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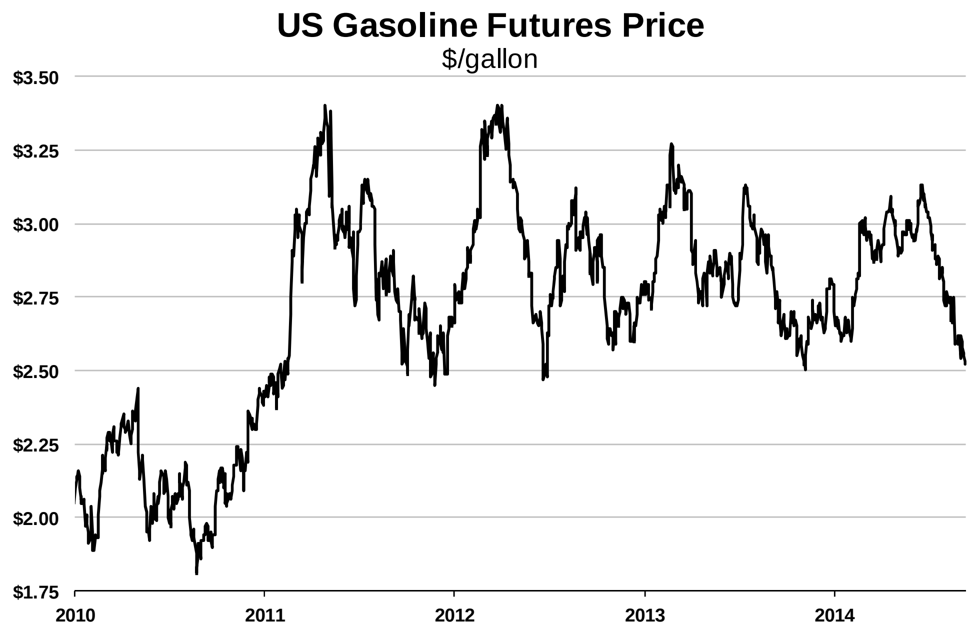
We think the Fed will hike rates judiciously without jeopardizing growth and enough to keep inflation in check. We think falling commodity prices and low inflation expectations will give the Fed some breathing room for tightening monetary policy as the economy continues to gradually improve.

We expect stocks to continue rising, albeit slower pace than the 20%-pace experienced over the last year.

Keeping The Fed At Bay

US economic data has been generally improving in recent weeks. August retail sales showed growth accelerating to 5% year over year from 4.2% in July. Excluding gasoline, retail sales were even stronger at 5.5%, and falling gas prices (see chart) should continue to help buoy consumer spending in the third quarter. According to ISI Group: "Since Labor Day, gasoline futures have plunged 28 cents to $2.50, putting retail prices on track to decline to $3.20 over the next six weeks (add 70 cents to futures). A 28 cent decline in gasoline prices saves the consumer about $30 billion, which if it occurred in one quarter, would be a $120 billion annualized rate. Assuming this was spent, it would lift consumer spending by roughly 1%, or a 4% quarter-to-quarter annualized rate. Gasoline prices may not stay down, but if they do, they would provide a nice lift for holiday sales."



