Outlook and Market Review – Second Quarter 2015

The U. S. economy grew at a modest 2.3% rate in the second quarter according to the preliminary report of the Bureau of Economic Analysis. First quarter growth was revised upward to 0.6% from the initial report of -0.2%. Consumer spending continues to lead growth even though personal disposable income only grew by 1.8% in the second quarter. The savings rate fell to 4.8% as consumer spending outpaced income. Key headline measures of the labor market have been good with the unemployment rate falling to 5.3% in July and monthly job gains averaging 246,000 over the past 12-month period. Job gains in July were more modest but respectable at 215,000. Less positive labor market news comes from a continued decline in the labor force participation rate, which is now only 62.6% in July. Labor compensation is not yet consistent with a tight labor market. Wages and salaries fell 0.2% in the second quarter following an anemic 0.7% increase in the first quarter. On a year-over-year basis, wages and salaries have increased a modest 2.1%. The Employment Cost Index, which includes wages and salaries as well as benefits, also had a 0.2% increase in the second quarter. As we approach seven years after the Great Recession, the economy still has a lot of ground to cover before reaching full employment. With soft compensation data in combination with a capacity utilization rate of only 78.4%, it appears that the U-3 unemployment rate will need to fall to the 4.8% to 5.0% range before bottlenecks and excess demand introduce unhealthy inflation.

Inflation rates remain very low and have failed to approach the Fed's 2.5% target for healthy inflation. The GDP deflator was 1.4% (annualized) in the second quarter and 1.6% in the first quarter. However, the All Items CPI index grew only 0.1% on a year-over-year basis ending in June. Over the same period the Core CPI, excluding energy and food, increased 1.8%. The Core CPI better reflects economic fundamentals and potential excess demand pressure. Falling oil prices have clearly been the driver of the miniscule All Items CPI rate of growth. Going forward, inflation may well be even lower as the price of exports decline with the devaluation of the yuan and labor market slack keeps the growth of compensation low.

Consumer confidence is holding up surprisingly well with a 3.1% increase in the University of Michigan Confidence Index from the end of June to end of July. On a 12-month period ending in July, the index posted a 13.85% increase. The Conference Board's Index of Leading Economic Indicators has also provided good monthly increases suggestive of continued economic improvement. Nevertheless, the optimism is not likely to carry through the year as recent stock market declines and worries of the yuan devaluation take hold. Investor wealth has been diminished in the most recent weeks and potential Fed policy moves to raise interest rates are looming in the coming months. The most promising news for consumers is the continued downward pressure on oil prices. Long term interest rates remain very low, helping the revival of the housing market and are expected to be low throughout the year even if the Fed bumps up short term rates.

Survey of Professional Forecasters – A More Pessimistic View Going Forward

The most recent survey of 44 forecasters by the Federal Reserve Bank of Philadelphia was posted on August 14, 2015. The consensus GDP growth rate estimate for the third quarter of 2015 is 2.7% followed by 2.8% in the fourth quarter. On an annual average basis, GDP is expected to grow only 2.3% in 2015. The GDP estimates are slightly lower than the consensus forecasts last quarter. The estimated 2015 growth rate is about equal to the average annual growth rate in the post-recession period. Looking out in the longer term, forecasters predict GDP growth rates of 2.8% for 2016 and 2.6% for 2017. Forecasters see the economy continuing on a growth trajectory below trend-line growth. Past consensus estimates for GDP over time have tended to be a bit too high, suggesting that growth rates may be lower than forecasted.

A surprising aspect of the survey is that while slow growth is expected, the forecasters offered very optimistic estimates of the unemployment rate. A realistic average of 5.3% is expected for 2015, but forecasts of 5.0% in 2016 and 4.8% in 2017 are at odds with such slow growth. In the most recent survey the consensus for the natural rate of full employment was 5.0%. This would mean that forecasters expect full employment in 2016, which seems a stretch given curent excess capacity and weak wage increases. Table 1 below provides a summary of key forecasts for GDP growth, unemployment rate, and payroll expansion for the next three quaraters.

Table 1. Summary of 2015 Forecasts for GDP Growth, Unemployment, and Payrolls

	Real GDP Growth (%)		Unemployment Rate (%)		Payrolls (000s monthly)	
Quarter	**Prior**	**Revised**	**Prior**	**Revised**	**Prior**	**Revised**
3rd Quarter 2015	3.1	**2.7**	5.3	5.3	223.3	**222.6**
4th Quarter 2015	2.9	**2.8**	5.2	**5.1**	223	**220.4**
1st Quarter 2016	2.4	**2.8**	5.1	5.1	177	**185**

Note: More pessimistic revisions are in red and more optimistic revisions are in green

Forecasters expect third quarter inflation to be higher than it has been over the last year but will remain well under the Fed's 2.5% target. Small differences between the expected headline and core inflation rate reflect the expectation that food and energy prices will change roughly in line with other prices in the economy. Given the current dynamics with commodity prices in general, and oil prices in particular, it is more likely that the headline inflation rates will be much lower than the core rates.Table 2 summarizes the consensus forecasts of inflation for the next three quarters.

