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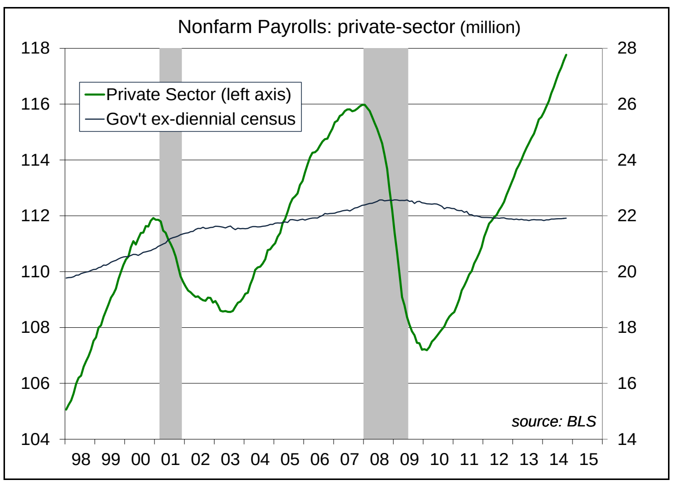
Monthly Economic Outlook

Eyeing U.S. Growth and the Outlook Abroad

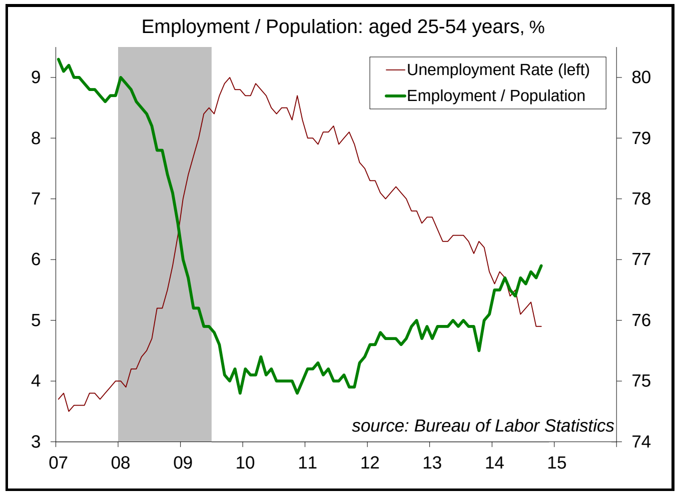
- *U.S. economic growth appears mixed, but moderate. Lower gasoline prices are expected to help offset the impact of lackluster wage growth into early 2015.*
- *Global developments will remain important. In recent weeks, U.S. investors have reacted negatively to signs of economic weakness in the euro area, China, and Japan, but positively to increased central bank efforts to spur growth.*
- *Having ended large-scale asset purchase, the focus shifts to when the Fed will begin raising short-term interest rates. That decision will be data-dependent, but there's no clear consensus.*

Real GDP rose at a 3.5% annual rate in the advance estimate for 3Q14. That figure is expected to be revised slightly lower, but it wasn't as strong as it looked. The headline figure was boosted by a narrower trade deficit and pop in defense spending. Excluding defense, Domestic Final Sales, a measure of underlying domestic demand, would have risen at about a 2.0% annual rate – not terrible, but not strong either. Consumer spending (70% of GDP) rose at a lackluster 1.8% pace, reflecting relatively weak growth in average wages.

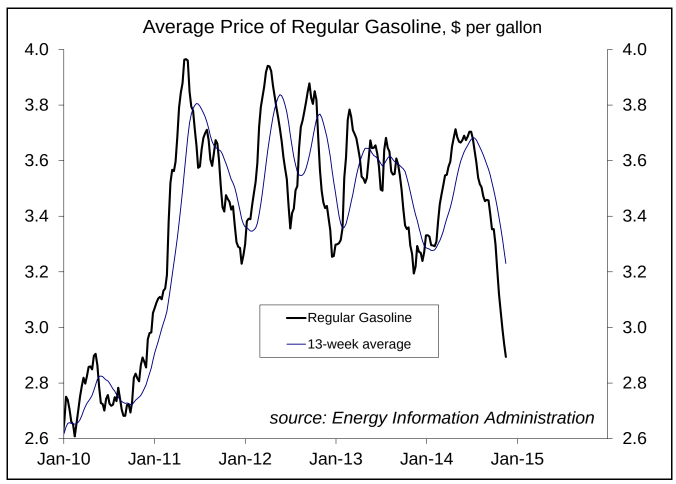
Job growth has been strong this year. The data continue to show a low level of job destruction. Weekly claims for unemployment benefits and short-term unemployment (less than 6 months) are trending at very low levels. New hiring has picked up and gains have been relatively broad-based.



