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# BEIGE BOOK: WINDOW ON MAIN STREET

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## KEY TAKEAWAYS

The Beige Book is consistent with our view that the Fed will raise rates later this month.

At +64, the November Beige Book 2016 reading is now back in the middle of the range it has been in since early 2012.

Despite the elevated level of uncertainty surrounding the U.S. presidential election and the outlook for the global economy, optimism on Main Street still reigns.

## BEIGE BOOK SUGGESTS CONTINUED MODEST ECONOMIC GROWTH

The latest edition of the Federal Reserve's (Fed) Beige Book was released Wednesday, November 30, 2016, and based on our analysis, continues to deliver a positive view of the U.S. economy. The Beige Book is a qualitative assessment of the U.S. economy and each of the 12 Fed districts individually. The report is prepared eight times per year, ahead of each of the eight Federal Open Market Committee (FOMC) meetings. The next FOMC meeting, the eighth and final meeting of the year, is December 13–14, 2016. We believe the Beige Book is best interpreted by measuring how the key words change over time. The qualitative inputs for the November 2016 Beige Book were collected from early October through November 18, 2016. Thus, they captured Main Street's reaction to:

- The unprecedented divisive rhetoric during the run-up to the November 8, 2016 U.S. presidential election...
- ...but also the rise in equity markets, consumer sentiment, and interest rates in the 10 days after the election.
- The better-than-expected economic data and rising odds of a Fed rate hike in December.
- The end to the nearly two-year earnings recession for S&P 500 companies as the Q3 2016 earnings season beat expectations.

## SENTIMENT SNAPSHOT

We created our proprietary Beige Book Barometer (BBB) [Figure 1], to evaluate the sentiment behind the entire Beige Book collage of data. The BBB is a diffusion index measuring the number of times the word "strong" or its variations appear in the Beige Book less the number of times the word "weak" or its variations appear. When the Beige Book Barometer is declining, it suggests that the economy is deteriorating. When the Beige Book Barometer is advancing, it suggests that the economy is improving.

In November 2016, the barometer rebounded to +64, after a +55 reading in September 2016 and a +41 reading in October 2016. At +64, the November 2016 reading is now back in the middle of the range it has been in since early 2012. You have to look back over a year (late 2015) to find a sustained reading over +64 on our Barometer. All of the improvement in the Beige Book versus October's came outside the three Fed districts in the nation's oil patch (Minneapolis, Dallas, and Kansas City), despite a pickup in oil production in the past few months.

## HOW THEY WORK

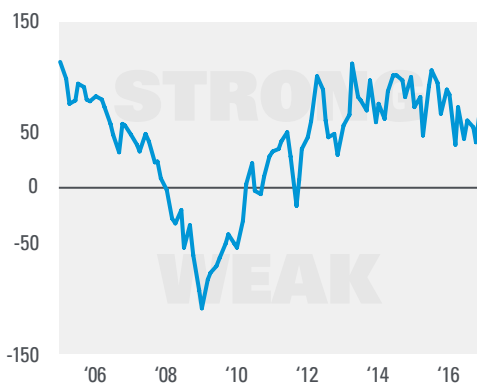
### BEIGE BOOK AND BEIGE BOOK BAROMETER

The **Beige Book** compiles qualitative observations made by community bankers and business owners about economic (labor market, prices, wages, housing, nonresidential construction, tourism, manufacturing) and banking (loan demand, loan quality, lending conditions) conditions in each of the 12 Fed districts (Boston, New York, Philadelphia, Kansas City, etc.). This local color that makes up each Beige Book is compiled by 1 of the 12 regional Fed districts on a rotating basis — the report is much more “Main Street” than “Wall Street” focused. It provides an excellent window into economic activity around the nation using plain, everyday language. The report is prepared eight times per year, ahead of each of the eight Federal Open Market Committee (FOMC) meetings. The next FOMC meeting is December 13–14, 2016.

The **Beige Book Barometer** is a diffusion index that measures the number of times the word “strong” or its variations appear in the Beige Book less the number of times the word “weak” or its variations appear. When the Beige Book Barometer is declining, it suggests that the economy is deteriorating. When the Beige Book Barometer is rising, it suggests that the economy is improving.

#### 1 BEIGE BOOK BAROMETER CONTINUES TO SUGGEST POSITIVE ECONOMIC GROWTH IN THE U.S.

- Number of Times “Strong” (and Variations of This Word) Is Mentioned Minus Number of Times “Weak” (and Variations) Is Mentioned



Source: LPL Research, Federal Reserve 11/30/16

Our Oil States Barometer (the barometer for the three Fed districts that include the top oil-producing states) moved from +9 in October to +8 in November, matching the +8 reading seen, on average, in the eight Beige Books ending in June 2016, which coincided with the worst of the declines in oil production and prices. The low readings on the Oil States Barometer in September (+7), October (+9), and November (+8) were even more disappointing given that the +21 reading in July put sentiment in these districts back to a level not seen since prior to the peak in oil prices in June 2014. The good news here is that barometer outside of the oil states (+56) has rebounded to levels not seen on a sustained basis since late 2015.

