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Economic Research
Published by Raymond James & Associates

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December 18, 2014

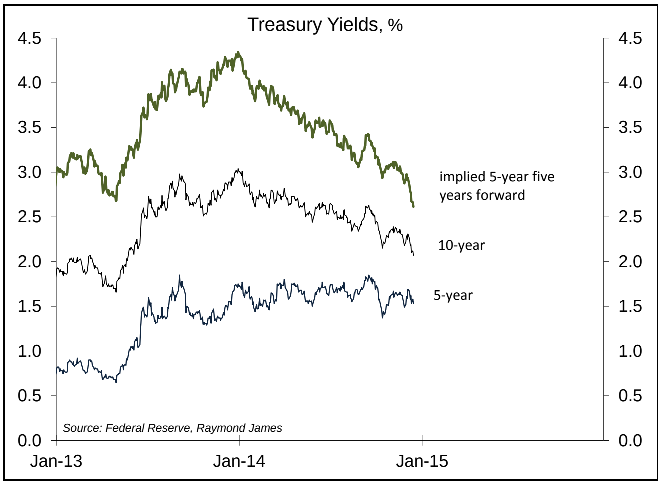
Monthly Economic Outlook

The 2015 Outlook – Many Moving Parts

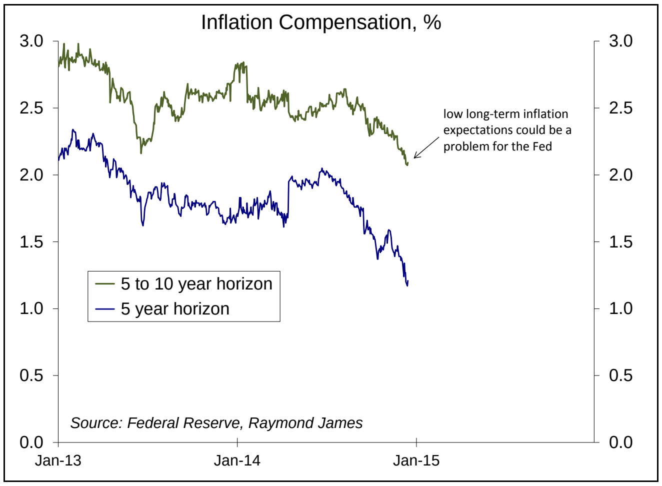
- *What's going on in the rest of the world will be a key factor for investors in 2015. Soft global growth is expected to have a mixed impact on the U.S. economy. There is some risk of increased geopolitical tensions and financial disruptions.*
- *A sustained decline in crude oil prices will have a negative impact on the U.S. energy sector, but lower gasoline prices should provide significant positive benefits to consumers and businesses.*
- *The Federal Reserve is expected to begin normalizing monetary policy. Managing financial market expectations is likely to prove one of the biggest challenges in 2015.*

The recovery has faced strong headwinds in the last few years – a major housing correction, a deleveraging in the financial system, tighter fiscal policy at the federal, state, and local level. With those headwinds largely out of the way, growth was widely expected to pick up in 2014. However, there were new constraints – bad weather in the first quarter, a softer global economy, and lackluster wage growth.

By far, the biggest surprise in 2014 was the decline in long-term interest rates. Instead of rising to 3.5% or more, as many had expected, the 10-year Treasury note yield is a lot closer to 2.0%. That's not what usually happens in a strengthening economy. The drop is interesting if you think of the 10-year Treasury note as a 5-year note plus an implied 5-year note five years into the future. The 5-year Treasury note yield is currently about where it was at the end of last year, trending roughly flat over the course of the year. In contrast, the implied 5-year Treasury note yield five years ahead has declined significantly. Why is that? Investors could be less fearful of higher future inflation, or perhaps they see a lower long-term growth path for the U.S. economy. Inflation compensation measures, calculated from inflation-adjusted Treasuries, have declined over the last several weeks.

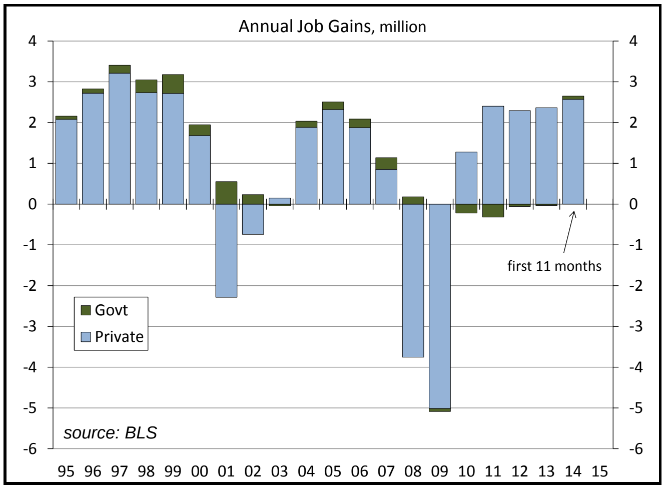

Treasury Yields, %

Source: Federal Reserve, Raymond James


Inflation Compensation, %

Source: Federal Reserve, Raymond James

Central bankers know that real (that is, inflation-adjusted) interest rates are what matters for the economy. All else equal, a drop in inflation expectations means higher real interest rates, implying somewhat slower growth. This is a much bigger deal for the euro area. For the U.S., the situation bears watching closely, but "inflation compensation," the rate implied by comparing inflation-adjusted Treasuries to regular fixed-rate Treasuries, doesn't actually measure inflation expectations. The drop could reflect distortions from a flight to safety into fixed-rate Treasuries, which are more liquid.


