U.S. Outlook

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Date	Indicator	For	Estimate	Consensus*	Previous Period
27-May-2014	Durable Goods Orders	APR	-0.5%	-0.7%	2.5%
27-May-2014	Durables Ex. Transportation	05/17	0.1%	0.0%	2.1%
27-May-2014	FHFA House Price Index MoM	MAR	0.5%	0.5%	0.6%
27-May-2014	S&P/Case-Shiller 20 City Index MoM	MAR	0.70%	0.70%	0.76%
27-May-2014	Consumer Confidence Index	MAY	82.5	83.0	82.3
27-May-2014	Dallas Fed Mfg Activity Index	MAY	N/A	9.0	11.7
29-May-2014	GDP Annualized -Second Release	Q1	-0.7%	-0.6%	0.1%
29-May-2014	Personal Consumption -Second Release	Q1	3.1%	3.0%	3.0%
29-May-2014	GDP Price Index –Second Release	Q1	1.3%	1.3%	1.3%
29-May-2014	Initial Jobless Claims	05/24	318K	320K	326K
29-May-2014	Pending Home Sales MoM	APR	0.9%	1.0%	3.4%
30-May-2014	Personal Income	APR	0.3%	0.3%	0.5%
30-May-2014	Personal Spending	APR	0.2%	0.2%	0.9%
30-May-2014	PCE Deflator MOM	APR	0.3%	0.3%	0.2%
30-May-2014	PCE Core MOM	APR	0.2%	0.2%	0.2%
30-May-2014	Chicago Purchasing Managers Index	MAY	61.0	60.0	63.0
30-May-2014	Univ. of Michigan Confidence Index	MAY	83.0	82.8	81.8

*Consensus from Bloomberg

The Fed's FOMC Talks Exit Strategy in April

Monetary normalization was front and center in the April FOMC minutes. Despite the caveat that the discussion was part of prudent planning and did not imply that normalization would necessarily begin sometime soon. It does remind the markets that the era of extraordinary monetary accommodation may be in its final days. The Fed started cutting interest rates in August 2007 and by December of 2008 the Fed funds target rate was already between zero and a quarter percentage point.

The FOMC discussed four policy tools for raising and controlling short-term interest rates when it comes time to tighten policy: interest paid on excess reserves, fixed rate overnight reverse repos, term reverse repos, and the term deposit facility. All these policy tools have been mentioned in past discussions of a Fed exit when the economy appeared on the brink of a self-sustaining revival, only to see the economy falter and additional asset purchases quickly ensue. Notably, there was no mention this time of selling assets on the Fed's balance sheet; a policy tool that was once on the list, but has gone out of favor at the Fed.

Discussions centered on each tools impact on a number of dimensions, including the degree of control of short-term interest rates, impact on the Fed balance sheet, impact on Fed remittances to the Treasury, the impact on the fed funds market, and implications for financial stability. It is clear the FOMC is still debating the right mix of these policy tools. The minutes stated that the FOMC should "consider a range of options" and be "prepared to adjust the mix" on the fly since they have never tried to unwind and manage such a large balance sheet before. In other words, they are not exactly sure how this is all going to work.

Past discussions of exit policy tools have emphasized using the interest rate on excess reserves as the primary tool. Right now the Federal Reserve pays a quarter percent to banks that hold reserves at the Fed. The Fed started paying interest on bank reserves in October 2008 when it became obvious that the size of the Fed's balance sheet would quickly force the Fed funds target rate to zero. By paying at least something for excess reserves,

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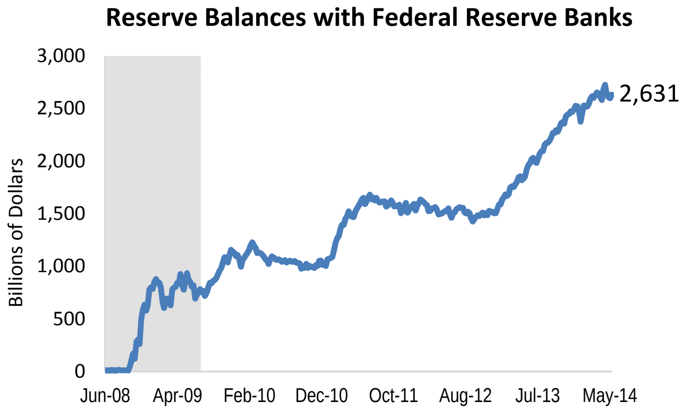
the Fed has put in a lower bound on the Fed funds rate, slightly above zero percent. The effective Fed funds rate last week was 0.08 percent. The Fed funds rate is below 0.25 percent because some institutions, such as government-sponsored enterprises (GSEs), are eligible to lend funds in the federal funds market, but are not eligible to earn interest on reserves. The plan is that as the Fed increases the Fed funds target rate it will first raise the interest rate on excess reserves.