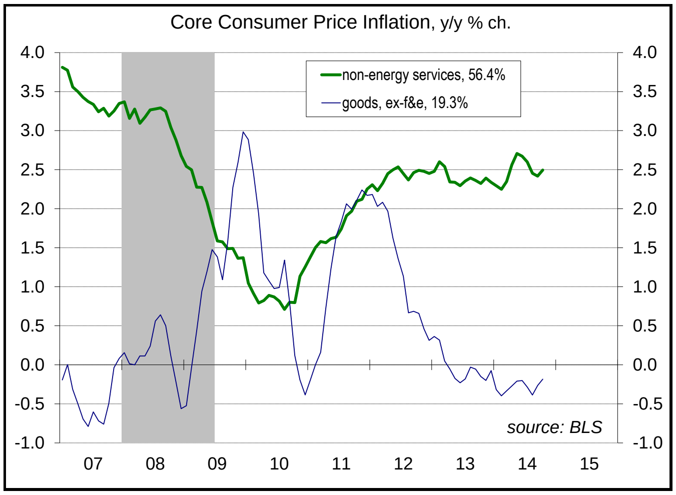
While job market conditions have continued to improve, they remain far from normal. Long-term unemployment is trending lower, but is still relatively high by historical standards. In addition, measures of underemployment and the number of people involuntarily working part-time suggest that a lot of slack remains. Labor force participation has fallen significantly, suggesting that there are potential workers on the sidelines who could take a good job if offered.



The employment/population ratio, a better measure of labor utilization, has risen gradually over the last several months, with improvement especially pronounced in the key age cohort (those aged 25-54). One would expect to see gains here first, then eventually spreading to other sectors. Unemployment rates for teenagers and young adults have been trending lower, but still have a long way to go.



Despite stronger job growth this year, growth in average wages has remained relatively weak. This, in turn, limits the upside potential for consumer spending growth. Lower gasoline prices are now adding to consumer purchasing power. However, gasoline prices normally fall in the second half of the year (making the decline less impressive than it appears at first glance). The impact on the consumer depends on how far gasoline prices fall and how long they stay low, but it also shows up with a lag. Gasoline futures, not a foolproof predictor, indicate that gasoline prices are likely to fall a bit further and then stay low into the first half of 2015, providing important support to consumer spending growth.



Inflation has remained relatively low this year. The Consumer Price Index rose at a 1.6% annual rate over the first 10 months of 2014, vs. +1.5% for all of 2013. Core inflation is trending at 1.8%, vs. 1.7% last year. Inflation is a monetary phenomenon, but shows up through pressure on resources. Weak global growth has put downward pressure on commodity prices. Increases in U.S. energy production have helped reduce oil prices. There are no appreciable signs of bottleneck pressures in manufacturing. The labor market, the widest channel for inflation pressure, has enough slack to keep wage increases at a generally low level.

To date, Federal Reserve officials have not expressed serious concerns about the low trend in inflation, something that they have worried about in the past. Most Fed officials still expect inflation to trend at or below the official 2% goal (PCE Price Index) for each of the next few years. However, Fed officials are aware that market-based measures of expected inflation have declined in recent weeks.

The minutes of the October 28-29 Fed policy meeting suggest no clear consensus view at the Fed on when to begin raising short-term interest rates. Officials differ in their views on the amount of slack in the labor market, how rapidly that slack is likely to be taken up, and on how much upward pressure on inflation the reduction in slack will generate. One thing Fed officials do agree on is that future monetary policy decisions will remain data-dependent. Most likely, a consensus on timing should begin to form in early 2015, but policy will be driven by the evolution of the economic outlook. Fed officials see a limited impact on the U.S. from slower growth abroad.

