ECONOMIC UPDATE AND FORECAST SUMMARY
October 2014

Quick Looks

- Ebola fears exacerbated concerns of a global slowdown causing world stock markets to drop and interest rates to fall
- Nevertheless, the U.S. economy is performing well, with rising consumer spending supported by strong job numbers and declining gasoline prices
- Non-Residential investment rebounded from a drop earlier in the year, but the residential-housing side of the market has lost steam of late
- We expect growth in excess of 3 percent over the next 12 months, and think that by mid-2015, the Fed will begin the process of raising interest rates. However, if growth falters, the Fed will be in no hurry to raise rates

Recent economic data have been relatively strong. Real GDP rebounded to at a 4.6 percent growth rate in the second quarter, industrial production is up 4.3 percent over the past year, and the economy added over 2 million jobs in the first nine months of 2014. Still, despite these and other positives, there is a lingering sense that the economy has not turned the corner from modest recovery to stronger expansion. To some extent, this may reflect non-economic concerns (Russia, ISIS, Ebola) that are weighing on people's minds. In addition, there is the ongoing trend of wages growing no faster than inflation which does much to explain why many workers feel the recovery has mostly passed them by. In this report, we focus on another source of economic weakness – the housing market. Though housing has certainly recovered from the depths of the recession, activity remains below not only the inflated levels of the boom years, but also below the normal levels that existed in the 1980s and 1990s. Given the fundamental role that housing plays in the lives of Americans, we think the struggles in this sector are having a wider impact on the overall economy.

The mixed labor news – employment up, wages flat, participation down – creates potential problems for the Federal Reserve which has tied its exit from its zero interest rate policy to conditions in the job market. Our feeling is that the Fed is in no hurry to raise interest rates and keep with our earlier projection of mid-2015 as the likely time for the first hike in the fed funds rate. That projection is based on the view that by then, the reduction in unemployment will finally reach the point at which the job market is tight enough to produce stronger gains in wages.

Inflation has been somewhat lower than we expected which is one reason why 10-year Treasury yields continue to be below our forecasted levels. The Ebola scare has further pushed down rates as investors flock to the safety of Treasuries. A third factor is the drop in rates on long-term bonds from other countries. The yield on 10-year German bonds recently fell below 1.0 percent which makes even a 2.5 percent yield on the corresponding U.S. bond an attractive option. Nonetheless, we expect short-term rates to rise as we get closer to the date of the first Fed rate hike. We project that the 10-year Treasury yield will rise above 3.00 percent by the middle of 2015.

We are encouraged by the gradual pick-up in consumer spending, which was up 2.6 percent in real terms in August versus a year earlier. Lower gasoline prices will put more dollars in consumers' pockets and offset slow growth in wages. Non-residential business investment rebounded strongly from a first quarter drop. The rise in the value of the dollar, though good for consumers, has been working against exporters and will likely be a slight drag on GDP growth going forward. Nevertheless, we see greater than 3.0 percent growth for the remainder of 2014 and the first-half of 2015. We expect unemployment to decline slowly but will focus more on two other labor statistics – wage growth and the number of involuntary prt-time workers. Both of these will need to improve for the economy to produce consistent growth of four percent.

Compared to the consensus forecast from the Wall Street Journal's survey of economists, we expect somewhat stronger growth and a bit more inflation over the next 6 to 12 months. However, we also foresee a smaller near-term increase in the fed funds rate as we believe Janet Yellen is not inclined to aggressively raise rates even if the economy improves as we project. One other point worth emphasizing: we expect two-year Treasury yields to continue their upward climb in advance of any increases in the fed funds rate.