Table 2. Summary of 2015 Forecasts for CPI and PCE Inflation Rates

	Headline CPI		Core CPI		Headline PCE		Core PCE	
	Prior	**Revised**	**Prior**	**Revised**	**Prior**	**Revised**	**Prior**	**Revised**
3rd Quarter	2.0	2.0	1.8	**1.9**	1.7	1.7	1.5	**1.6**
4th Quarter	1.9	**1.8**	1.9	1.9	1.7	**1.4**	1.6	1.6
1st Quarter	1.9	**2.2**	1.9	**2.0**	1.7	1.7	1.7	1.7

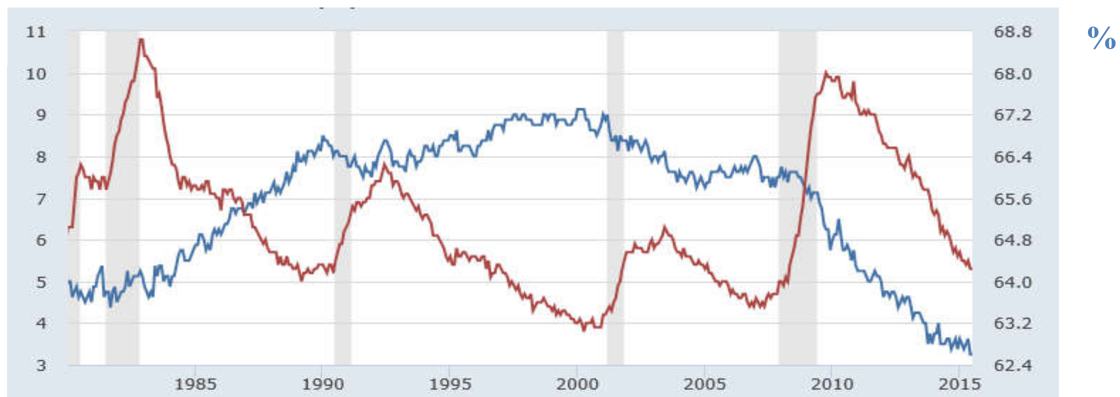
Note: More pessimistic revisions are in red and more optimistic revisions are in green.

Overall, the remainder of 2015 is expected to continue the pattern of slow growth and low inflation. Unemployment is expected to remain near the current rate of 5.3% with monthly payroll gains in the 200,000 to 230,000 range. If the forecasters have correctly pegged full employment in 2016, we would expect higher inflation rates next year. This seems to be an inconsistency in the forecasts given the ample slack in both the product and labor markets.

Slumping Labor Participation Rate – A Chronic Problem?

The labor participation rate is tracked by the Bureau of Labor Statistics and is defined as: "the percentage of the population (16 years and older) that is either employed or unemployed (that is, either working or actively seeking work)." Currently, the participation rate is 62.6% and has been trending downward for about 15 years. Figure 1 below shows the time trend of the labor force participaiton rate (right side scale) along with the U-3 unemployment rate (left side scale) since 1980. There is a bias in the data since the number of recorded unemployed workers is included in the numerator of the participation rate, resulting in an upward bias in the participation rate when the number of unemployed workers is high. The participation rate has plunged since 2010 even as the number of unemployed workers increased. Currently, there are about 8.3 million unemployed workers counted as part of the participating work force.

Figure 1.The U. S. Labor Participation Rate and the U-3 Unemployment Rate since 1980



Note:
Unemployment Rate (U-3) = Left Scale
Participation Rate = Right Scale

Source: Federal Bank of St. Louis (FRED)

The "employment ratio" is a revealing statistic that is not reported to the public but can easily be calculated. The employment ratio is defined as the ratio of employed workers to the labor force. There is a predictable relationship between the unemployment rate (U-3), labor participation rate (LPR), and the employment rate (ER) as follows:

U-3 = unemployed workers / labor force = 5.3% currently
LPR = (unemployed workers / labor force) + (employed workers / labor force) = 62.6% currently
ER = (employed workers / labor force) = 62.6% - 5.3% = 57.3% currently

Looking back at Figure 1 above, the gap between the participation rate and the unemployment rate represents what is happening to the employment ratio. For example, the participation rate was relatively stable from the mid -1980s until the late 1990s so when the unemployment rate declined it reflected a rising employment rate and healthier labor market. The more interesting pattern occurs after 2010 when both the labor force participation rate and the unemployment tend to decline in a parallel trend. Over this period the employment ratio rate has been relatively constant. The most important implication is that the real health of the labor market has not improved as much as the declining U-3 rate might indicate since 2010. The employment participation rate has remained in a narrow range. This type of analysis illustrates why the U-3 headline rate must be considered in conjunction with what is happening to the labor participation rate to really get a fix on the labor market. Of course the entire analysis of the labor market is clouded by the large amount of undocumented workers in the "real" labor force but not recorded as employed or unemployed in the labor statistics. This factor may also contribute to the sluggish wage growth even though the reported unemployment rate is falling.

