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ECONOMIC UPDATE AND FORECAST SUMMARY JANUARY 2015

Quick Looks

- The economy enters 2015 with considerable forward momentum especially from the labor market which added three million jobs in 2014, the best year since 1999
- Despite stronger employment and GDP growth, 10-year yields fell in 2014, indicating that many investors are not convinced that recent economic gains are long-lasting
- We believe the gains will persist and project the economy to grow almost 3.5 percent in 2015, as lower gasoline prices spur household spending. We also expect the Fed to raise rates by mid-year, though the pace of increases thereafter is likely to be slower than in the past

2014 was the best year of the recovery and in many ways the best year for the U.S. economy in more than a decade. GDP growth in Q2 and Q3 averaged almost 5 percent, the strongest six-month period since 2003. The economy added about 3 million jobs in 2014, the best annual total since 1999. The federal budget deficit fell to an acceptable level of 3 percent of GDP amid strong gains in tax revenues and essentially flat government spending. Consumer spending, boosted by a substantial drop in gasoline prices, grew nearly 3 percent above inflation, and wages rose faster than prices as well. Yet there remains a sense that these recent successes may not be long-lasting. In fact, even as the economy has strengthened in the short-run, the idea that the U.S. may be in a period of prolonged stagnation has gained support. One need look no further than the bond market where long-term yields declined throughout 2014, a condition usually associated with a pessimistic outlook. Certainly growth outside the U.S. has slowed, and there is the question of whether the U.S. economy can continue to be an exception to that pattern.

Moreover, there are still some areas of weakness that warrant concern. The housing market recovery stalled with home sales and housing starts flat-lining throughout the year, despite lower mortgage interest rates. And while the 50 percent decline in oil prices has been a major plus for consumers, it has also put pressure on the profits of energy companies, perhaps threatening the expansion of domestic oil production which has been a driver of job growth in various parts of the economy.

Still, we expect the good times to continue into 2015 and hold to our projection of GDP growth above 3.0 percent for the year. If achieved, it would mark the first such year since 2004-2005 which, not coincidentally, was when the Federal Reserve started raising interest rates. Consequently, we also believe the Fed will raise rates in 2015 and think the first increase might come as early as June. However, we think rate increases will occur more slowly than they did in the 2004-2006 period when the Fed hiked the fed funds rate from 1.00 percent to 5.25 percent over a period of 24 months. Instead, we see rates increasing to only 1.00 percent by year-end, and to 2.50 percent by the end of 2016. From a historical perspective then, interest rates will remain low, and the negative impact of somewhat higher borrowing costs should be offset by the positive impact of stronger consumer

spending and, perhaps, a rebound in the housing sector as the millennial generation finally moves from renting to owning.

Importantly, the economy is well positioned to handle higher rates because of the tremendous improvement in household and business finances that has occurred over the past five years. Lower debt levels and increased savings provide a cushion that the economy did not have during the mid-2000s. We see another year of 2.5 – 3.0 million additional jobs, and a modest drop in the unemployment rate to 5.2 percent by year-end. Inflation will remain low, in part because of the drop in oil prices but also because we believe increases in consumer spending will mostly be absorbed by more production instead of higher prices. Low inflation will limit any increase in long-term bond yields, but we do expect the 10-year rate to move toward 3.00 percent over the next 12 months.

Specific projections aside, we think 2015 will be a crucial year for the U.S. economy. If growth falters again, the prospect of long-term stagnation becomes more likely. If real wages fail to grow amid declining unemployment, we will wonder if the middle-class will ever regain the ground lost since the recession. For now, we put these scenarios in the possible but not probable category and hope that 2015 is the year when we can finally put an end to the lingering impacts of the Great Recession.