Annual Job Gains, million

source: BLS

The drop in bond yields is odd given the relative strength of the U.S. economy. We've already added more jobs in the first 11 months of 2014 than in any full year since 1999. Job destruction remains very low by historical standards. New hiring has gradually picked up. Yet, public perceptions of the economy's strength remain generally poor. That's not unusual; perceptions of economic strength typically lag in a recovery. Additionally, long-term unemployment and underemployment remain elevated and wage growth has been subpar.

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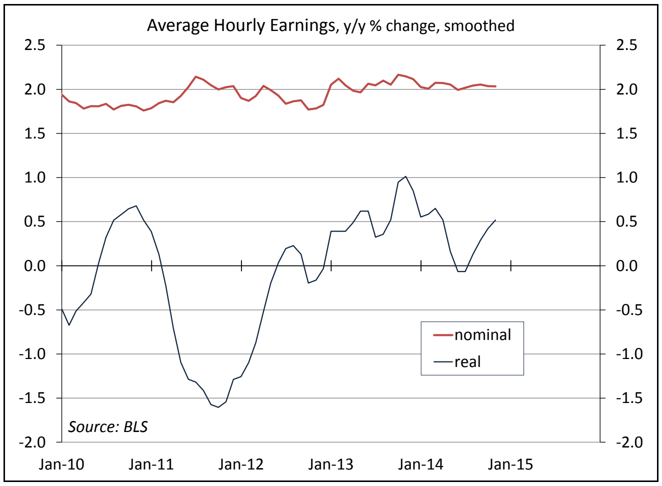
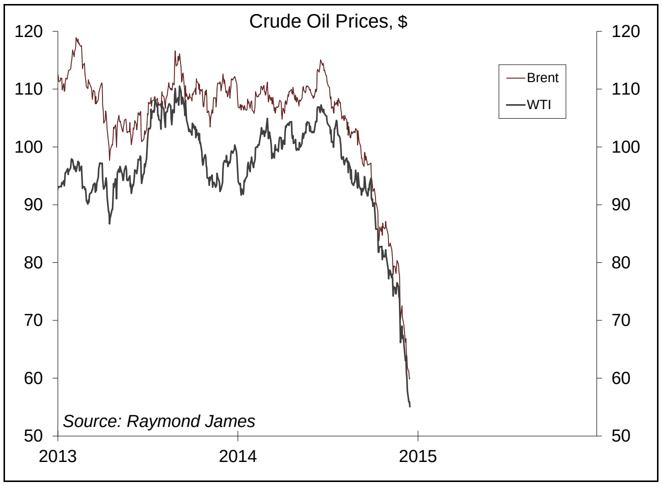
Average hourly earnings have been rising at a 2% annual rate over the last few years, barely keeping pace with inflation. Under "normal" labor market conditions, workers would be expected to share in productivity gains and compensation would rise 3.5% to 4.0% per year. In turn, the increase in purchasing power would fuel strong consumer spending growth (and remember, consumer spending accounts for 70% of Gross Domestic Product). Instead, consumer spending has been driven largely by job growth. Weak wage growth has also been a factor in the lackluster recovery in the housing sector, limiting affordability and leading to less improvement in homeowners' ability to service mortgage debt.


Average Hourly Earnings, y/y % change, smoothed

Source: BLS

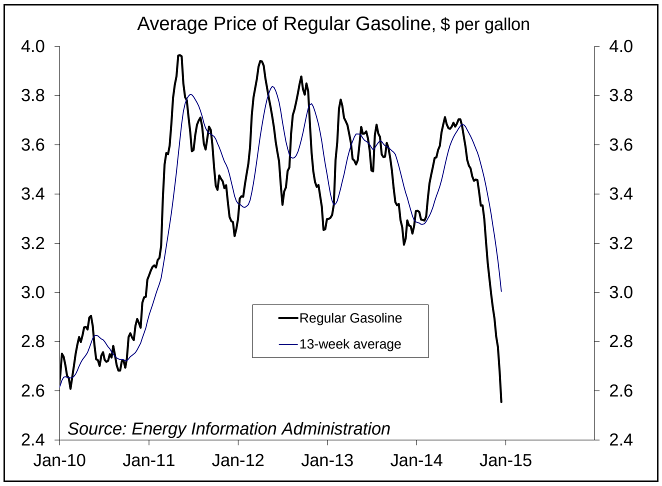
The price of oil is often a wildcard in the economic outlook. The plunge in oil prices caught many investors off guard in late 2014. Some of the decline reflects the increase in U.S. production, but most appears to be a symptom of weaker global demand. Emerging economies were expected to account for much of the global growth over the next few decades, but they've been unexpectedly weak.