The Bureau of Labor Statistics (BLS) projects a declining labor force participation rate with a rate of 60.4% in 2050. The BLS estimates of the labor force participation rate have been too low to date. For example, in the 2006 report, BLS projected the participation rate would decline to 64.5 percent in 2020. It is currently already 1.9 percentage points below that prediction. Three key reasons are normally given for the chronic decline in the labor force participation rate. First, aging baby boomers make the participation rate lower because a lower percentage of older people work, even though they are counted in the labor force. The baby boom generation is expected to survive as a group until about 2030, before the demographics are no longer driving the participation rate lower. Second, there is a decline in the participation rate for women since 1999. Finally, more young people are going to college rather than entering the labor market, even with record high tuition.

The first factor driving the participation rate lower, baby boomers, is a demographic dynamic that is difficult to amend. The last two factors are affected by choice. The participation rate falls if the labor market is not attractive enough to bring women into the market, especially with low wages and high child care expenses, or if entry jobs are no longer leading to middle-class careers as they once did in manufacturing. The labor force participation rate will continue to fall unless there is a return of middle-class jobs along with higher compensation. A healthy labor market should encourage entry into the workforce and policies to encourage work choices are likely to be part of any solution to the declining participation rate.

Fed Conundrum – Raise Short Term Rates in a Disinflationary Environment?

The general disinflationary trend in key inflation measures, slumping wage gains, declining equity market, and slower than expected GDP growth must be causing some pause with respect to the Fed's plan to raise rates this fall. If general conditions weren't bad enough, the recent devaluation of the yuan and its implications for U. S. exports and investor confidence add another layer of complications for Fed policy makers. Lower short term rates now will certainly flatten the yield

curve as the flight to quality has supported higher long term Treasury bonds and lower yields. Even the recent selling of U. S. Treasury bonds by China to invest in growth was easily offset by investors moving to Treasuries due to fears of slower global growth.

Commodity prices have tanked, led by falling oil prices. For most of the world the recent plan to end sanctions on Iran were more about the ample new supply of Iranian oil in the world market (especially for Europe) than on nuclear inspections. Even the core levels of inflation (CPI or PCE) that exclude energy and food prices are tame. The core PCE was only 1.29% for the 12-month period ending in June. Given analysts' revisions for lower growth and capacity utilization below 80%, the likelihood of meeting "healthy" inflation of 2.5% is very small. Normal monetary policy would not tighten short term liquidity in this environment.

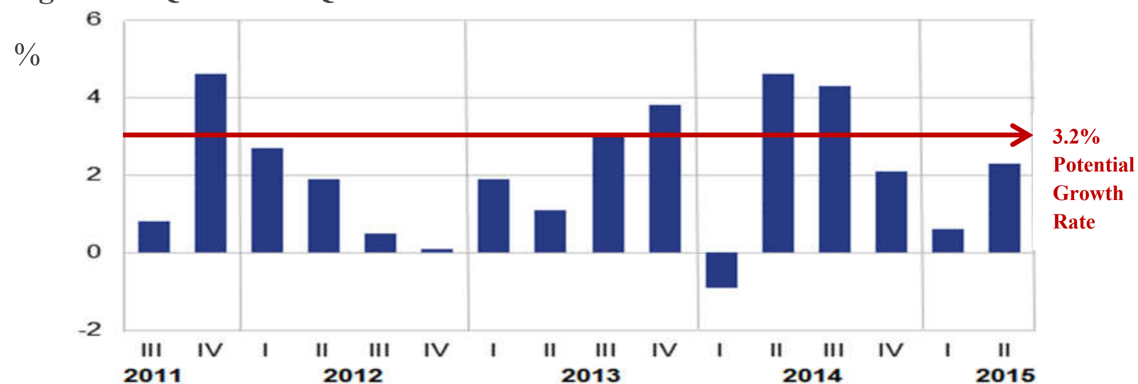
In a recent Bloomberg release, the probability of a Fed rate hike in September was 38%, down from the 48% probability in early August. There is "new thinking" taking place in the Fed that may lead to a rate hike without concern for current inflation, wages, and growth. St. Louis Fed President, James Bullard, is a vocal proponent of a rate hike and author of a new line of research suggesting that traditional thinking based on quantitative easing and forward guidance policies to a recovery may not hold. While the argument is technical, the essential new line of thinking is that the policy of driving rates to an "effectively zero" level and public promises to keep the rate around zero is counterproductive. This research points out that prolonged periods of zero nominal rates have not resulted in the intended higher consumption and efficient rates of inflation. Financial markets do not function properly when Fed policy artificially prevents adjustment of prices and output. The upshot of this argument is that the Fed should target nominal GDP, which is a much different perspective. As Bullard and others in the Fed begin to adopt this new line of thinking the targeting of Fed fund rates to artificial levels will become history and market determined rates will be the norm.

Summary of Recent Economic Data

***Gross Domestic Product** – The preliminary estimate of second quarter real GDP was 2.3% following the upward revision to 0.6% growth in the first quarter. Growth remains well below the long run average and the potential growth estimated to be 3.2%. Analysts are now revising third quarter GDP growth below earlier forecasts of about 3% for the remainder of the year. Consumer spending was a key driver of GDP in the second quarter.*

- Real GDP increased at an annual rate of 2.3% in the second quarter of 2015, according to the "advance" estimate by the Bureau of Economic Analysis. The first revision will be released on August 27, 2015. First quarter real GDP increased only 0.6% (revised upward from the initial estimate of negative .2%). Figure 2 below illustrates the quarterly growth of real GDP relative to a long run expected average of about 3.2%.

