RAYMOND JAMES

Economic Research

Published by Raymond James & Associates

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October 16, 2014

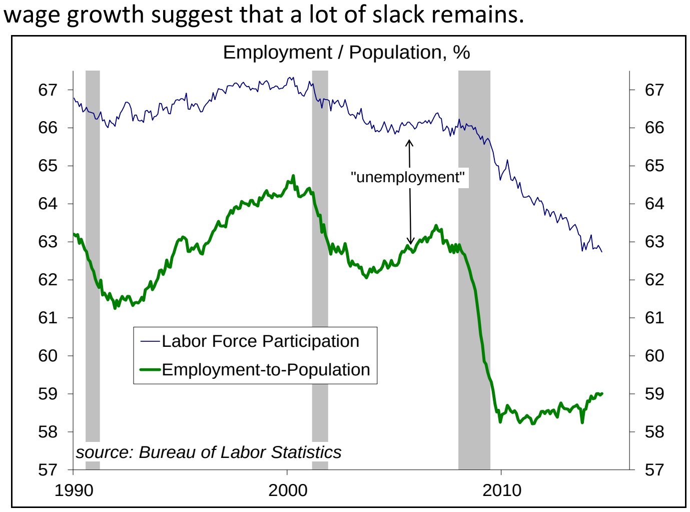
Monthly Economic Outlook

Downside Risks to the Global Outlook

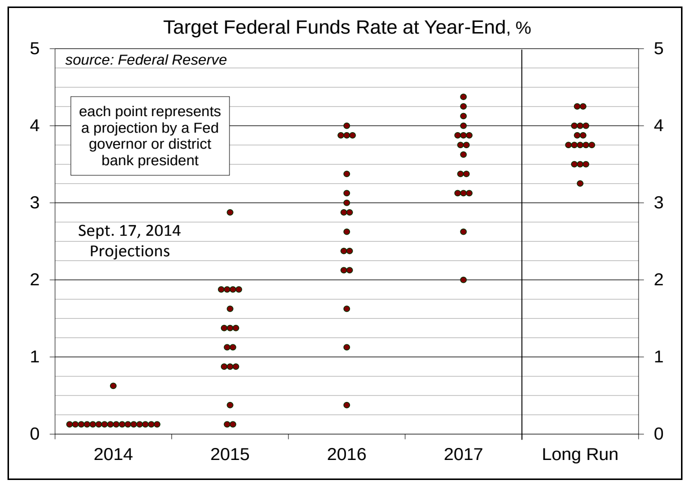
- *U.S. economic growth appears to have remained moderate heading into the fourth quarter, while consumer price inflation continues to trend at a low level.*
- *Global growth is expected to be somewhat soft, limiting U.S. export growth in the quarters ahead, while the stronger dollar is likely to trim earnings from abroad. However, global weakness should put downward pressure on commodity prices and lower gasoline prices could provide important support for consumer spending growth into the early part of 2015.*
- *While the focus for the Federal Reserve remains on the U.S. job market and domestic inflationary pressures, policymakers have to take overseas developments into account. Global weakness could delay the Fed's initial interest rate hike.*

The government's advance estimate of 3Q14 is due on October 30. We still don't have a complete picture of the GDP components and the figures that we do have are subject to revision, but following uneven growth in the first half of the year, GDP is likely to have risen at about a 3% annual rate in 3Q14. Consumer spending (70% of GDP) appears to have advanced at a lackluster-to-moderate pace (on track for an annual rate of about 2%). Data on factory shipments suggests a relatively strong quarter for business fixed investment. Inventory growth is expected to have slowed relative to the previous quarter, subtracting from overall GDP growth. However, a narrower trade deficit is expected to add.

For Federal Reserve policymakers, the key issue is how much slack remains in the job market. Some measures, such as weekly claims for unemployment benefits and the percentage of people out of work for half a year or less, are consistent with an economy that has fully hit its stride. However, measures of long-term unemployment, underemployment, and sluggish wage growth suggest that a lot of slack remains.

