US Economic Outlook

How long will the ride last?

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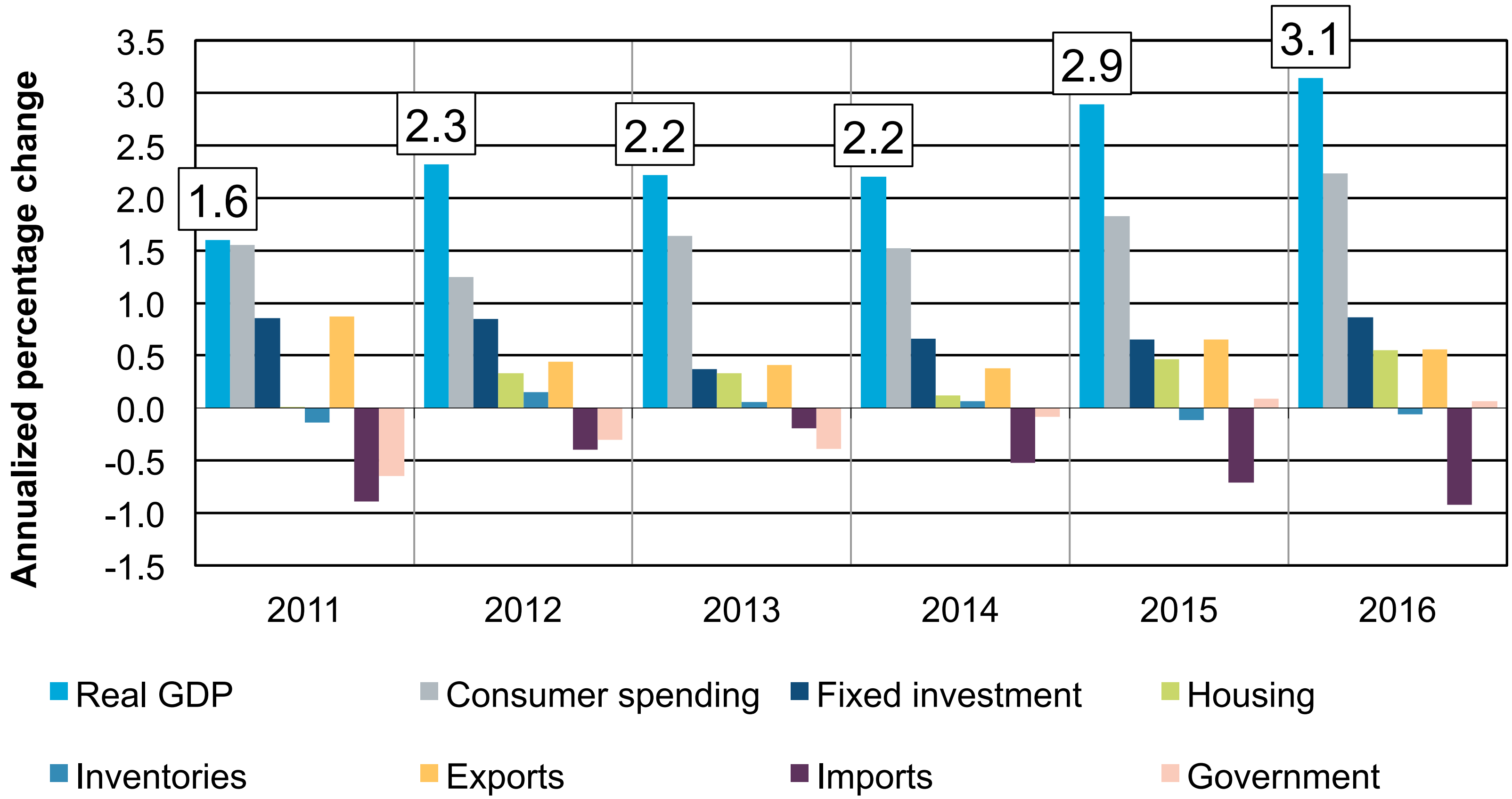
The US economy is gaining momentum

- Third-quarter economic growth remains strong, supported by a pickup in homebuilding, a drop in imports, and robust capital spending.
- An end to above-trend inventory accumulation will be a headwind to growth in late 2014 and early 2015.
- Consumers will cautiously boost spending in response to gains in employment, income, and household net worth.
- Homebuilding will rise in 2014–16 as supply catches up with demand.
- Capital spending will accelerate in 2014–15 in response to global market growth, replacement needs, and technological advances.
- Interest rates will rise significantly over the next three years as monetary accommodation is withdrawn.

Looking forward, we will still be counting on consumer spending to drive the bulk of economic growth

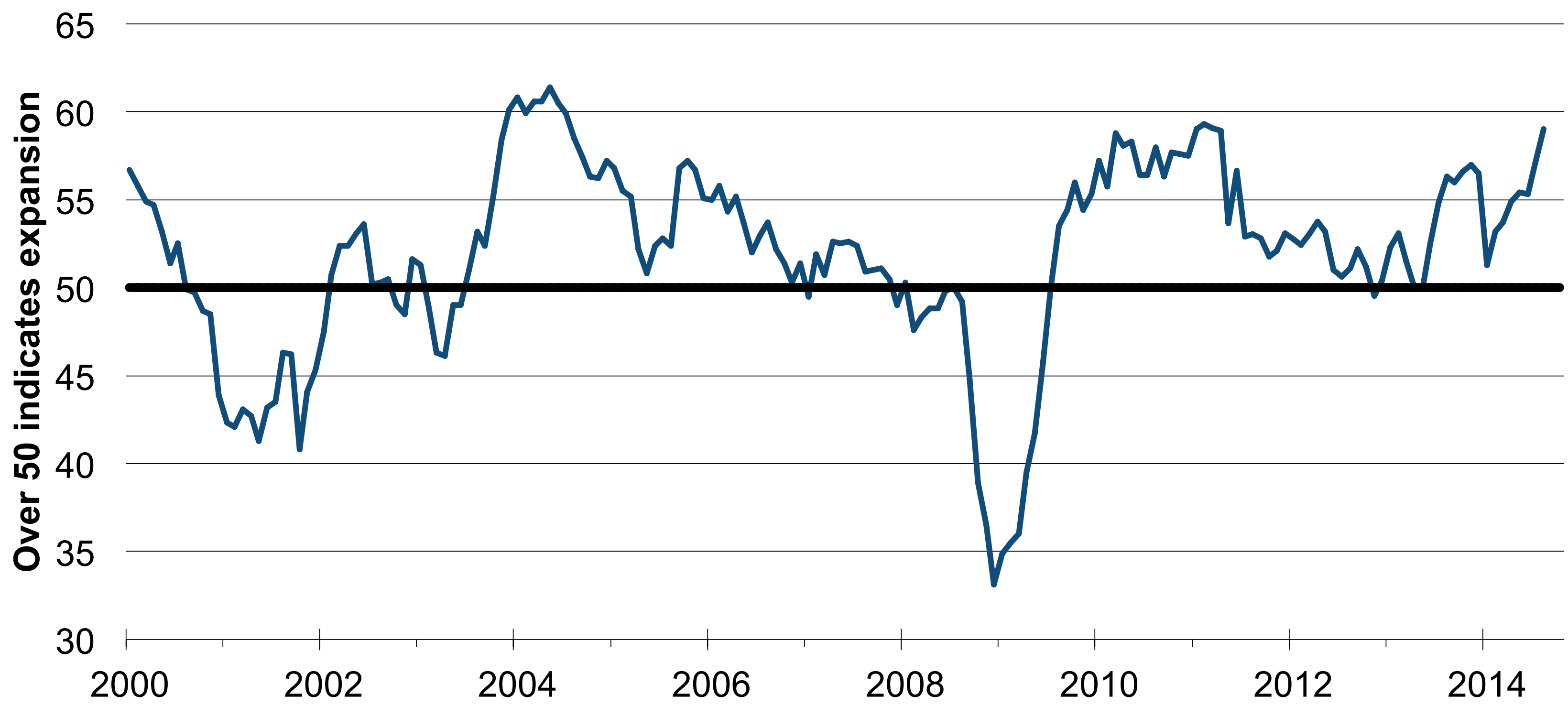
Contributions to real GDP growth



Source: IHS

The Institute for Supply Management's indexes signal growth in manufacturing and services

ISM indexes



Source: Institute for Supply Management (ISM)

Is the labor market getting tight enough to drive wage pressures?

Job creation and the unemployment rate

Source: IHS

The big question: Is the labor market loose or tight?

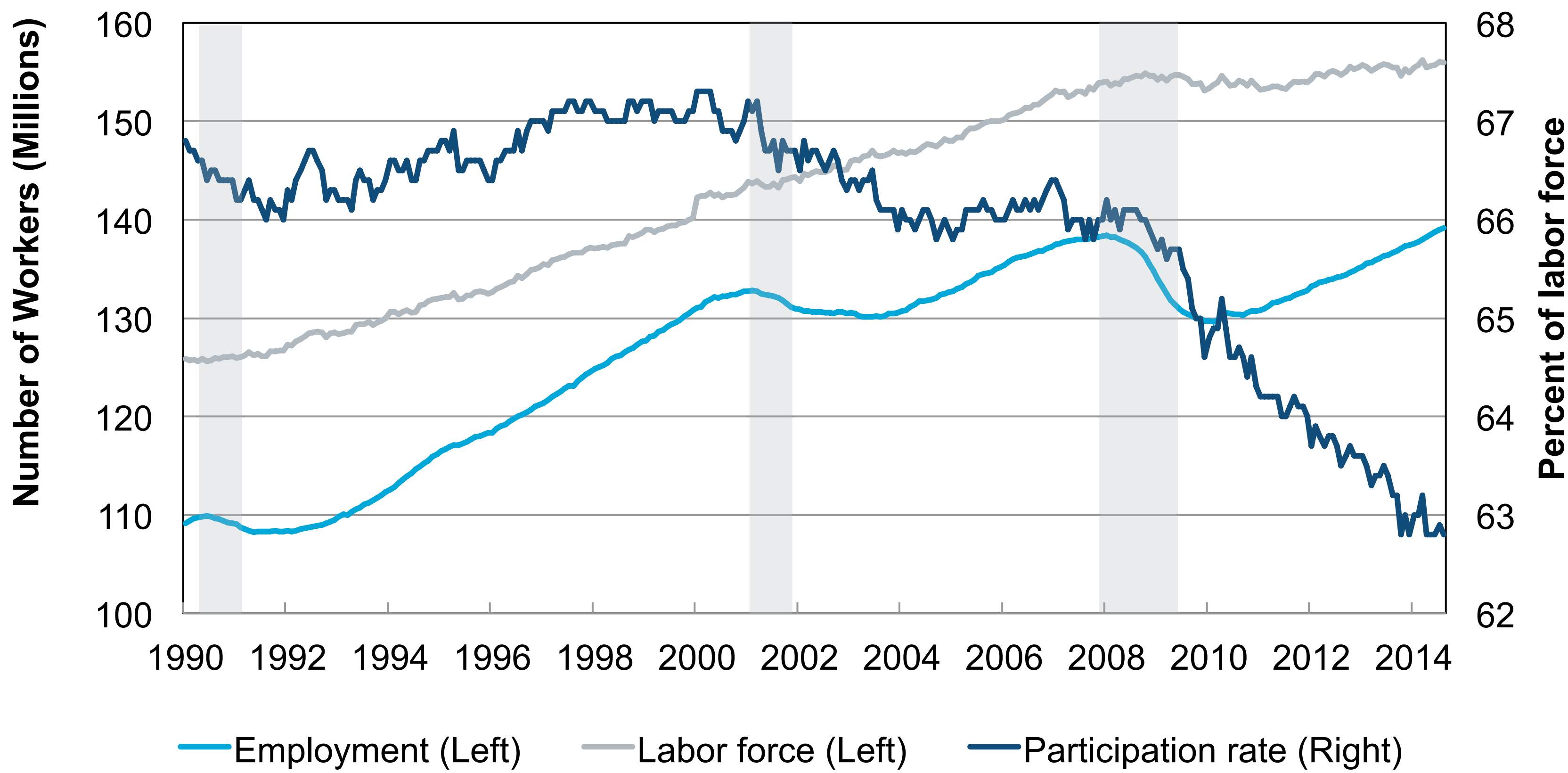
- Why do we need to know?
  - Will drive timing and magnitude of Fed actions.

- Is the current condition of the labor market due to either:
  - Structural issues – mismatches between labor supply and demand (TIGHT)
  - Cyclical issues – inadequate economic growth (LOOSE)

Structural Issues	Cyclical Issues
Aging labor force	Disillusionment with job search prospects
Inadequate skills	Poor job growth in manufacturing and construction sectors
Poor mobility	Inadequate wages

About 3% of the working age population has dropped out of the labor force since the end of the recession