Figure 2. Quarter to Quarter Growth in Real GDP



Source: U.S. Bureau of Economic Analysis

- Real GDP in the second quarter reflected positive contributions from personal consumption expenditures, state and local government spending, exports, and residential fixed investment. Drags on GDP growth include federal government spending, private inventory investment, imports, and nonresidential fixed investment.

- Real personal consumption expenditures, the largest component of GDP, increased 2.9% in the second quarter following an increase of 1.8% in the first. Durable goods increased 7.3%, compared with an increase of 2.0%. Nondurable goods increased 3.6% following an increase of 0.7%. Services increased 2.1%, the same increase as in the first quarter.

- Real nonresidential fixed investment fell 0.6% in the second quarter, in contrast to an increase of 1.6% in the first. Investment in nonresidential structures fell 1.6%, compared with a decrease of 7.4%. Investment in equipment declined 4.1%, in contrast to an increase of 2.3%. Investment in intellectual property increased 5.5%, compared with an increase of

7.4% in the first quarter. Real residential fixed investment increased 6.6%, in the second quarter following an increase of 10.1% in the first quarter.

- Real exports of goods and services increased 5.3% in the second quarter, in contrast to a decrease of 6.0% in the first. Real imports of goods and services increased 3.5% in the first quarter, compared with an increase of 7.1% in the prior quarter.

- Real federal government consumption expenditures and gross investment fell 1.1% in the second quarter, in contrast to an increase of 1.1% in the first. National defense spending fell 1.5%, in contrast to an increase of 1.0%. Nondefense spending decreased 0.5%, in contrast to an increase of 1.2%. Real state and local government consumption expenditures and gross investment increased 2.0%, in contrast to a decrease of 0.8%.

- The change in real private inventories subtracted 0.08% from the second-quarter change in real GDP after adding 0.87% to the first-quarter change. Private businesses increased inventories $110.0 billion in the second quarter, following increases of $112.8 billion in the first quarter and $78.2 billion in the fourth. Real final sales of domestic product (GDP minus the change in private inventories) increased 2.4% in the second quarter, in contrast to a decrease of 0.2% in the first.

***Unemployment** – Recent jobs data have been good and the U-3 unemployment rate is stable at 5.3% with a U-6 rate of 10.4%. Nevertheless, lower unemployment rates have been aided by a very low labor participation rate. The number of unemployed remained at 8.3 million in July.*

- The Bureau of Labor Statistics reported that total nonfarm payroll employment increased by 215,000 in July, and the unemployment rate was unchanged at 5.3%. Over the prior 12 months the average monthly job gain was 246,000. In July, broad job gains occurred in retail trade, health care, professional and technical services, and financial activities. Many analysts believe the stronger-than-expected July labor market data will tip the scales in favor of the Fed announcing rate increases in September.

- The number of unemployed remained at 8.3 million in July. On a year-over-year basis, both the unemployment rate and number of unemployed declined by 0.9%.

- The number of long-term unemployed in July (those jobless for 27 weeks or more) had little change at 2.2 million, accounting for 26.9% of the unemployed. Over the past 12 months, the number of long-term unemployed is down by 986,000.

- Table 3 below shows a comparison of the U-3 and U-6 unemployment rates from July 2014 and July 2015 as well as the month by month rates in the second quarter of 2015. The U-6 remains approximately twice the U-3 rate.

Table 3. Headline U-3 and Broader U-6 Unemployment Rates

Unemployment Measure	July '14	April '15	May '15	June '15	July '15
U-3: Total unemployed, as a% of the civilian labor force (official unemployment rate)	6.2	5.4	5.5	5.3	5.3
U-6: Total unemployed, plus all persons marginally attached to the labor force, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all persons marginally attached to the labor force	12.2	10.8	10.8	10.5	10.4

Source: Bureau of Labor Statistics

- The civilian labor force participation rate was unchanged at 62.6% in July, after declining by 0.3% in June. The employment-population ratio, at 59.3%, was also unchanged in July and has shown little movement so far this year.

Consumer Income, Savings, and Wages *– The momentum of wage gains going into the first quarter came to a halt in the second quarter. The 0.2% rise in wages and salaries during the second quarter is the smallest increase since records began in 1982. Wages increased .7% during the first quarter and both economists and policy makers expected to see a steady increase as the economy picked up steam. Fed Chair, Janet Yellen, has repeatedly pointed to wages as the key to the Fed's timing of higher interest rates. While headline unemployment is only 5.3%, the labor market is still not tight enough to drive healthy wage growth.*

- Current-dollar personal income increased $145.0 billion in the second quarter following an increase of $118.9 billion in the first. The increase was largely due to higher personal interest income and farm proprietors' income. Slower growth rates in government social benefits and in personal dividend income created drags on personal income growth.

- Even though personal income recovered in the second quarter, real disposable personal income increased only 1.5% compared with an increase of 3.8% in the first quarter. The personal saving rate fell to 4.8% in the second quarter compared to 5.2% in the first.

