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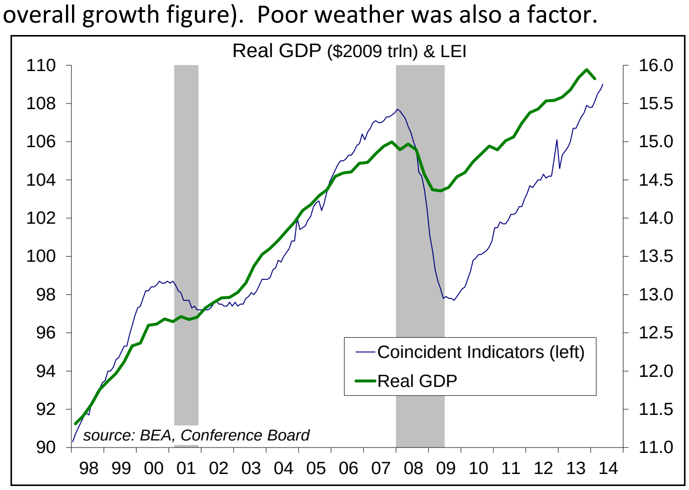
Scott J. Brown, Ph.D., (727) 567-2603, Scott.J.Brown@RaymondJames.com **July 22, 2014**

Economic Trends

The 2H14 Outlook

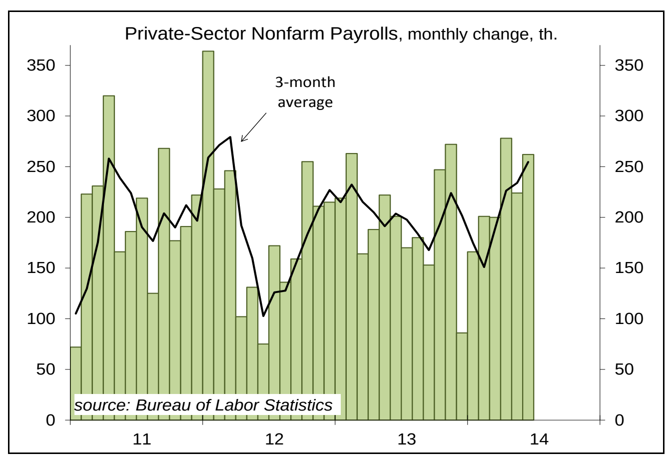
- *Real GDP growth is expected to expand at a moderately strong pace in the second half of 2014, reflecting diminished headwinds, but the pace may disappoint somewhat.*
- *Chief concerns are the lack of growth in real average wages and increased geopolitical tensions. In addition, lawmakers and the central bank will have limited scope for stimulative polices if needed (in the face of a large negative shock).*
- *The Federal Open Market Committee will continue to reduce the monthly pace of asset purchases, ending after the October 29 policy meeting. Officials are currently debating the mechanics of policy normalization. However, short-term interest rates are unlikely to be raised until mid-2015.*

Real GDP was reported to have fallen at a 2.9% annual rate in 1Q14 (vs. +0.1% in the advance estimate and -1.0% in the 2nd estimate). The downward revision to the 1Q14 GDP estimate was an eye-opener, but the broad range of data, particularly employment figures, suggest that the U.S. economy is a long way from a recession (the National Bureau of Economic Research's Business Cycle Data Committee defines a recession as *"a period of falling economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales"* – and not *"two consecutive quarterly declines in real GDP"*). The first quarter's drop in GDP was due largely to slower inventory growth and a wider trade deficit (which together subtracted 3.2 percentage points from the overall growth figure). Poor weather was also a factor.



The advance estimate of 2Q14 GDP growth, along with annual benchmark revisions, is due on July 30. Recent economic data reports (including retail sales and industrial production figures through June) suggest a relatively strong rebound in growth in 2Q14 (from weather-related weakness in 1Q14), but with some loss of momentum heading toward the third quarter. The trade deficit appears to have widened further, which will subtract from 2Q14 GDP growth. June economic figures will be subject to revision, but recent trends may be indicative of a continued moderate pace of growth in the second half of this year. The economic recovery remains firmly on track, but the pace is likely to be somewhat disappointing. The slack that was generated during the downturn is likely to be taken up only gradually over time. That may not be bad news for the stock market, as it means that corporate earnings should generally improve, while the Fed will be in no rush to take the punchbowl away.