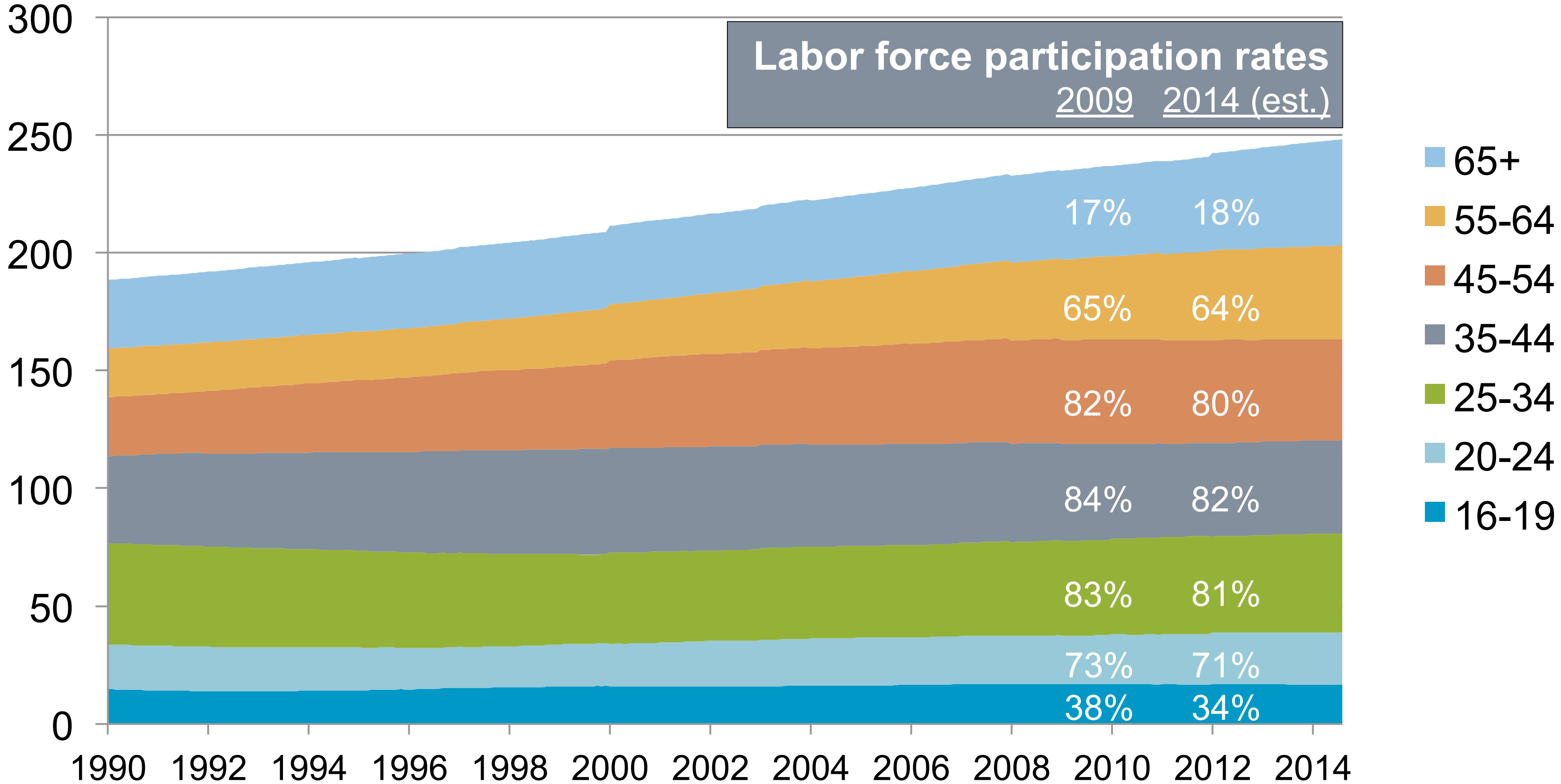
Employment and labor



Source: IHS

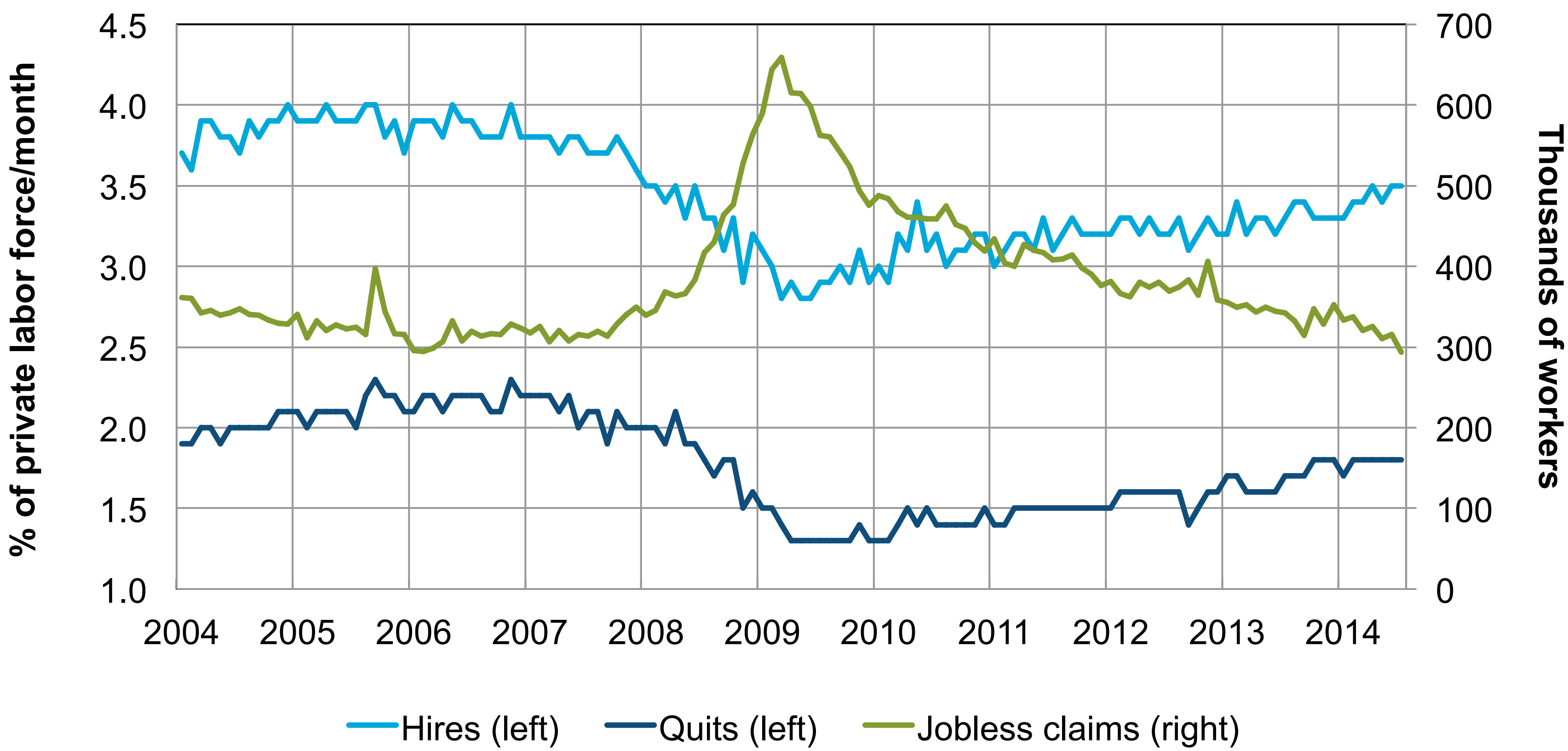
Two problems: (1) Participation rates are falling. (2) More people are moving into age cohorts with generally lower participation rates.

Working age population by age cohort (Millions)



Layoffs are down, but labor market lacking in dynamism.

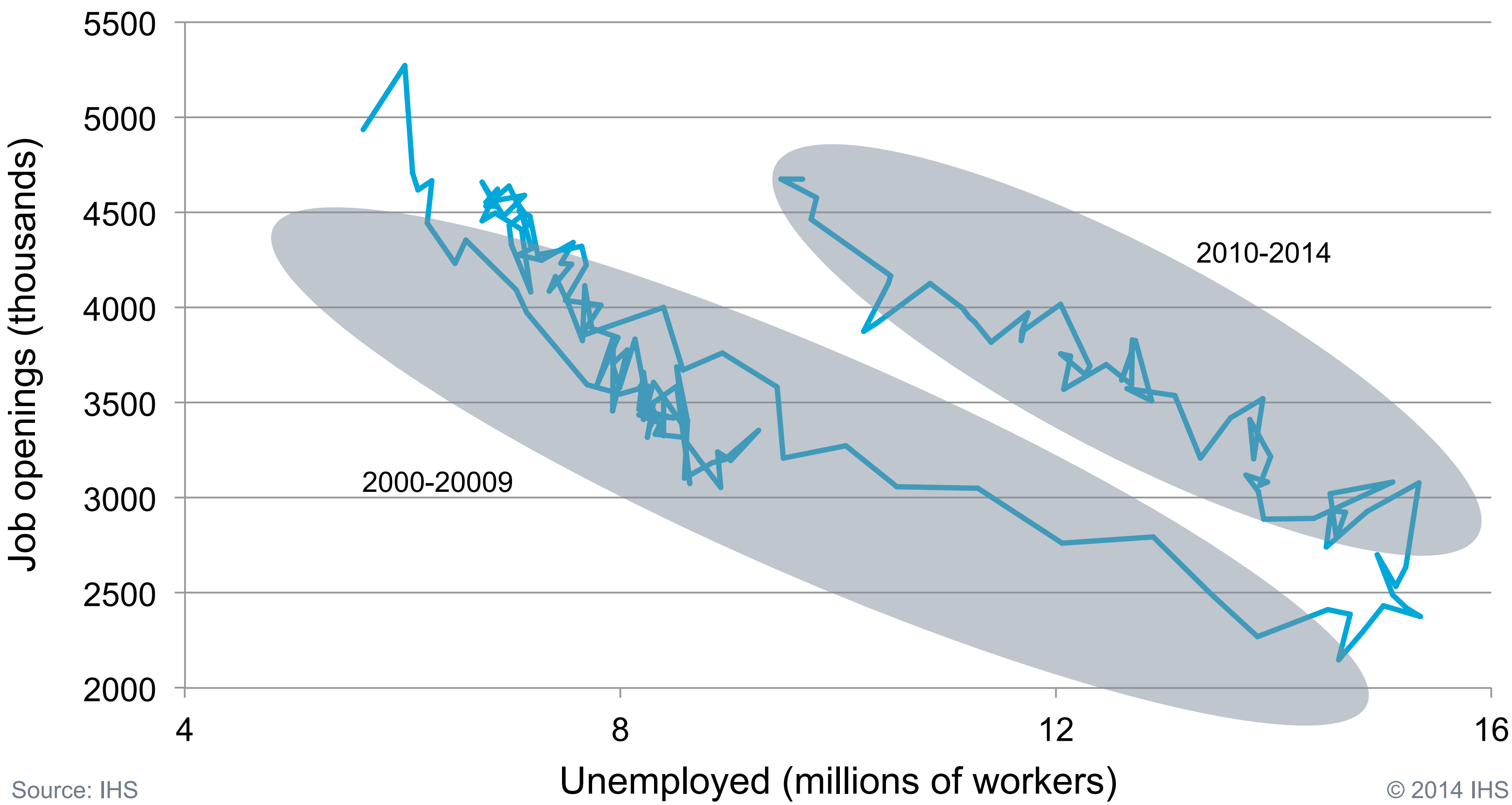
Labor market mobility characteristics



Source: IHS

Structural unemployment? More unemployed workers per job opening

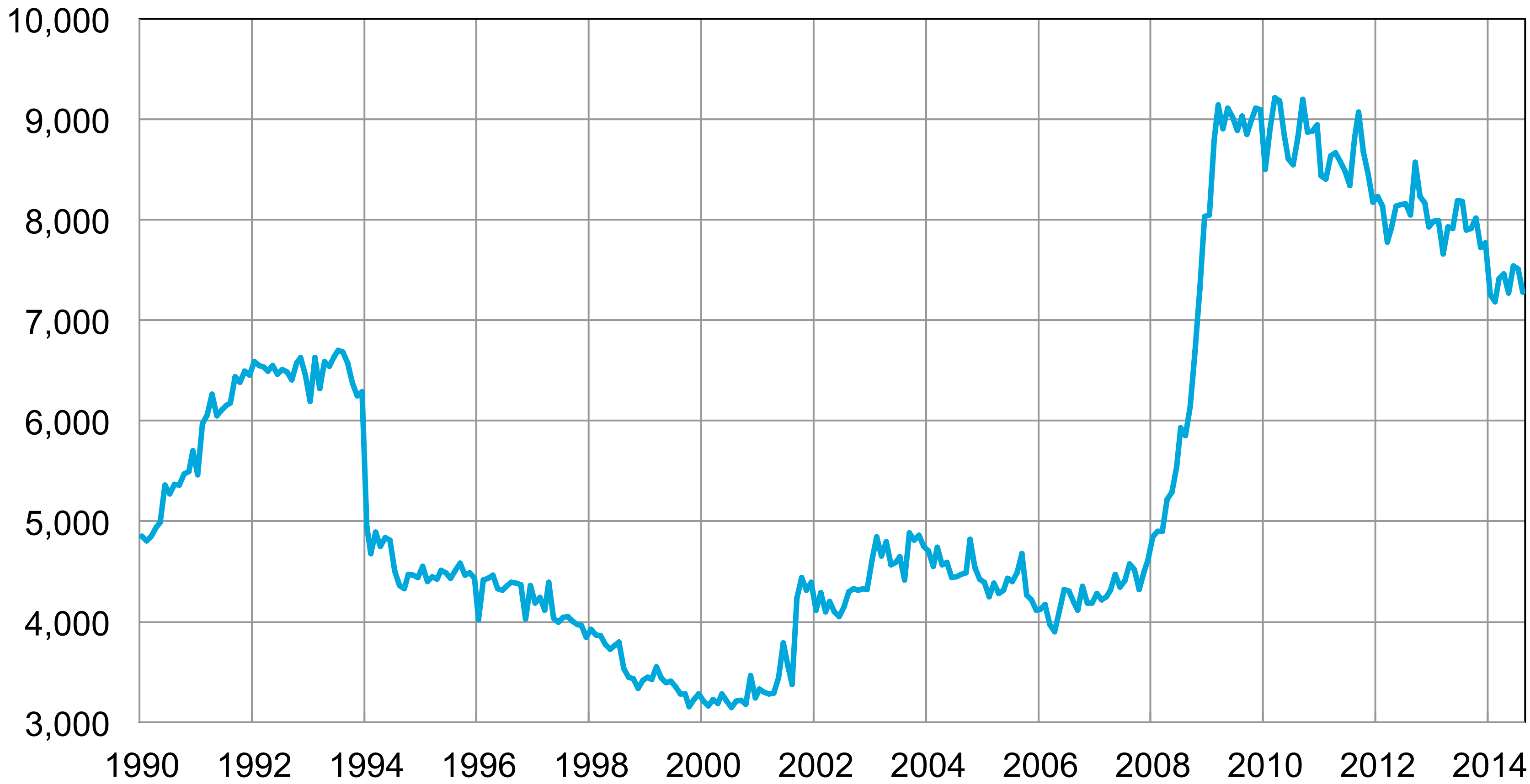
Beveridge Curve (2001-2014)



Source: IHS

There's still a cadre of workers looking to add hours.

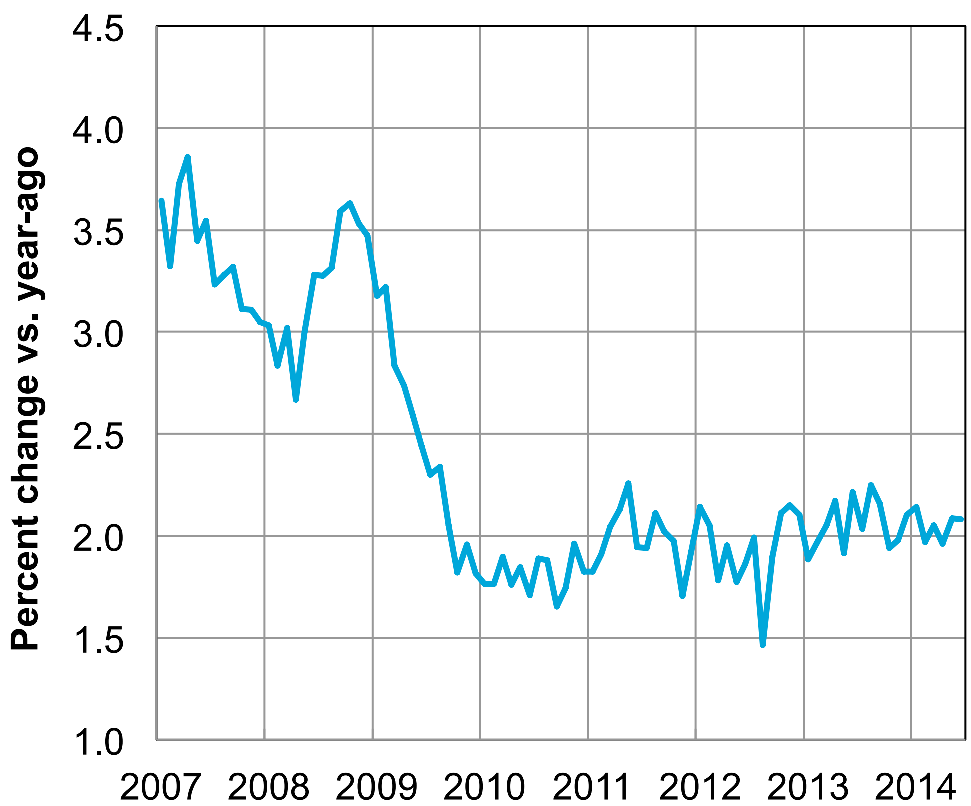
Part-timers for economic reasons (000s)



