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U.S. Outlook

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Date	Indicator	For	Estimate	Consensus*	Previous Period
8-Jun-2015	Labor Market Conditions Index Change	May	NA	NA	-1.9
9-Jun-2015	NFIB Small Business Optimism	May	97.7	97.0	96.9
9-Jun-2015	Wholesale Inventories MoM	Apr	0.2%	0.2%	0.1%
9-Jun-2015	JOLTS Job Openings	Apr	NA	NA	4994
11-Jun-2015	Retail Sales Advance MoM	May	1.0%	1.1%	0.0%
11-Jun-2015	Retail Sales Ex Auto MoM	May	0.6%	0.7%	0.1%
11-Jun-2015	Import Price Index MoM	May	1.0%	0.9%	-0.3%
11-Jun-2015	Initial Jobless Claims	06-Jun	278K	NA	276K
11-Jun-2015	Business Inventories	Apr	0.2%	0.2%	0.1%
12-Jun-2015	PPI Final Demand MoM	May	0.5%	0.4%	-0.4%
12-Jun-2015	PPI Ex Food and Energy MoM	May	0.1%	0.1%	-0.2%
12-Jun-2015	U. of Mich. Sentiment	Jun P	92.0	91.0	90.7

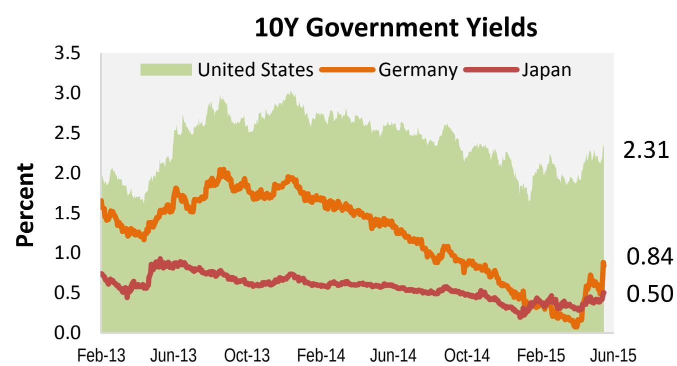
*Consensus from Bloomberg

Fixed Income Markets on the Move

We are seeing a dramatic sell-off in global fixed income markets that it appears is driven by vigorous selling of Eurozone sovereign bonds, but is also spilling over into the U.S. and elsewhere around the world. Indeed in the last week alone, the U.S. 10-Year Treasury bond yield has moved up 25 basis points or 0.25 percentage points. Thirty-year fixed-rate mortgages are following suit and mortgage rates are on the rise. In this week's report, I explore in more detail what might be behind this dramatic sell-off and what the implications could be for the FOMC, and the timing and pace of Federal Reserve interest rate hikes.

The calm and complacency that has held sway in the global bond market since January when the ECB announced its own QE program is beginning to unravel. A quick look at global bond yields reveals the epicenter of the selling has originated in Europe with the 10-Yr German bund jumping from around a 0.07 percent yield on April 20th to a peak of 0.99 percent earlier today.

Bond Market Sell-Off Epicenter in Europe



Source: Bloomberg

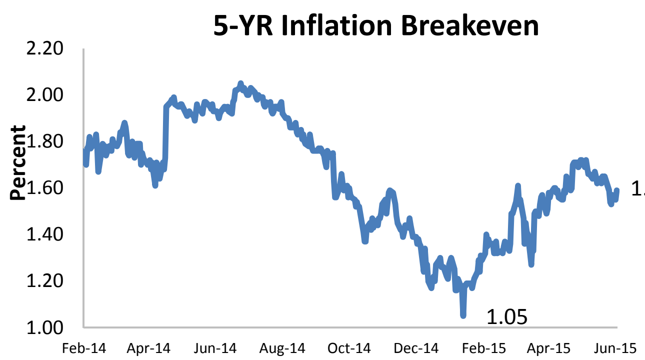
Mario Draghi's seeming lack of empathy for bond investors in his post monetary policy meeting press conference, appears to have given investors another reason to hit the sell button. His comment- bond market investors had to "get used" to volatility. If you've met a bond market investor, you know how much they hate volatility and uncertainty. So why is the market selling off now?

Fixed-income valuations appear rich in this economic environment. The Eurozone economy is much improved and growth forecasts have been revised higher this year.

Stronger growth is often a fundamental driver of higher bond market yields.