Economic Forecasts: RCF and Consensus
Actual Economic Data as of January 12, 2015

		What We Said	What We Saw	What We See	
		2014 2nd Half	2014 2nd Half	2015 1st Half	2015 2nd Half
Real GDP	**RCF**	**3.4%**	+3.8%	**3.3%**	**3.6%**
	Consensus	*3.1%*	(estimated)	*3.0%*	*2.9%*
Inflation	**RCF**	**2.0%**	1.3%	**1.0%**	***1.6%***
	Consensus	*1.9%*		*0.5%*	*1.6%*
Core Inflation#	**RCF**	**2.0%**	1.7%	**1.6%**	***1.8%***
	Consensus	*2.1%*		*1.9%*	*1.9%*
Unemployment	**RCF**	**5.8%**	5.6%	**5.4%**	**5.2%**
	Consensus	*5.8%*		*5.4%*	*5.2%*
Fed Funds Rate	**RCF**	**0.125%**	0.125%	**0.25%**	***1.00%***
	Consensus	*0.125%*		*0.25%*	*0.875%*
2-year Treasury Rate	**RCF**	**0.75%**	0.67%	**0.85%**	**1.30%**
	Consensus	*n.a.*		*n.a.*	*n.a.*
10-year Treasury Rate	**RCF**	**2.55%**	2.17%	**2.35%**	***2.85%***
	Consensus	*2.75%*		*2.49%*	*2.87%*

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

RCF
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I. Interest Rate Overview

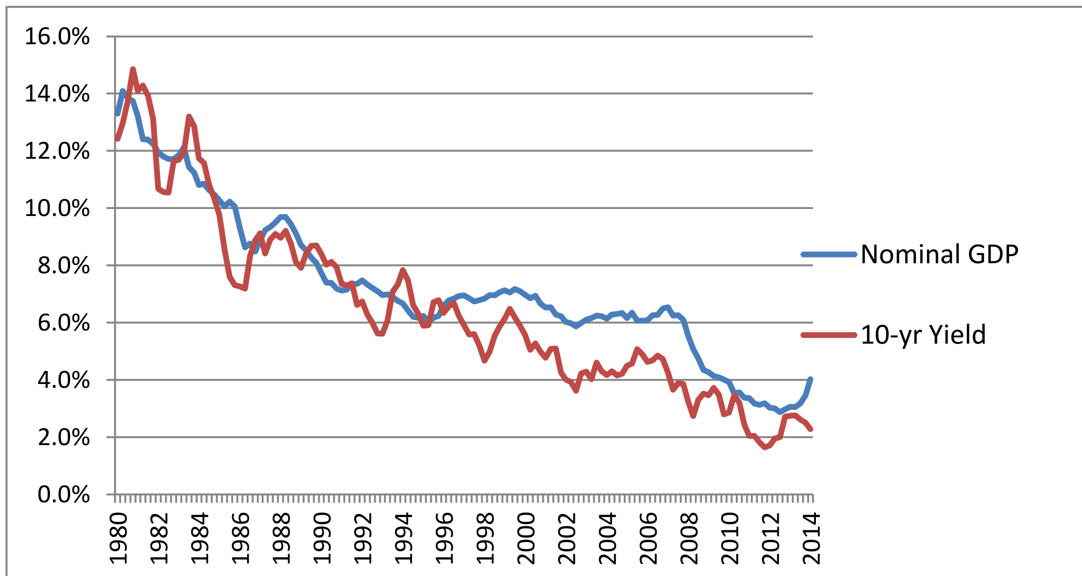
At the start of 2014, we projected that the economy would strengthen, unemployment would fall, household and business spending would increase, and the Fed would end its bond-buying program. Based on these predictions, we also expected 10-year Treasury rates to rise. As it turned out, all our projections were right except the rate forecast. Instead of rising from the 3.0 percent level at the start of 2014, yields fell, ending the year at just 2.17 percent.

Even in hindsight, the low level of 10-year bond rates is hard to understand. As an investment, the yield barely covers inflation. Low bond yields make sense as a hedge against economic decline, but the economy performed well in 2014, and appears in good shape heading into 2015. So what made long-term U.S. debt so much more attractive at the end of 2014 than it was at the beginning of the year?

