U.S. Outlook

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Date	Indicator	For	Estimate	Consensus*	Previous Period
17-Aug-2015	Empire Manufacturing	Aug	3.5	5.0	3.9
17-Aug-2015	NAHB Housing Market Index	Aug	61	61	60
18-Aug-2015	Housing Starts	Jul	1190K	1190K	1174K
18-Aug-2015	Building Permits	Jul	1230K	1210K	1337K
19-Aug-2015	CPI MoM	Jul	0.1%	0.2%	0.3%
19-Aug-2015	CPI Ex Food and Energy MoM	Jul	0.2%	0.2%	0.2%
19-Aug-2015	FOMC Minutes from July Meeting	Jul	NA	NA	NA
20-Aug-2015	Initial Jobless Claims	15-Aug	272K	NA	274K
20-Aug-2015	Existing Home Sales	Jul	5.45M	5.41M	5.49M
20-Aug-2015	Philadelphia Fed Business Outlook	Aug	6.2	7.0	5.7
20-Aug-2015	Leading Index	Jul	0.3%	0.2%	0.6%

*Consensus from Bloomberg

Dispatches from China

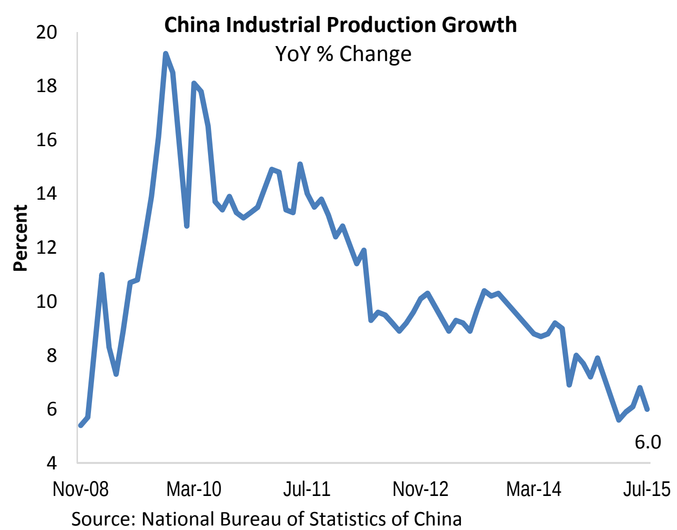
Just when the July employment report and the markets suggested smooth sailing for the Fed to lift interest rates as soon as September (on Friday the futures market implied probability of a September Fed funds rate hike increased to 54%, the highest it has been ever), China's economic data and surprise yuan devaluation have muddied the waters.

While advertised by the People's Bank of China as a logical market liberalization move that keeps the yuan on the path toward reserve currency status, the timing of the currency action doesn't pass the smell test. The market senses economic policy desperation that has dented investor confidence in the stability of China's economy and raised fears of a new currency devaluation war in Asia that, if realized, could slow growth and intensify deflationary pressures to the rest of the world.

From the Chinese perspective, the renminbi has been appreciating along with the U.S. dollar over the past year, while other emerging market countries and many of China's trading partners have seen currency depreciation on looser monetary policy and quantitative easing. Since the beginning of the year and before China's devaluation, the Malaysian Ringgit had depreciated 10.6% against the yuan, the South Korean Won 5.1%, Singapore Dollar 3.6% and Japanese Yen 3.3%. This has put additional downward pressure on Chinese exports and manufacturing performance at a time when economic activity in China appears to be continuing to fall short of its annual government growth target of 7.0%.

Looking beyond the relatively sanguine Q2 China GDP report, other Chinese economic data reveal a far gloomier picture. China's industrial production growth slipped to 6.0% year-on-year in July, near its March low of 5.6%.

China Industrial Production Continues to Slump



Moreover, China's Official Manufacturing PMI Employment sub-index has signaled steady contraction in China's manufacturing employment since June 2012.

China's Manufacturing Employment Contracting

Source: China Federation of Logistics and Purchasing

China's exports remained 8.3% below year ago levels in July, after trending at 10% annual growth since 2009.

China Export Growth Stalling-Out

Source: National Bureau of Statistics of China

Despite these downbeat indicators of Chinese economic growth, the two-day global market reaction from the yuan devaluation itself does appear to be an overreaction. So far, the renminbi has depreciated about 2.95% against the U.S. dollar. Since China's weight in the Fed's nominal broad trade-weighted dollar index is about 21%, the overall impact on the trade weighted dollar is even smaller at just over a half a percent (0.62% to be exact)- not yet a game changer for U.S. export competitiveness. In fact, historically we know it takes a 10% real appreciation in the broad U.S. trade-weighted dollar to subtract only 0.7 percentage points from U.S. real GDP growth and inflation over a two year period.

Let's assume a pessimistic scenario for the U.S. dollar where China, South Korea, Malaysia, Taiwan, Russia, India, Singapore, Brazil and India all depreciate 10% in nominal terms against the dollar over the next few weeks. Combined their weight is just 37% of the broad trade-weighted dollar. So the U.S. trade-weighted dollar appreciates 3.7% in nominal terms and only half that in real-terms (1.9%), implying a two-year drag on U.S. real GDP growth and inflation of around 0.13 percentage points.