The other major fundamental driver of bond yields is also pointing to higher interest rates. The global deflation scare around plunging oil and commodity prices is unwinding. For example, in the U.S., the five-year inflation break-evens, a market expectation of inflation over the next five years, has moved up to more normal levels of around 1.6 percent, after being just 1.0 percent in January.

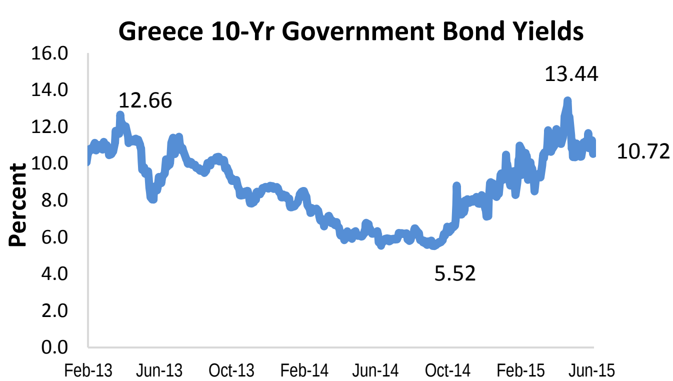
Inflation Break-Evens Recovering



Source: Federal Reserve System

Fear of a Greek exit is also being unwound. Global bond investors rushed into US Treasuries and German bunds to protect themselves from the risk of a Greek exit, but based on the recent behavior of Greek bond yields, it appears the fears of default have diminished recently, despite the continued political brinkmanship, highlighted in the newspapers.

Fear of a Greek Exit and Default Subsides



Source: Bloomberg

At the same time, the Fed is about as close to raising short-term interest rates for the first time in more than nine years as it can get. The June FOMC meeting is on the horizon and it's an **important** one. No one expects the Fed to actually raise the Fed funds target rate at the June meeting, but they will set the table. We will get a revised economic and interest rate forecast from the Fed, and Fed Chair Janet Yellen will have an opportunity at the scheduled press conference to explain in English how they see the economy, inflation, and the Fed funds rate evolving over the next few years.

If that isn't enough, there is rising concern about the functioning of global bond markets. Some prominent folks, including Jamie Dimon at JP Morgan, have voiced concerns about diminishing bond market liquidity and the risk that a financial market shock or Fed liftoff could exacerbate or even create sudden moves in long-term interest rates.

There does appear to be some basis for these concerns. Dealers no longer have the same capacity to be market markers. Dealer inventories of sovereign and corporate bonds are 40-50% lower than in the past. Institutional investors report large sales and buys are harder to get done without moving price. Some of this could be an unintended outcome of regulations designed to improve financial stability of the banking system, as well as the heavy involvement of central banks in global bond markets that pushed interest rates so low that they may now be crowding-out private sector investors.

In short, any one of these catalysts could have sparked a sell-off in global fixed-income markets, it just so happens that they all came together at once.

What to Expect At the June FOMC Meeting

The June FOMC Summary of Economic Projections will be closely scrutinized by the markets for clues on timing of the first Fed rate hike, but more importantly the likely pace of future rate hikes in 2016 and 2017. Watch the long-run fed funds rate estimate in the Fed's new dot-plot. More FOMC participants have been pushing their long-run fed funds rate estimate lower; the median forecast here could slip to 3.5% from 3.75% seen in March. I suspect a flatter dot-plot than we had at the March meeting. The Fed should initiate their crawl to normalization at the September FOMC meeting, but the next rate hike might not happen until January 2016. My estimate of the Fed funds target rate at the end of 2016 is now about 25 basis points lower than my estimate from a few months ago.

I see the Federal Reserve reducing their economic growth forecasts for 2015 and perhaps even for 2016 or 2017 from their March forecast. In contrast, the unemployment rate and inflation forecasts are likely to remain similar to the projections made in March.

