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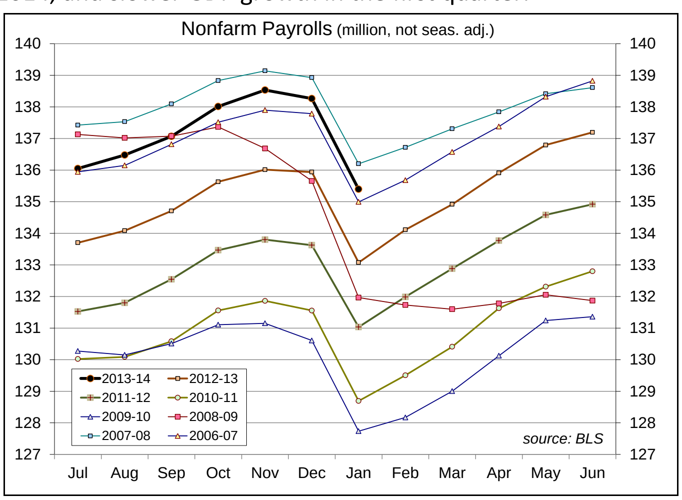
Monthly Economic Outlook

Poor Weather, Revisions, and Continued Optimism

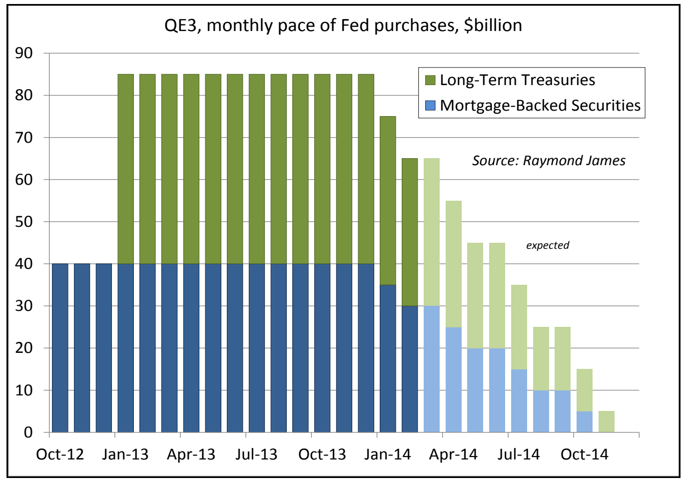
- *One should always be careful in interpreting the economic data for the winter months. Seasonal adjustment can magnify the impact of adverse weather. The bigger test for jobs, consumer spending, and housing will come in the spring.*
- *While financial market participants have come to accept the weather distortions, much of the economic data for the fourth quarter have been revised to show less momentum at the end of the year, and implicitly somewhat slower growth in early 2014.*
- *Janet Yellen has stressed continuity at the Fed. While the tapering of asset purchases is "not on a preset course," officials expect further reductions "at a measured pace" at future policy meetings (read that as -$10 billion per FOMC meeting). It would take a material change in the outlook for the Fed to alter that path, and the outlook for 2014 remains positive.*

Real GDP rose at a 3.2% annual rate in the advance estimate for 4Q13. That figure is expected to be revised lower based on recent economic data reports. Retail sales and industrial production figures for January disappointed, but poor weather and large seasonal adjustment make that irrelevant. The economy should pick up as the weather improves (however, adverse weather continued in February). More importantly, retail sales and manufacturing production figures for November and December have been revised lower, suggesting less strength in 4Q13, less momentum heading into 2014, and slower GDP growth in the first quarter.



Nonfarm payrolls rose by 113,000 in the initial estimate for January, vs. +75,000 in December and a +205,000 pace over the previous 12 months. Poor weather appeared to be a factor, hitting mostly construction and manufacturing payrolls in December and retail and education jobs in January. Note that we lost 2.87 million jobs in January before seasonal adjustment, roughly in line with the usual seasonal pattern.