Fed data currently puts U.S. bank excess reserves at over $2.5 trillion dollars. Bank excess reserves are analogous to a bank's checking account at the Fed. The bank can draw on those excess reserves to make new loans such as mortgages, auto loans, or business loans. For that reason, economist's call bank excess reserves "high-powered" money that can generate faster money supply growth and inflation on Main Street USA. The FOMC needs to control the release of those excess reserves and slowly shrink the amount of excess reserves in the banking system as the economy normalizes without generating faster inflation or deflationary pressures. A feat that is easier said than done.

Controlling Bank Reserves Is The Key



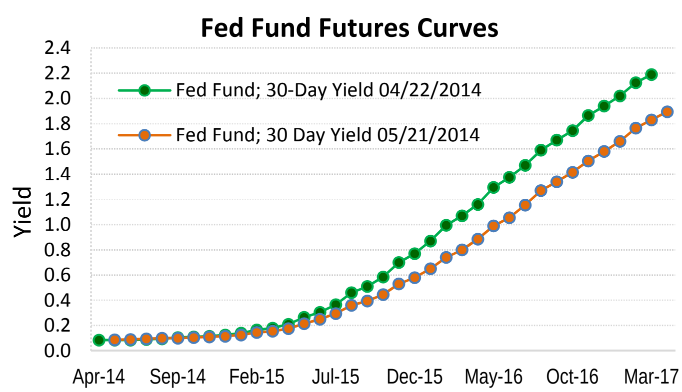
Source: Federal Reserve System

The April minutes seem to give each of the four monetary policy tools in the Fed's toolkit more equal billing than I have seen in the past. Testing of some of these tools, like the reverse repo market and term deposit facility, has already begun. The FOMC directed staff to do additional operational testing on these tools. Whatever the ultimate "mix" of policy tools the FOMC agrees upon; there will need to be extensive preparing of the ground ahead of time. Early communication of the FOMC game plan as it approaches the policy exit will help the market digest the change in stance without adverse disruptions due to uncertainty and lack of credibility.

On that score, the FOMC gave itself a To Do list. Some FOMC members thought they should clarify the reasoning underlying the FOMC statement that "…even after employment and inflation are near mandated-consistent levels, economic conditions may, for some time, warrant keeping the target fed funds rate below levels the Committee views as normal in the longer-run…"

The Fed funds futures market has scaled back expectations around the pace of Fed tightening and the endpoint of the Fed funds rate once monetary policy is normalized. Expectations have been that the Fed funds rate would rise to around 4.0 percent. But if U.S. potential growth has been permanently diminished, the endpoint on the Fed funds rate could remain a bit lower. The Fed funds futures thinks that lower rate could be closer to 3.5 percent. I am doubtful the futures markets have it right. The market's current expectations are well below the Fed's own median forecast of the Fed funds target rate. In March, the Fed saw the Fed funds rate at 1.0 percent at the end of 2015 and 2.25 percent by the end of 2016.

Fed Funds Futures Scaling Back Rate Hike Expectations



Source: Chicago Board of Trade

Also a number FOMC members want to provide additional information regarding how long the Committee would continue its policy of rolling over maturing Treasury securities and reinvesting the principal payments on all agency debt and agency mortgage backed securities. In the past, the Fed has hinted that it would stop rolling over and reinvesting Treasury and agency debt, well before it began hiking interest rates. The timing of this has important implications, since the end of rolling over the debt would start to shrink the Fed's balance sheet. In a recent Speech, William Dudley, New York Federal Reserve President, advocated for continuing to rollover the debt even after short-term interest rate hikes have begun, perhaps signaling a shift in FOMC thinking on the sequencing of the exit. My expectation is that the Fed would want to stop rolling over the debt at the same time it begins raising short-term interests. But there remains much uncertainty, so let's hope the Fed clearly communicates its intentions on this at the next FOMC meeting in June.