One factor is that the low rate on U.S. debt is still much higher than the rate on government debt from other industrialized countries. As a result, foreigners continue to be buyers of long-term Treasuries. A second factor is that there was an expectation at the start of 2014 that stronger growth would bring higher inflation. Instead, inflation has declined, even if one looks at measures that remove the effect of lower energy prices.

But perhaps the most important factor is that despite recent economic strength, longer-term macroeconomic trends are still restrained. Chart 1 compares the 10-year Treasury yields to the average change in nominal GDP [total spending in the economy] over the prior 5-year period. As can be seen, yields have followed spending downward, with an even greater drop in interest rates due to the Fed's low interest rate policies.

Chart 1: 5-Year Average Growth in Nominal GDP and 10-Year Treasury Yield



Sources: U.S. Department of Commerce, Federal Reserve, and RCF Calculations

Chart 1 does show the recent pick-up in nominal GDP, a factor which might be expected to push 10-year yields upward. However, it appears that bond buyers are focusing more on the long-term downward trend than on this recent strength. Put differently, there remains a sense that the U.S. economy is in a slow-growth mode and will remain so for the foreseeable future. Hence, low yields on bonds.

Moreover, the fed's zero interest funds rate is keeping down short-term yields, which spill into longer-term yields. In fact, the current spread between the 10-year Treasury yield and the fed funds rate is 200 basis points, well above the 100 basis point historical average.

The conclusion then is that meaningful increases in the 10-year rate will not occur until a) people are convinced that stronger growth is long-lasting and not temporary and b) the Fed starts to hike short-term rates. These two conditions are related, of course, since the Fed's decision to raise interest rates will be tied to their assessment of whether recent growth is temporary or not. Our expectation is that within six months, the economy's rebound will have sufficient legs to convince the Fed to begin the process of raising interest rates. Until then, however, we expect 10-year rates to remain closer to 2 percent than 3 percent.

The anticipation of increases in the fed funds rate has caused the yield curve to flatten. Chart 2 compares the yield curve at the end of 2014 with the curves from the end of 2013 and 2012. Relative to 2013, the curve is flatter because long-term rates have fallen. Relative to 2012, the curve is flatter because short-term rates have risen since then. By year-end, we expect short-term and long-term rates to rise with the 2-year Treasury yield ending the year at 1.50 percent and the 10-year at 2.85 percent.

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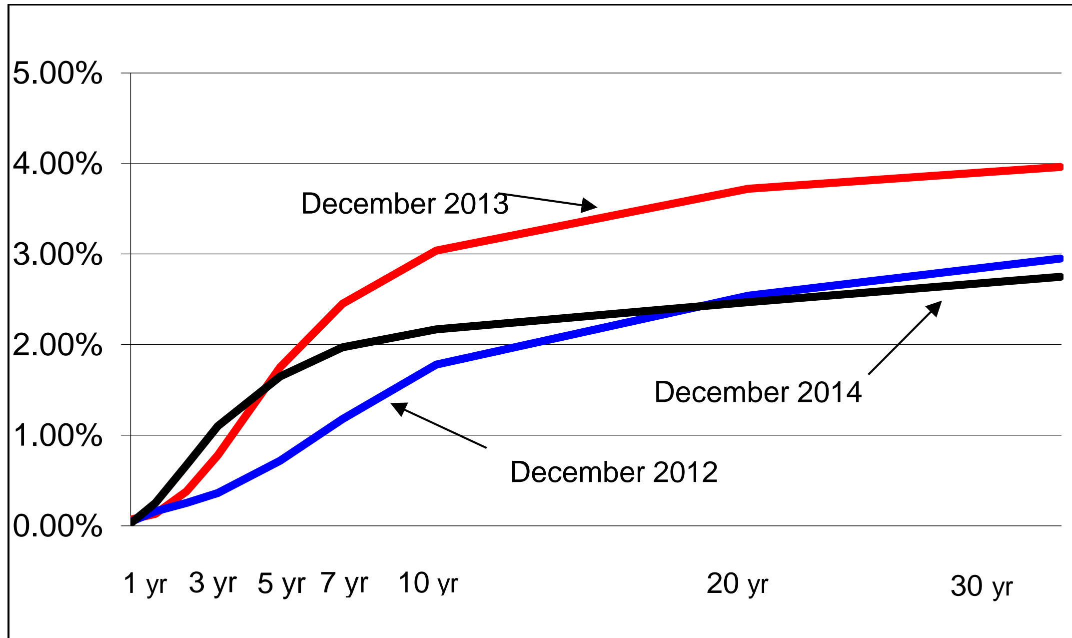
Chart 2: Treasury Yield Curve, December 2014, December 2013, and December 2012



