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BEIGE BOOK: WINDOW ON MAIN STREET

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KEY TAKEAWAYS

Signs of a tightening labor market and concerns about tariffs should be viewed within the context of Main Street's positive view of the overall economy.

Trade is a prominent concern for Main Street, as trade-related words have jumped significantly over the past four Beige Books.

While inflation-related words rose to a multiyear high, economic trends show inflationary pressures remain manageable.

BEIGE BOOK SUGGESTS CONTINUED MODERATE ECONOMIC GROWTH

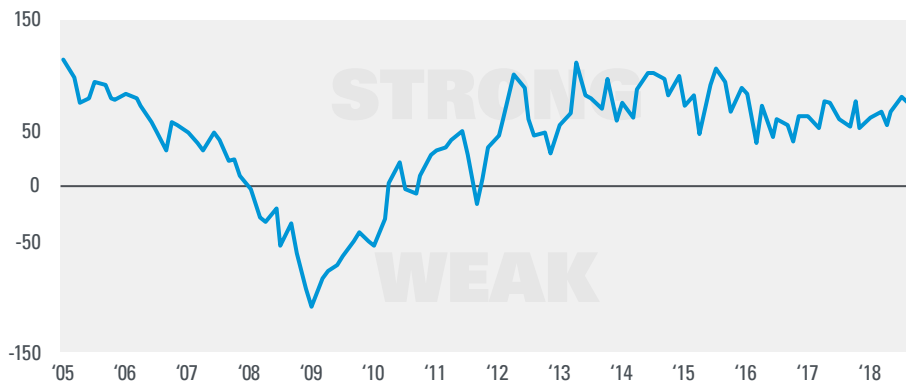
The latest edition of the Federal Reserve's (Fed) Beige Book, released last week, suggested continued steady economic growth. While signs of a tightening labor market and concerns about tariffs continue to appear, we believe they should be viewed within the context of Main Street's generally positive view of the overall economy. The Beige Book is a qualitative assessment of the domestic economy and each of the 12 Fed districts individually. The report is prepared eight times per year, ahead of each Federal Open Market Committee (FOMC) meeting—the next of which is scheduled for the end of this month. We believe the Beige Book is best interpreted by measuring how key words change over time. Details in the September 2018 Beige Book were collected in the weeks prior to August 31.

SENTIMENT SNAPSHOT

At LPL Research, we created our proprietary Beige Book Barometer (BBB) [Figure 1] to evaluate the sentiment behind the Beige Book collage of data. The BBB measures the difference between the number of times the word "strong" or its variants appear in the Beige Book and the number of times the word "weak" or its variants appear. When the BBB is declining, it suggests the economy is deteriorating; when it's advancing, it suggests the economy is improving.

1 BEIGE BOOK BAROMETER SUGGESTS MODERATE ECONOMIC GROWTH, SOLID LABOR MARKET

- Number of Times "Strong" (and Variants) Is Mentioned Minus Number of Times "Weak" (and Variants) Is Mentioned



Source: LPL Research, Federal Reserve 09/12/18

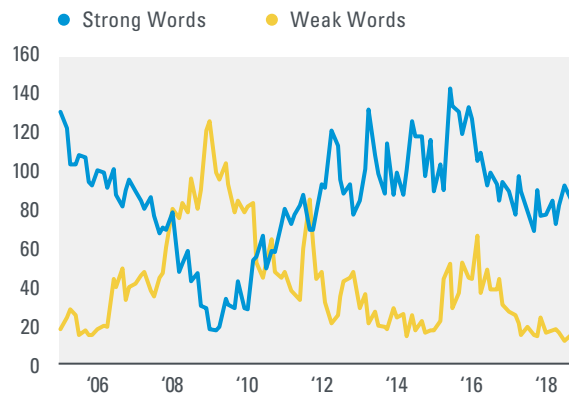
HOW THEY WORK

BEIGE BOOK AND BEIGE BOOK BAROMETER

The **Beige Book** compiles qualitative observations made by community bankers and business owners about economic (housing, labor market, manufacturing, nonresidential construction, prices, tourism, wages) and banking (lending conditions, loan demand, loan quality) conditions in each of the 12 Fed districts (Boston, Kansas City, New York, Philadelphia, 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 September 25–26.

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.

2 NUMBER OF WEAK WORDS AT LOWEST POINT OF EXPANSION



Source: LPL Research, Federal Reserve 09/12/18

The barometer’s reading was +71 in September, down from its July reading of +81 (which was the highest since January 2016), but above its 12-month rolling average of +67. The reading indicates continued steady growth for the U.S. economy as the number of strong words remains solid [Figure 2]. There were 86 strong words in the September Beige Book, compared with 93 in the July Beige Book (the most in 15 months). There were 15 weak words in the September Beige Book, compared with 12 in the July Beige Book. Weak words ticked up slightly, but they remain near expansion lows. Strong words also tend to signal a pickup from economic weakness. With fairly steady growth over the last year, the low level of weak words may be a more telling indicator of the overall economic environment.