Economic Forecasts: RCF and Consensus
Actual Economic Data as of October 6, 2014

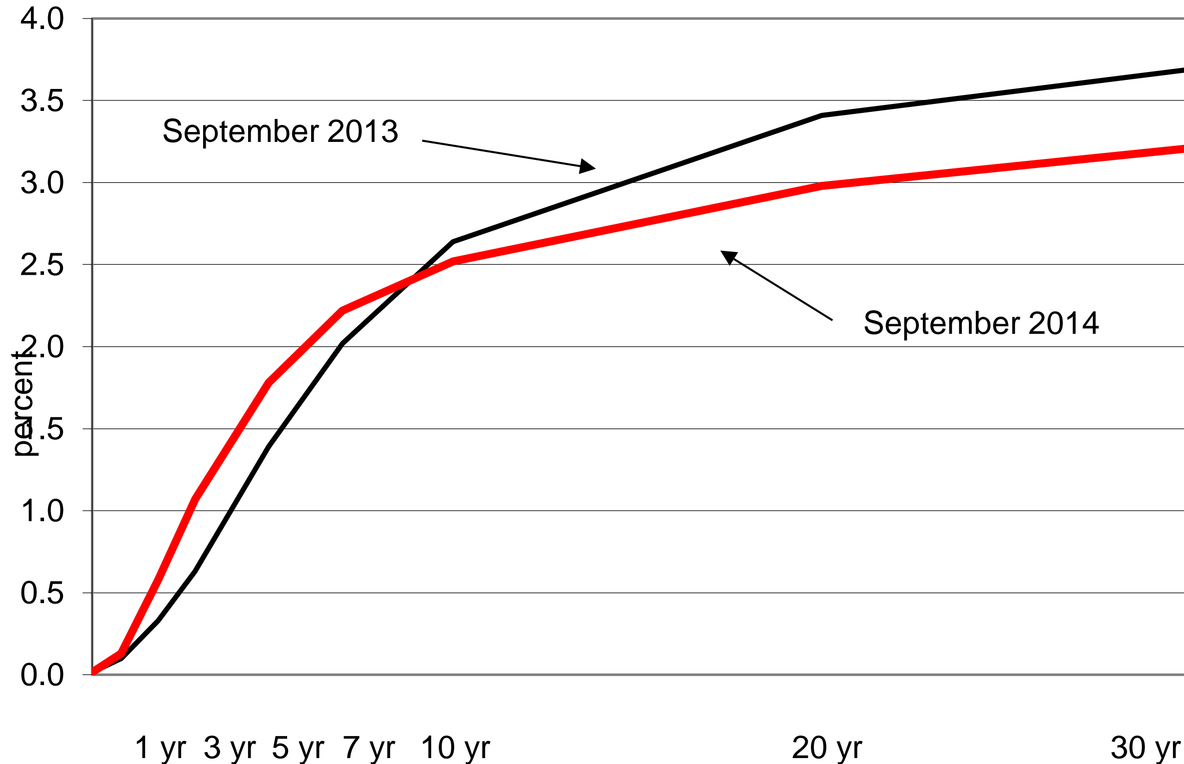
		What We Said	What We Saw	What We See	
		2014 2nd Half	2014 3rd Quarter	2014 2nd Half	2015 1st Half
Real GDP	**RCF**	**+3.4%**	+3.2% (estimate)	**+3.4%**	**+3.2%**
	Consensus	*+3.0%*		*+3.1%*	*+2.8%*
Inflation	**RCF**	**2.3%**	1.7%	**2.0%**	**2.0%**
	Consensus	*2.1%*		*1.9%*	*1.7.0%*
Core Inflation#	**RCF**	**2.1%**	1.7%	**2.0%**	**1.9%**
	Consensus	*1.9%*		*2.1%*	*2.1%*
Unemployment	**RCF**	**5.9%**	5.9%	**5.8%**	**5.5%**
	Consensus	*6.3%*		*5.8%*	*5.6%*
Fed Funds Rate	**RCF**	**0.125%**	0.125%	**0.125%**	**0.25%**
	Consensus	*0.125%*		*0.125%*	*0.375%*
2-year Treasury Rate	**RCF**	**0.60%**	0.58%	**0.75%**	**1.10%**
	Consensus	*n.a.*		*n.a.*	*n.a.*
10-year Treasury Rate	**RCF**	**3.00%**	2.52%	**2.55%**	**3.10%**
	Consensus	*3.16%*		*2.75%*	*3.16%*