Source: IHS

No discernible inflation pressures here…

Average hourly earnings



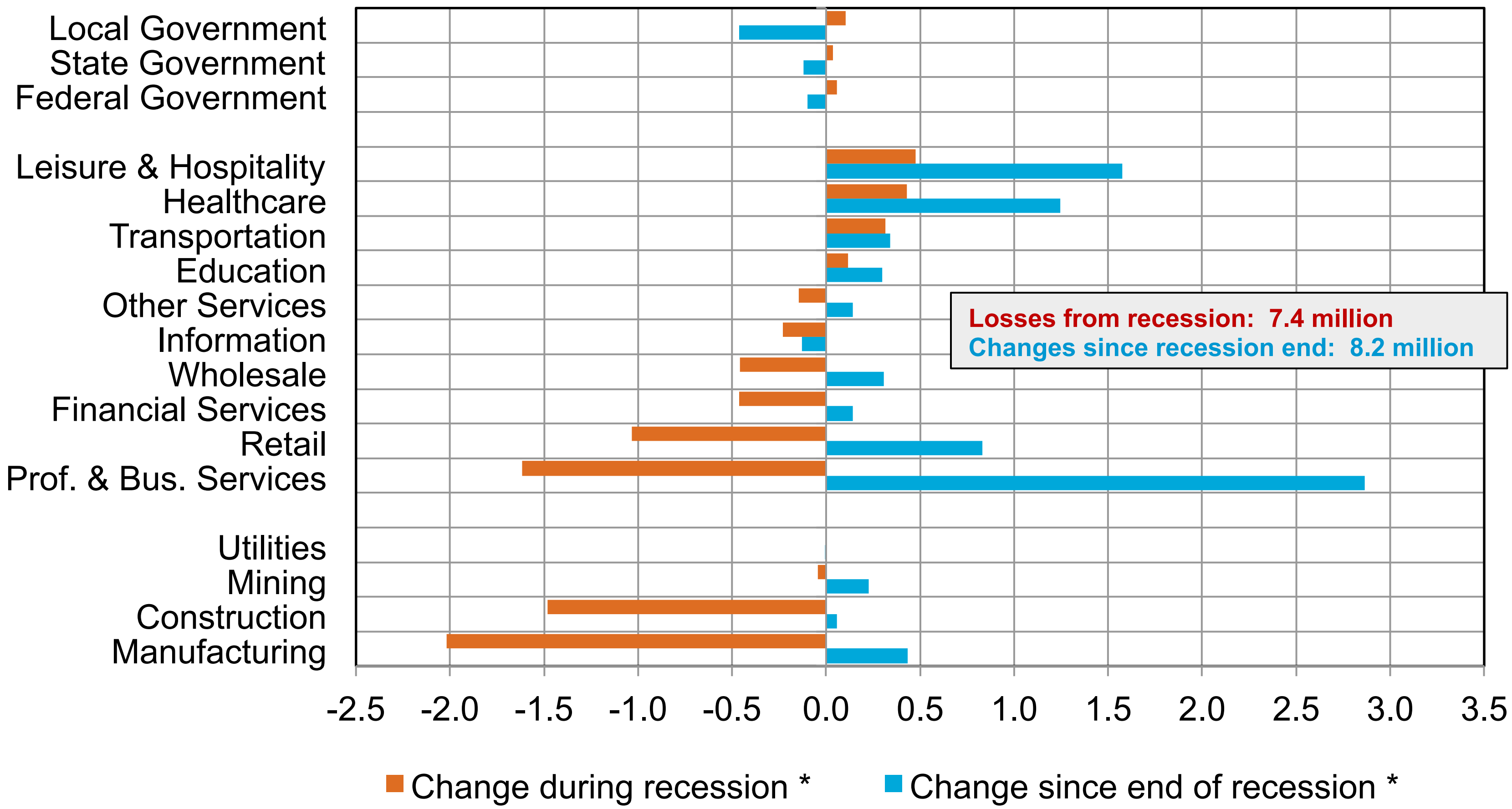
Why are wages not rising?

- Sector mix – a disproportional amount of jobs created in lower-paying fields
- Skills displacement – improved tools enabling lower paid employees to work at levels formerly held by higher paid staff
- "Pent up wage deflation" – sticky wages prevented full wage adjustments from occurring during the recession
- Labor market slack – many facets of the labor market still face excess supply issues

Source: IHS

Only the services areas are materially adding jobs

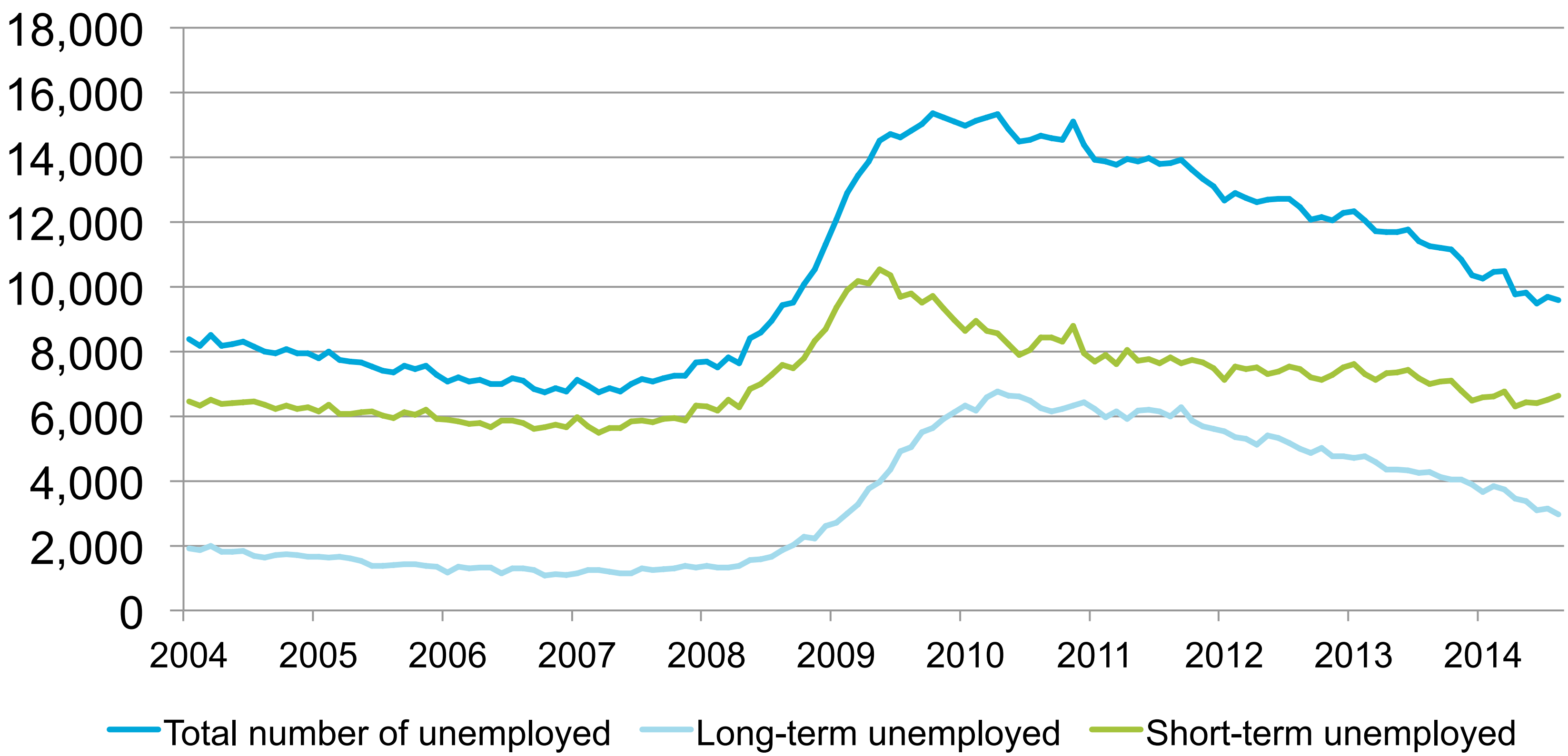
Employment before and after the recession (millions)



*=Recession period: December 2007 through June 2009
Source: IHS

Do we exclude the long-term unemployed when looking at how a tight labor market may drive wage pressures?

Number of unemployed in the labor force (000s)



Source: IHS

Here's what the Fed is looking at to identify inflation.

Personal consumption deflators

Source: IHS

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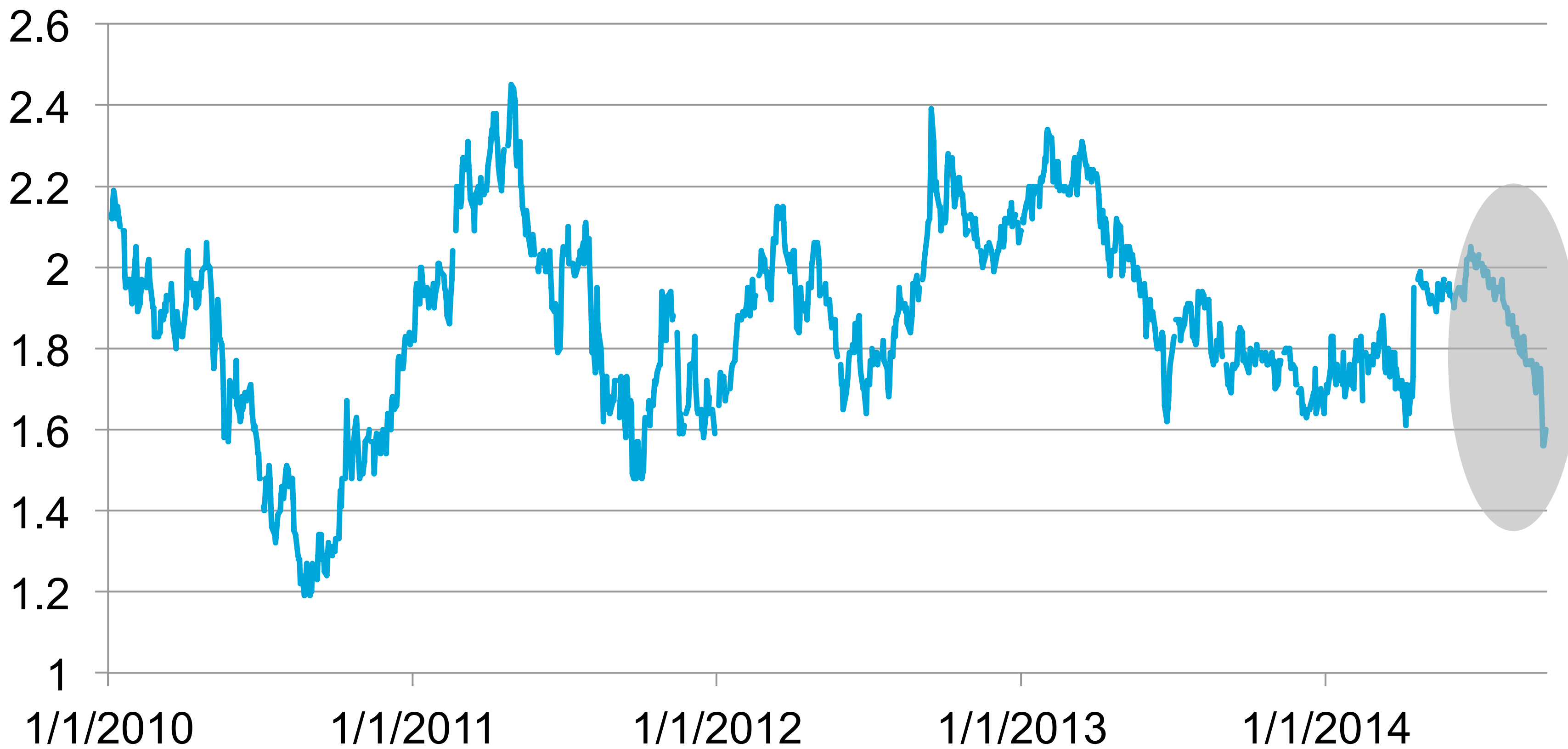
Are inflation expectations “well anchored?”

5-year TIPS spread



Source: IHS

Consumer spending: Positives beginning to outweigh the negatives.

Negative Forces	Positive Forces
Slow wage growth	Pent-up demand for durable goods (autos)
Debt burdens still high	Jobs growth picking up
Student loan debt on the rise	House prices rising
Low fertility rates and population growth rates	Debt burdens lower
Real median household income flat, income inequality up	Household asset values surpassed pre-crisis levels (for some)
Poverty rates elevated	E-commerce retail sales gaining share of retail trade
Food prices creeping up	Back-to-school retail sales looking solid but not as strong as last year

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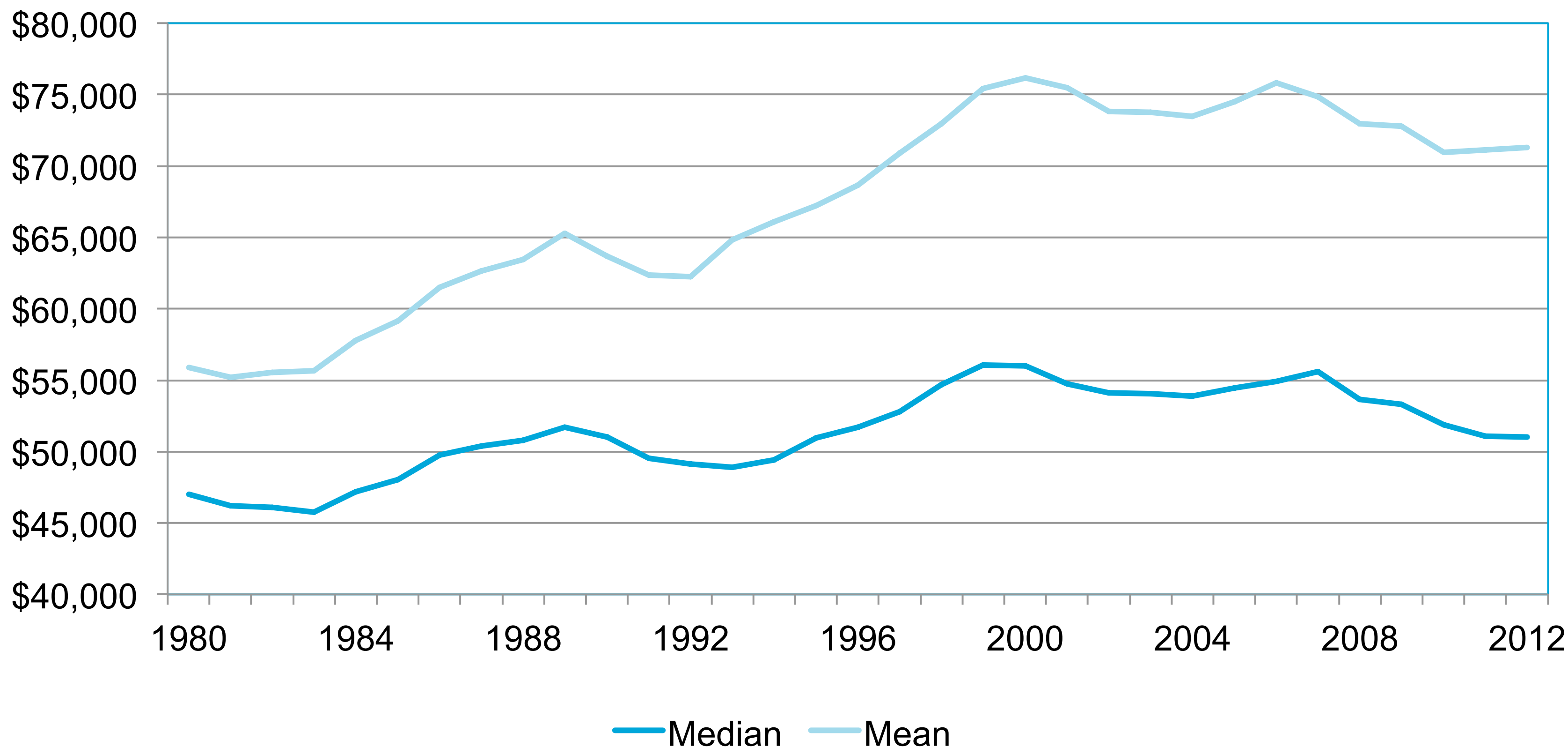
Household median and mean incomes have been stagnant for more than a decade.