TRADE TAKES CENTER STAGE

Trade uncertainty is a prominent theme on Main Street, according to the Beige Book. Trade-related words appeared 81 times in the September Beige Book, the highest number of mentions since we began tracking trade mentions at the beginning of 2017. In 2017, trade-related words appeared an average of just over 13 times in each Beige Book. Out of those words, “tariffs” appeared 42 times, while “trade” itself appeared 34 times. Trade concerns have steadily ramped up this year following the imposition of tariffs on \$50 billion of Chinese goods and threatened tariffs on an additional \$467 billion, as well as ongoing NAFTA renegotiations. Tariff impacts continued to weigh on manufacturing, primarily through higher material costs. Several districts pointed out increasing input prices, but some firms noted they intend to pass along these costs.

In Philadelphia, the Beige Book observes:

Nearly two-thirds of the firms that offered general comments noted that price hikes and/or supply disruptions had already occurred or were anticipated because of tariffs and the threat of tariffs.

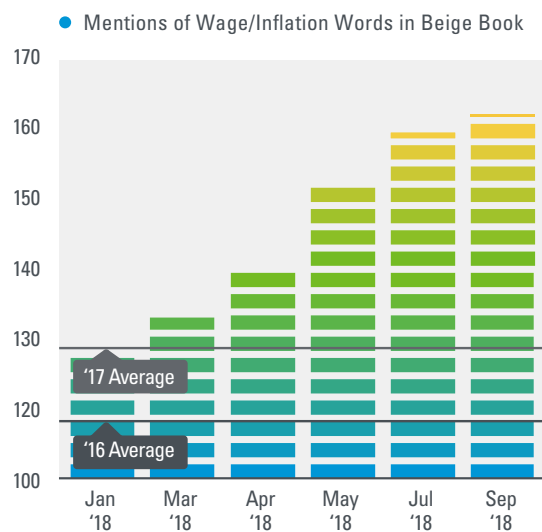
For those firms already impacted, contacts often cited double-digit price increases; some typical responses were that tariffs “have put us out of business” on certain products and “are a cloud on every facet of our business planning.”

Trade anxiety has also spread to other facets of Main Street. Multiple districts noted that the uncertainty has prompted some U.S. businesses to scale back or postpone capital investment. Retailers in multiple districts also noted higher input costs, indicating the impact of tariffs is spreading throughout the supply chain. Farmers in several districts highlighted lower commodities prices and bleaker outlooks for the agricultural industry because of trade uncertainty. While we expect the overall impact of trade on growth to be limited, segments of the economy are clearly seeing effects, both from policies in place and the increased uncertainty that makes it more difficult for some businesses to plan.

WATCHING WAGES & INFLATION

Market participants continue to monitor inflation data closely, as the Fed considers pricing and wage pressures when determining the future path of interest rates. Wage growth has been closely

3 WAGE PRESSURES GROWING, BUT INFLATION REMAINS MANAGEABLE



scrutinized lately after a report earlier this month showed average hourly earnings grew in August at their fastest pace of the cycle. The Beige Book provides valuable context on inflationary pressures, as each version provides an economy-wide assessment of wages and prices.

On wages, the Beige Book observes:

Wage growth was mostly characterized as modest or moderate, though a number of Districts cited steep wage hikes for construction workers. Some Districts indicated that businesses were increasingly using benefits—such as vacation time, flexible schedules, and bonuses—to attract and retain workers, as well as putting more resources into training.

Although the impact on inflation overall has been limited to date:

Prices of final goods and services continued to rise at a modest to moderate pace in most Districts, though there were some signs of a deceleration. All Districts noted fairly widespread input price pressures, particularly for construction materials and freight transportation. Tariffs were reported to be contributing to rising input costs, mainly for manufacturers. Businesses' input costs have generally been rising more rapidly than selling prices, though there have been increased efforts to pass along cost hikes to customers. A few Districts noted some increase in inflation expectations.

We monitor wage and price pressures via our Inflation Barometer, which is a simple count of the number of times wage/inflation words (“wage,” “skilled,” “shortage,” “widespread,” and “rising”) appear in the Beige Book. Consistent with the moderate price growth noted in the Beige Book’s overview, words related to inflation rose to 161 in September, the highest level since we began tracking in 2015 and above the 2018 average of 142 mentions [Figure 3]. Modestly accelerating

wages are healthy for the economy: Higher incomes empower the U.S. consumer and fuel faster growth in consumer spending, which accounts for about 70% of gross domestic product (GDP). However, rapidly increasing inflation could force the Fed to take a more aggressive stance on monetary policy, which could weigh on growth. While wage pressure is increasing, the Beige Book and recent economic data show that inflationary pressures remain manageable, and they are nowhere near the levels that preceded previous recessions.

CONCLUSION

The Beige Book Barometer continues to point toward moderate economic gains, in line with our estimate for GDP growth of near 3% in 2018.* Main Street's growing uneasiness over trade tensions remains a concern, but the overall impact on growth has been limited so far. Inflationary pressures are also rising modestly, but we don't see the current pace of inflation as enough to threaten economic output or speed up the pace of the Fed's interest-rate increases. Overall, Beige Book sentiment remains positive, and reflects continued optimism on Main Street. ■

*LPL Research projects real gross domestic product (GDP) growth of up to 3% in 2018, as stated in our *Midyear Outlook*. This is in line with historical mid-cycle growth of the last 50 years. Economic growth is affected by changes to inputs such as business and consumer spending, housing, net exports, capital investments, and government spending.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

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Investing involves risk including loss of principal.

DEFINITIONS

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments, and exports less imports that occur within a defined territory.

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