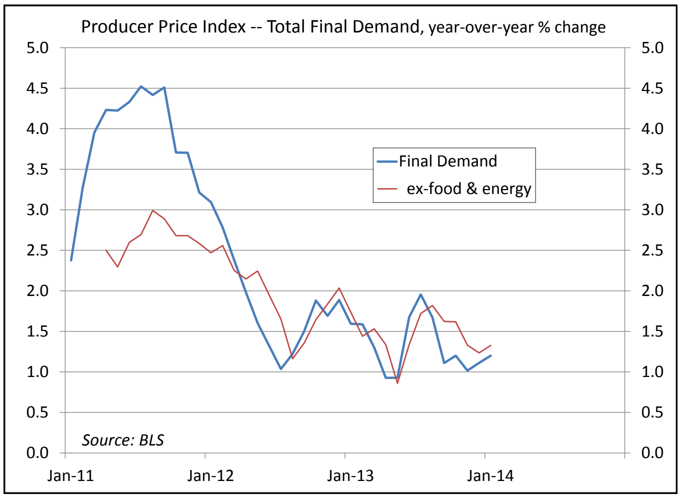
Recent data have not had much of an impact on the economic outlook for 2014 as a whole. The headwinds of the last few years have faded and some have turned into moderate tailwinds. Monetary policy will remain very accommodative. Firms generally expect better sales and plan to increase hiring. The federal government has a budget for FY14 and FY15 and the debt ceiling has been waived through March 15, 2015.



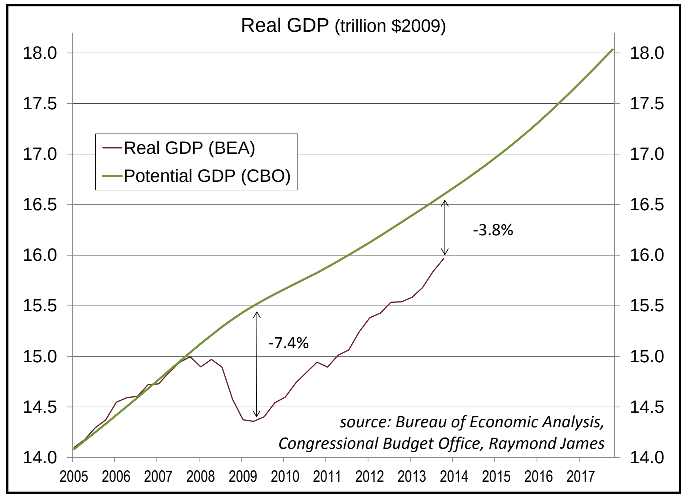
The Federal Open Market Committee reduced the monthly pace of asset purchases by another $10 billion in February. The next policy meeting is set for March 19, where officials are expected to trim the pace further (the cut would take effect in April). Fed officials continue to stress that tapering is not on a preset course. Fed Chair Yellen indicated that the tapering could be paused if there were *"a notable change"* in the outlook and the Fed could increase asset purchases if the outlook *"deteriorated significantly."* However, she noted that Fed policymakers anticipate reductions *"in further measured steps."* The rate of asset purchases is expected to continue to stair-step lower, ending in 4Q14. Yellen and other Fed officials have continued to stress the target rate for federal funds (the overnight lending rate) will remain low *"well past the time that the unemployment rate falls below 6.5%."* The Fed is set to alter the forward guidance language in March.

For the financial markets, Janet Yellen's first testimony on monetary policy was about confidence. She pledged continuity in monetary policy and regulatory reform. She appeared calm, confident, and in control. Yellen cautioned against reading too much into the recent slowing in nonfarm payrolls and, speaking for other officials as well as herself, she presented an optimistic outlook for 2014. She noted that the Fed has been *"watching closely the recent volatility in global financial markets,"* but *"our sense is that at this stage these developments do not pose a substantial risk to the U.S. economic outlook."* She pledged to continue to monitor the situation.

Problems in a number of individual countries have led to concerns about the state of emerging markets in general. This is largely a story of capital flows. As capital inflows begin to slow and then turn out, there is more incentive for other investors to flee (amid weakening currencies and declining asset prices). Countries appear to be in better position compared to the Asian Financial Crisis of 1997 (more currency reserves, greater technical expertise). Turkey and South Africa have responded by raising interest rates. This may keep capital outflows in check, but higher rates slow economic growth. China has stricter capital controls, but the central bank is wrestling to control a shadow banking system and a housing bubble. Given the country's size, developments bear watching.