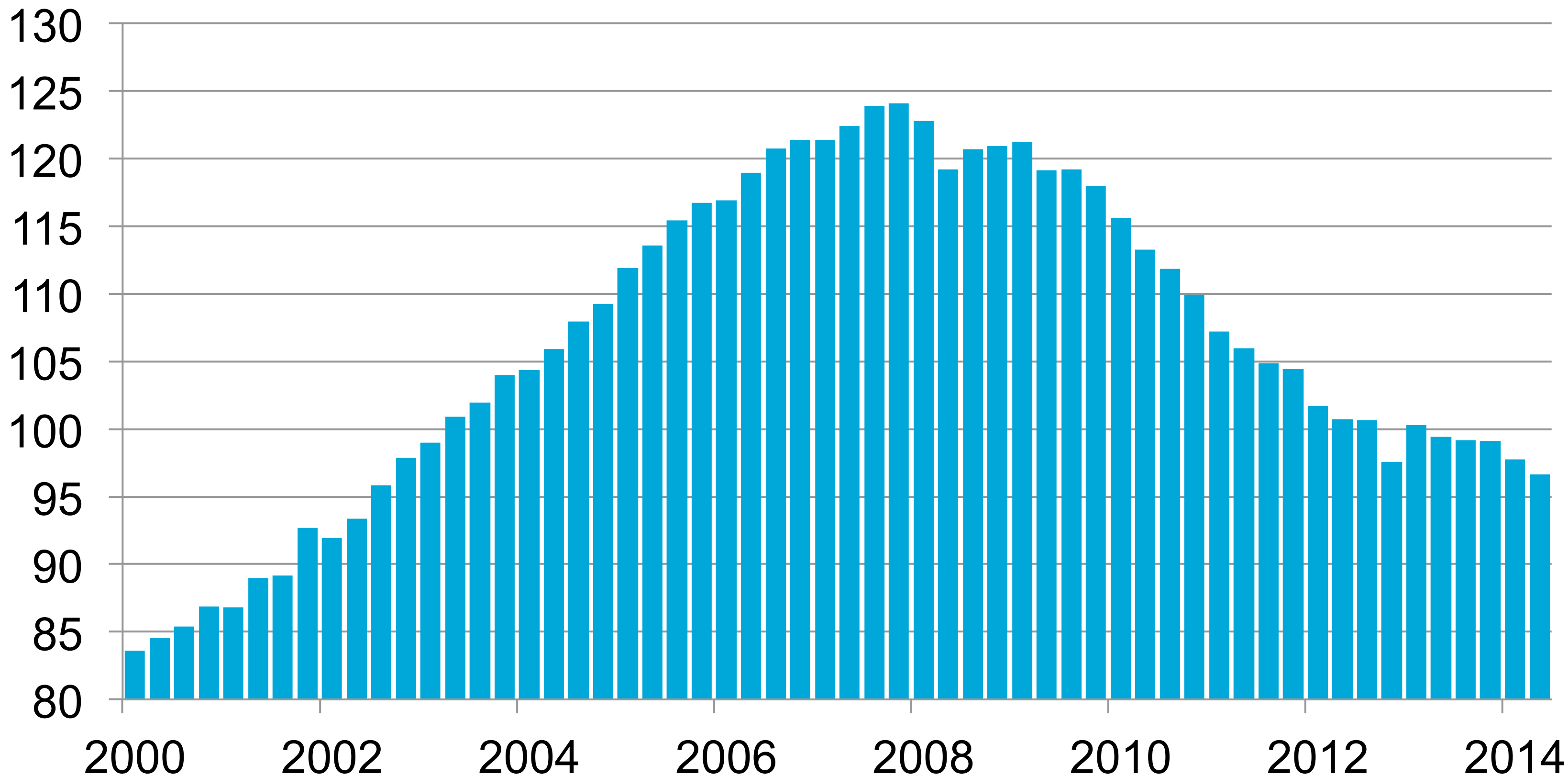
2012 dollars



Source: US Census: Income, Poverty and Health Insurance Coverage in the United States

Households still deleveraging, though more slowly

Mortgage and non-mortgage debt as percent of disposable income



Source: IHS

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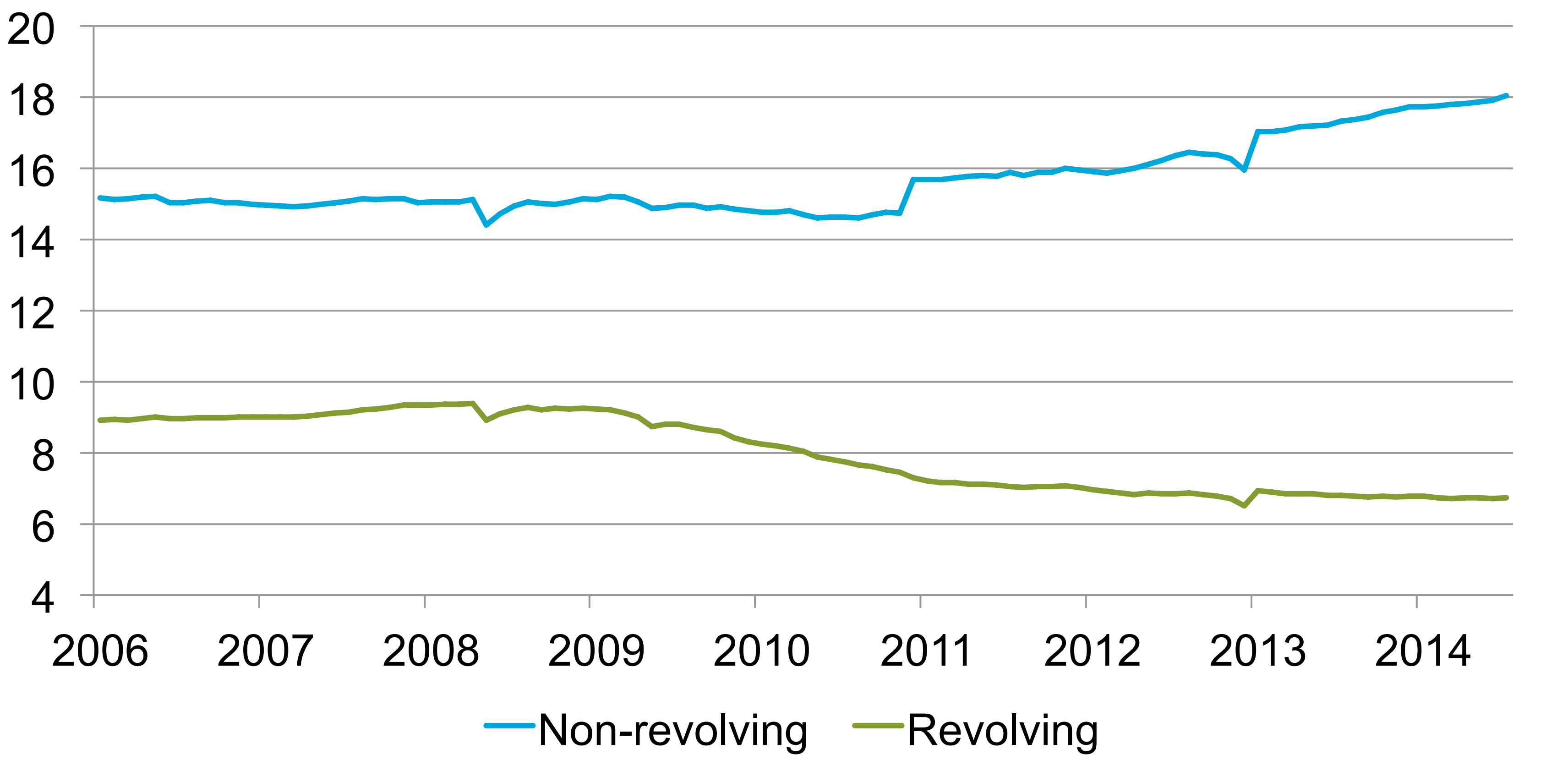
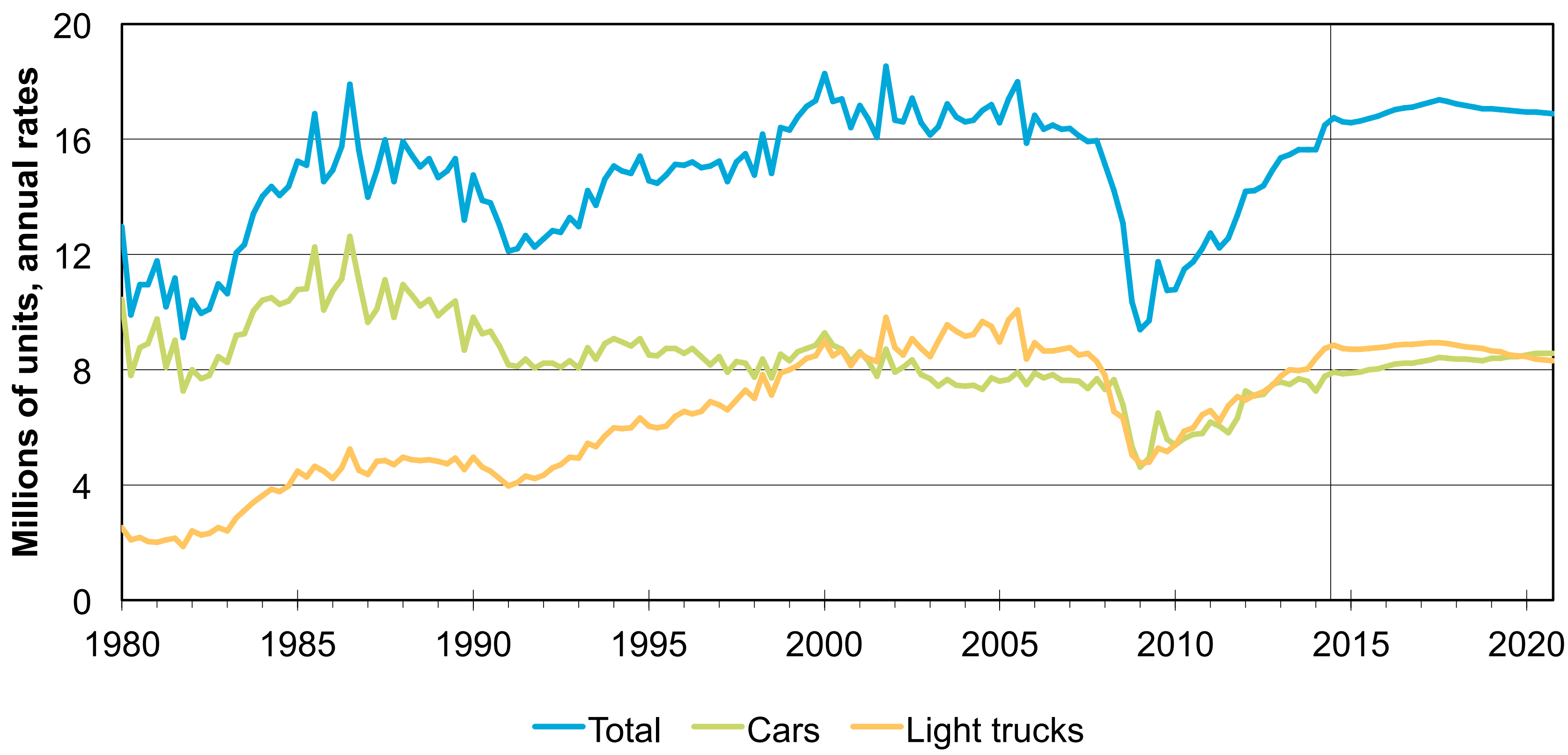
Households only willing to accumulate certain types of debt.

Percent of disposable income



US light-vehicle sales hold at near pre-recession sales rates.

Light-vehicle sales



Source: IHS

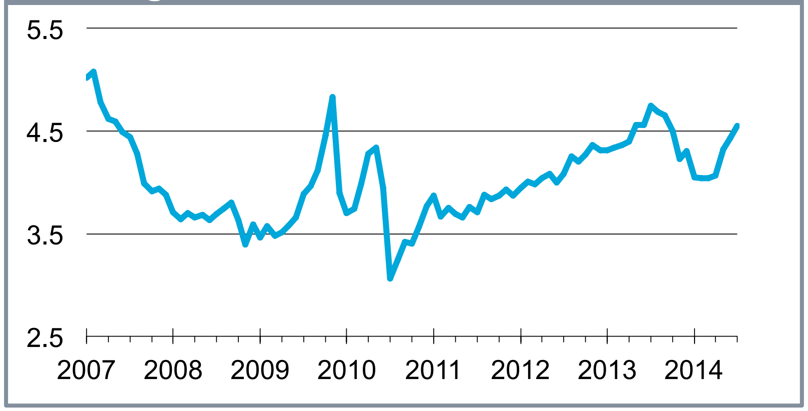
The housing recovery should be here, but…

Pluses
Reasonable mortgage rates
Decent job creation
Consumer deleveraging helps affordability
Recent history of price appreciation
Rental markets tight, helping spur multi-family starts

Minuses
Adverse household formation among under-35 and 35-44 y.o. households.
Greater perceived risk of holding real estate
Higher input prices for builders squeezing margins
Shortage of buildable lots
Very stringent lending standards for builders and buyers
Job mobility stuck at recession levels
Significant student loan burden
Lack of distressed properties for sale, especially impacting investor demand
Household formation has slowed again

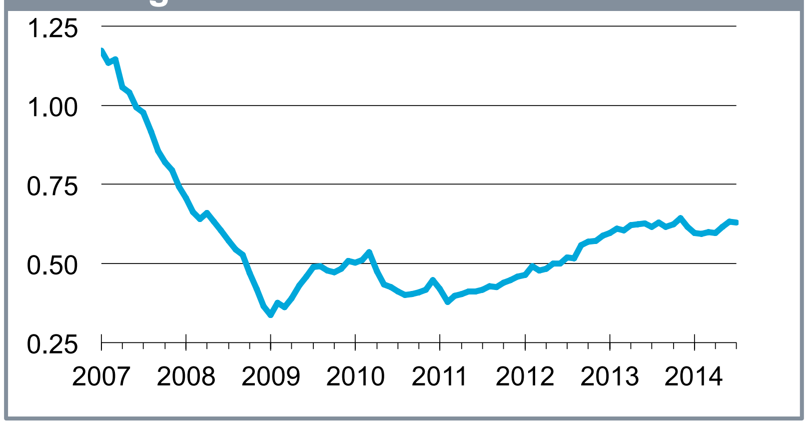
Single-family housing indicators: Also improving, but slowly