Job growth has been relatively robust in recent months. Nonfarm payrolls averaged a 272,000 monthly gain in the third quarter. Note that there is a fair amount of noise in the payroll data, which can yield "lumpy" results from quarter to quarter. However, unadjusted payrolls suggest a strong spring hiring season. Prior to seasonal adjustment, we added 3.85 million private-sector jobs between February and June, vs. 3.51 million for the same period in 2013. Initial claims for unemployment benefits have trended low, consistent with a limited pace of job destruction. New hiring appears to have picked up, led by expansions at small and medium-sized firms. The unemployment rate has continued to trend lower, but the employment/population ratio has increased only gradually, suggesting that a large amount of slack remains in the job market. Measures of short-term unemployment are near normal levels. In contrast, long-term unemployment and underemployment remain elevated, but are gradually declining.



Consumer spending appears to have been mixed in the last few months. Vehicle sales have continued to strengthen, fueled by replacement needs and relatively easy credit. Otherwise, sales lost some momentum in June following the spring rebound from bad weather. Consumer credit remains relatively tight and real wage growth has been flat.

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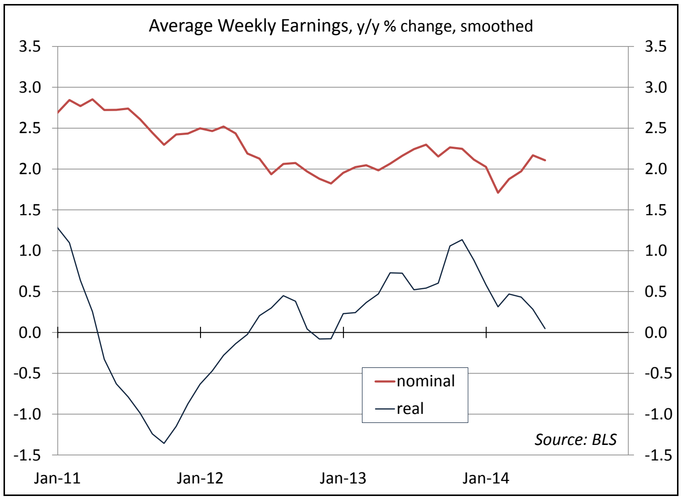
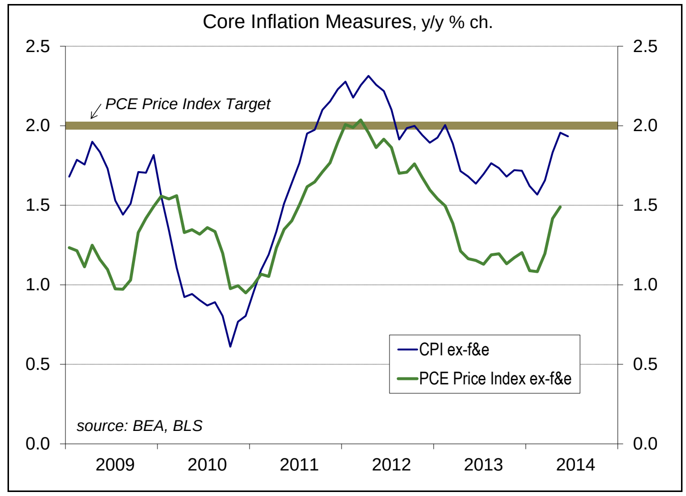
The lack of growth in real average wages is likely to be a limiting factor for economic growth in the second half of the year. Consumer spending accounts for 70% of Gross Domestic Product. Note that, as employment expands, real aggregate wage income can improve even if real average wages are stagnant. However, the weakness in real average wage growth implies that overall consumer spending will be slower than it would be otherwise (that is, if workers were more evenly sharing gains from productivity growth).



The weak trend in real wages has contributed to a continued low trend in consumer price inflation. Monthly inflation figures were somewhat higher in the first half of the year, boosted partly by higher energy prices and by drought conditions in California. Core inflation has remained relatively mild. Import prices (commodities and finished goods) have been trending very low. The Producer Price Index (expanded in recent months to include services) shows no appreciable pipeline pressures for inflation.