- Personal income increased 0.4% in May and June. Real disposable income, adjusted for inflation, increased 0.2% in June, compared with an increase of 0.1% in May. Real personal

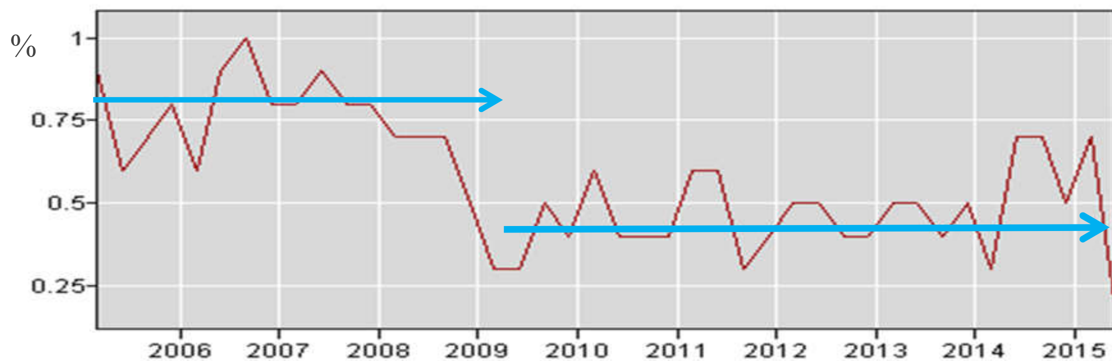
consumption expenditures fell less than 0.1% in June, in contrast to an increase of 0.4% in May.

- For the second quarter, seasonally adjusted total compensation costs for civilian workers increased only 0.2%. Wages and salaries, which is about 70% of compensation costs, also changed only 0.2% while benefits changed about 0.1%.

- Wages and salaries increased 2.1% for the current 12-month period. Benefit costs increased 1.8% for the 12-month period ending June 2015.

- The employment cost index is a quarterly economic series prepared by the Bureau of Labor Statistics detailing the changes in the costs of labor for businesses. The index is a comprehensive measure of labor compensation because it includes benefits as well as wages and salaries. Figure 3 below shows the decline in the employment cost index since the Great Recession with a dramatic decline in 2015. The data show that compensation continues to lag labor market improvements.

Figure 3. Quarterly Percentage Change in the Employment Cost Index



Source: Bureau of Labor Statistics

Inflation *– Inflation rates continue to be well below the Fed's target of 2.5% with no indication that price pressures will develop anytime soon. Both the All Items indexes and the Core indexes for the CPI and the PCE measures of inflation are trending downward. Of special interest is the Flat Core index, which is most sensitive to fundamental economic activity. When combined with the weak employment cost data, the low inflation data suggest that the fundamental economy has yet to come near full employment.*

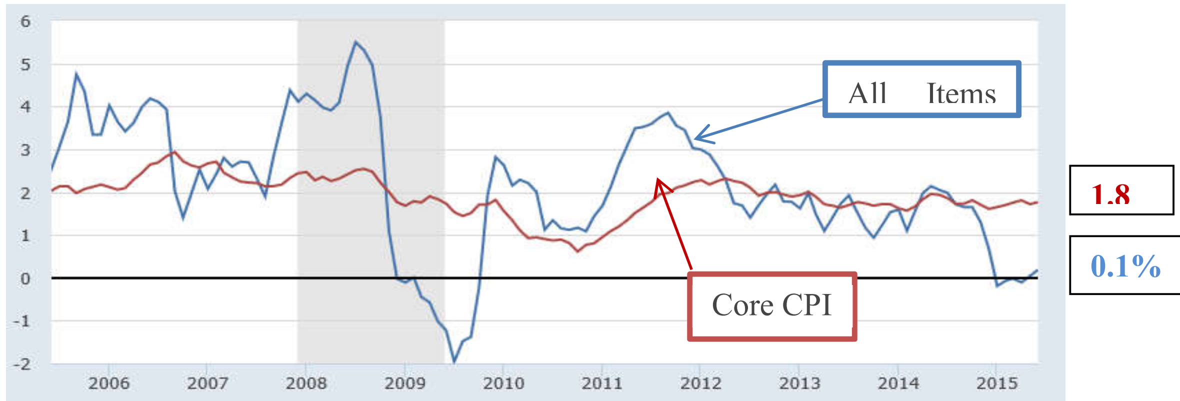
- The price index for gross domestic purchases, which measures prices paid by U.S. residents, increased 1.4% APR (annual percentage rate) in the second quarter, in contrast to a decrease of 1.6% APR in the first. Excluding food and energy prices, the price index

for gross domestic purchases increased 1.1% APR in the second quarter, compared with an increase of only 0.2% APR in the first quarter.

- The Consumer Price Index increased 0.3% in June on a seasonally adjusted basis. The core CPI, the index for all items less food and energy, rose 0.2% in June.

- Over the last 12 months, the All Items CPI Index rose only 0.1% APR before seasonal adjustment. However, the core CPI increased 1.8% APR over the past 12 months. Low energy and food costs have had a dramatic effect on the All Items Index. Figure 4 shows the ten-year history of the CPI for both the All Items and core measures using a monthly year-over-year percentage change.