Crude Oil Prices, $

Source: Raymond James

The drop in oil prices should have a substantial negative effect on U.S. exploration and production. Energy extraction has been a rapidly growing area of the economy, with job growth roughly 5.5 times that of overall nonfarm payrolls since 2009. However, oil and gas extraction payrolls were 215,200 in November, just 0.15% of total nonfarm payrolls. Even if you add twice that in support jobs, you're still talking about a small fraction of U.S. employment. The bigger impact will be in capital spending. Energy-related structures and equipment accounted for 6.8% of business fixed investment (or 0.9% of GDP) in 3Q14. That will be missed. Low oil prices are expected to have a significant impact on certain regions of the country and we may see some decrease in tax revenues and problems at local banks. However, the negative impact on the overall economy should be relatively limited.

The impact of lower gasoline prices on the consumer depends on how low prices go and how long they stay low. The futures market (which doesn't necessarily provide accurate forecasts) suggests that oil prices will remain low for a few years (WTI below $65 at the end of 2016, but that outlook can change quickly). The impact on spending shows up with a lag (the 13-week average is a good gauge to use). While the decline in gasoline prices is somewhat supportive for spending during the critical holiday shopping period, we should see a more significant impact in the first half of 2015.


Average Price of Regular Gasoline, $ per gallon

Source: Energy Information Administration

A $1 decline in gasoline prices is equivalent to about $100 billion per year in spending (that's 0.8% of consumer spending or about 0.6% of GDP). Spending less on gasoline, consumers will have more money to spend on other things. For someone who works 25 miles from home and gets 20 miles per gallon, a $1 decline in gasoline prices would free up about $50 per month (twice that for a two-income household).

Lower oil prices will help reduce transportation costs for businesses and should benefit energy-intensive manufacturing. However, most large firms, such as airlines, hedge their energy costs out into the future, so it will likely be some months before we see the full effect.

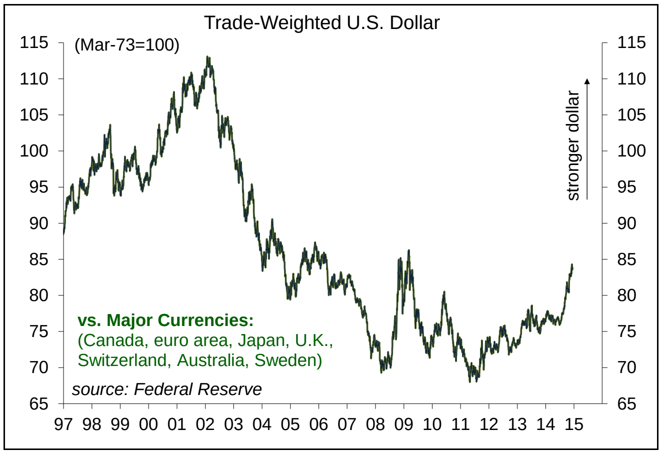
Outside the U.S., the impact of a sustained decline in oil prices will be mixed. Energy producers, such as Venezuela, Iran, Nigeria, and Russia, will have a harder time. Energy importers, such as China and Japan, stand to benefit.

Ultimately, supply and demand should push oil prices toward equilibrium, but it may take some time for the market to determine where that is. However, in the near term, lower oil prices should be a net benefit to the U.S. economy.

U.S. financial markets were rocked by the increase in geopolitical tensions in the summer of 2014. The situation in Ukraine and the troubles with the Islamic State have not gone away, although the financial markets have paid less attention in recent months. These tensions could intensify and new ones, made worse by the drop in oil prices, could appear, adding to financial market volatility over the course of 2015.

The slowdown in global growth has been a more immediate concern. The euro area has been flirting with recession. China and other emerging economies are dependent on exports and have yet to develop sufficient domestic demand. So, sluggishness in the advanced economies hasn't helped. In early October, the International Monetary Fund downgraded the outlook for global growth. However, the greater worry was the increase in downside risks.