Existing Home Sales*

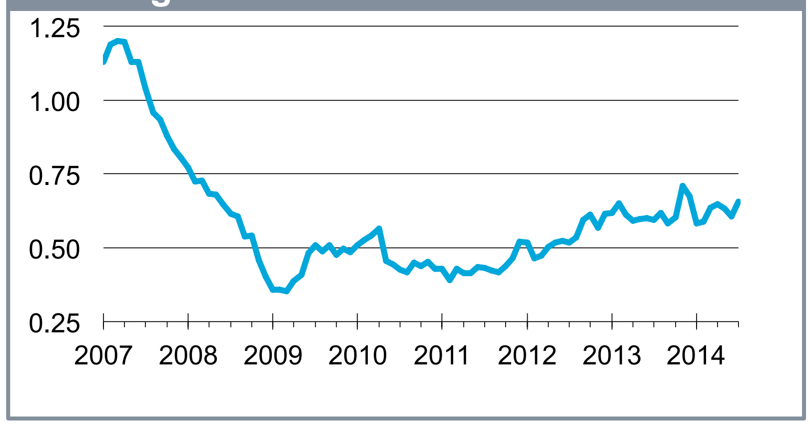


New Home Sales*

Housing Permits*



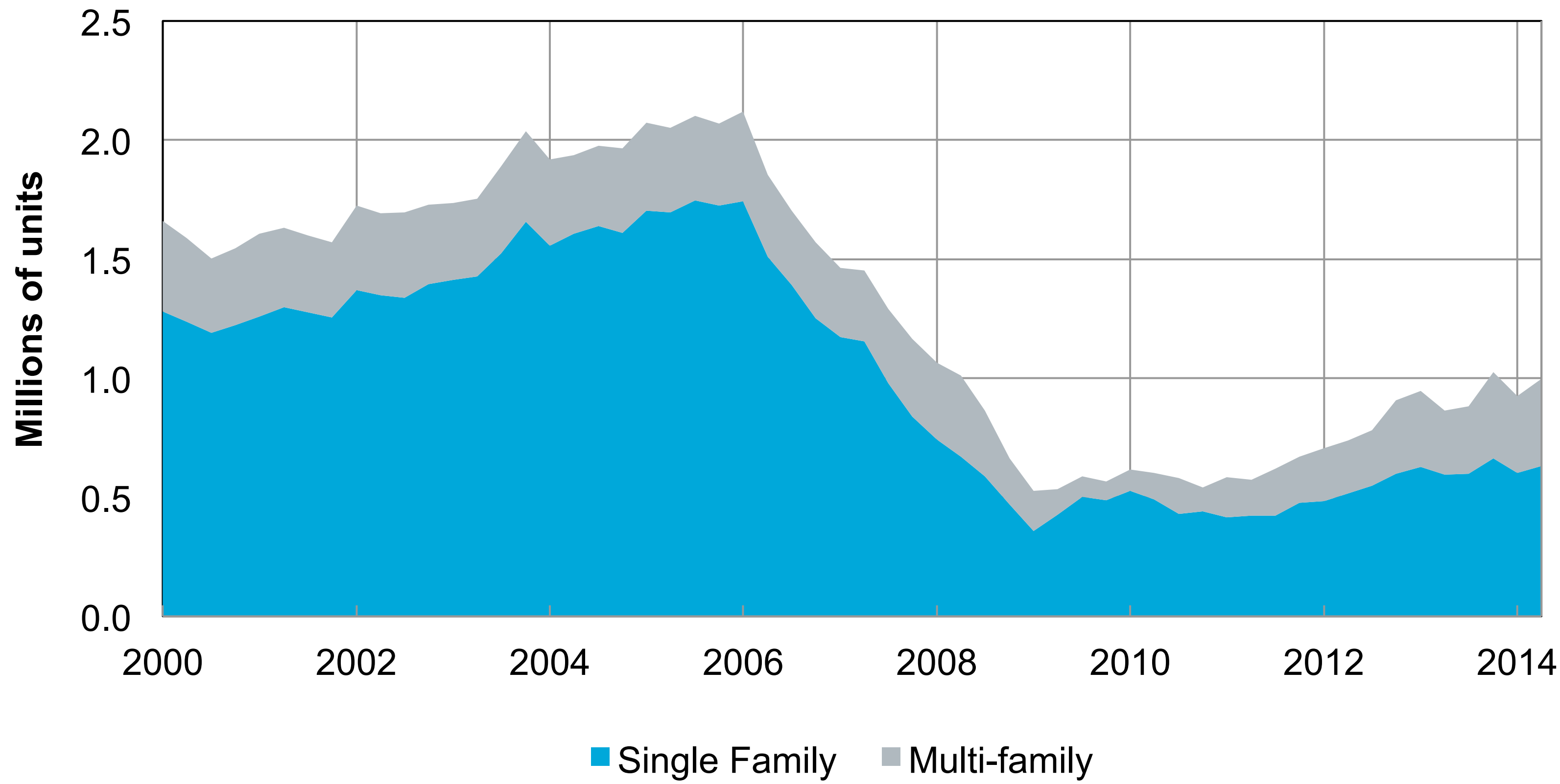
Housing Starts*



*Millions, SA
Source: IHS

Housing picks up, but not back to last decade's peaks; share of multi-family increases.

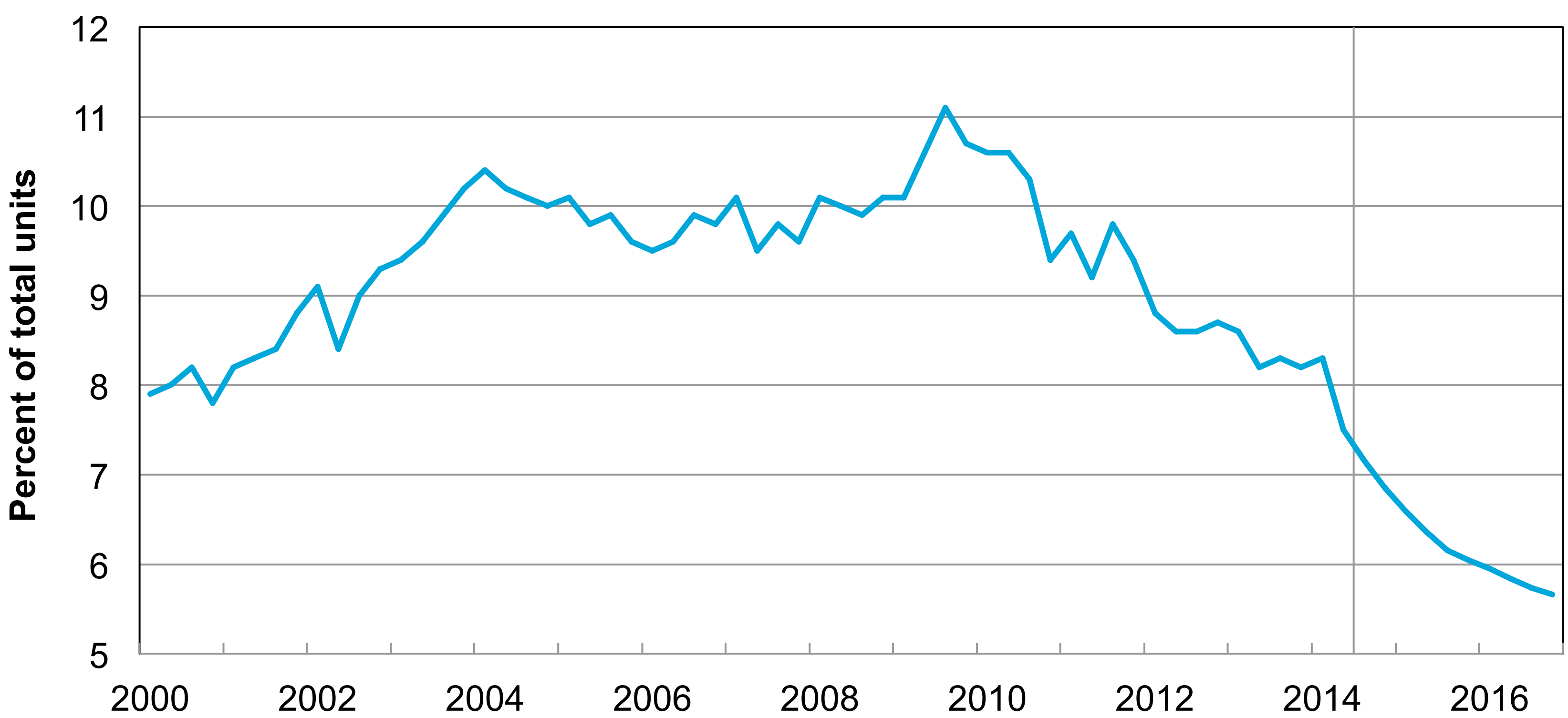
Housing starts



Source: IHS

We expect the decline in rental vacancy rates to spur building activity

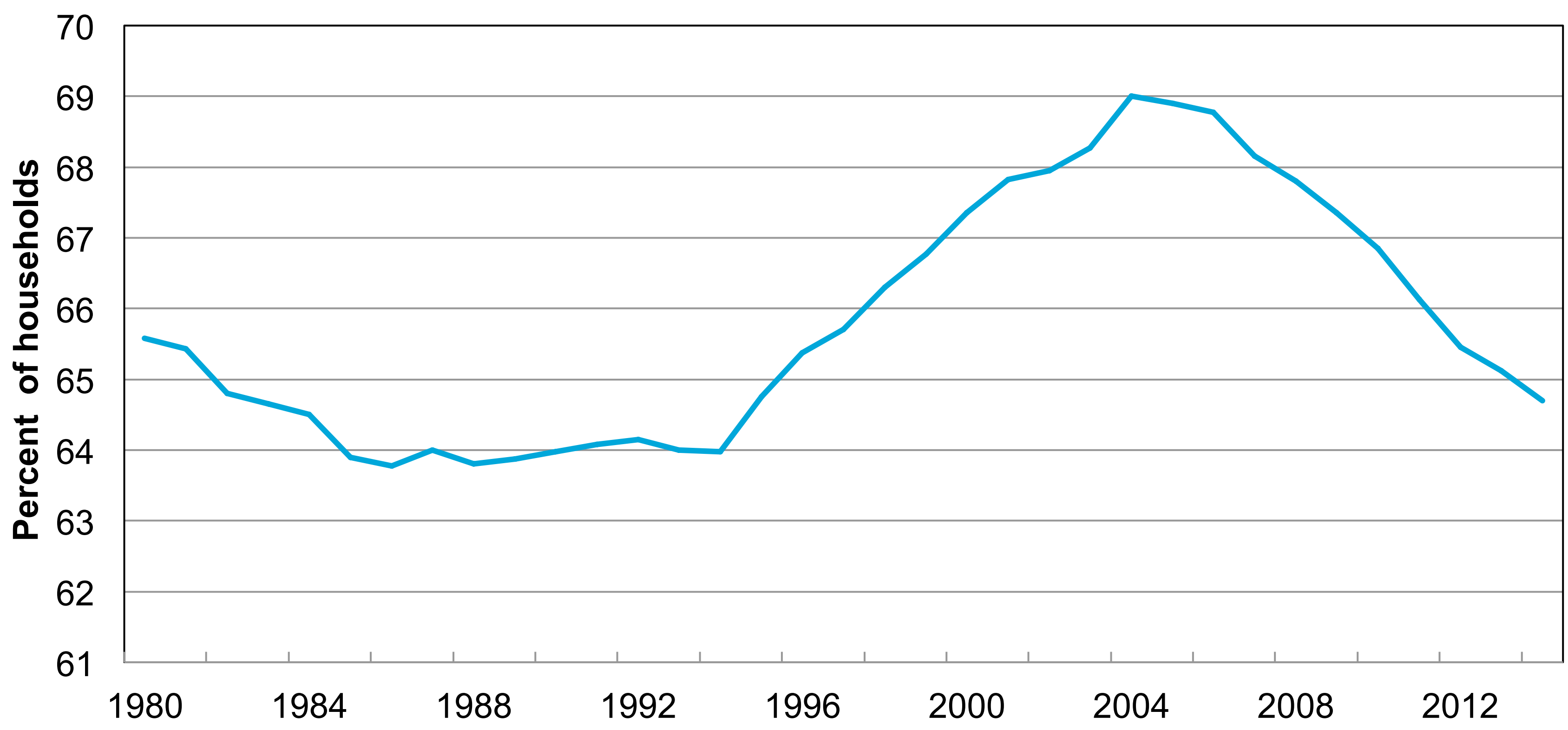
Rental vacancy rates



Source: IHS

Over the past ten years, 4% of all households have sold their homes without buying anew