In her recent monetary policy testimony to Congress, Federal Reserve Chair Janet Yellen indicated that the Fed's asset purchase program will likely end after the October 29 meeting. Officials are currently debating the mechanics of policy normalization (the tools to be employed and the order of steps to be taken) and expect to inform the public of their decisions later this year. Short-term interest rates are not expected to be raised until around the middle of next year, but the timing of any rate hike will depend critically on the evolution of the economic outlook in the second half of 2014.

On July 30, the Bureau of Economic Analysis will release its advance estimate for 2Q14 GDP. The government will not have all of the source data and will have to make assumptions about foreign trade, inventories, and a number of other components. The BEA will also release annual benchmark revisions to the GDP figures back to 1Q11 (this is a garden-variety benchmark – no changes to the methodology). The Federal Open Market Committee will release its policy statement that afternoon.

	3Q13	4Q13	1Q14	2Q14	3Q14	4Q14	1Q15	2Q15	3Q15	4Q15	2013	2014	2015
GDP (↓ *contributions*)	4.1	2.6	-2.9	2.7	3.0	2.9	2.8	2.8	2.7	2.7	1.9	1.5	2.8
consumer durables	0.6	0.2	0.1	0.8	0.4	0.4	0.3	0.3	0.4	0.4	0.5	0.4	0.4
nondurables & services	0.8	2.0	0.6	0.4	1.4	1.4	1.4	1.4	1.4	1.4	0.8	1.0	1.4
bus. fixed investment	0.6	0.7	-0.1	0.8	0.7	0.7	0.7	0.7	0.7	0.7	0.3	0.5	0.7
residential investment	0.3	-0.3	-0.1	0.6	0.6	0.3	0.3	0.2	0.2	0.2	0.3	0.2	0.3
government	0.1	-1.0	-0.1	0.2	0.2	0.1	0.2	0.2	0.2	0.2	-0.4	-0.1	0.2
Domestic Final Sales	2.3	1.6	0.3	3.0	3.2	3.0	2.9	2.8	2.8	2.8	1.6	2.0	2.9
exports	0.5	1.2	-1.3	0.9	0.4	0.4	0.4	0.5	0.5	0.5	0.4	0.3	0.5
imports	-0.4	-0.2	-0.3	-1.8	-0.5	-0.6	-0.6	-0.6	-0.6	-0.6	-0.2	-0.7	-0.6
Final Sales	2.5	2.7	-1.3	2.1	3.1	2.9	2.8	2.7	2.7	2.7	1.5	1.8	2.8
ch. in bus. inventories	1.7	0.0	-1.7	0.6	-0.1	0.0	0.0	0.0	0.0	0.0	0.2	-0.1	0.1
Unemployment, %	7.3	7.0	6.7	6.2	6.0	5.9	5.7	5.6	5.5	5.4	7.4	6.2	5.6
NF Payrolls, monthly, th.	172	198	190	272	210	210	210	200	190	185	194	220	196
Cons. Price Index (q/q)	2.2	1.1	1.9	3.0	2.2	1.8	1.9	1.9	1.9	1.9	1.5	2.2	1.9
excl. food & energy	1.8	1.6	1.6	2.5	1.9	1.9	1.9	2.0	2.0	2.0	1.8	2.0	2.0
PCE Price Index (q/q)	1.9	1.1	1.4	2.3	1.9	1.7	1.8	1.8	1.8	1.8	1.1	1.5	1.8
excl. food & energy	1.4	1.3	1.2	1.9	1.7	1.7	1.8	1.8	1.9	1.9	1.2	1.4	1.8
Fed Funds Rate, %	0.09	0.09	0.07	0.10	0.12	0.17	0.22	0.26	0.70	1.22	0.11	0.12	0.60
3-month T-Bill, (bond-eq.)	0.0	0.1	0.1	0.0	0.1	0.1	0.2	0.3	0.7	1.2	0.1	0.1	0.6
2-year Treasury Note	0.4	0.3	0.4	0.4	0.6	0.9	1.2	1.5	2.0	2.4	0.3	0.6	1.8
10-year Treasury Note	2.7	2.7	2.8	2.6	2.9	3.1	3.4	3.6	3.8	4.0	2.4	2.9	3.7