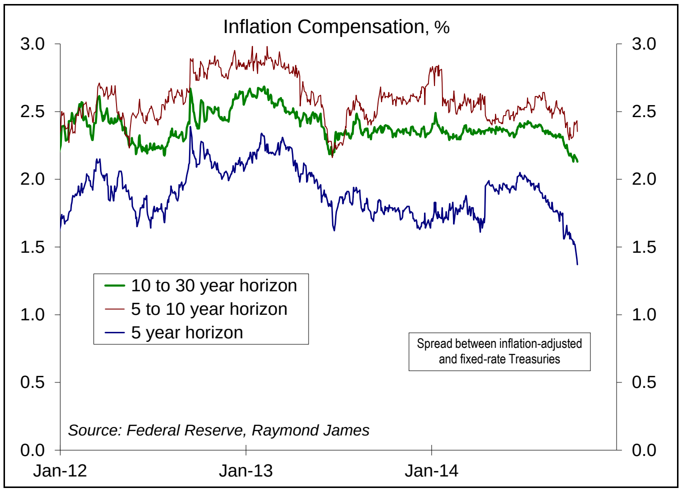


Four times a year, at every other policy meeting, Fed officials (the five governors and 12 district bank presidents) submit forecasts of growth, unemployment, and inflation. They also make projections of the appropriate year-end target rate for federal funds (the overnight lending rate). Fed Chair Janet Yellen has cautioned financial market participants against reading too much into "the dots," but they do allow one to make some inferences about when officials expect to begin raising short-term interest rates. The mid-September outlook shows a wide range of opinion. There are hawks, who want to tighten early, and doves, who want to tighten later, but there is no clear consensus. Officials have different opinions about how much slack remains in the job market and how rapidly that slack is being taken up. Over time (officials will revise these forecasts in mid-December), we should see the dots begin to bunch up. However, as Yellen has indicated, the Fed's policy decisions in 2015 will depend critically on the evolution of the economic outlook over the next several months.



In recent months, the Fed has worked to complete plans for policy normalization (this is "prudent planning," not a signal that a rate hike is imminent). Policy normalization is expected to be a lengthy process. When the Fed begins to raise short-term interest rates, it will announce a range for the federal funds rate, with the interest paid on excess reserves (IOER) set at the top end of the range. The Fed is expected to end its current program of reinvesting mortgage principal payments and maturing Treasury securities sometime after the first rate hike. Over time, the size of the Fed's balance sheet will decrease naturally, a process that could take a decade (the Fed could sell securities from its portfolio, but that's unlikely).

Fed officials will also consider the outlook for inflation. Consumer price inflation has continued to trend at a low level and inflationary pressures appear to have remained mild. Longer-term inflation expectations have declined.



In the recent update of its World Economic Outlook, the International Monetary Fund lowered its expectation for global growth in 2014 and 2015. That wasn't a surprise, but the IMF noted increased downside risks to the outlook, especially for Europe. Europe's crisis was initially about whether the monetary union would survive. That issue was put to bed when European Central Bank President Mario Draghi promised to do "whatever it takes." Misguided austerity efforts slowed the economic recovery. Europe has now entered a much more dangerous phase as it battles the possibility of deflation.

Real (that is, inflation-adjusted) interest rates are what matter for an economy. For any given nominal interest rate, lower inflation means a higher real rate, and growth will be slower than it would be otherwise. Consumer price inflation in the euro area was 0.3% over the 12 months ending in September. Benchmark interest rates in Europe are already near zero (and with the deposit facility rate, negative). The scope for conventional monetary policy is exhausted.

Thus, for Europe, quantitative easing is the only game in town. The ECB has begun a program to purchase asset-backed securities. This is more akin to the Fed's Term Asset-Backed Securities Loan Facility (TALF) that was employed during the financial crisis (March 2009 to June 2010). The idea is that in selling these securities, banks will use the proceeds to make new loans. The ECB is likely to embark on actual quantitative easing (purchasing sovereign debt) in the months ahead, but there are some significant hurdles (the Germans will strongly object and there are legal challenges).

A weaker Europe has implications for the rest of the world. China is still dependent on exports, so a European recession is not going to help (China may also have to deal with a collapse of a credit bubble). For U.S. firms doing business in Europe, earnings will slow or contract, while a stronger greenback reduces the dollar value of any given level of euro revenues.