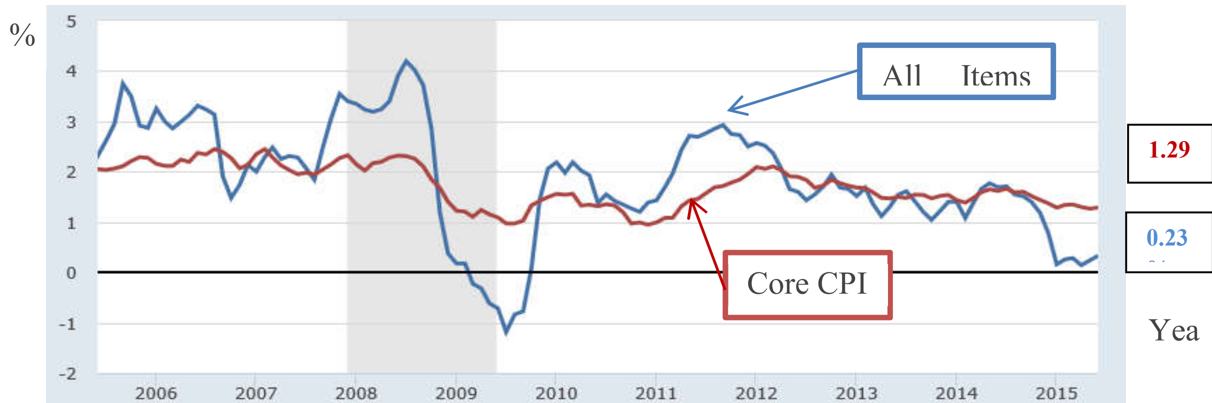
Figure 4. 12-Month Percentage Change in CPI for all Urban Consumers by Month



Source: Federal Reserve Bank of St. Louis

- The latest Headline (all items) PCE price Index year-over-year rate is 0.23% for June, down from a revised 0.31% the previous month. The Core PCE Index (less Food and Energy) for June was 1.29% APR, which is essentially unchanged from the previous month's 1.27% year over year rate. Figure 5 shows the same 12-month percentage change in the PCE that Figure 4 provided for the CPI measure.

Figure 5. 12-Month Percentage Change in PCE by Month



Source: Federal Reserve Bank of St. Louis

Sentiment and Confidence – *Consumer confidence indexes have been improving in 2015 but July numbers suggest a break in the trend of optimism. The Conference Board Confidence Index fell from 99.8 to 90.9 and the University of Michigan Sentiment Index fell 3.1% in July. The indexes have reacted to improved job markets in the first part of the year but sluggish wages and salaries, along with lower disposable income, will likely cool off confidence.*

- The Conference Board Consumer Confidence Index®, which had improved in June, declined in July. The Index now stands at 90.9 (1985=100), down from 99.8 in June. The Present Situation Index decreased moderately from 110.3 last month to 107.4 in July, while the Expectations Index declined sharply to 79.9 from 92.8 in June.

- The Conference Board Leading Economic Index® for the U.S. increased 0.6% in June following a 0.8% increase in May, and a 0.6% increase in April. Going into July the index suggested optimism for higher growth in the second half of the year. However, while the July reading is not yet available, recent data point to a decline in the index.

- Consumer confidence slipped in the July 2015 University of Michigan Consumer Confidence Survey. Table 4 provides recent index readings as well as the percentage change in the index on a month-over-month and year-over-year basis.

Table 4. University of Michigan Confidence Survey for June and July

Index Component	July 2015	June 2015	Month over Month % Change	Year over Year % Change
Consumer Sentiment	93.1	96.1	- 3.1%	+13.8%
Consumer Expectations	84.1	87.8	- 4.2%	+ 17.1%

Source: University of Michigan

- Figure 6 shows the long run history of the index back to 1978. The index has now reached pre-recession levels and has averaged 94.5 since December 2014, the highest eight-month average since 2004.

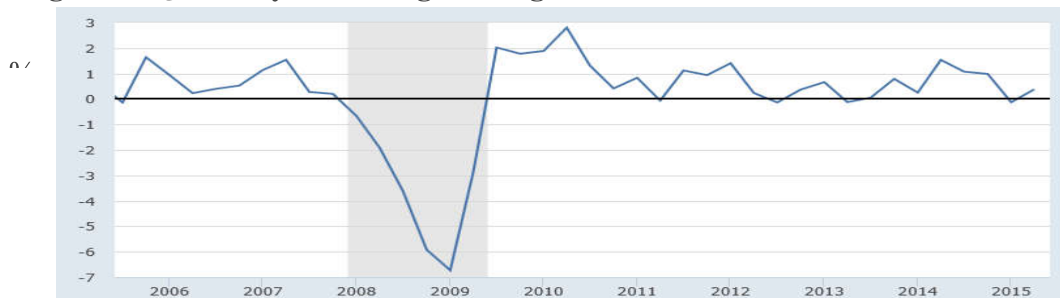
Figure 6. University of Michigan Consumer Confidence Index

Source: Federal Reserve Bank of St. Louis

Production and Manufacturing –*The Industrial Production Index fell 1.4% in the second quarter of 2015. On a year-over-year basis ending in June, industrial production increased 1.5%, below the overall GDP growth rate. Capacity utilization is only 78.4%, considered to be well below full employment.*

- The Industrial Production Index is an economic indicator published by the Federal Reserve Board that measures the real output of manufacturing, mining, and utilities. The index was 107.1 at the end of the second quarter. Industrial production increased 0.3% in June but fell at an annual rate of 1.4% for the second quarter of 2015. Total industrial production in June was 1.5% above its level one year ago. Figure 7 illustrates the quarter-to-quarter percentage change in the Industrial Production Index over the past 10 years.