Major Economic Indicators

	History				Forecast								Yr/Yr % chg or Annual Avg.			
Economic Data	**2014.1**	**2014.2**	**2014.3**	**2014.4**	**2015.1**	**2015.2**	**2015.3**	**2015.4**	**2016.1**	**2016.2**	**2016.3**	**2016.4**	**2013**	**2014**	**2015**	**2016**
Real GDP*	-2.1	4.6	5.0	2.2	-0.7	2.0	3.0	2.9	2.7	2.8	2.7	2.7	2.2	2.4	2.1	2.8
Personal Consumption Expenditures*	1.2	2.5	3.2	4.4	1.8	2.5	3.5	3.4	3.1	3.1	2.9	2.8	2.4	2.5	3.0	3.2
Non-residential Fixed Investment*	1.6	9.7	8.9	4.7	-2.8	1.2	5.0	5.0	4.7	4.6	4.6	4.2	3.0	6.3	3.0	4.6
Private Housing Starts (000s units)	934	984	1,029	1,055	975	1,080	1,101	1,133	1,145	1,170	1,230	1,250	928	1,001	1,072	1,199
Vehicle Sales (mill. Units, annualized)	15.7	16.5	16.7	16.8	16.6	16.8	17.0	17.1	17.2	17.2	17.3	17.3	15.5	16.4	16.9	17.2
Industrial Production*	3.9	5.7	4.1	4.6	-0.7	-0.8	3.3	3.2	3.4	3.4	3.4	3.4	2.9	4.2	2.0	3.1
Nonfarm Payroll Employment (mil.)	137.8	138.6	139.4	140.2	141.0	141.7	142.4	143.1	143.8	144.5	145.2	145.9	136.4	139.0	142.0	144.9
Unemployment rate	6.6	6.2	6.1	5.7	5.6	5.3	5.1	5.0	4.9	4.8	4.8	4.7	7.4	6.2	5.3	4.8
Consumer Price Index* (percent)	2.1	2.4	1.2	-0.9	-3.0	1.7	1.9	1.9	1.9	1.9	2.0	2.1	1.5	1.6	0.1	1.9
"Core" CPI* (percent)	1.8	2.2	1.4	1.5	1.9	1.8	1.8	1.9	1.9	1.9	2.0	2.0	1.8	1.7	1.8	1.9
PPI (finished goods)* (percent)	4.1	3.5	0.4	-5.1	-11.5	0.3	1.0	1.1	1.3	1.3	1.4	1.4	1.2	1.3	0.3	1.8
Trade Weighted Dollar (Fed BOG, major)	76.9	76.4	77.5	82.2	89.3	91.0	91.4	91.7	91.0	91.8	92.5	92.4	76.1	78.3	90.9	91.9
Crude Oil Prices -WTI ($ per barrel)	99	103	98	73	49	58	60	60	62	63	64	65	98	94	57	64

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

	History				Forecast								Annual Average			
Financial Data	**2014.1**	**2014.2**	**2014.3**	**2014.4**	**2015.1**	**2015.2**	**2015.3**	**2015.4**	**2016.1**	**2016.2**	**2016.3**	**2016.4**	**2013**	**2014**	**2015**	**2016**
S & P 500	1,835	1,900	1,976	2,009	2,064								1,644			
Dow Jones Industrial Average	16,177	16,604	16,954	17,345	17,808								15,010			
Federal Funds Rate (effective)	0.07	0.09	0.09	0.10	0.11	0.13	0.21	0.38	0.63	0.88	1.13	1.38	0.11	0.08	0.21	1.00
Treasury-3 Month Bills (yield)	0.05	0.03	0.03	0.02	0.02	0.03	0.11	0.30	0.55	0.78	1.03	1.28	0.06	0.03	0.12	0.91
Treasury-2 Year Notes (yield)	0.37	0.42	0.52	0.54	0.60	0.63	0.78	0.98	1.35	1.65	1.90	2.23	0.31	0.45	0.75	1.78
Treasury-5 Year Notes (yield)	1.60	1.66	1.70	1.60	1.46	1.55	1.72	1.95	2.34	2.54	2.79	2.92	1.17	1.63	1.67	2.65
Treasury-10 Year Notes (yield)	2.77	2.62	2.50	2.28	1.97	2.17	2.35	2.51	2.71	2.84	2.95	3.18	2.35	2.54	2.25	2.92
Treasury-30 Year Notes (yield)	3.68	3.44	3.27	2.97	2.55	2.80	3.05	3.15	3.26	3.37	3.50	3.63	3.44	3.34	2.89	3.44
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.33	3.50	3.75	4.00	4.25	4.50	3.25	3.25	3.33	4.13
Libor 3-Mo. U.S. Dollar	0.26	0.25	0.24	0.25	0.30	0.30	0.33	0.50	0.75	1.00	1.25	1.50	0.28	0.25	0.36	1.13
Mortgage-30 Year (yield)	4.36	4.23	4.14	3.96	3.72	3.92	4.16	4.30	4.52	4.65	4.76	4.99	3.98	4.19	4.02	4.73
BAA Corporate (yield)	5.12	4.82	4.74	4.73	4.50	4.65	4.78	4.87	5.05	5.20	5.32	5.55	5.10	4.86	4.70	5.28

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