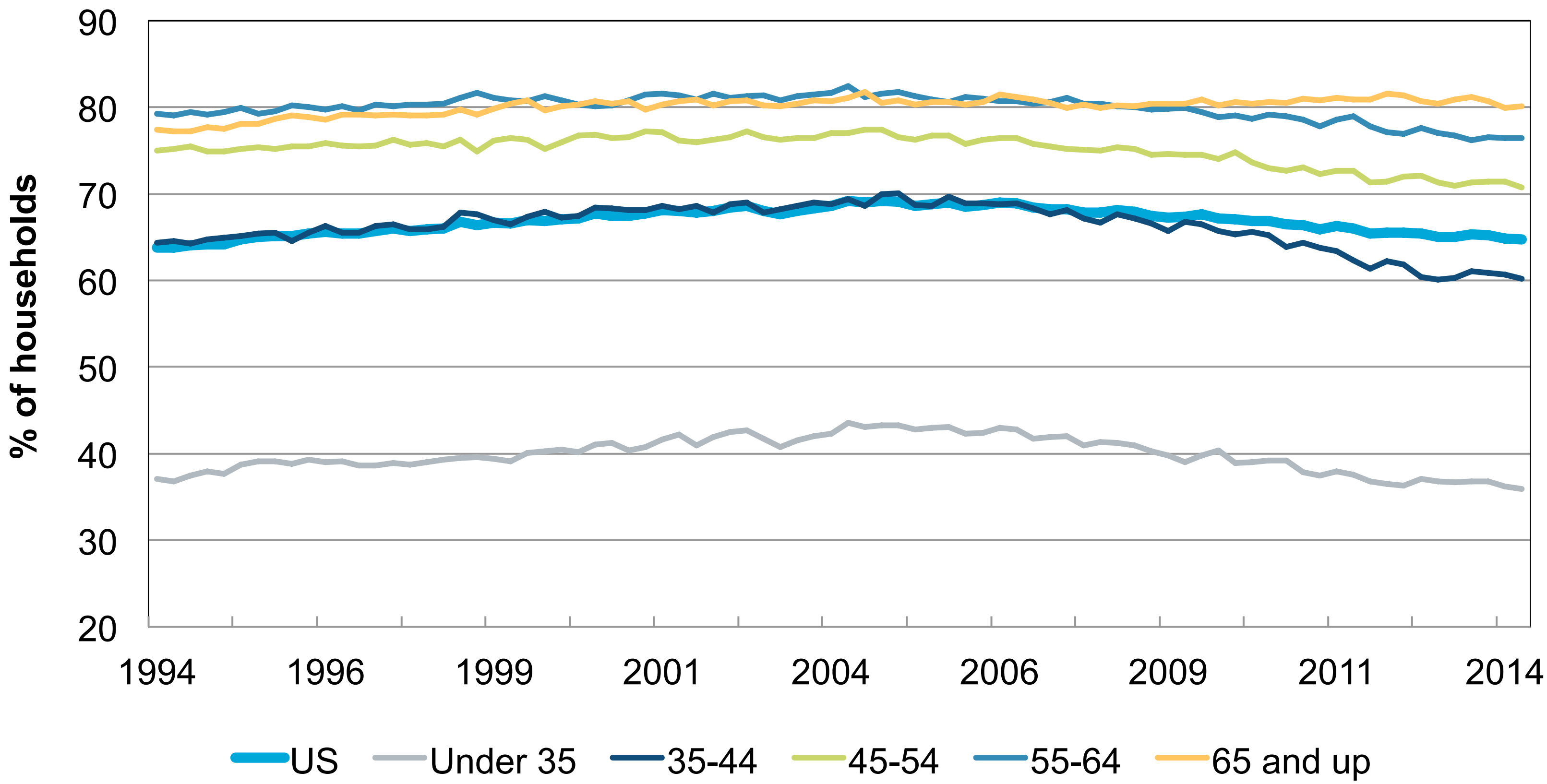
Homeownership rates



Source: IHS

Homeownership rates are dropping for all age cohorts except maybe 65+

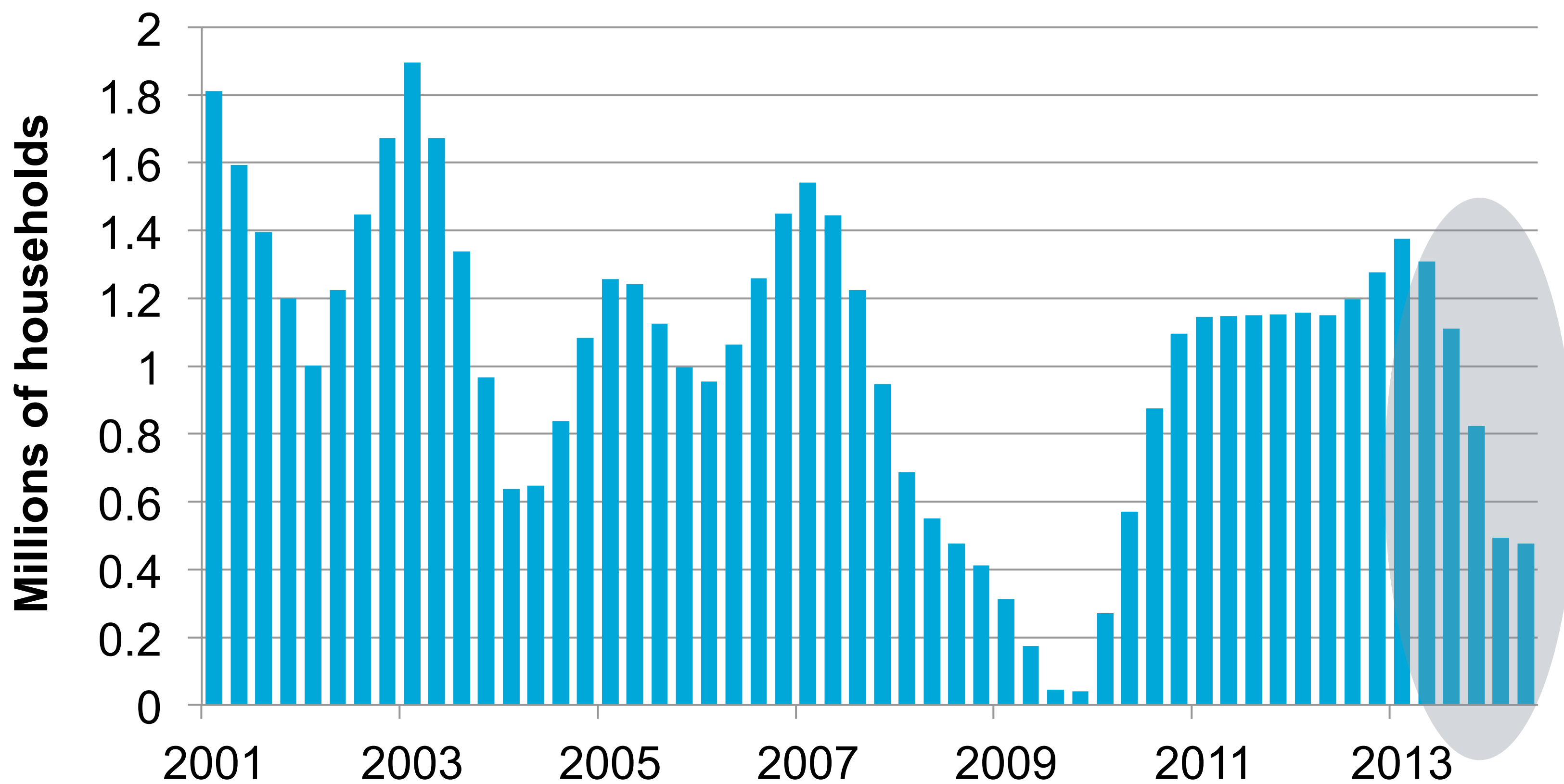
Homeownership rates by age cohort



Source: IHS

Household formation has slowed sharply

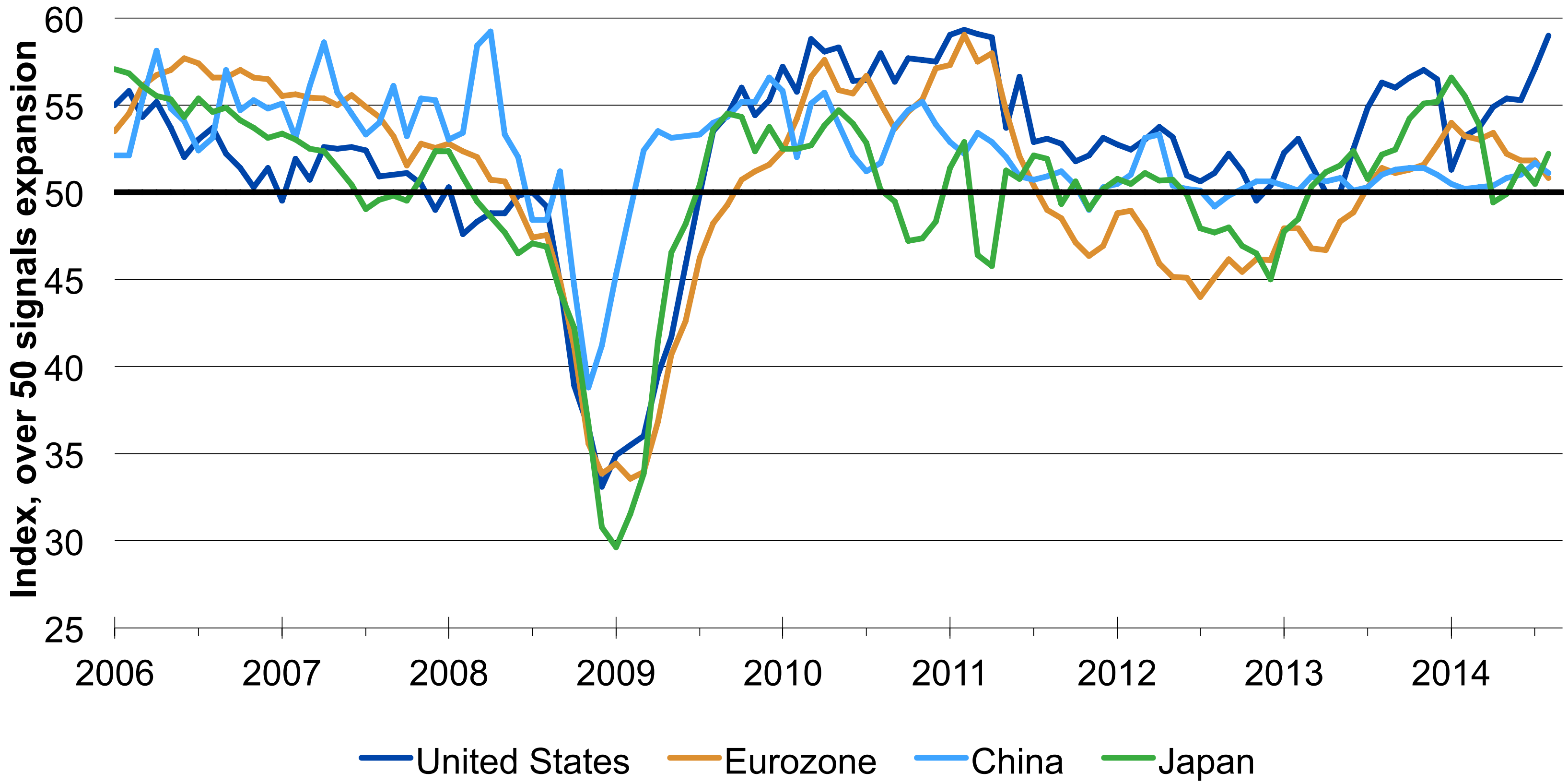
Household formation – year-on-year change



Source: IHS

Purchasing managers' indexes for manufacturing give mixed signals

Purchasing managers' indexes



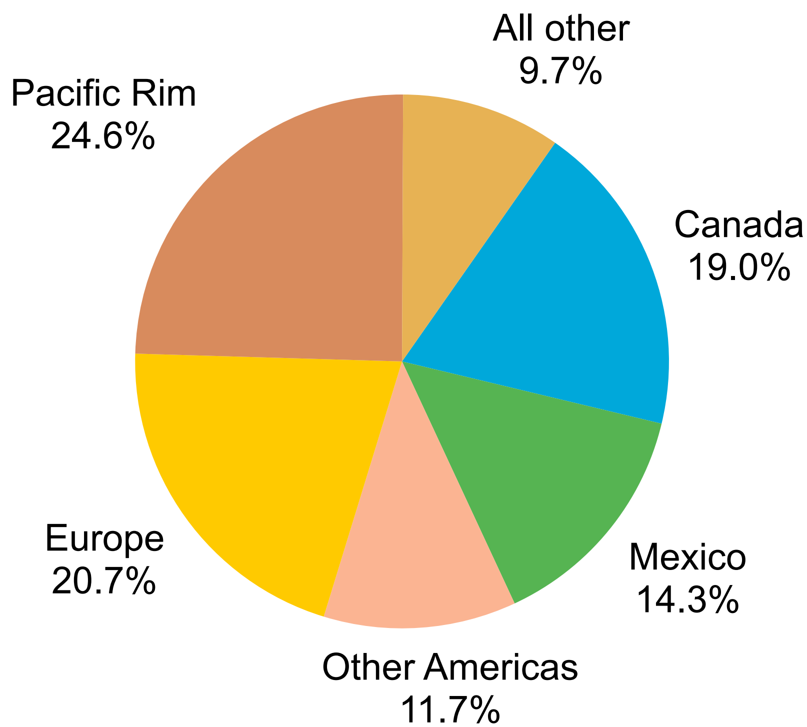
Sources: Institute for Supply Management (US), Markit, National Bureau of Statistics (China)

Destinations of US merchandise exports

Merchandise exports

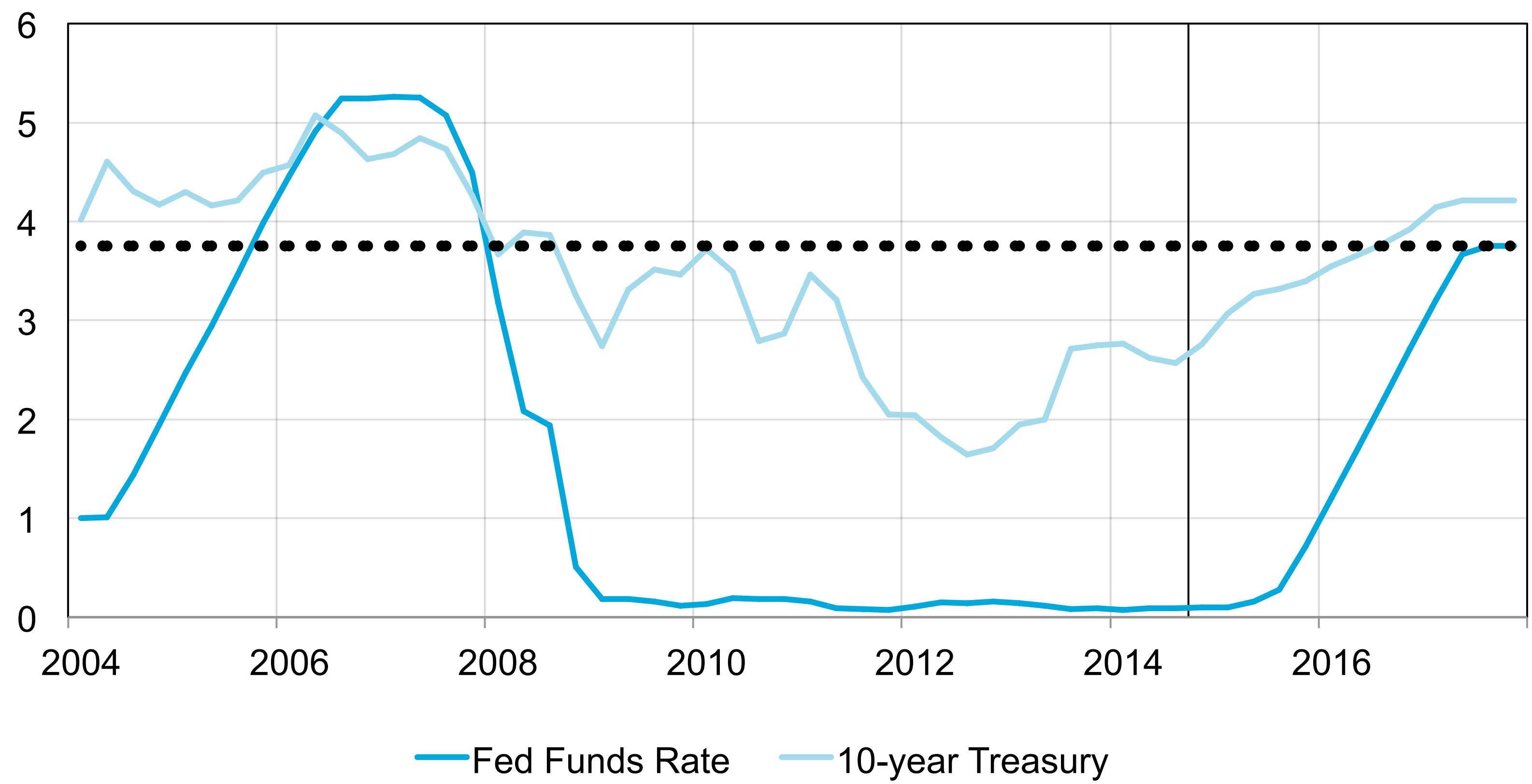
Percent of total, 2013

China	7.7%
Japan	4.1%



Interest rate lift-off in June 2015.