Figure 7. Quarterly Percentage Change in the Industrial Production Index



Source: Federal Reserve Bank of St. Louis

- Manufacturing output was unchanged in June and increased at an annual rate of 1.4% in the second quarter of 2015.

- Capacity utilization for the industrial sector increased 0.2% in June to 78.4%, a rate that is 1.7% points below its long-run (1972–2014) average. Figure 8 shows the long run time series for the capacity utilization rate.

Figure 8. Total Industry Capacity Utilization (Percent of Capacity)

Source: Federal Reserve Bank of St. Louis

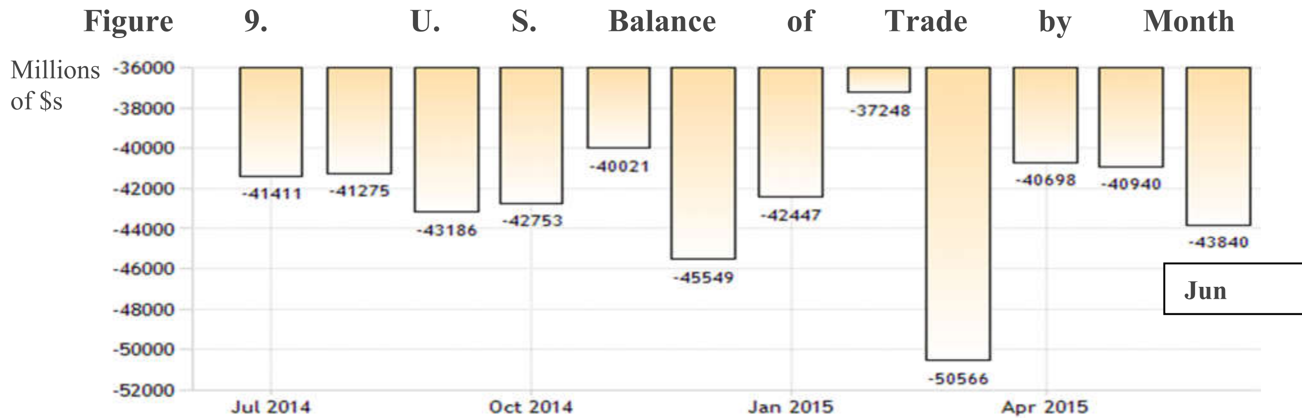
***Housing** – The housing market had strong performance in the first half of 2015 with rising home prices and growing housing starts. Part of the growth is linked to low mortgage rates and the expectation that rates will rise later in the year.*

- U. S. housing starts increased to 1.174 million in June from 1.069 million in May. The rate of increase was 9.8%. Housing starts averaged 1.446 million from 1959 to 2015.
- Building permits in June were at a seasonally adjusted annual rate of 1,343,000, a 7.4% increase above May. May building permits increased at the highest level since July of 2007. Single-family authorizations in June increased 0.9%.
- Home prices continued to climb in the second quarter amidst insufficient supply in most metro areas, according to the latest quarterly report by the National Association of Realtors. The median existing single-family home price increased in 93% of measured markets, with 163 out of 176 metropolitan statistical areas showing gains. In the first quarter price gains were recorded in 85% of metro areas.
- The national median existing single-family home price in the second quarter was $229,400, up 8.2% from the second quarter of 2014 ($212,000). The median price during the first quarter of this year increased 7.1% from a year earlier.

***U.S. Trade** – Overall, the trade deficit is a chronic drag on growth. The chronic deficit is linked to prolonged government spending deficits and higher investment than savings. The balance of trade deficit is offset by a U. S. capital account surplus (borrowing in excess of lending abroad).*

- The U. S. trade deficit was $43840 Million in June of 2015 and averaged -$12987.51 Million from 1950 until 2015. The all-time high of $1946 Million occurred in June of 1975 and the record low of -$67823 Million was recorded in August of 2006. Figure 9 illustrates the monthly trade balance for the U.S.

Figure 9. U. S. Balance of Trade by Month



Global Economy Highlights *- Market adjustments to the recent yuan devaluation have taken center stage with falling equity values, a flight to quality, and prospects for even lower inflation in the U.S. due to lower import prices.*

- Global GDP growth was sluggish in the first half of 2015. Growth in the world economy has become increasingly reliant on just three countries with China, the United States and India making up 80% of global growth. Emerging markets contributed less than 13% of global growth, the smallest proportion since late 2009.