Source: Federal Reserve

II. Inside GDP

The economy grew at a 5.0 percent pace in the third quarter of 2014, the last quarter for which data have been reported at the time of this report. Usually when we see a strong quarter of growth it is due to some special factor that is not likely to be repeated – a temporary build-up of inventories or a spike in one particular aspect of GDP. For 2014Q3, however, this was not the case, as strength was seen across all components. Consumer spending increased 3.2 percent, business investment (both with and without inventories included) grew more than 7.0 percent, exports rose (despite the global slowdown) and imports fell (due mainly to the drop in oil prices). Government purchases also increased, mainly through greater defense spending related to action against ISIS.

Chart 3 also shows GDP growth compared to 2013Q3. Growth measured over this period is lower (2.7 percent) due to the drop in GDP in the first quarter of 2014. Nonetheless, we are encouraged by the pattern of growth over the past year with solid gains in spending by consumers and businesses as well as growth in exports exceeding growth in imports.

Chart 3: Annualized Percent Change in GDP and its Components

	2014Q3 vs. 2014Q2	2014Q3 vs. 2013Q3
Real GDP	5.0	2.7
Consumer Spending	3.2	2.7
Business Investment	7.2	5.4
Fixed Investment Excl inventories	7.7	5.9
Exports	4.5	3.8
Imports	-0.9	3.4
Government Purchases	4.4	0.3

Source: U.S. Department of Commerce

Clearly one of the drivers of the third quarter burst in GDP is the decline in oil and gasoline prices. For each $1 decline in gasoline prices, real consumer spending increases by about 1 percent on an annualized basis. In the third quarter (July – September), gas prices were only about 20 cents less than during the second quarter meaning that very little (0.2 percent) of the 3.2 percent gain in consumer spending during that quarter was due to cheaper gas. That also means that most of the 5.0 percent gain in real GDP in the third quarter was due to general improvements in the economy, and not the fall in gas prices. The bigger benefit from lower gasoline prices was felt in the fourth quarter (60 cent drop in prices adding about 0.6 percent to consumer spending) and into 2015 (where prices may average a dollar or more below their 2014 peak). Overall, then, most of the boost in consumer spending from lower prices has not yet shown up in the GDP data and will instead be seen in the first-half of the year. This is one reason we expect real consumer spending to increase by three percent in 2015.