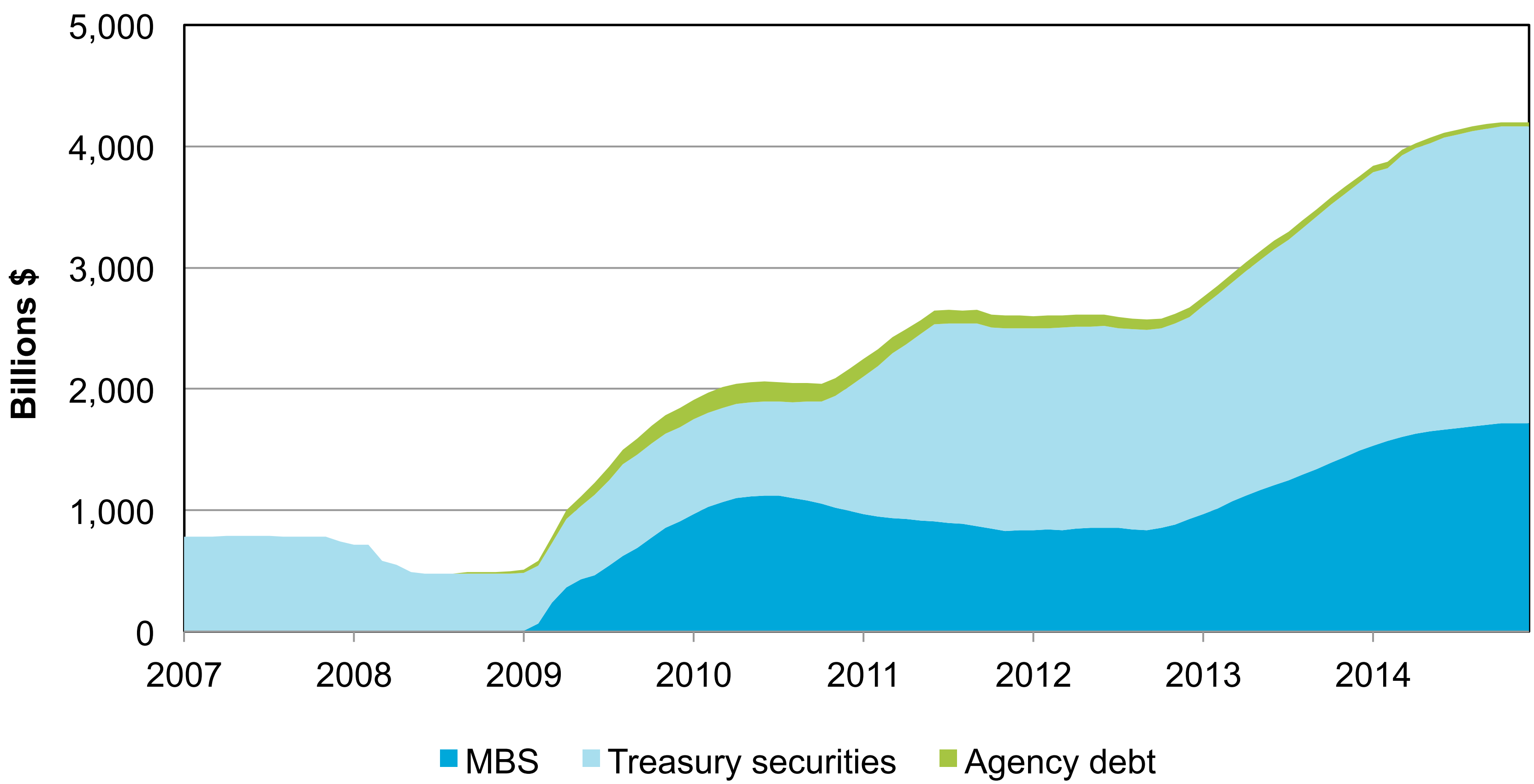
Interest rates



Source: IHS

Fed will tighten with a “big” balance sheet

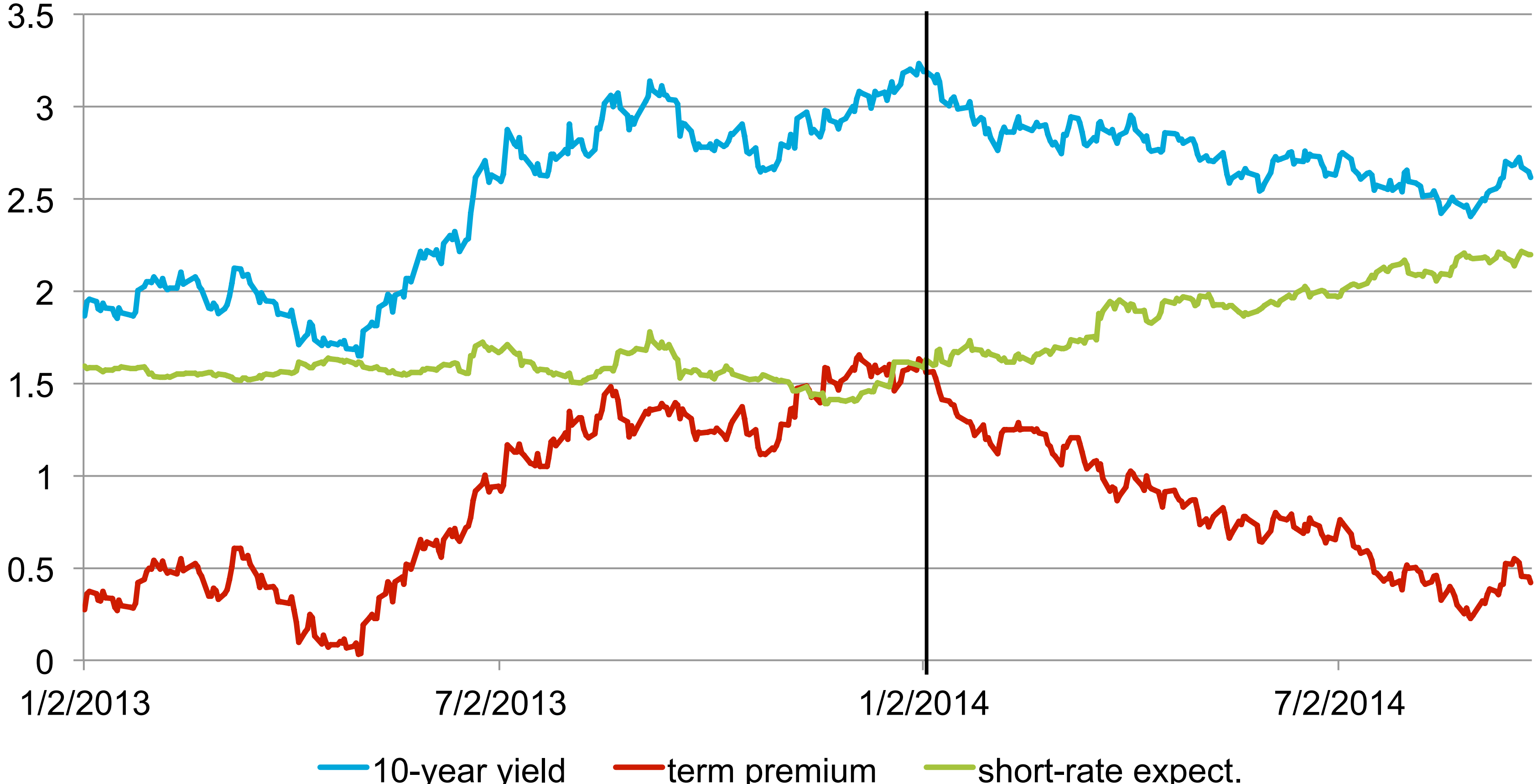
Fed assets



Source: IHS

Bond market conundrum – “flight-to-safety” theory

Decomposition of 10-year Treasury yield (percent)



Source: IHS

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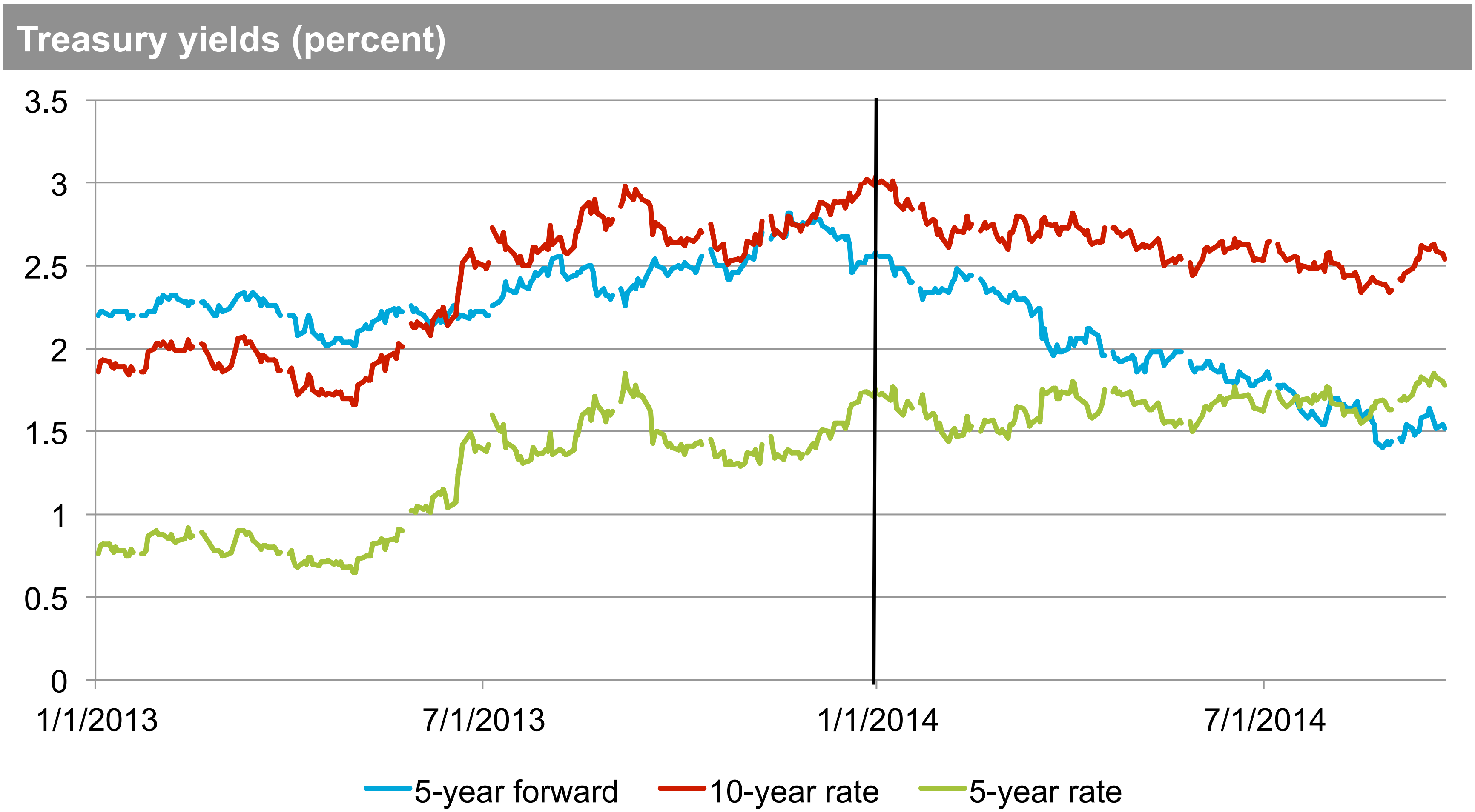
Bond market conundrum – "secular stagnation" theory



Source: IHS

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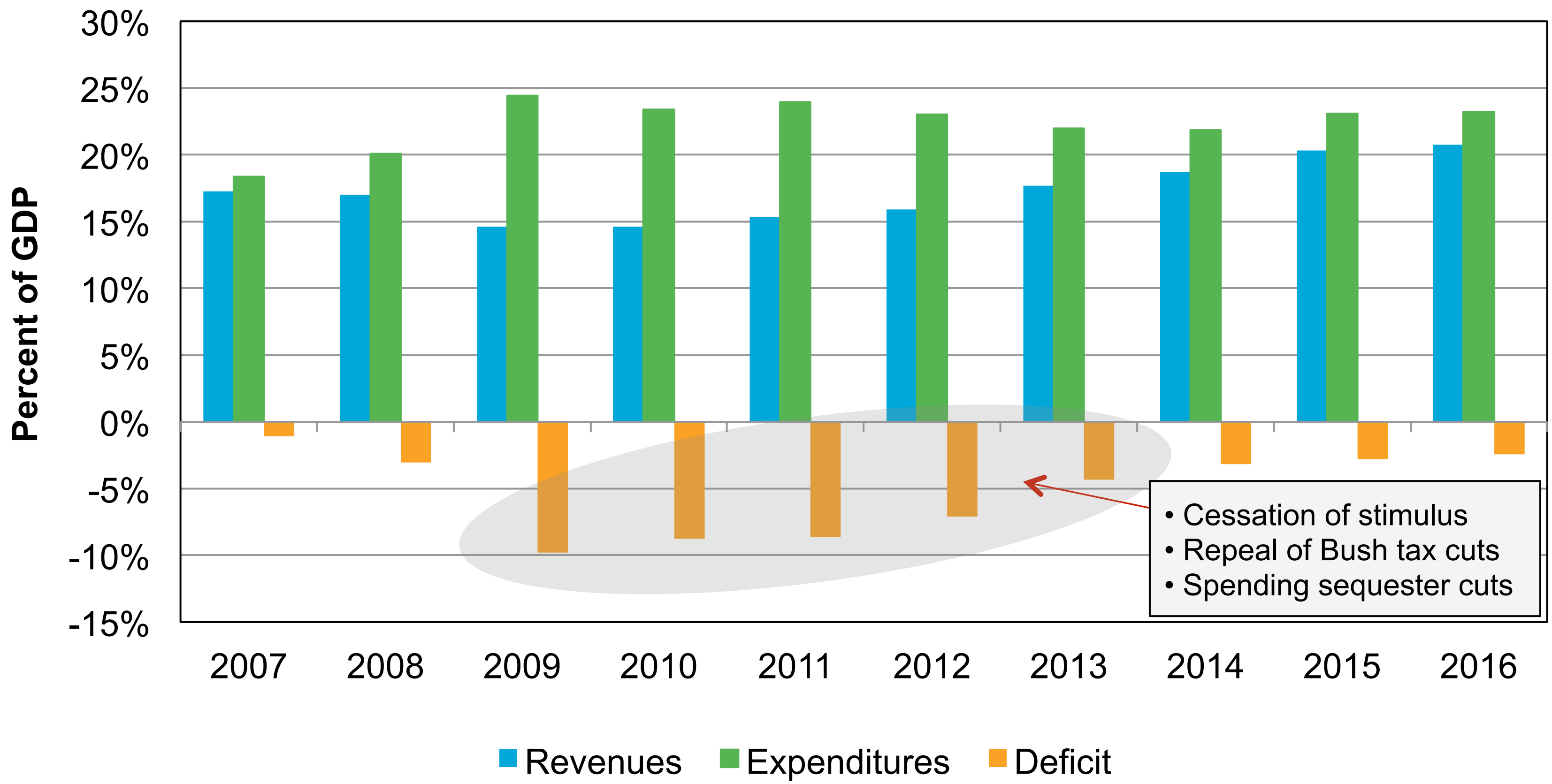
The secret isn't out yet in Washington: The federal budget deficit is unproblematic

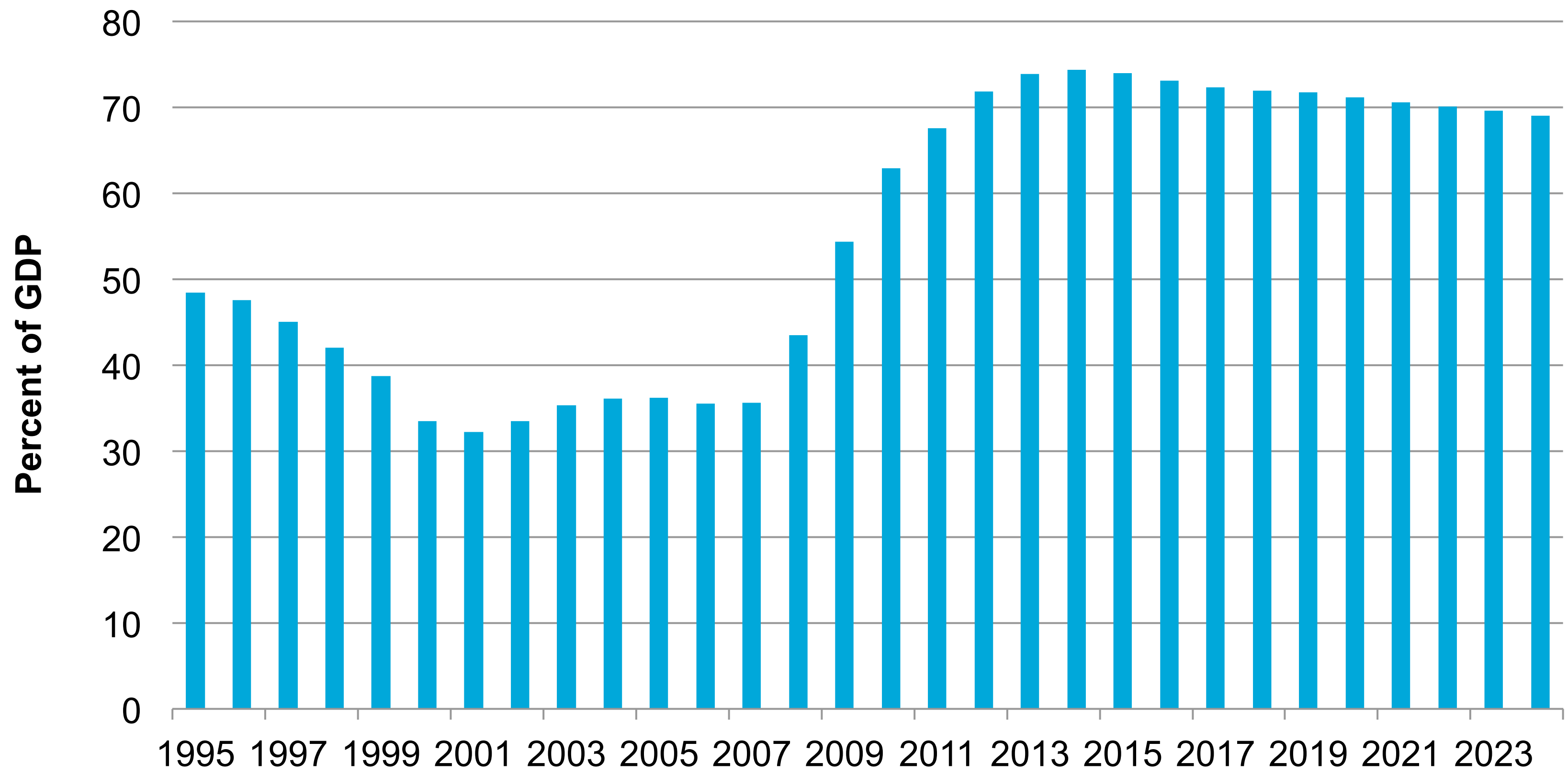
Federal budget balance sheet



Source: IHS

Federal debt to stabilize at around 70% of GDP.