- The yuan devaluation, which is the largest since the peg ended a decade ago, is having a ripple effect in financial markets. China's central bank cut the currency's reference rate by a record 1.9%, allowing depreciation to combat a slump in exports. The currency immediately fell 1.3% to 6.2920 yuan per dollar. The People's Bank of China announced that the currency move was a one-time adjustment to make the yuan more market oriented. A secondary motivation was to encourage global use of the yuan in hopes of making it an IMF reserve currency. The lower yuan and prospects of further moves by China to prop up growth have spooked investors who are now likely to move to safer investments. The lower yuan also hurts the expected earnings and stock prices of U.S. export-oriented firms. In addition to lower equity values the Chinese move is likely to drive up long term Treasury bonds (lower yields) and lead to deflationary pressures from lower U.S. import prices; none of which is good for the U.S. at this point.

- The official gauge of Chinese manufacturing fell to a five-month low, leading to another tailspin for the Chinese stock market. China's official manufacturing PMI (Purchase

Managers Index) fell to 50 for July, down slightly from the 50.2 reading in June. Analysts are beginning to see a "hard landing" scenario for China even though growth has only slowed to this point. Chinese GDP is predicted by the IMF to be 6.8% in 2015 with a 6.3% growth in 2016. By comparison, the growth rate averaged 9.8% since the Chinese markets opened in 1978.

- The IMF Commodity Price Index fell by 1.6% in June, which was the first decline in three months. The index decline was based on price drops in metals and energy, due to macroeconomic risks in Greece and China. Agricultural prices registered a slight increase, mainly due to weak supply. During the first six months of 2015 the Commodity Prices Index fell by 5.8%, with declines recorded in all main indices.

- Oil prices softened, largely due to the expected higher supply once sanctions are lifted in the controversial agreement with Iran. The Iranian Oil Minister, Bijan Namdar Zanganeh, said output could be increased by as much as 1 million barrels a day within a month of sanctions being lifted. The thirst for oil by most of the world leaders helps explain the support for a deal with Iran. Lower oil prices have increased pressure on the Canadian dollar, Mexican peso and Norwegian krone, all of which are sensitive to crude prices.

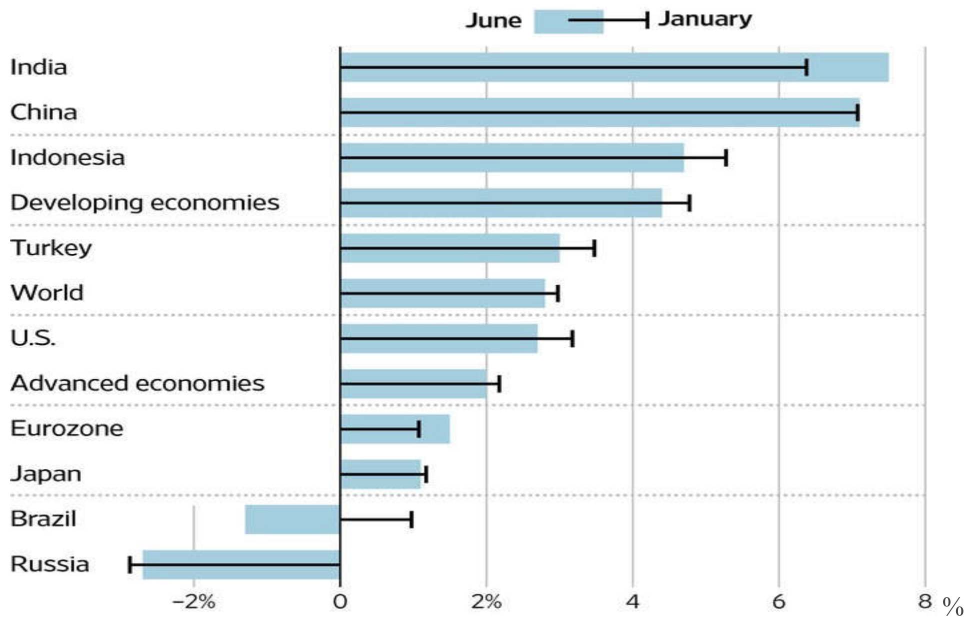
- The euro area's slow recovery has continued with a 1.1% year-on-year growth in the first quarter of 2015 compared with 0.9% in the previous quarter. The euro zone improvement is broadening as the major sources of weakness are concentrated in Greece, Finland, and the Baltic countries. Greece is getting closer to a new bailout, but financial and economic costs have already been significant. The terms of the bailout will add to the contraction.

- Analysts expect growth in Europe and Central Asia to weaken further to 1.8% in 2015. A 2.7% contraction is expected in Russia with a moderate recovery in 2016 as the economy adjusts to a lower oil prices.

- The U.K. economy has done well but growth is likely to cool. Factory production fell in June and the collective psyche has weakened. Japan's economy likely contracted in the second quarter but this should prove short-lived. Russia remains in recession. Similarly, Brazil's recession is intensifying while Mexico is growing below its potential.

- The table below provides the World Bank's revised estimates of growth for a number of countries as of June 2015 compared to January of 2015. The estimates in June are shown as the blue bar and January estimates are the black line. Brazil stands out as the most pessimistic revision.

Figure 10. World Bank Revision of Growth Estimates for Selected Countries



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Source: World Bank/Wall Street Journal