There are some benefits for the U.S. Europe's weakness has put downward pressure on commodity prices. Lower gasoline prices are likely to support consumer spending growth into 2015. The trade deficit should widen (which subtracts from growth), but capital inflows should increase, supporting share prices and helping to keep long-term interest rates low.

Fed policy will remain focused on the job market and the inflation outlook here at home, but as Governor Stanley Fischer recently noted, the Fed has to take into account what is going on in the rest of the world. All else equal, Europe's weakness will contribute to a delay in the Fed's initial rate hike.

For the most part, financial market participants have reacted more to the downside risks to Europe than to the actual economic data, but geopolitical concerns (Ukraine, ISIS, Hong Kong) and overblown fears of the Ebola virus have also added to the anxiety. Market conditions may remain volatile in the near term, but the U.S. economic outlook isn't bad at all.

	4Q13	1Q14	2Q14	3Q14	4Q14	1Q15	2Q15	3Q15	4Q15	2013	2014	2015	2016
GDP (↓ *contributions*)	3.5	-2.1	4.6	3.0	2.8	2.9	2.9	2.7	2.6	2.2	2.2	3.0	2.6
consumer durables	0.4	0.2	1.0	0.5	0.5	0.5	0.5	0.4	0.4	0.5	0.5	0.5	0.4
nondurables & services	2.1	0.6	0.8	0.9	1.4	1.5	1.5	1.4	1.4	1.2	1.1	1.4	1.4
bus. fixed investment	0.7	-0.1	1.2	1.0	0.8	0.7	0.7	0.6	0.6	0.3	0.6	0.8	0.6
residential investment	-0.3	-0.2	0.3	0.2	0.3	0.3	0.3	0.2	0.2	0.3	0.1	0.3	0.2
government	-0.7	-0.2	0.3	0.2	0.4	0.2	0.2	0.2	0.2	-0.4	-0.1	0.3	0.2
Domestic Final Sales	2.7	0.7	3.4	2.8	3.5	3.2	3.1	2.9	2.8	1.9	2.2	3.1	2.8
exports	1.3	-1.3	1.4	1.0	0.2	0.3	0.4	0.4	0.4	0.4	0.5	0.5	0.4
imports	-0.2	-0.4	-1.8	-0.2	-0.6	-0.6	-0.6	-0.6	-0.6	-0.2	-0.6	-0.6	-0.6
Final Sales	3.9	-1.0	3.2	3.6	3.0	2.9	2.8	2.7	2.6	1.8	2.1	3.1	2.6
ch. in bus. inventories	-0.3	-1.2	1.4	-0.6	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Unemployment, %	7.0	6.7	6.2	6.1	5.8	5.6	5.5	5.4	5.3	7.4	6.2	5.5	5.4
NF Payrolls, monthly, th.	198	190	267	224	230	225	220	210	200	194	228	214	205
Cons. Price Index (q/q)	1.1	1.9	3.0	1.0	0.7	1.8	1.9	1.9	1.9	1.5	1.7	1.6	2.0
excl. food & energy	1.6	1.6	2.5	1.3	1.5	1.7	1.8	1.8	1.8	1.8	1.8	1.7	1.9
PCE Price Index (q/q)	1.0	1.4	2.3	1.3	1.1	1.7	1.8	1.8	1.8	1.2	1.4	1.6	1.8
excl. food & energy	1.3	1.2	2.0	1.4	1.5	1.6	1.7	1.7	1.8	1.3	1.4	1.6	1.9
Fed Funds Rate, %	0.09	0.07	0.09	0.09	0.11	0.18	0.23	0.30	0.74	0.11	0.09	0.36	1.97
3-month T-Bill, (bond-eq.)	0.1	0.1	0.0	0.0	0.1	0.1	0.2	0.4	0.9	0.1	0.0	0.4	2.1
2-year Treasury Note	0.3	0.4	0.4	0.5	0.4	0.8	1.1	1.6	2.0	0.3	0.4	1.4	2.8
10-year Treasury Note	2.7	2.8	2.6	2.5	2.4	2.7	3.0	3.2	3.3	2.4	2.6	3.1	3.7