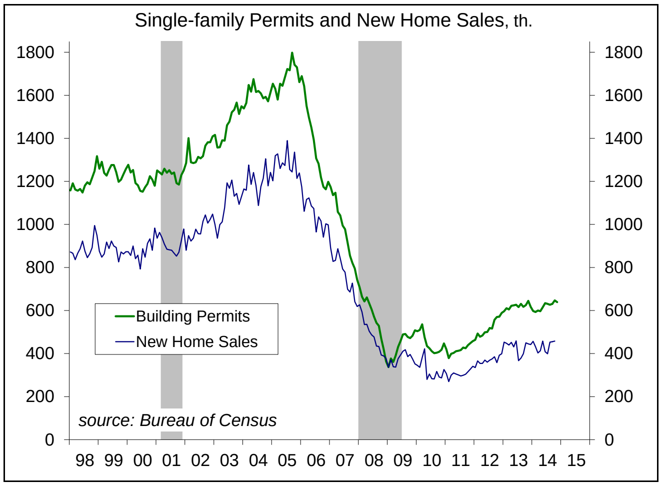
Europe's crisis has entered a new, potentially more dangerous phase. Initially, the crisis was about the survivability of the monetary union. However, European Central Bank President Mario Draghi's promise to do whatever it takes to keep the currency union intact effectively put that worry to bed. In the meantime, austerity, the result of a misdiagnosis of the problem (it's a capital crisis, not a sovereign debt crisis), weakened Europe's recovery from recession. Now the euro area faces the possibility of deflation and an extended period of economic stagnation. The ECB is expected to launch its version of quantitative easing in early 2015, but the fear is that this may be too little, too late, to do much good.


Trade-Weighted U.S. Dollar

source: Federal Reserve

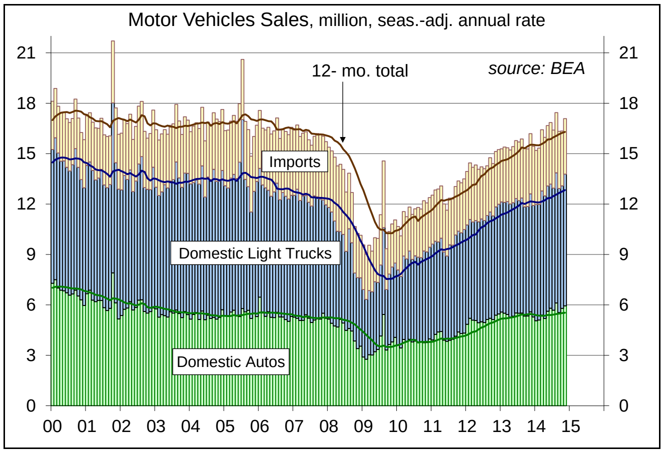
Weak global growth will have a significant impact on many U.S. firms (which should be more apparent in 1Q15 earnings). Overseas earnings are likely to slow or decline, while the stronger currency will reduce the dollar value of any given level of foreign earnings. Exports are likely to soften, while imports should increase, subtracting from GDP growth in 2015 (domestic demand should remain relatively strong).

Weaker global growth also provides benefits to the U.S. Commodity prices, oil prices in particular, have fallen, boosting consumer spending growth. Capital inflows will pick up as trade outflows increase. Lower long-term interest rates abroad put some downward pressure on U.S. bond yields (lower mortgage rates than would occur otherwise).


Single-family Permits and New Home Sales, th.

source: Bureau of Census

The housing market recovery was disappointing in 2014, restrained by a variety of factors. Supply issues (a lack of available lots on which to build, a scarcity of skilled labor, higher costs for materials, and tight bank credit) were a problem for many homebuilders in the first half of the year, but constraints are now less binding. Strong job growth would normally be a significant positive factor for the housing market, but affordability was reduced by 2013's taper tantrum (higher mortgage rates) and by an increase in home prices into the first half of the year. Affordability has now improved, mortgage credit is getting gradually easier, and job growth is expected to remain strong in 2015. However, weak growth in average wages has been a drawback for the mid-range of the market.


Motor Vehicles Sales, million, seas.-adj. annual rate

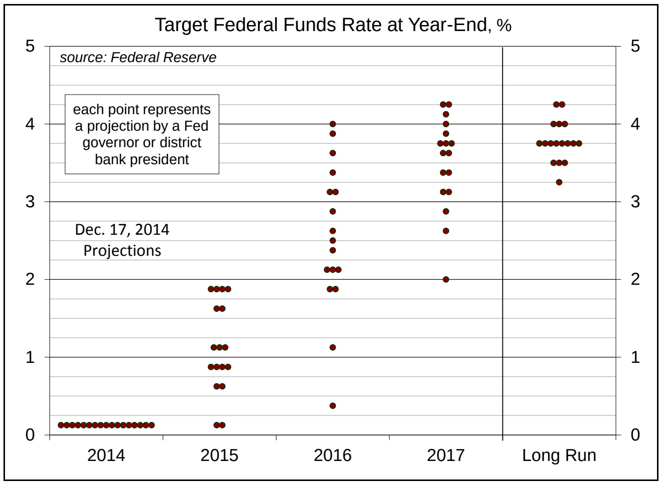
source: BEA

Increased autos sales and production have been important to the economic recovery. Improvement has been due to two key factors: cars get old and have to be replaced; and banks are very willing to make auto loans (it's a lot easier to repossess a car than a home). However, the pace of vehicle sales, now nearing the pre-recession average, may be reaching equilibrium. With sales stabilizing, motor vehicles should provide less support to GDP growth in 2015.