RCF: RCF Economic & Financial Consulting, Inc. Consensus (except for core inflation): Wall Street Journal October Survey of Economists. # Core Inflation (excludes food and energy prices); consensus forecast is from the Philadelphia Federal Reserve's 2014Q3 Survey of Professional Forecasters

I. Interest Rate Overview

Chart 1 compares the Treasury yield curve in September 2014 to September 2013. An interesting feature shown in Chart 1 is that the two curves cross, with long-term rates lower now than a year ago while short-term rates are higher.

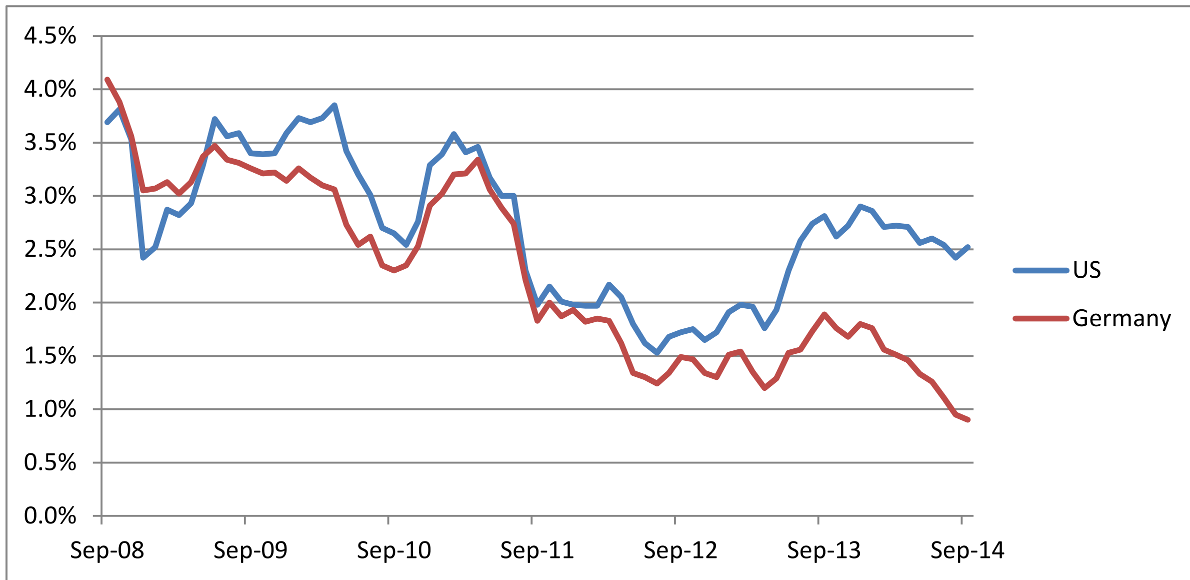
Chart 1: Treasury Yield Curve, September 2014 vs. September 2013



Source: Federal Reserve

Another factor affecting long-term yields in the U.S. is the sharply lower interest rates in other industrialized countries, most notably Germany. Chart 2 compares the yields on 10-year U.S. and German bonds since the financial collapse in 2008. For the most part, yields on the two countries' bonds have moved together, but recently the gap between the two has increased to more than 150 basis points, the greatest difference since the fall of the Berlin Wall. To a large extent, this gap reflects differences in growth prospects between the two countries, with the U.S. economy advancing far more rapidly than Germany. But fundamental factors aside, the bottom line is that while 2.50 percent yields on U.S. bonds are low by historical standards, they are a considerably more attractive investment than alternatives with a similar risk profile elsewhere in the world. In short, declining rates in Germany (and elsewhere) are acting to keep U.S. rates lower as well.