In recent months, the Fed has made progress in mapping out its strategies to normalize monetary policy. However, managing market expectations will be a major challenge. In the October 29 policy statement, the FOMC repeated that rates would likely remain low for a *"considerable time"* after the asset purchase program ends (QE3 was completed at the end of October). The FOMC minutes reflected a high level of anxiety around how to change that language, fearing that such a move could be misinterpreted by financial market participants. In the months ahead, we can expect the Fed to make its decision-making process more explicit – so that the initial rate hike will appear to be a natural consequence based on the economic data available up to that point.

In recent weeks, U.S. financial market participants have reacted negatively to signs of economic weakness in the euro area, China, and Japan, but foreign central banks' efforts to spur growth have been taken positively. While the outlooks for the domestic economy and Federal Reserve policy will remain dominant factors, investors are expected to keep a close eye on what's happening in the rest of the world. On December 4, the European Central Bank is expected to signal that it will begin buying sovereign debt. That's a big deal.

	1Q14	2Q14	3Q14	**4Q14**	**1Q15**	**2Q15**	**3Q15**	**4Q15**	**1Q16**	2013	**2014**	**2015**	**2016**
GDP (↓ *contributions*)	-2.1	4.6	3.5	2.4	3.0	2.9	2.6	2.6	2.6	2.2	2.2	2.9	2.6
consumer durables	0.2	1.0	0.5	0.2	0.5	0.5	0.4	0.4	0.4	0.5	0.5	0.5	0.4
nondurables & services	0.6	0.8	0.7	1.4	1.5	1.5	1.3	1.4	1.4	1.2	1.0	1.3	1.4
bus. fixed investment	-0.1	1.2	0.7	0.8	0.7	0.7	0.6	0.6	0.6	0.3	0.6	0.7	0.6
residential investment	-0.2	0.3	0.1	0.4	0.3	0.3	0.2	0.2	0.2	0.3	0.1	0.3	0.2
government	-0.2	0.3	0.8	-0.1	0.2	0.2	0.2	0.2	0.2	-0.4	0.0	0.2	0.2
Domestic Final Sales	0.7	3.4	2.7	2.7	3.2	3.1	2.8	2.8	2.8	1.9	2.1	3.0	2.8
exports	-1.3	1.4	1.0	0.4	0.3	0.4	0.4	0.4	0.4	0.4	0.5	0.5	0.4
imports	-0.4	-1.8	0.3	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.2	-0.6	-0.6	-0.6
Final Sales	-1.0	3.2	4.2	2.6	2.9	2.9	2.6	2.6	2.6	1.8	2.1	3.0	2.6
ch. in bus. inventories	-1.2	1.4	-0.6	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Unemployment, %	6.7	6.2	6.1	5.6	5.4	5.3	5.2	5.1	5.0	7.4	6.2	5.3	5.2
NF Payrolls, monthly, th.	190	267	224	240	190	220	210	200	190	194	230	205	205
Cons. Price Index (q/q)	1.9	3.0	1.0	-0.1	1.4	1.9	1.9	1.9	2.0	1.5	1.7	1.4	1.9
excl. food & energy	1.6	2.5	1.3	1.6	1.6	1.8	1.8	1.8	1.9	1.8	1.8	1.7	1.9
PCE Price Index (q/q)	1.4	2.3	1.2	0.6	1.5	1.8	1.8	1.8	1.8	1.2	1.4	1.5	1.8
excl. food & energy	1.2	2.0	1.4	1.5	1.5	1.7	1.7	1.8	1.8	1.3	1.4	1.6	1.9
Fed Funds Rate, %	0.07	0.09	0.09	0.10	0.18	0.23	0.30	0.74	1.23	0.11	0.09	0.36	1.97
3-month T-Bill, (bond-eq.)	0.1	0.0	0.0	0.0	0.1	0.2	0.4	0.9	1.4	0.1	0.0	0.4	2.1
2-year Treasury Note	0.4	0.4	0.5	0.5	0.7	1.0	1.6	2.0	2.3	0.3	0.5	1.3	2.8
10-year Treasury Note	2.8	2.6	2.5	2.4	2.6	3.0	3.2	3.3	3.5	2.4	2.6	3.0	3.7