Overseas economic weakness and a strong dollar are expected to widen the trade deficit in 2015, which will subtract from overall GDP growth. However, Domestic Final Sales (GDP less net exports and the change in inventories) is likely to be relatively strong over the course of the year.

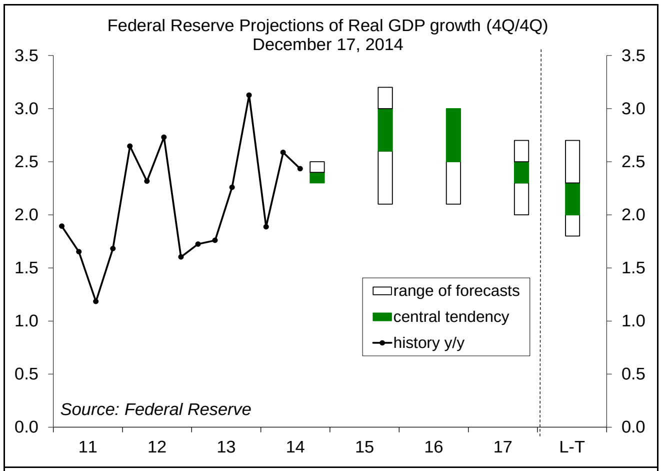
With short-term interest rates at exceptionally low levels and its balance sheet expanded well beyond normal, the Federal Reserve is expected to begin normalizing monetary policy in 2015. Over the last several months, Fed officials have mapped out a broad strategy for how this will be done. The Federal Open Market Committee is expected to announce a target range for the federal funds rate (rather than a specific level), with the interest rate paid on excess bank reserves held at the Fed (IOER) at the top of that range. Sometime after the first increase in short-term rates, the Fed is expected to end the current program of reinvesting mortgage principal payments and maturing Treasury securities in its portfolio. The size of the Fed's balance sheet will then decrease naturally, a process that is expected to take several years.

The key questions for the financial markets are when the Fed will begin raising short-term rates and how rapidly. In the December 17 monetary policy statement, the FOMC abandoned its conditional commitment to keep rates low for *"a considerable time,"* instead saying that it could *"be patient"* in beginning to normalize policy. Yet, the FOMC emphasized that this new language did not represent any change in its policy intentions. Fed officials are unanimous in their view that future policy moves will be data-dependent. However, some are more patient than others. Two hawks (Plosser, Fisher) and one dove (Kocherlakota) will roll off the FOMC in 2015, replaced by one hawk (Lacker) and two doves (Evans, Williams).

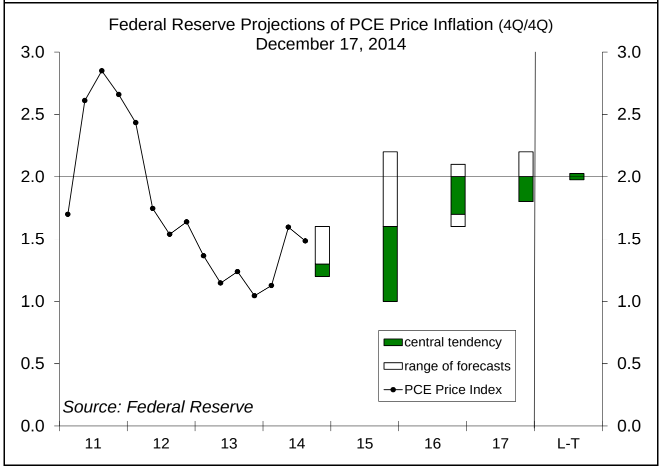

Target Federal Funds Rate at Year-End, %

source: Federal Reserve

Fed officials' projections of the appropriate federal funds rate for the end of 2015 and the end of 2016 are still dispersed, suggesting that officials have different views on the amount of slack in the economy and how rapidly that slack will be taken up in the months ahead. The dots in the dot chart imply that officials may be gravitating toward two camps, one wanting to raise rates sooner, the other later. The impact of monetary policy has a long and variable lag. However, the risks around the timing of the first rate hike are not symmetric. If the Fed hikes too soon, and the economy slows, it will have a limited ability to change course (rates are already low and nobody wants to embark on another round of quantitative easing). In contrast, if the Fed hikes too late, and inflation picks up more than intended, it can easily raise rates to correct course.