In short, the impact from the Chinese yuan policy change should not have earth-shattering consequences for U.S. economic growth or inflation, and should not factor much into the decision on when to raise the Fed funds target rate. However, what the change in currency policy says about the extent of economic weakness in China, knock-on effects for commodity prices, and the potential for full-blown global recession is a different story altogether. It's the risk of global recession that I think the markets were reacting too this week.

The three key issues that Fed policy makers will have to sort out before September as I see it are 1) How bad off is the Chinese economy really (Is this the beginning of a global recession?), and what is China's outlook now that monetary and fiscal policy has been loosened, the stock market has been supported, and the currency has been devalued? And 2) How far will the Chinese devaluations against the dollar likely go: 5%, 10%, 20% or more? Finally, 3) What will be the global foreign exchange and commodity price reaction to this shift in policy? Will China's exporting neighbors in Korea, Taiwan, Singapore, and Japan follow with sharp depreciations of their own that could start a tit-for-tat period of competitive devaluations to support their own manufacturing and export sectors?

In my opinion, China's economic outlook has modestly improved by their recent devaluation, and, combined with other fiscal and monetary policy measures, the devaluation should gradually begin to lift China's economic activity out of its slump. Because of this, the risk of global recession remains quite low. Moreover, the impact on U.S. trade competitiveness and growth should remain limited. Finally, even if other countries follow China's lead on devaluation and commodity prices continue to sell off, this is likely to only temporarily delay the return to the Fed's inflation target of 2.0%.

The impacts from China's yuan devaluation on the U.S. economic and inflation outlook will likely remain small, and in the end shouldn't necessarily delay an initial Fed interest rate hike in September. However, it does raise the probability that it won't be followed by others this year, and the path toward interest rate normalization will remain a very shallow one next year.

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*	-0.9	4.6	4.3	2.1	0.6	3.3	2.7	2.8	2.7	2.7	2.7	2.7	1.5	2.4	2.5	2.8
Personal Consumption Expenditures*	1.3	3.8	3.5	4.3	1.7	3.2	3.5	3.4	3.1	3.1	2.9	2.8	1.7	2.7	3.2	3.2
Non-residential Fixed Investment*	8.3	4.4	9.0	0.7	1.6	0.9	2.5	5.0	4.7	4.6	4.6	4.1	3.0	6.2	2.7	4.2
Private Housing Starts (000s units)	934	984	1,029	1,055	978	1,144	1,175	1,195	1,220	1,235	1,240	1,260	928	1,001	1,123	1,239
Vehicle Sales (mill. Units, annualized)	15.7	16.5	16.7	16.8	16.6	17.1	17.3	17.2	17.3	17.3	17.2	17.2	15.5	16.4	17.1	17.3
Industrial Production*	3.6	5.7	3.9	4.7	-0.2	-1.7	3.0	3.0	3.2	3.2	3.3	3.3	1.9	3.7	1.9	2.9
Nonfarm Payroll Employment (mil.)	137.8	138.6	139.4	140.2	141.0	141.6	142.3	143.0	143.6	144.3	145.0	145.7	136.4	139.0	142.0	144.7
Unemployment rate	6.6	6.2	6.1	5.7	5.6	5.4	5.2	5.1	5.0	4.9	4.9	4.8	7.4	6.2	5.3	4.9
Consumer Price Index* (percent)	2.1	2.4	1.2	-0.9	-3.1	3.0	2.0	2.0	2.0	2.0	2.0	2.1	1.5	1.6	0.3	2.1
"Core" CPI* (percent)	1.8	2.2	1.4	1.5	1.7	2.5	1.8	1.9	1.9	1.9	2.0	2.0	1.8	1.7	1.8	2.0
PPI (finished goods)* (percent)	4.1	3.5	0.4	-5.1	-11.2	3.6	1.8	1.7	1.7	1.7	1.8	1.8	1.2	1.9	-2.6	1.9
Trade Weighted Dollar (Fed BOG, major)	76.9	76.4	77.5	82.5	89.3	90.0	92.1	92.3	92.4	92.4	93.1	93.0	75.9	78.4	90.9	92.7
Crude Oil Prices -WTI ($ per barrel)	99	103	98	73	48	58	50	52	55	57	59	60	98	93	52	58

*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	2,102							1,644			
Dow Jones Industrial Average	16,177	16,604	16,954	17,345	17,808	18,004							15,010			
Federal Funds Rate (effective)	0.07	0.09	0.09	0.10	0.11	0.12	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	0.02	0.05	0.24	0.53	0.78	1.03	1.28	0.06	0.03	0.08	0.91
Treasury-2 Year Notes (yield)	0.37	0.42	0.52	0.54	0.60	0.61	0.74	0.98	1.35	1.65	1.90	2.23	0.31	0.45	0.73	1.78
Treasury-5 Year Notes (yield)	1.60	1.66	1.70	1.60	1.46	1.53	1.68	1.90	2.34	2.54	2.79	2.92	1.17	1.63	1.64	2.65
Treasury-10 Year Notes (yield)	2.77	2.62	2.50	2.28	1.97	2.16	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	2.88	3.10	3.22	3.31	3.37	3.50	3.63	3.44	3.34	2.94	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	0.32	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	3.82	4.08	4.23	4.52	4.65	4.76	4.99	3.98	4.17	3.96	4.73
BAA Corporate (yield)	5.12	4.82	4.74	4.73	4.50	4.83	5.22	5.30	5.55	5.70	5.82	6.05	5.10	4.86	4.96	5.78

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