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Major Economic Indicators

	History					Forecast							Yr/Yr % chg or Annual Avg.			
Economic Data	**2013.1**	**2013.2**	**2013.3**	**2013.4**	**2014.1**	**2014.2**	**2014.3**	**2014.4**	**2015.1**	**2015.2**	**2015.3**	**2015.4**	**2012**	**2013**	**2014**	**2015**
Real GDP*	1.1	2.5	4.1	2.6	0.1	3.6	3.3	3.4	3.1	3.1	2.8	2.7	2.8	1.9	2.5	3.2
Personal Consumption Expenditures*	2.3	1.8	2.0	3.3	3.0	3.5	3.2	3.2	2.7	2.8	2.6	2.6	2.2	2.0	3.0	2.9
Non-residential Fixed Investment*	-4.6	4.7	4.8	5.7	-2.1	4.6	4.5	5.1	4.7	4.9	4.8	4.9	7.3	2.7	3.2	4.9
Private Housing Starts (000s units)	957	869	882	1,008	923	990	1,005	1,030	1,106	1,171	1,173	1,178	783	929	987	1,157
Vehicle Sales (mill. Units, annualized)	15.3	15.5	15.7	15.6	15.9	16.1	16.2	16.3	16.4	16.5	16.7	16.6	14.4	15.5	16.1	16.6
Industrial Production*	4.2	1.9	2.5	4.9	4.5	4.6	4.7	4.5	4.2	4.1	4.1	4.0	3.8	2.9	4.2	4.4
Nonfarm Payroll Employment (mil.)	135.5	136.1	136.6	137.2	137.8	138.5	139.2	139.9	140.7	141.4	142.1	142.8	134.1	136.4	138.8	141.8
Unemployment rate	7.7	7.5	7.2	7.0	6.7	6.4	6.3	6.2	6.1	6.0	5.9	5.8	8.1	7.4	6.4	6.0
Consumer Price Index* (percent)	1.2	0.4	2.2	1.1	1.9	2.0	2.0	1.7	1.7	1.7	1.8	1.8	2.1	1.5	1.7	1.8
"Core" CPI* (percent)	2.0	1.4	1.8	1.6	1.6	1.8	1.8	1.8	1.8	1.8	1.8	1.8	2.1	1.8	1.7	1.8
PPI (finished goods)* (percent)	0.8	-1.0	2.3	1.2	3.5	4.4	1.9	1.8	1.5	1.3	1.2	1.3	2.0	1.2	2.5	1.7
Trade Weighted Dollar (Fed BOG, major)	74.8	76.6	76.8	76.0	77.1	76.8	77.3	78.0	79.5	80.0	80.7	81.3	73.6	76.1	77.3	80.4
Crude Oil Prices -WTI ($ per barrel)	94	94	106	98	98	101	101	101	99	99	99	98	94	98	101	99

*Quarterly Data Percent Change At Annual Rate; Annual Data Year-on-Year % Chg, or Annual Average.

	History					Forecast							Annual Average			
Financial Data	**2013.1**	**2013.2**	**2013.3**	**2013.4**	**2014.1**	**2014.2**	**2014.3**	**2014.4**	**2015.1**	**2015.2**	**2015.3**	**2015.4**	**2012**	**2013**	**2014**	**2015**
S & P 500	1,514	1,610	1,675	1,769	1,835								1,379	1,644		
Dow Jones Industrial Average	13,994	14,959	15,286	15,736	16,177								12,965	15,010		
Federal Funds Rate (effective)	0.15	0.12	0.09	0.09	0.07	0.07	0.08	0.08	0.15	0.25	0.38	0.87	0.14	0.11	0.08	0.41
Treasury-3 Month Bills (yield)	0.09	0.05	0.03	0.06	0.05	0.04	0.05	0.06	0.10	0.20	0.33	0.83	0.09	0.06	0.05	0.37
Treasury-2 Year Notes (yield)	0.26	0.27	0.37	0.33	0.37	0.38	0.49	0.62	1.00	1.06	1.29	1.59	0.28	0.31	0.47	1.24
Treasury-5 Year Notes (yield)	0.82	0.91	1.50	1.44	1.60	1.65	1.70	1.74	1.98	2.19	2.40	2.68	0.76	1.17	1.67	2.31
Treasury-10 Year Notes (yield)	1.95	1.99	2.71	2.74	2.77	2.72	3.00	3.10	3.20	3.38	3.61	3.76	1.80	2.35	2.90	3.49
Treasury-30 Year Notes (yield)	3.13	3.14	3.71	3.79	3.68	3.60	3.85	3.90	4.14	4.30	4.41	4.51	2.92	3.44	3.76	4.34
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.38	3.87	3.25	3.25	3.25	3.44
Libor 3-Mo. U.S. Dollar	0.29	0.28	0.28	0.28	0.26	0.24	0.25	0.26	0.27	0.36	0.60	0.97	0.42	0.28	0.25	0.55
Mortgage-30 Year (yield)	3.50	3.67	4.44	4.29	4.36	4.28	4.47	4.65	4.75	4.94	5.16	5.31	3.66	3.98	4.44	5.04
BAA Corporate (yield)	4.81	4.82	5.40	5.36	5.12	4.90	5.07	5.19	5.30	5.48	5.70	5.86	4.94	5.10	5.07	5.59

Source: Bank of the West Economics, Bloomberg, Federal Reserve