largely reversed by Thursday, with the 10-year Treasury yield hovering at 2.62 percent at the time of this writing—virtually unchanged from last week's close.

- **Industrial production** rebounded in May, jumping 0.6 percent after a 0.3 percent decline in the prior month. Manufacturing production rose 0.6 percent, driven by the strongest gain in motor vehicle production since February of this year. Mining production continued to show strong gains, jumping at a 21 percent annual rate over the three months ending in May, while utilities production declined for the fourth consecutive month following a sharp rise in January due to the unusually severe winter weather.

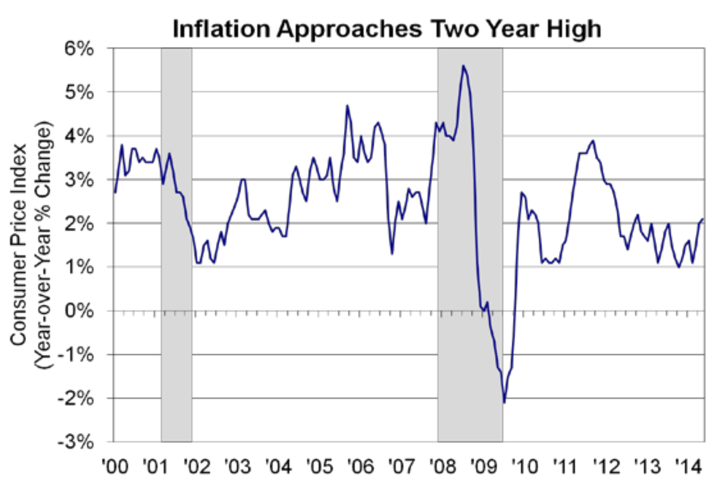
- **The consumer price index (CPI)** increased 0.4 percent in May—the fastest monthly gain in over a year—driven by the largest monthly jump in food prices since 2011 and a sharp rise in energy prices. On a year-over-year basis, consumer prices rose 2.1 percent, surpassing the Fed's comfort zone of 2 percent inflation for the first time since late 2012. Core prices (excluding the volatile food and energy categories) also picked up, increasing 0.3 percent in the month of May (a two-year high), and 2.0 percent over the last 12 months (a one-year high). The gain was broad-based, boosted by price gains in apparel, new vehicles, medical care commodities, rent of primary residence and owners' equivalent rent, and a particularly sharp increase in transportation services due to a surge in airline fares to a 14-year high.

- **Initial claims for unemployment insurance** ticked down 6,000 to 312,000 in the week ending June 14, right in the middle of the range witnessed over the past three months. The four-week moving average, a better gauge of the underlying trend, also moved lower to 311,750—just 1,250 above the more than six-year low reached at the end of May.

- **The Conference Board Index of Leading Indicators**, a gauge of economic activity over the next three to six months, rose 0.5 percent in May following a 0.3 percent gain in April. The three-month moving average held steady at 0.6 percent, the highest reached since last November. Financial indicators pushed the index higher, though persistent weakness in building permits acted as a drag.



Source: Federal Reserve Board



Source: Bureau of Labor Statistics

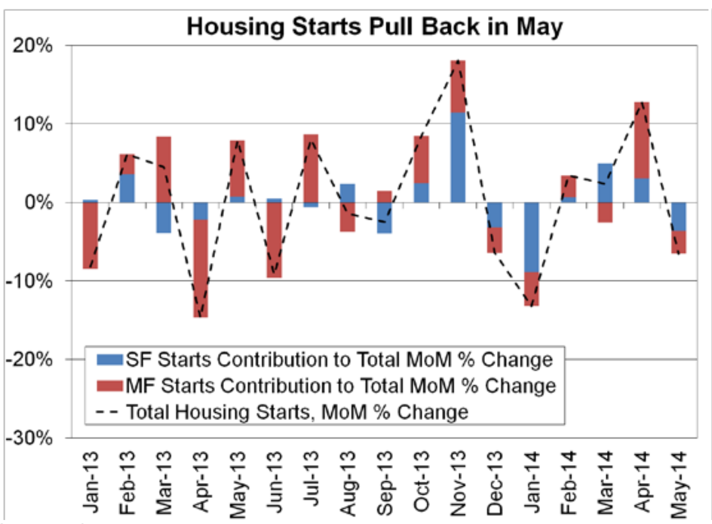
Housing: Patiently Waiting for a Meaningful Rebound

This week's housing indicators were mixed as new home construction and mortgage applications slid while homebuilder sentiment improved. The surge in the pace of new residential construction seen in April proved to be unsustainable as the pace of both multifamily and single-family homebuilding retreated in May, creating cause for concern that a notable rebound in housing construction might remain elusive. However, improved homebuilder sentiment in June and an increase in single-family permits in May suggest that things might start to turn upward for the single-family construction industry in the near term. Next week's new home sales report may hint at whether the improving sentiment is justified.

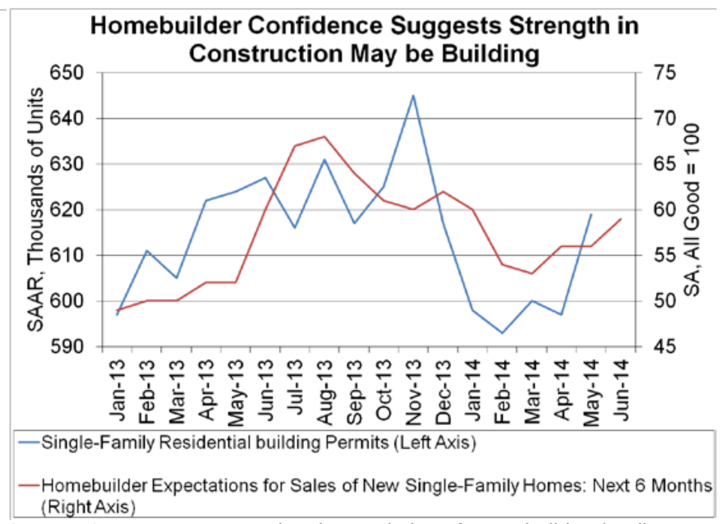
- **The National Association of Home Builders** Housing Market Index—a gauge for home builders' confidence—rose in June to 49, its highest level since January. The index was up across all but one region, as the Northeast decreased from 35 to 33. Sentiment increased by the greatest amount in the West, rising 9 points to 53. While the upshot in homebuilder sentiment is welcome news, the index is still below 50, indicating that a majority of home builders surveyed view market conditions unfavorably.

- **Total Housing Starts** retreated 6.5 percent in May to a 1 million unit seasonally adjusted annual rate, down from April's 1.07 million units. Single-family starts dropped 5.9 percent while multifamily starts fell 7.6 percent from the prior month. The decline was widespread, with only the South region managing to post a gain from April. Homebuilding activity is still performing better than last year, however, as single-family and multifamily starts are up 4.7 percent and 18.2 percent, respectively. Single-family permits—a leading indicator of starts—increased 3.7 percent. Combined with a pickup in the Housing Market Index's component measuring expectations of sales over the next six months, the second rise in single-family permits over the last six months offers a ray of sunshine in an otherwise cloudy report.

- **The Mortgage Bankers Association's mortgage applications survey** showed that mortgage applications pulled back last week, dropping 9.2 percent and giving back almost all of the prior week's gain. The refinance index led the fall, sinking 12.7 percent, while the purchase index decreased 4.7 percent. Compared to last year, the purchase index was down 15 percent and has yet to show a positive year-over-year change in 2014.



Source: Census Bureau



Source: Census Bureau, National Association of Homebuilders/Wells Fargo

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