Inflation has continued to trend at a low level. The newly expanded Producer Price Index (which includes services and much greater detail on intermediate prices) suggests limited pipeline inflation pressures. Continued slack in the labor market should keep average wage increases relatively low.



At its worst, real GDP fell 7.4% below its potential at the end of the recession. More than four and a half years into the recovery, we've closed about half of that gap (but note that potential GDP slowed during the recession). GDP growth will hopefully be higher than trend over the next few years. Looking further out beyond the next 10 years, growth in potential GDP is expected to slow to about 2% per year, reflecting the aging of the population.

Projections

The 4Q13 GDP growth estimate is expected to be revised down. The pace of inventory accumulation was elevated in the second half of 2013 and should slow in the first half of 2014, subtracting from overall GDP growth. Weather is expected to restrain the pace of improvement in 1Q14, but we should see a pickup in the spring. Investors should take the weather-related softness with a grain of salt and remain relatively optimistic about the remainder of the year. Long-term interest rates may remain a bit choppy, but should trend gradually higher.

	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14	3Q14	4Q14	1Q15	2Q15	2013	2014	2015
GDP (↓ *contributions*)	1.1	2.5	4.1	3.2	2.0	2.8	3.1	3.1	3.1	3.1	1.9	2.9	3.1
consumer durables	0.4	0.5	0.6	0.5	0.2	0.4	0.4	0.4	0.4	0.4	0.5	0.4	0.5
nondurables & services	1.1	0.8	0.8	1.8	1.4	1.4	1.5	1.5	1.5	1.5	0.8	1.4	1.5
bus. fixed investment	-0.6	0.6	0.6	0.5	0.4	0.6	0.7	0.7	0.7	0.7	0.3	0.5	0.7
residential investment	0.3	0.4	0.3	-0.3	0.2	0.5	0.4	0.3	0.3	0.3	0.3	0.2	0.3
government	-0.8	-0.1	0.1	-0.9	0.4	0.1	0.1	0.1	0.1	0.1	-0.4	0.0	0.1
Domestic Final Sales	0.5	2.1	2.3	1.4	2.7	3.1	3.0	3.0	3.0	3.0	1.6	2.5	3.0
exports	-0.2	1.0	0.5	1.5	0.5	0.6	0.6	0.6	0.6	0.6	0.4	0.8	0.6
imports	-0.1	-1.1	-0.4	-0.2	-0.4	-0.5	-0.5	-0.6	-0.6	-0.6	-0.2	-0.4	-0.5
Final Sales	0.2	2.1	2.5	2.8	2.8	3.2	3.1	3.1	3.1	3.0	1.5	2.5	3.1
ch. in bus. inventories	0.9	0.4	1.7	0.4	-0.8	-0.5	0.0	0.0	0.0	0.0	0.2	0.0	0.0
Unemployment, %	7.7	7.5	7.3	7.0	6.5	6.3	6.1	6.0	5.9	5.8	7.4	6.3	5.7.0
NF Payrolls, monthly, th.	207	182	167	172	185	205	205	210	210	200	182	201	196
Cons. Price Index (q/q)	1.2	0.4	2.2	1.1	1.9	1.6	1.7	1.8	1.9	1.9	1.5	1.6	1.9
excl. food & energy	2.0	1.4	1.8	1.6	1.6	1.7	1.8	1.9	1.9	2.0	1.8	1.7	1.9
PCE Price Index (q/q)	1.1	-0.1	1.9	0.7	1.5	1.5	1.6	1.7	1.8	1.8	1.1	1.3	1.7
excl. food & energy	1.4	0.6	1.4	1.1	1.3	1.5	1.6	1.7	1.8	1.8	1.2	1.4	1.8
Fed Funds Rate, %	0.14	0.12	0.09	0.09	0.09	0.12	0.16	0.20	0.24	0.60	0.11	0.14	0.91
3-month T-Bill, (bond-eq.)	0.1	0.1	0.0	0.1	0.1	0.1	0.1	0.2	0.2	0.6	0.1	0.1	0.9
2-year Treasury Note	0.3	0.3	0.4	0.3	0.4	0.5	0.8	1.0	1.1	1.3	0.3	0.7	1.6
10-year Treasury Note	2.0	2.0	2.7	2.7	2.8	2.9	3.2	3.4	3.7	3.8	2.4	3.1	4.0