Federal Reserve Projections of Real GDP growth (4Q/4Q)
December 17, 2014

Source: Federal Reserve

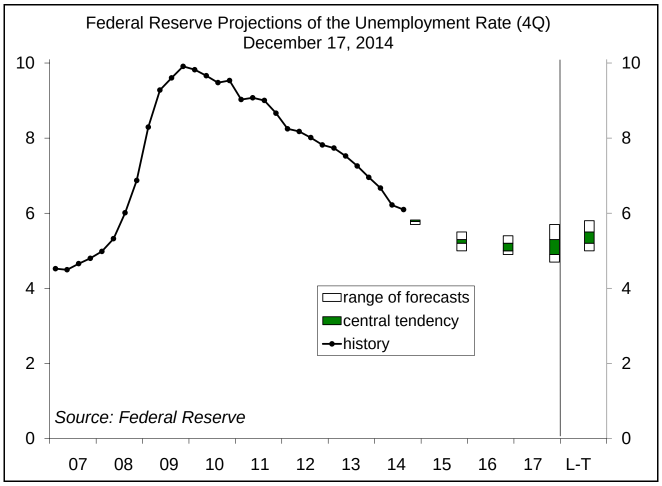

Federal Reserve Projections of PCE Price Inflation (4Q/4Q)
December 17, 2014

Source: Federal Reserve

How do low oil prices factor into the Fed's decision? Not as much as one might think. The Fed sees the drop in oil prices as transitory. Oil prices are not going to fall forever. Overall inflation will be lower for some time and we could see that feed through to a decrease in core inflation. However, lower oil prices will also stimulate growth and should help reduce the amount of slack in the economy. The Fed keeps a close eye on inflation expectations, but officials don't seem to be too worried by the market-based decline in long-term inflation compensation (the difference in yields between inflation-adjusted Treasuries and fixed-rate Treasuries), which, according to Fed Chair Yellen, could reflect a decrease in perceived inflation risk or a flight to safety into fixed-rate Treasuries.

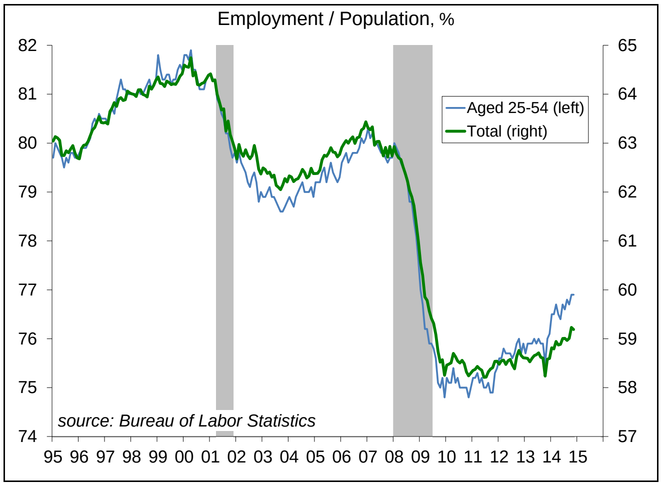
In her press briefing, Yellen dispelled a couple of popular misconceptions about future Fed decisions. One is that the Fed could raise rates at any policy meeting, not just the ones with a press conference. The other is that, once the Fed begins policy normalization, it may not raise rates at a "measured" pace (25 basis points per FOMC meeting).

In a recent speech, NY-Fed President William Dudley noted that the Fed also has to react to a possible overreaction or incorrect reaction to Fed policy. For example, bond yields rose (and credit tightened) in the taper tantrum, but then fell when the Fed actually reduced the monthly pace of asset purchases. However, the decision to begin raising short-term rates should be less confusing for the markets than quantitative easing.


Federal Reserve Projections of the Unemployment Rate (4Q)
December 17, 2014

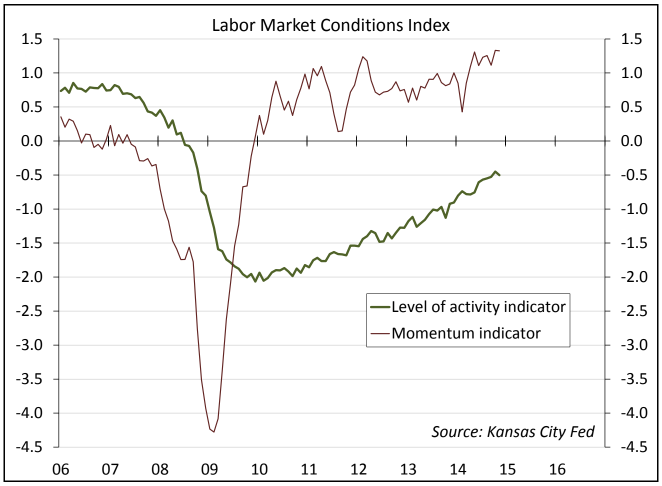
Source: Federal Reserve

The Fed's views on the labor market will play a central role in monetary policy deliberations in 2015. In their December 17 projections, senior Fed officials expect a further decline in the unemployment rate (5.8% in November) in 2015, likely edging below what the Fed considers to be a long-term sustainable rate in 2016 and 2017. That doesn't mean that the Fed will be trading off higher inflation for a lower unemployment rate. Rather, the unemployment rate is a distorted measure of labor force utilization. Specifically, there are a lot of people on the sidelines, not officially counted as "unemployed," but who would take a good job if one were available. These include the long-term jobless who have given up looking for work, as well as recent retirees and stay-at-home spouses.