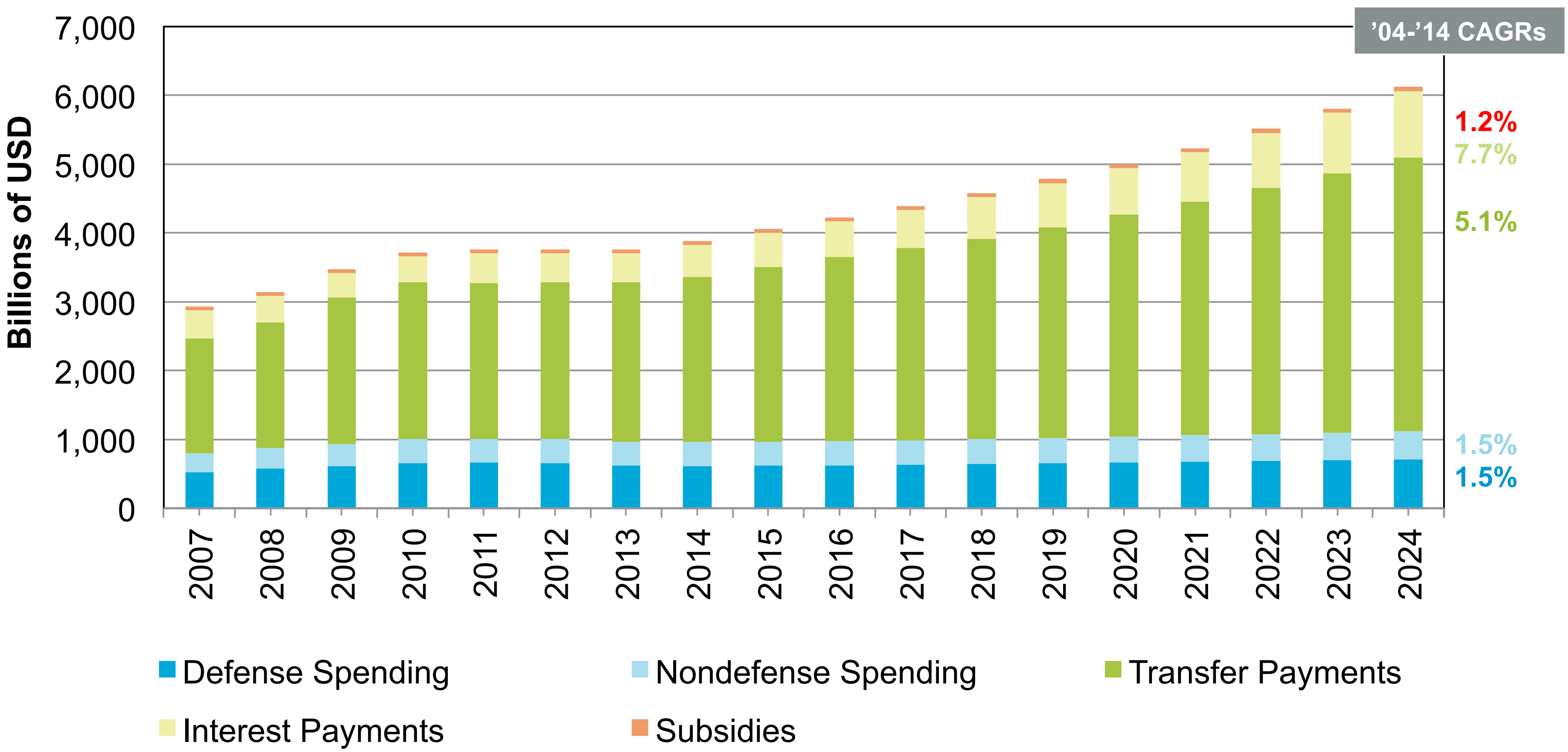
Publically held federal debt



Source: IHS

Most federal spending growth that will occur over the next decade will involve transfer payments

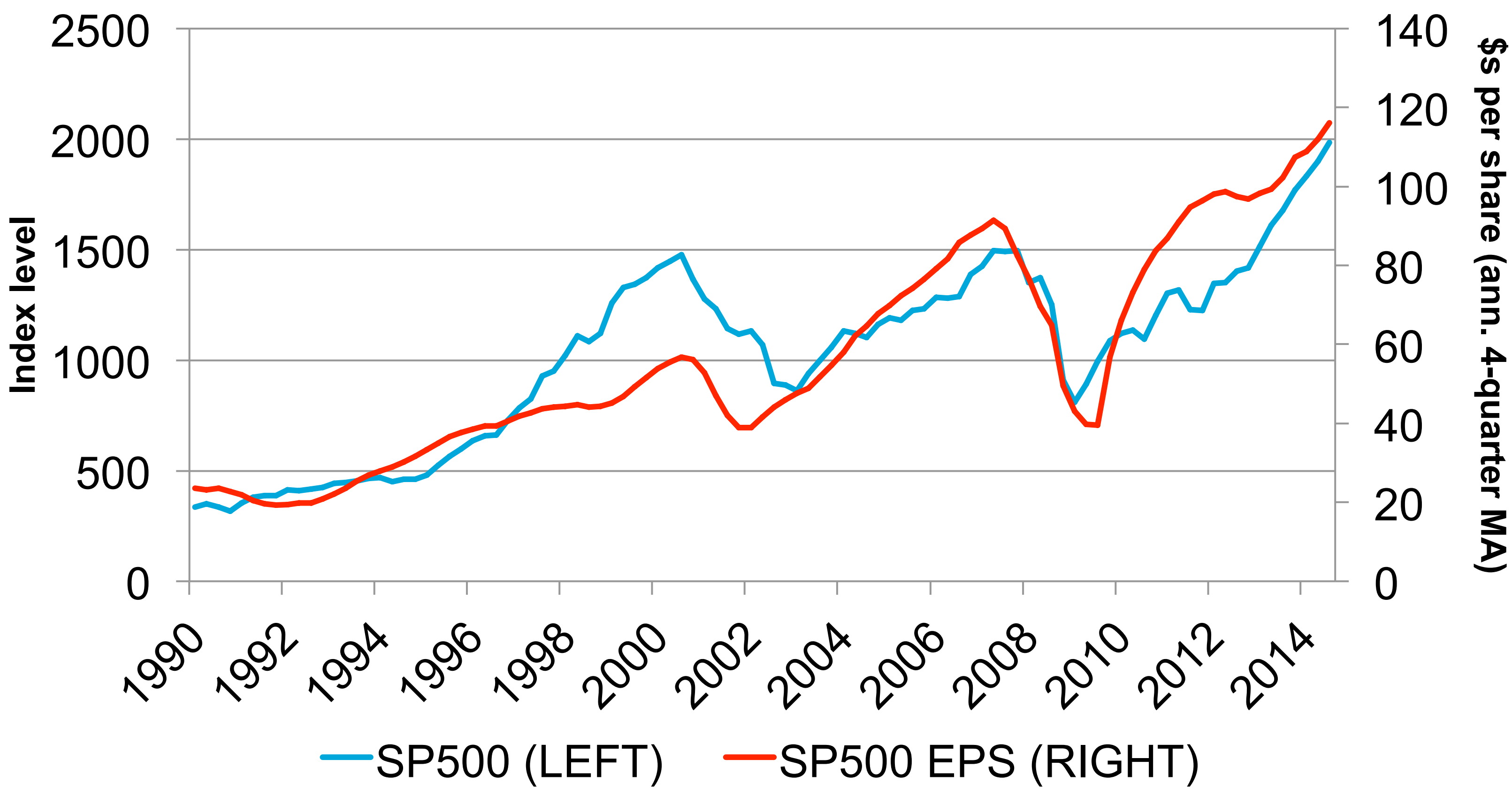
Federal budget expenditures



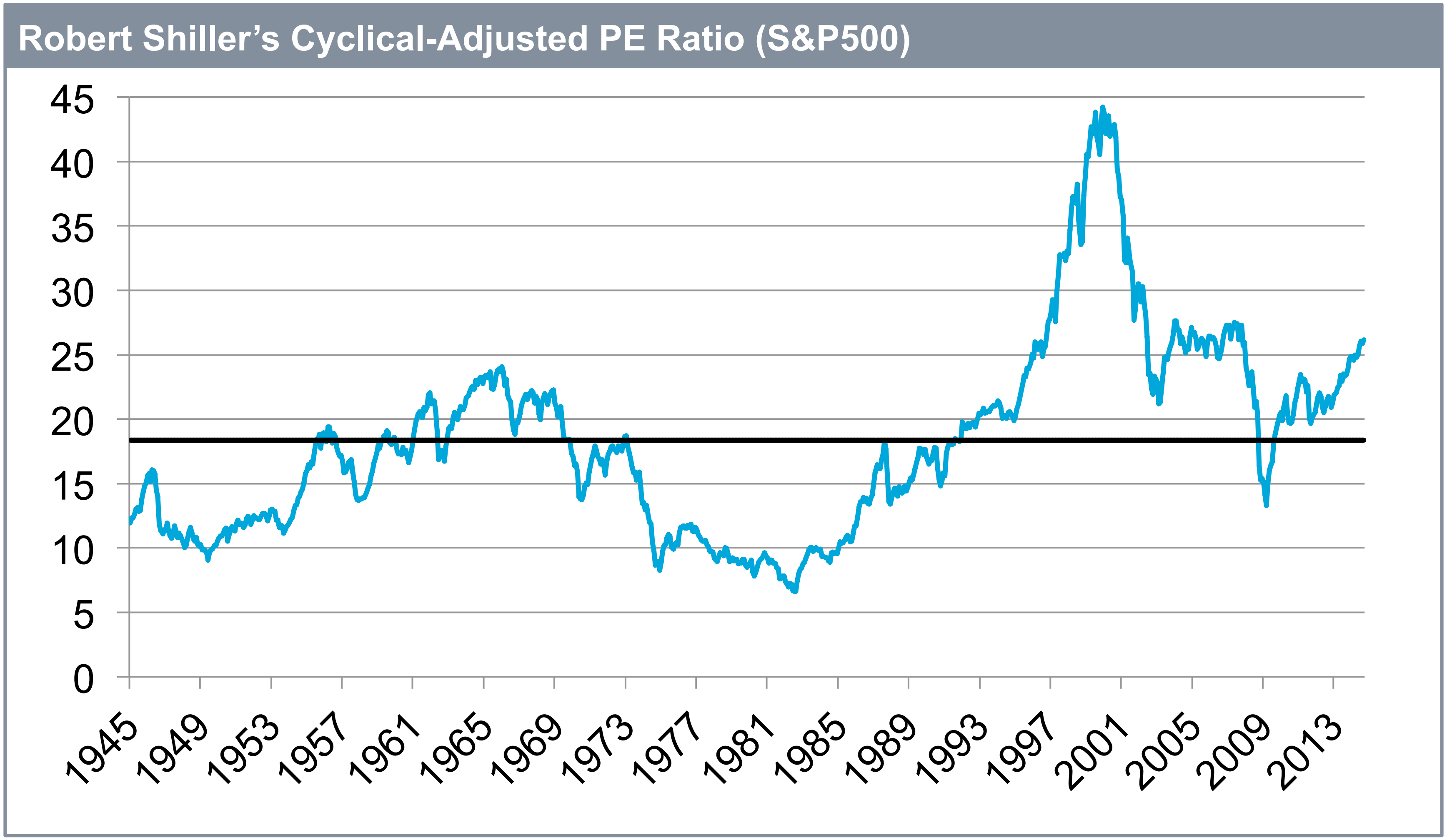
Source: IHS

Stock prices are reaching new peaks: S&P 500

S&P 500 stock price index

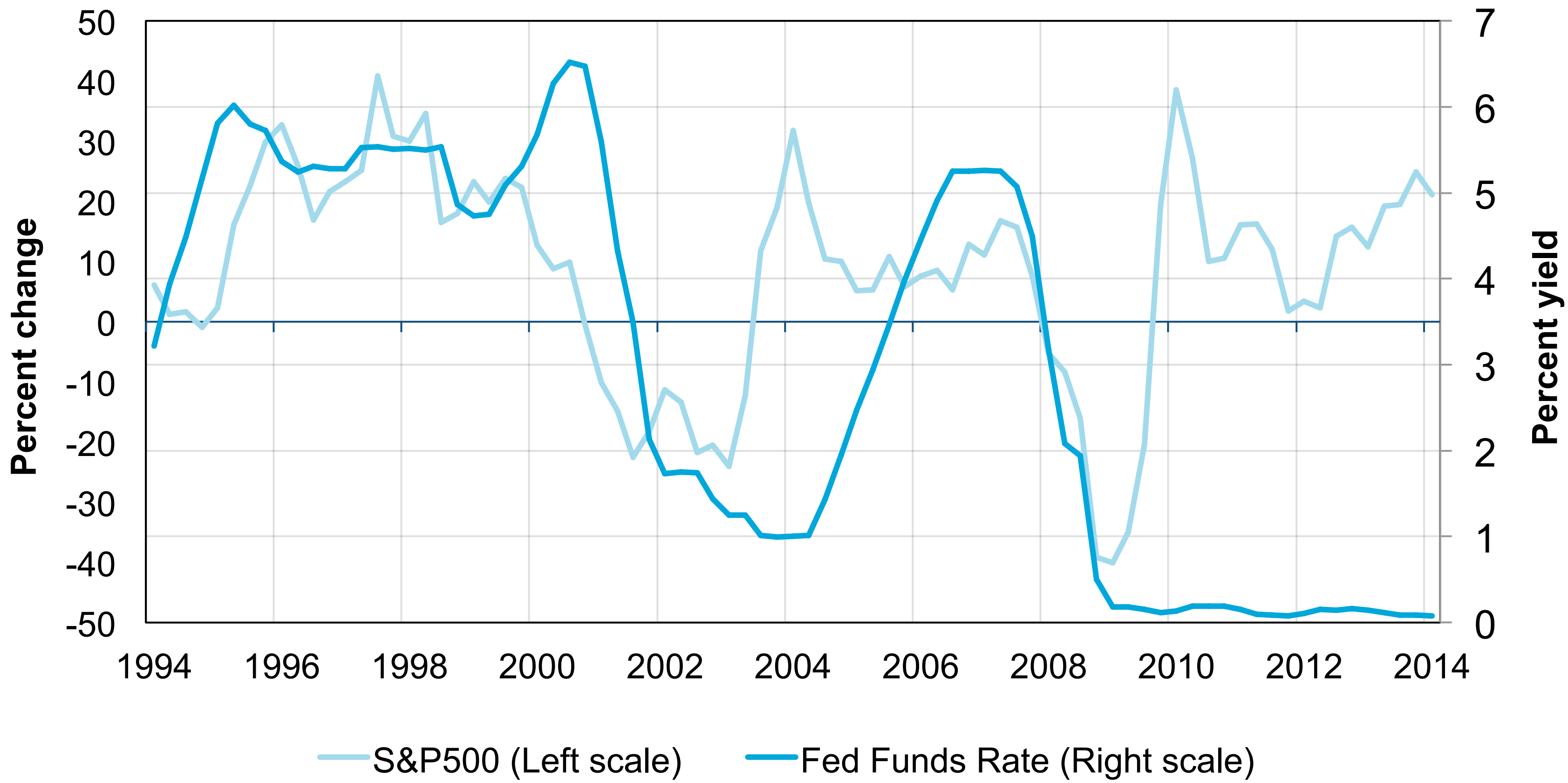


Stock prices are looking overvalued on some measures.



Increases in interest rates lead to turning points in the equity market.

Relationship between S&P 500 and Fed policy



Source: IHS

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