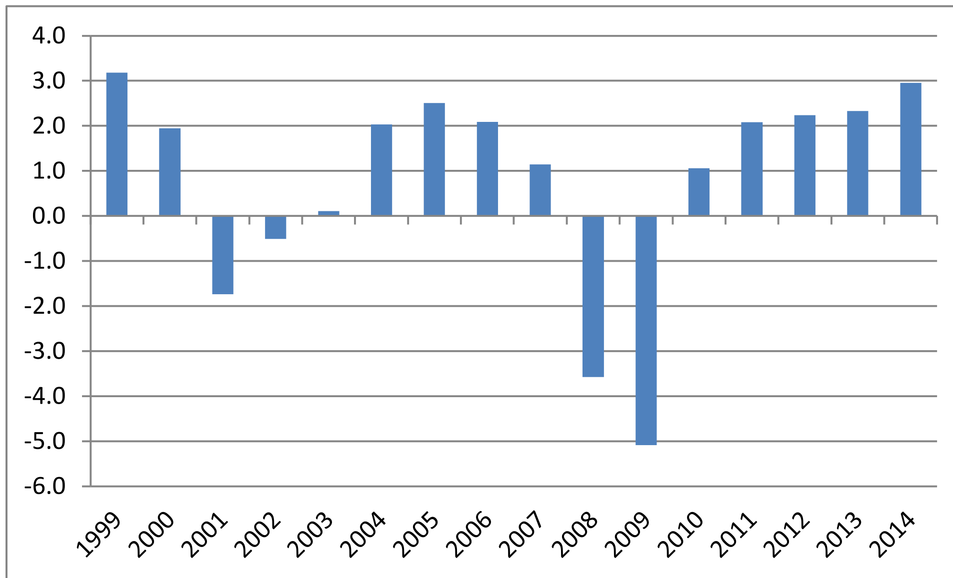
We also expect business investment spending to grow at a solid pace in 2015. There will likely be some reductions in investment in the energy sector, but corporate balance sheets are mostly in good shape, and after-tax corporate profits in the third quarter were up 5.1 percent compared to a year earlier. One area of weakness could be exports, due to slowdowns in Europe and Asia, as well as the impact of the stronger dollar. Because global oil prices are denominated in dollars, the stronger dollar and correspondingly weaker Euro means that Europe's consumers have not seen as big a drop in oil and gas prices as Americans have. Nevertheless, whatever negative we see in exports will likely be offset by a reduction in U.S. spending on imported oil meaning that the net trade impact is likely to be a positive contributor in 2015. As a result, we expect GDP to grow almost 3.5 percent in 2015, which would make it the first year of above three percent growth in more than a decade.

Ultimately, whether the economy can sustain faster than 3 percent growth depends on more than just lower energy prices. Consistently strong growth must come from solid increases in household incomes, which in turn would lead to more spending, more production and even more income. That will require a continuation of the improvements in the labor market that we saw in 2014.

III. The Jobs Picture

Preliminary estimates show that the economy added 866,000 jobs during the fourth quarter of 2014, bringing the full-year increase to 3 million. That made 2014 the strongest year for job creation since 1999. Moreover, the number of involuntary part-time workers fell by one million during the year, showing that job growth was concentrated in full-time positions.

Chart 4: Annual Change in Payroll Employment in millions



Source: Bureau of Labor Statistics

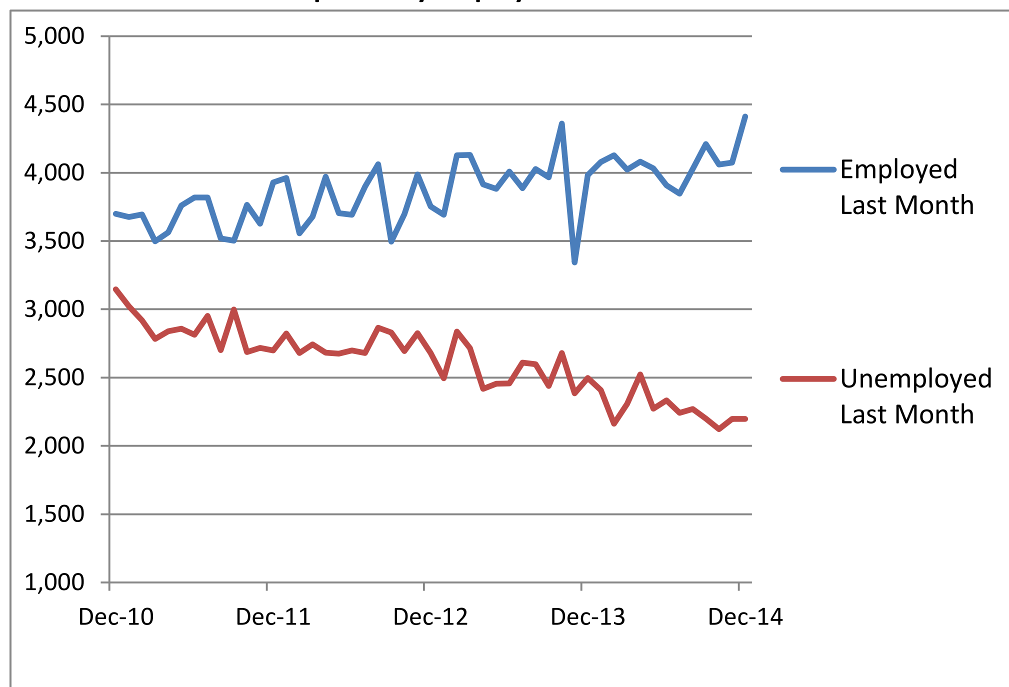
In addition to more jobs, 2014 saw an increase in average hours worked and average hourly earnings. Although neither of the gains in hours nor wages was particularly large, all components of the labor market moved in a positive direction in 2014 – more jobs, more hours, more pay – resulting in overall increase in labor earnings of more than 4 percent, well above the rate of inflation.