Chart 2: Yields on U.S. and German 10-Year Government Securities



Source: Federal Reserve, OECD

Since the end of September, 10-year yields fell (temporarily) below 2.00 percent as investors flocked to the safety of U.S. Treasuries as global stock markets dropped. Given this situation, and the relationship shown in Chart 2, we have lowered our year-end projection for the yield on 10-year U.S. Treasuries to 2.55 percent. However, we still expect the Fed to raise rates in mid-2015. We believe short-term yields will continue to move up in anticipation of these increases in the funds rate, with the 2-year Treasury yield ending the year at 0.75 percent, which would be its highest level since early 2011.

We project that 10-year Treasury yields will rise above 3.00 percent by mid-2015, 75 basis points higher than the current rate. The impact on Treasury rates from the additional increases in the fed funds rate expected over the next two years will be addressed in our discussion on monetary policy, later in this report.

II. Inside GDP

The economy grew at an upwardly revised 4.6 percent rate in the second quarter of 2014, a solid rebound from the first quarter decline. Third quarter data are not yet available, but we expect the economy to grow at a 3.4 percent rate in the second half of this year, driven by steady increases in consumer spending and stronger growth in business investment.

Our GDP projection might seem optimistic given that GDP growth has averaged only 2.6 percent over the past four quarters. However, if one excludes the 2014Q1 decline, the economy has grown at a much stronger pace. Chart 3 compares the average change in GDP and its components with and without the first quarter of 2014. Excluding this one quarter, GDP growth averaged a robust 4.2 percent. Consumer spending has increased a solid 2.7 percent, business investment is up 7.5 percent, and exports have grown faster than imports. We expect consumer spending and business investment to continue along this path. The recent strength in the dollar – and economic weakness in Europe – will work against growth in exports which is why the economy will not be able to repeat its strong performance from the second quarter of this year. However, the decline in gasoline prices could free up as much as $5 billion each month for households, which could boost consumer spending by 0.5 percent on an annual basis.

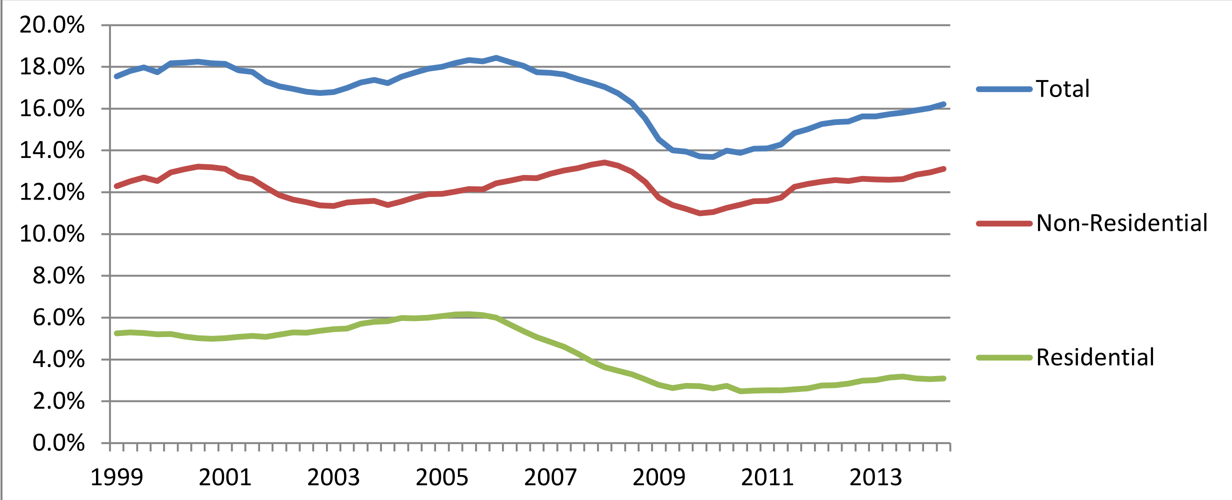
Chart 3: Annualized Percent Change in GDP and its Components: 2013Q3 – 2014Q2