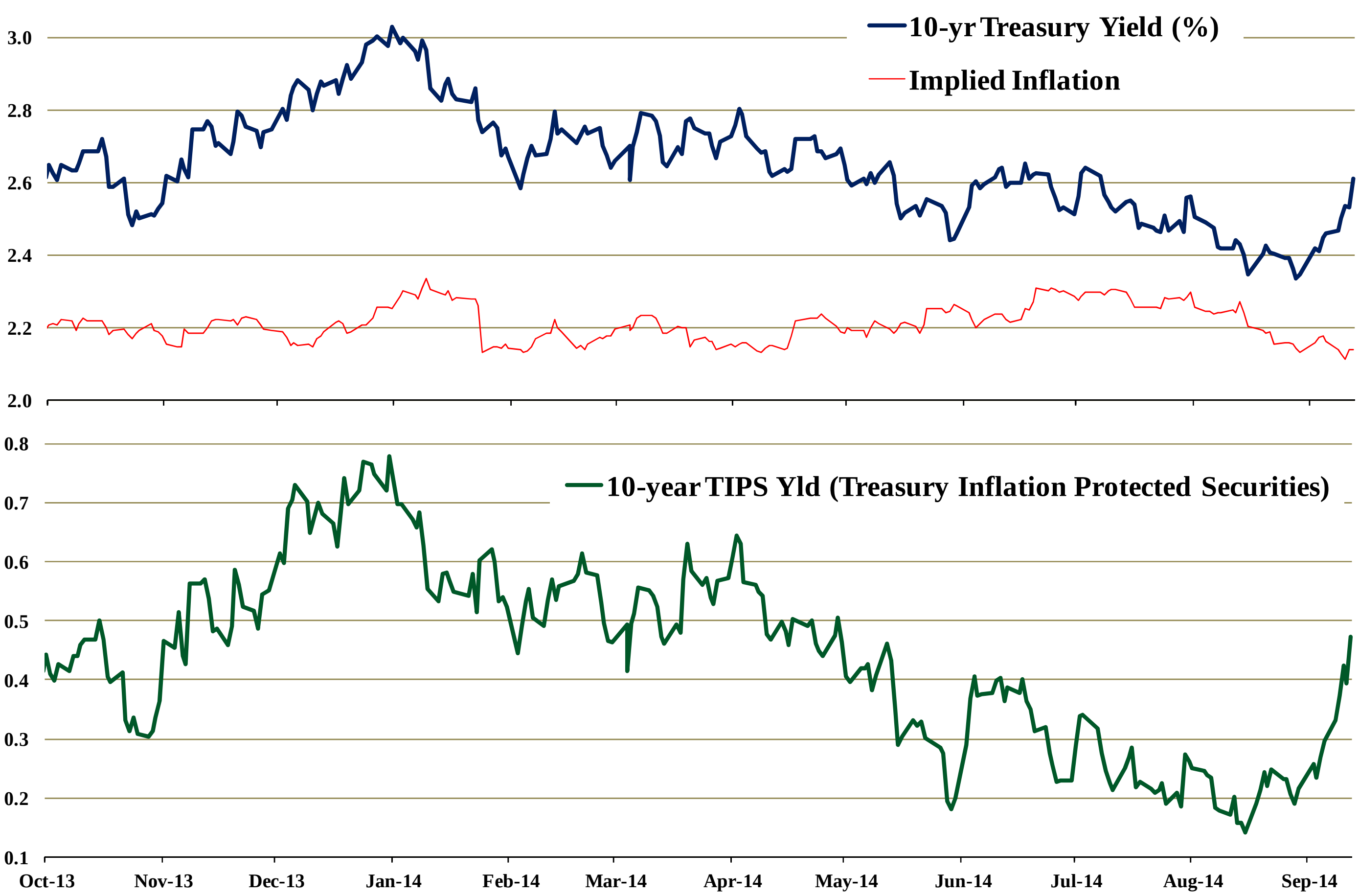
Source: RiverFront Investment Group; FactSet Research Systems

Rising household incomes also support growth. Although August employment gains were less than expected – 142,000 jobs added versus a year-to-date average of 200,000 – aggregate payrolls (hours worked multiplied by hourly earnings) continued making new highs and are up 4.3% year over year. Purchasing manager indexes for both manufacturing and services also rose in August, strongly suggesting accelerating expansion of business activity.

Improving economic growth is raising concerns that Federal Reserve accommodation will soon end. Quantitative easing is scheduled to conclude next month, and markets are anticipating rate hikes by the middle of next year. In our view, the key for stocks is whether any tightening of monetary policy stops a self-sustaining economic expansion prematurely. We think the Fed will hike rates judiciously without jeopardizing growth and enough to keep inflation in check. In this environment we expect stocks to continue rising, albeit slower than the 20%-plus pace experienced over the last year.

Even with a strengthening economic environment, we don't see any inflation trouble ahead. This is partly because of falling energy prices, which makes up about 10% of the consumer price index. Other major global commodities, such as iron ore, corn, and rubber, have had big price declines and continue to trend lower. We also credit US dollar strength in recent weeks for putting the lid on commodity prices in general. A stronger dollar also helps lower import costs, which is another way to keep inflation under control. Thus, one of the beneficial side effects of stronger economic growth and rising expectations of monetary tightening is to boost the currency (and its purchasing power) while actually lowering inflation expectations.

THE WEEKLY CHART: BONDS SIGNAL GROWTH WITH LOW INFLATION



Source: RiverFront Investment Group

Improving economic growth without accelerating inflation is being reflected in the US bond market. Nominal 10-year Treasury yields (bold blue line in the top panel in the chart above) are up 0.28 percentage points from their late-August lows, driven by an increase in real yields (10-year TIPS yield, green line bottom panel), which are up 0.33 percentage points from mid-August. Typically, rising real (inflation-adjusted) yields reflect higher borrowing costs, consistent with a growing economy. Inflation expectations – measured by the difference between nominal and real yields – at 2.14% have been trending lower since June and are near the bottom of their one-year range (thin red line, top panel). We think falling commodity prices and low inflation expectations will give the Federal Reserve some breathing room for tightening monetary policy as the economy continues to gradually improve. Hence, we do not expect any indication from the Fed's meeting this week that it will begin raising interest rates sooner than the middle of 2015.