The weakness in wage growth is somewhat surprising given the strength in hiring. However, our interpretation of the data is that average wages are being held down because many of the new jobs are relatively low paying. Along the same lines, we see that employment among 25 – 34 year-olds grew at a faster pace than overall employment, a good sign for the struggling millennial generation but also a factor in the slow growth in wages since many of these young workers earn less than the national average.

Strong job growth reduced the unemployment rate to 5.6 percent in December, the lowest level since June of 2008. As has often been the case, part of the decline was due to a decline in the labor force. Over the 12 months of 2014, the labor force actually increased by one million people, but that is still a slower increase than was typical in the years prior to the Great Recession.

Thus, there is a suspicion that the reported declines in unemployment are driven by unemployed workers giving up and leaving the labor force as opposed to real and long-lasting improvements in labor conditions. That question can be answered by looking at Bureau of Labor Statistics data on labor force flows, reprinted in Chart 5. As it turns out, about two thirds of the people who dropped out of the labor force in December were employed in the previous month. That suggests that they are likely retirees who have quit working as opposed to discouraged workers who have given up trying. Moreover, the number of unemployed people leaving the labor force has been in steady decline since peaking in 2010.

Chart 5: Labor Force Drop Outs by Employment Status in Previous Month



Source: Bureau of Labor Statistics

The data shown in Chart 5 lead to two conclusions. First, recent drops in the unemployment rate have primarily been due to improvements in labor market conditions. A second conclusion is that the slow growth in the labor force is likely to be a long-lasting feature of the U.S. economy as more and more baby boomers retire in the coming years. That in itself has both positive and negative implications. On the plus side, it suggests a tighter labor market which should lead to growth in wages, incomes, and spending. On the negative side, it indicates some constraints on the pace of long-term growth.

Near-term, however, we expect the labor market conditions to continue to improve in 2015 and project net job gains in the 2.5 to 3.0 million range. We also project that the unemployment rate will decline to 5.2 percent by year-end, a level that is arguably at the point economists refer to as “full employment.” Perhaps most importantly, we think that gains in employment and drop in the unemployment rate will

finally create upward pressure on wages – a good thing for workers but ultimately a potential challenge for employers and for the Federal Reserve.