	2013Q3	2013Q4	2014Q1	2014Q2	AVG	AVG w/o 2014Q1
Real GDP	4.5	3.5	-2.1	4.6	2.6	4.2
Consumer Spending	2.0	3.7	1.2	2.5	2.4	2.7
Business Investment	6.6	6.3	0.2	9.5	5.7	7.5
Exports	5.1	10.0	-9.2	11.1	4.3	8.7
Imports	0.6	1.3	2.2	11.3	3.9	4.4
Government Purchases	0.2	-3.8	-0.8	1.7	-0.7	-0.6

Source: U.S. Department of Commerce

The solid numbers for business investment shown in Chart 3 run contrary to the narrative that businesses are just not spending, preferring to hoard their money or use it to pay shareholder dividends or fund share buy-backs. As Chart 4 shows, total business investment spending as a share of GDP is still below its pre-recession level. However, Chart 4 also shows that this spending shortfall is entirely due to weakness in the housing market. Non-Residential investment spending has fully recovered but residential investment spending remains well below not only the inflated level of the boom years, but below the 5 percent share of GDP that it commanded 15 years ago.

Chart 4: Total, Non-Residential, and Residential Business Investment Spending as shares of GDP



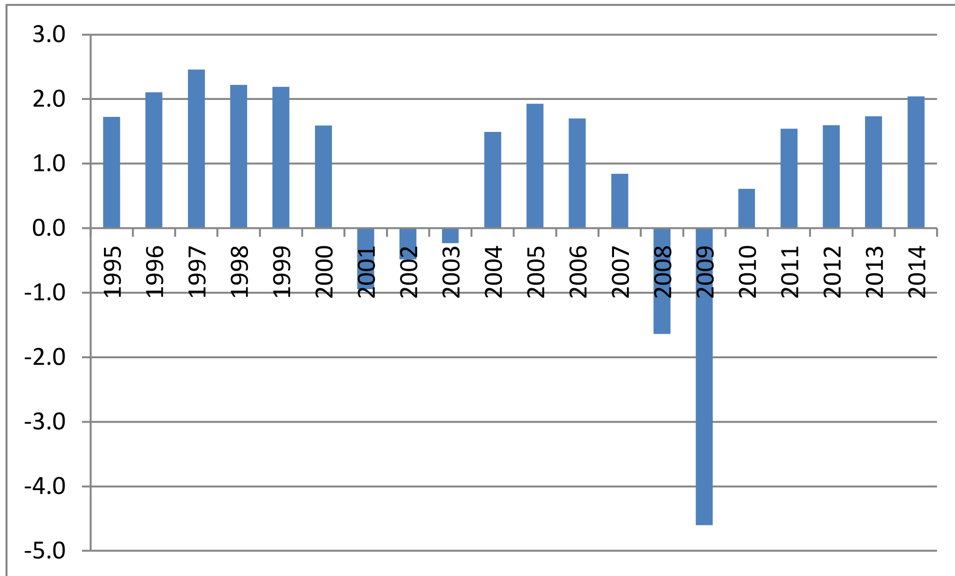
Source: U.S. Department of Commerce

We think the slow recovery of the housing sector is a major reason why the economy is not feeling as strong as other measures suggest. Consider housing starts – they fell from over 2 million in 2005 to a low of 500,000 in 2009. Starts have recovered to about 1.0 million in 2014 but are still well below the 1.5 million that the economy enjoyed in the 1980s and 1990s. Housing is an integral part of the U.S. economy, a source of good paying jobs and a highly tangible sign of economic activity. Home building and home buying also stimulate other sectors of the economy. A rough estimate is that the incomplete recovery in the housing market has reduced GDP growth by between 0.5 and 1.0 percent per year since the end of the Great Recession, essentially the difference between the slow recovery we have seen and a more normal rebound. In that regard, the recent strength in the economy absent much boost from housing is a positive sign.