## WATCHING WAGES & INFLATION

Our long-held view is that the FOMC will raise rates by 0.25% at the conclusion of its meeting on December 13-14, 2016, and the fed funds futures market has fully priced in that outcome. Market participants are now looking ahead to 2017 and watching inflation and wages closely, as they gauge what the Fed may do. Each Beige Book provides an economy-wide assessment of wages and prices. The November 2016 Beige Book noted that “a tightening in labor market conditions was reported by seven Districts, with modest employment growth on balance. Districts noted slight upward pressure on overall prices.”

We monitor wage pressures via the data in [Figure 2](#), which show the recent trend in the number of wage/inflation words in the Beige Book. We counted the number of times the words “wage,” “skilled,” “shortage,” “widespread,” and “rising” appeared in recent editions of the Beige Book. In November 2016, these words appeared 114 times, similar to the 117 mentions in the October 2016 Beige Book and well above the 2016 low of 100 in January.

By comparison, in the first half of 2016, these “inflation words” appeared, on average, just 108 times per Beige Book. These words appeared, on average, 109 times per Beige Book in 2015. In

all of 2014—when deflation, not inflation, was a concern—those words appeared an average of just 98 times per Beige Book. So, after a brief drift back toward deflation worries in the January 2016 edition (100 mentions), the Beige Books released over the late summer and fall 2016 show a pickup in the number of inflation words. For reference, during 2011–13, also a period when heightened risk of deflation was evident, inflation words appeared 80 times per Beige Book on average.

## OPTIMISM STILL RULES

One final thought on the Beige Book. Despite the elevated level of uncertainty surrounding the U.S. presidential election and the outlook for the global economy, optimism still reigns on Main Street. In the November 2016 Beige Book, the word “optimism” (or its related words) appeared 14 times, whereas the word “pessimism” appeared just twice [Figure 3]. In the 16 Beige Books released since early 2015, optimism appeared, on average, 18 times per Beige Book, whereas the word “pessimism” has appeared a total of just 21 times,

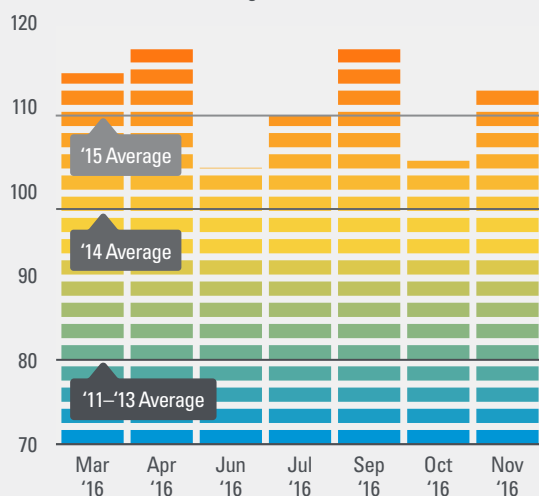
with over 70% (15 of 21) of those mentions coming in the Dallas and Kansas City districts and related to the outlook for the oil and gas sector.

As reassuring as it is to see that Main Street can remain optimistic despite the flow of bad news, the large number of optimistic comments in the Beige Book is not the start of a new trend: In the eight Beige Books released in 2014, the word “optimism” appeared, on average, 30 times. In 2013, “optimism” appeared, on average, 25 times per Beige Book. In the eight Beige Books released in 2009, during some of the worst of the financial crisis and Great Recession, the word “optimism” appeared, on average, just nine times.

Concerns that today’s economic and market environment is similar to the onset of the Great Recession and the stock market peak in late 2007 also appear to be misplaced. In the eight Beige Books released in 2007, the word “optimism” appeared, on average, just 10 times per edition—a far cry from the 30 times per edition in the eight Beige Books released in 2014, the 21 times in 2015, and 14 so far in 2016. ■

### 2 PRICE PRESSURES CONTINUE IN BEIGE BOOK INFLATION BAROMETER

- Number of Times Inflation Words Are Mentioned in Beige Books



Source: LPL Research, Federal Reserve 11/30/16

### 3 OPTIMISM REMAINS FOR MAIN STREET

	Mentions per Beige Book:	
	Optimism	Pessimism
Nov '16	14	2
Oct '16	14	1
Sep '16	15	1
July '16	10	2
June '16	17	2
Apr '16	14	1
Mar '16	14	4
'15	21	1
'14	30	0
'13	25	1
'09	9	5
'07	10	1

Source: LPL Research, Federal Reserve 11/30/16

For full years, averages of all 8 Beige Books from that year are shown.

## IMPORTANT DISCLOSURES

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The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

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