Employment / Population, %

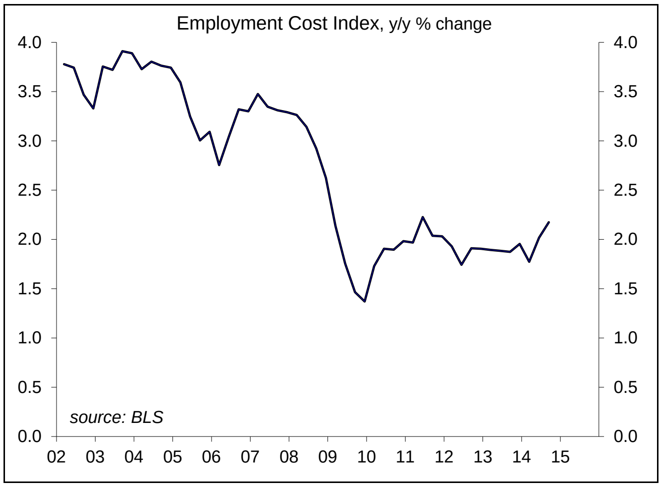
source: Bureau of Labor Statistics

The employment/population ratio is the preferred measure of labor utilization. This ratio has improved over the last year, suggesting that labor market slack is being gradually reduced, but a lot of slack remains. Bear in mind that as the baby boomers move into retirement, labor force participation should decline. Participation fell more than three percentage points in the recession. Perhaps a third of that was due to the demographics. Improvement in the employment/population ratio has been more pronounced for the key age cohort, those aged 25-54 (where retirement isn't much of an issue). At the same time, unemployment rates for teenagers and young adults, while lower, are still relatively high.


Labor Market Conditions Index

Source: Kansas City Fed

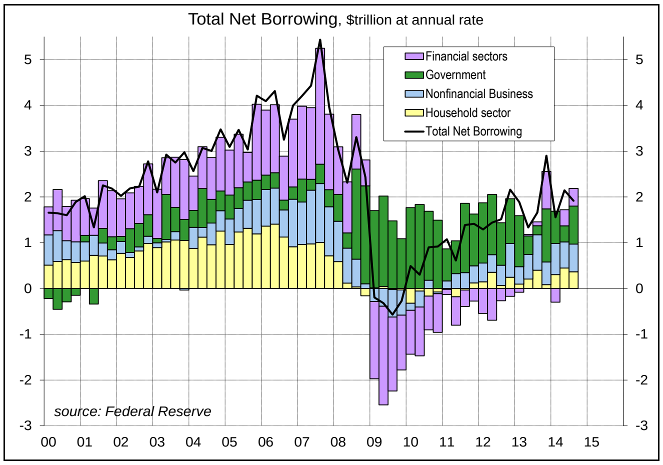
There are many job market indicators. The Kansas City Fed's Labor Market Conditions Index, which is a composite of 24 of them, provides a convenient summary (according to Fed Chair Yellen). The level suggests that a lot of slack remains, while the momentum gauge has been relatively strong. At this pace, the job market ought to be close to normal in early 2017.


Employment Cost Index, y/y % change

source: BLS

One clear sign of labor market slack is the lackluster pace of wage growth. Normally, labor compensation costs would increase at an annual rate of about 3.5%, as workers share in productivity gains. The recent pace has been around 2%, barely keeping pace with inflation. For an individual business, this is a zero-sum game. That is, profits decline if workers are paid more. In the aggregate, it's not a zero-sum game, as wage increases get spent back into the economy. Income inequality has been an important topic this year, but one that failed to gain much traction in the U.S. The bigger concern has been the apparent "whittling away" of the middle class. Many observers fear a decline in mobility. Weak growth in average wages has been a limiting factor for consumer spending and housing. Yet, wage growth should take care of itself as the labor market tightens. There are already reports of better wage growth for many skilled labor positions, but a broader pickup in average wages may not come until the second half of 2015 or later. Uncertainty over wage growth will be another important factor in the Fed's monetary policy decisions.

Total Net Borrowing, $trillion at annual rate



source: Federal Reserve

The recession can be characterized largely as an unwinding of a housing bubble and a massive deleveraging in the financial system (roughly matched by a large, temporary increase in government borrowing). Credit growth now appears to be relatively well-balanced (although the housing sector has remained somewhat soft) and should help to support an expansion in the domestic economy in 2015. There's no need for the Fed to hit the brakes, but it certainly has to consider taking the foot off the gas pedal at some point.

Republicans will control both chambers of Congress in 2015. However, we're unlikely to see a new era of bipartisanship. Republicans (like Democrats) have their own internal divisions. They do not have a 60-seat super-majority in the Senate, which means that Democrats can still bog things down, and they do not have the two-thirds majority needed in both chambers to override a presidential veto. Next year is likely to be dominated by posturing ahead of the 2016 presidential election. Don't expect much.

The battle over the FY15 budget has been settled, but the debt ceiling could be a sticking point in 2015. The debt ceiling is currently waived, but will go back into effect on March 18. The debt ceiling will then be whatever the level of the national debt is at that time. Treasury can then use creative accounting to fund the government, and April tax payments will help, but a drop-dead date on the debt ceiling will likely be reached in the late summer or early autumn. There's some chance of another unnecessary showdown over the debt ceiling next summer, but investors have experienced this nonsense before, and ought to take such disruptions in stride.