III. The Jobs Picture

The job market continues to add an average of more than 200,000 jobs per month but still does not get much respect. Through the first nine months of 2014, there was a net gain of two million jobs, the most during this time period since 1999. For the year, we expect a 2.7 million increase in employment, not far below the 3.0 million mark that economists generally describe as an "employment boom."

Chart 5: Net Change in Jobs First 9 Months of Year, in millions



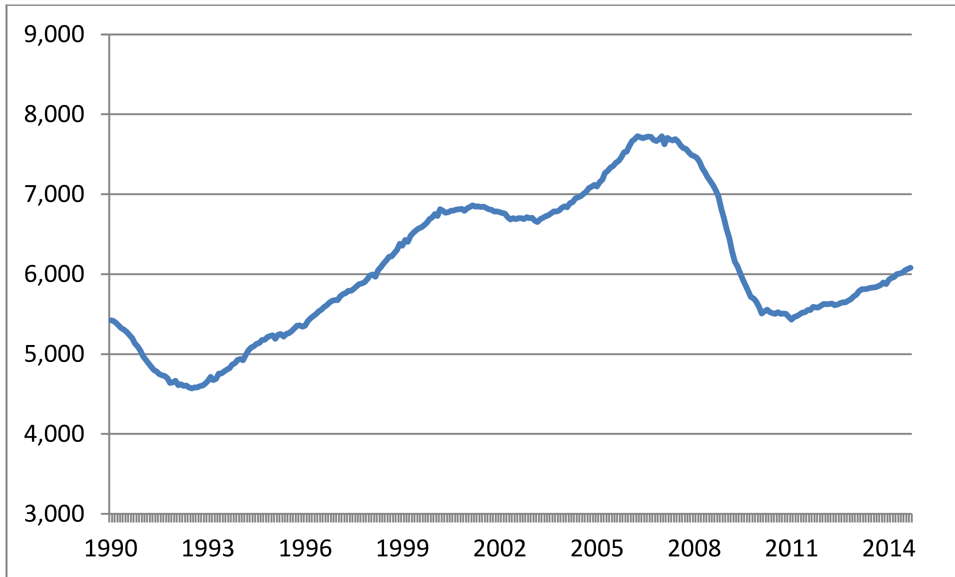
Source: Bureau of Labor Statistics

The good news in job growth is partly offset by the fact that wages are growing no faster than inflation and that there are still seven million part-time workers who wish they were working full-time. Nonetheless, continued gains in employment are likely to bring other improvements to the labor market. Already, average hours worked has rebounded to its pre-recession level. The number of workers who are involuntarily working part-time has declined from a peak of more than nine million. Real wages tend to rise when unemployment falls below 6.0 percent, which is where we are now. Thus, the prospects for further increases in employment, hours, and wages are as good now as they have been in some time.

In fact, we may be getting close to the point where unemployment is not likely to fall much further. New claims for unemployment insurance which were already at pre-recession levels have recently dropped to their lowest point in 15 years. As such, claims are about as low as they are likely to go. Our forecast is for the unemployment rate to reach 5.5 percent by the middle of next year as the economy continues to add more than 200,000 jobs on a monthly basis.

One question, of course, is what types of jobs will be added. We noted in the previous section that the housing market has not yet fully recovered, and that can also be seen with the data on employment in the construction industry.