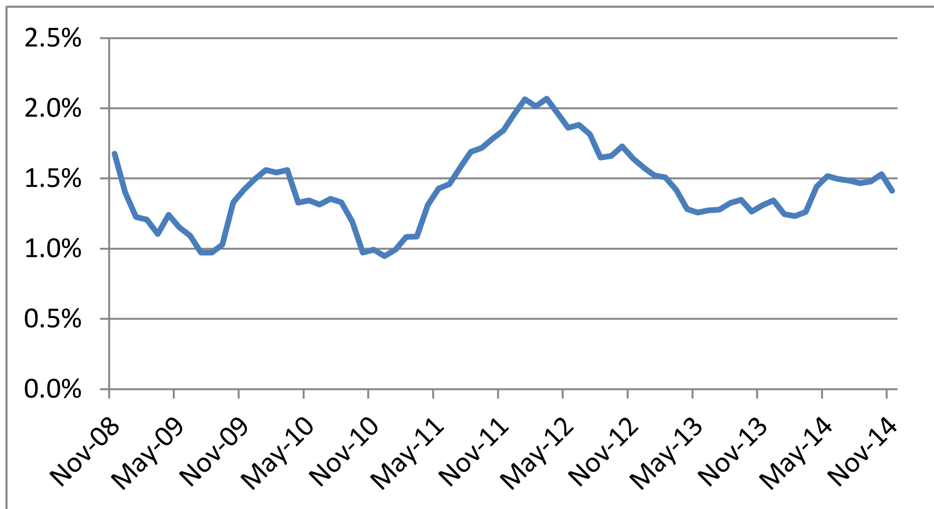
IV. Monetary and Fiscal Policy

Janet Yellen has the well-earned reputation of being a data-driven economist and she has on several occasions insisted that the decision to raise interest rates will be based on economic facts. Well here are some economic facts: Real GDP growth of 5 percent, 3 million new jobs, unemployment at 5.6 percent, real incomes and real consumer spending up nearly 3 percent, consumer credit rising at pre-recession rates, business investment well above pre-recession levels, stock prices 3 times what they were six years ago.

These data do not seem consistent with an economy that is in need of zero interest rates to keep growing. Instead, this is the kind of environment that has caused the Fed to raise interest rates in the past. Still, there is one economic statistic that supports the case for no rate increase – the absence of inflation. This point may seem obvious, but we think it bears some emphasis – a strong economy is not a bad thing that should be stopped through higher interest rates. Rather, it is that a stronger economy often leads to higher inflation which ultimately requires larger increases in interest rates (by the Fed and by lenders). It is these inflation-driven interest rate spikes that often lead to recessions. But if there is no inflation, why raise rates at all?

Chart 6 shows the annual rate of inflation using the Fed's preferred measure (personal consumption deflator excluding food and energy prices) since the Fed cut interest rates to zero at the end of 2008. Inflation is currently running at less than 1.5 percent and only briefly reached as high as 2.0 percent at any time during the last 6 years.

Chart 6: Fed Measure of Inflation since Fed Funds Rate was Reduced to 0%



Source: U.S. Department of Commerce and Federal Reserve

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If one ignores all other economic data and focuses entirely on inflation, the data would not give any reason to raise the federal funds rate. Obviously, Chair Yellen and the rest of the Fed look at more than price changes to determine their interest rate strategy. However, the key takeaway is that there appears to be no urgency with respect to rate increases, allowing the Fed to continue its patient approach to monetary policy.

Therefore, while we believe the Fed will raise rates at their June meeting, it is possible that the zero interest rate policy may be with us a bit longer. In either case, our sense is that once the Fed does raise rates, the increases will be somewhat less aggressive than in the past. This is partly because the long-period of low borrowing costs may have created more uncertainty as to how higher rates will affect the economy. But it may also be because until the Fed sees evidence of rising inflation, they may not feel it necessary to increase rates well above their current level.

One entity that faces considerable uncertainty regarding the impact of higher interest rates is the federal government. Although the budget deficit has been reduced to a reasonable level of 3 percent of GDP, the build-up of debt during and immediately after the Great Recession is still with us. To date, low interest rates have allowed the Treasury to finance its $17 trillion in outstanding bonds at a low cost, which has helped keep the lid on government spending. But if rates rise, the U.S. government – like everyone else – will have to pay more to lenders. However, most everyone else has reduced their debt burden through the deleveraging process of the last several years. The U.S. government has not. The fiscal impacts of higher interest rates are likely to factor into the Federal Reserve's policy decisions, another reason why we think the eventual increase in the fed funds rate will be more modest than in the past.

Earlier in our report we said that the decline in long-term Treasury yields indicates that many investors are not convinced that the U.S. economy has actually entered a period of stronger economic growth. One reason why this belief holds is that the Fed does not seem convinced that stronger growth is here to stay. At least that is one interpretation of their hesitancy to raise interest rates. It is possible though that when the Fed does raise rates it will be seen not as a threat to economic growth, but as a confirmation of the sustainability of the current upward trend. If so, we should welcome rate increases instead of fearing them.