Corporate cash flows and profits are likely to be mixed in 2015, reflecting weak economic growth in the rest of the world and solid strength at home. In turn, business fixed investment is likely to be uneven across both time and industries. Data on factory orders and shipments through October suggest relatively poor momentum for capital spending in the near term. Small business, which has struggled with tight credit in the recovery, is poised to pick up and should account for much of the job growth over the course of the year.

Forecasting, as everyone should know, is not clairvoyance. We can piece together a coherent story of what to expect in 2015, but that should be viewed as a base-case scenario. Clearly, there are many moving parts and those parts have interactions that may evolve in unpredictable ways in the months ahead. The global economy is expected to remain soft, but there are important downside risks and some possibility of wider-scale financial problems (to which the U.S. would not necessarily be immune). Lower oil prices should be a net positive for the domestic economy. The job market should continue to improve. Fed policymakers are likely to be somewhat cautious as they begin to normalize policy. It's an optimistic outlook, but one with a number of uncertainties.

	1Q14	2Q14	3Q14	**4Q14**	**1Q15**	**2Q15**	**3Q15**	**4Q15**	**1Q16**	2013	**2014**	**2015**	**2016**
GDP (↓ *contributions*)	-2.1	4.6	3.9	***2.2***	***2.7***	***2.7***	***2.6***	***2.6***	***2.6***	2.2	***2.3***	***2.8***	***2.6***
consumer durables	*0.2*	1.0	0.6	***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	0.9	***1.5***	***1.6***	***1.6***	***1.3***	***1.4***	***1.4***	*1.2*	***1.1***	***1.4***	***1.4***
bus. fixed investment	*-0.1*	1.2	0.9	***0.4***	***0.5***	***0.8***	***0.7***	***0.6***	***0.6***	*0.3*	***0.6***	***0.7***	***0.7***
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	***0.0***	***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	3.2	***2.5***	***3.2***	***3.4***	***2.9***	***2.8***	***2.8***	1.9	***2.2***	***3.1***	***2.8***
exports	*-1.3*	1.4	0.7	***0.4***	***0.3***	***0.3***	***0.4***	***0.4***	***0.4***	*0.4*	***0.4***	***0.5***	***0.4***
imports	*-0.4*	-1.8	0.1	***-0.8***	***-0.7***	***-0.7***	***-0.6***	***-0.6***	***-0.6***	*-0.2*	***-0.6***	***-0.6***	***-0.6***
Final Sales	-1.0	3.2	4.1	***2.2***	***2.9***	***3.0***	***2.7***	***2.6***	***2.6***	1.8	***2.1***	***3.0***	***2.6***
ch. in bus. inventories	*-1.2*	1.4	-0.1	***0.0***	***-0.2***	***-0.3***	***0.0***	***0.0***	***0.0***	*0.0*	***0.1***	***-0.1***	***0.0***
Unemployment, %	6.7	6.2	6.1	***5.8***	***5.5***	***5.4***	***5.3***	***5.2***	***5.1***	7.4	***6.2***	***5.4***	***5.3***
NF Payrolls, monthly, th.	190	267	224	***255***	***170***	***230***	***210***	***200***	***190***	194	***234***	***203***	***208***
Cons. Price Index (q/q)	1.9	3.0	1.0	***-1.2***	***-0.3***	***1.7***	***1.8***	***1.8***	***1.9***	1.5	***1.6***	***0.7***	***1.9***
excl. food & energy	1.6	2.5	1.3	***1.6***	***1.6***	***1.7***	***1.8***	***1.8***	***1.9***	1.8	***1.8***	***1.7***	***1.9***
PCE Price Index (q/q)	1.4	2.3	1.3	***-0.1***	***0.3***	***1.5***	***1.6***	***1.6***	***1.7***	1.2	***1.4***	***0.9***	***1.7***
excl. food & energy	1.2	2.0	1.4	***1.6***	***1.5***	***1.6***	***1.6***	***1.6***	***1.7***	1.3	***1.4***	***1.6***	***1.7***
Fed Funds Rate, %	0.07	0.09	0.09	***0.09***	***0.17***	***0.20***	***0.28***	***0.74***	***1.23***	0.11	***0.09***	***0.35***	***1.97***
3-month T-Bill, (bond-eq.)	0.1	0.0	0.0	***0.0***	***0.1***	***0.2***	***0.4***	***0.9***	***1.3***	0.1	***0.0***	***0.4***	***2.1***
2-year Treasury Note	0.4	0.4	0.5	***0.5***	***0.8***	***1.4***	***1.8***	***2.2***	***2.6***	0.3	***0.5***	***1.6***	***2.8***
10-year Treasury Note	2.8	2.6	2.5	***2.3***	***2.5***	***2.8***	***3.0***	***3.1***	***3.4***	2.4	***2.5***	***2.9***	***3.5***