Chart 6: Construction Employment (in thousands)



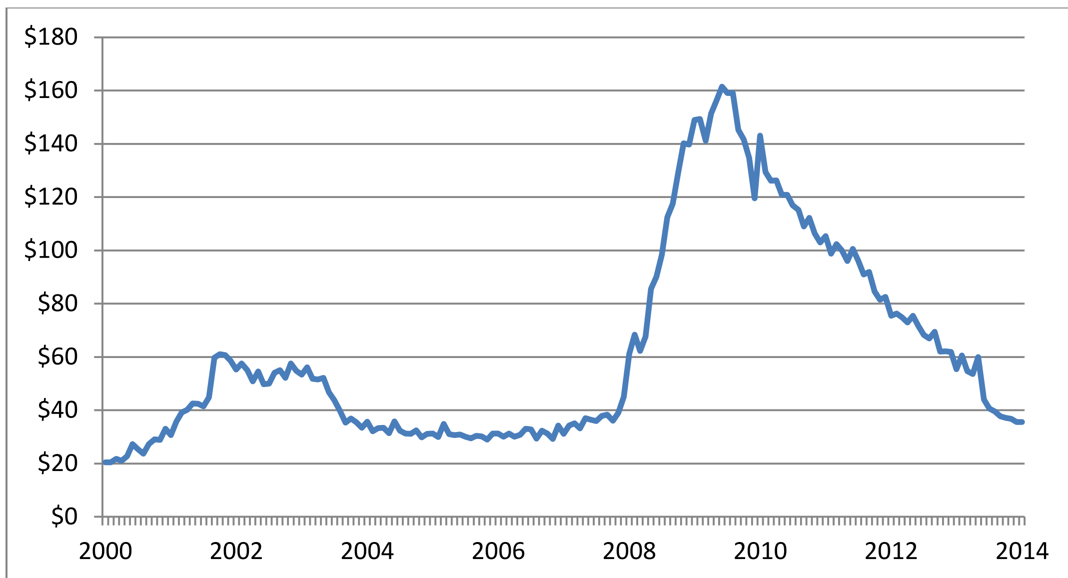
Source: Bureau of Labor Statistics

While overall employment has surpassed its pre-recession level, there are almost two million fewer people employed in construction than there were in 2007. Construction jobs pay about 10 percent more than the national average, and about 30 percent more than jobs in the retail or restaurant sectors, which have seen stronger growth. Thus, while the unemployment rate has fallen to a point that is suggestive of labor market strength, the mix of jobs has changed in a way that acts to reduce average earnings. That is one reason why Janet Yellen has recently been emphasizing growth in wages as opposed to growth in employment as a basis for determining the timing and pace of future rate increases.

IV. Fiscal and Monetary Policy

In 2014, there have been two fiscal positives for the economy. The first is that year-to-date federal tax revenues are up nine percent compared to the same period last year. The second fiscal positive is that government spending has slowed due in part to a large decline in payments for unemployment benefits, reflecting improvements in the labor market. As Chart 7 shows, unemployment benefit payments have fallen about 75 percent since their peak. The budget deficit for 2014 is projected to be $500 billion, less than 3.0 percent of GDP. That is by far the smallest percentage since the Great Recession, and even lower than the average deficit for the past 30 years.

Chart 7: Annual Government Payments for Unemployment Insurance

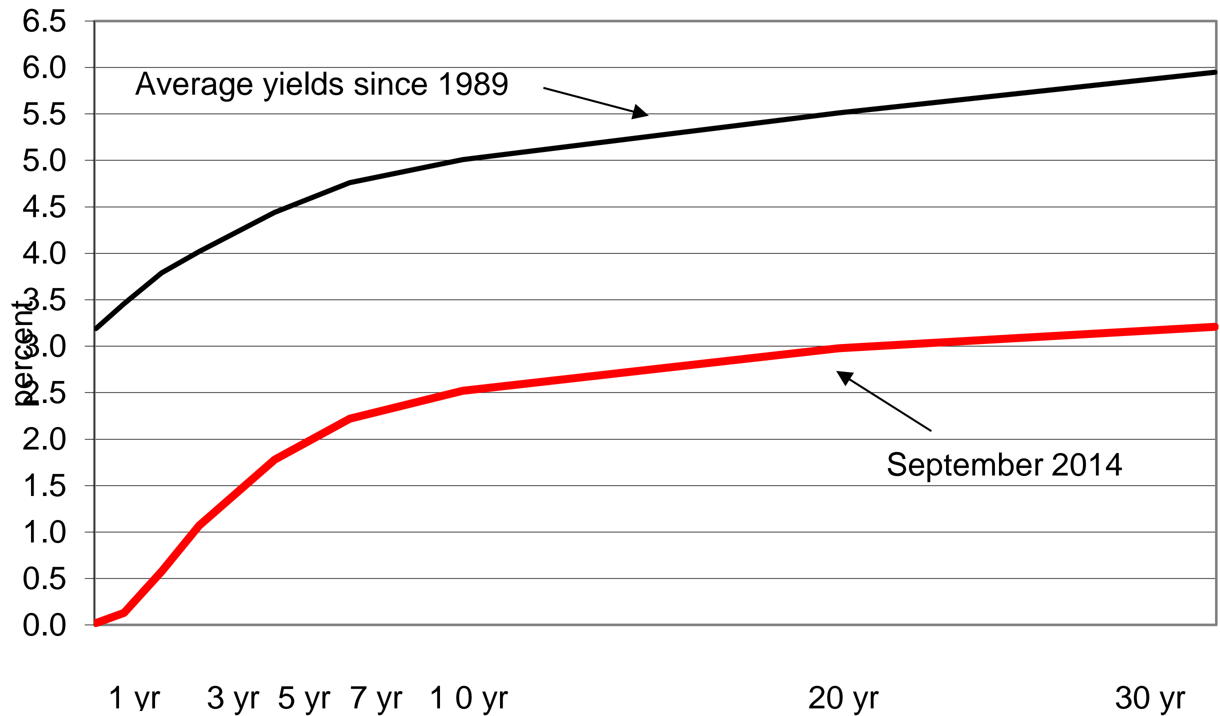


Source: Department of the Treasury, U.S. Census

Fiscal improvements aside, the main policy issue rests with the Federal Reserve. We expect the Fed to raise the fed funds rate in mid-2015 and foresee it climbing above 1.00 percent by the end of that year. Based on projections made by Fed officials, it is likely the fed funds rate could climb as high as 3.00 percent by the end of 2016. Interestingly, the average fed funds rate over the past 25 years is 3.35 percent which suggests the Fed is planning to normalize the funds rate over the next two to three years.

If the Fed moves the funds rate back to its recent historical average, it stands to reason that other interest rates will revert to their averages as well. Chart 8 compares the current Treasury yield curve with the average yield curve over the past 25 years, essentially a graph of average Treasury rates since 1989 for different maturities. Chart 8 clearly shows how much rates have been on average compared to current rates. Since our outlook is for the Fed to move the funds rate back to its historical average, it is reasonable to think other interest rates will follow suit.

Chart 8: Current Yield Curve vs. Average Yield Curve since 1989



Source: Federal Reserve and RCF Calculations

Ultimately, the path of future rate increases will depend on how the economy and financial markets respond. There is much that can happen between now and the middle of 2015 that could cause the Fed to rethink its plans. If the economy were to slow appreciably, we have little doubt that Chair Yellen would delay any rate hike. There is also concern that the prolonged period of low, low, interest rates has created a situation where higher rates will have severe negative consequences. Perhaps, but that is not our outlook. We believe the Fed can end its zero-interest rate policy without substantially disrupting the economy. Support for our position comes from this observation. Quantitative easing has come to an end as scheduled and without creating much turmoil. That suggests that it is possible for the Fed to move away from its easy money policies, and that higher interest rates may not derail an economy which, despite some concerns, is showing increasing signs of strength.