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ECONOMIC TALKING POINTS

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Economic Summary Outlook – 2014

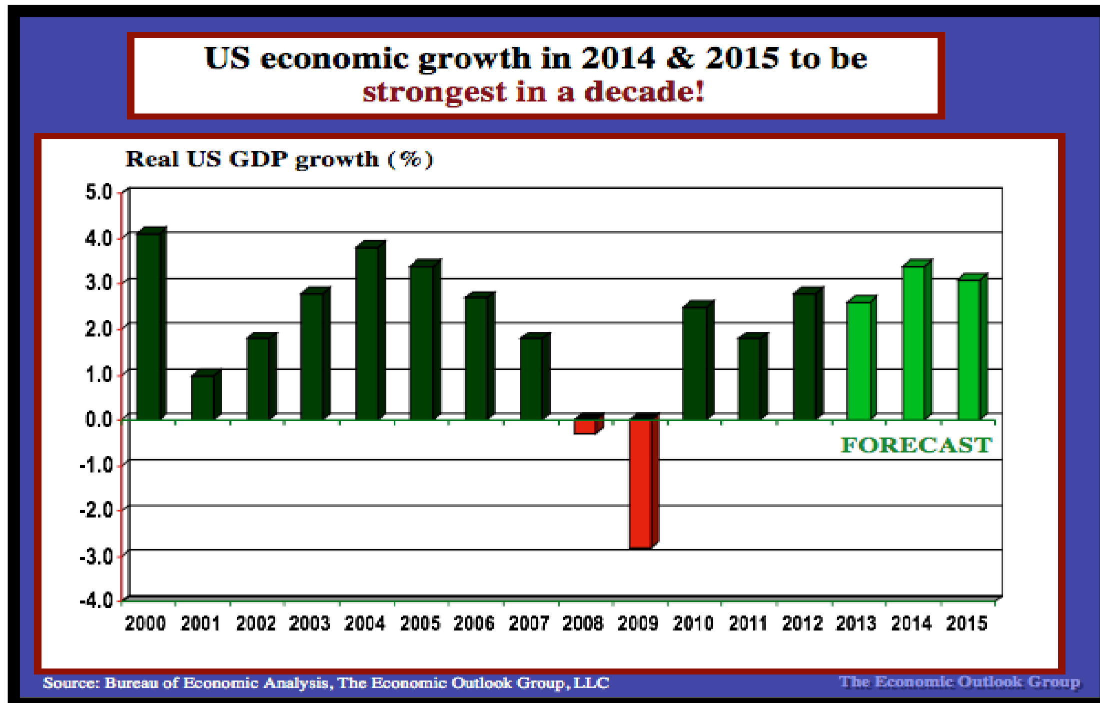
- **Key U.S. and International Forecasts**
- **What Could Go Wrong?**

We begin the year on an optimistic note. Not only is the U.S. economy gaining more traction as it enters the new year, but evidence continues to mount that this expansion could last into 2015.

Such an upbeat forecast so early in the year may bring on a sense of dejavu. After all, the last several years have been characterized by a pattern of robust economic activity in the first quarter or so --- only to turn terribly sluggish shortly thereafter. So we understand the initial skepticism to any longer term positive forecast. The argument we are making is that a different set of dynamics are now at work that should propel the economy forward with enough momentum to finally depart from the frustrating cycle we experienced in the recent past.

Clearly, the fundamentals that underpin the U.S. economy have improved. **Indeed, we are forecasting GDP growth of 3.4% and 3.1% in 2014 and 2015, respectively, the strongest back-to-back performance in a decade**. Leading the charge will be consumer

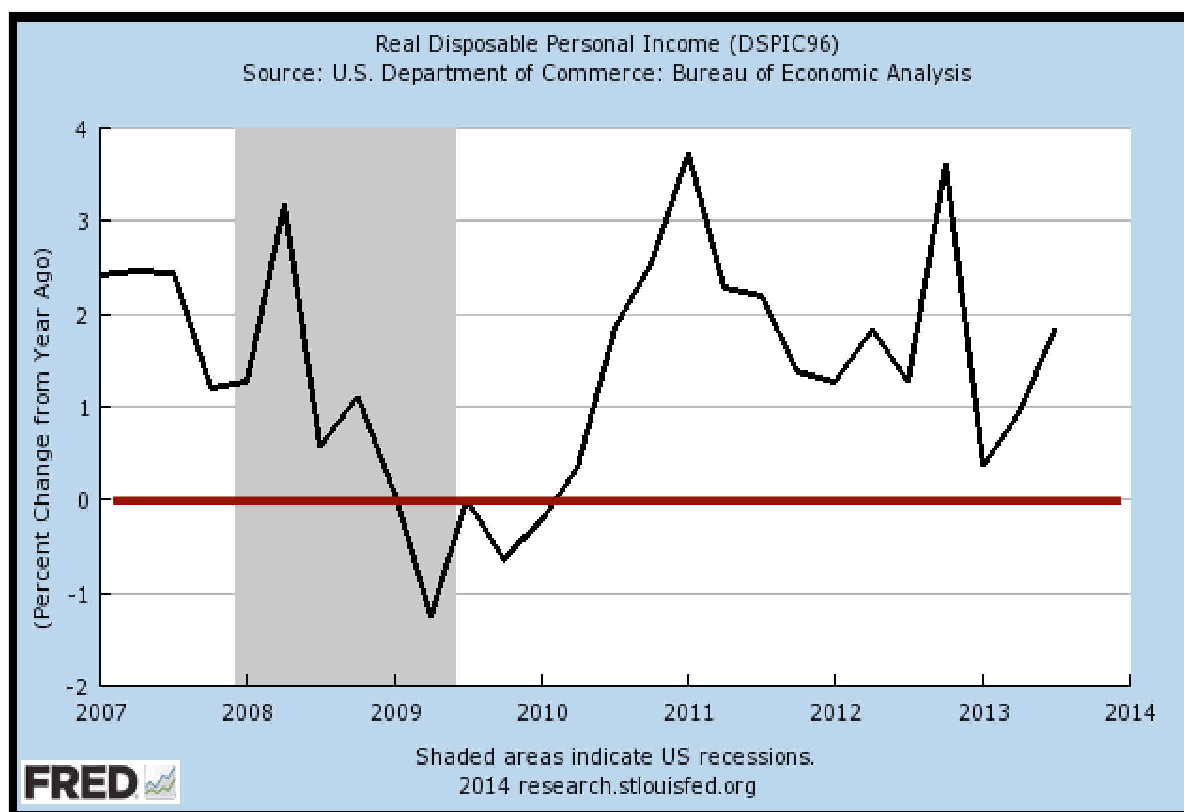
spending, followed by a rebound in business capital expenditures and finally a marked improvement in net exports.



CONSUMERS

Let's first focus on the all-important consumer. Households have demonstrated, both in sentiment surveys as well as through their actions, that they are clearly more confident about the economic outlook. The job numbers have improved the last three months (September thru November), with gains in nonfarm payrolls averaging 200,000 gains a month. **That pace should increase an average of 225,000 a month in the first half, and 250,000 in the second half of 2014.** At the same time, the unemployment rate, which fell to a 5-year low of 7% in November, **is projected to drop below 6.5% by the end of this year, and 5.9% in the final months of 2015.**

Americans are also experiencing a pick up in real incomes and thus purchasing power. However, this has been due more to inflation being dormant and less to a meaningful rise in nominal wages. Looking ahead, we do see nominal pay gains accelerating as labor market conditions improve and thus provide even more fuel for consumer spending.



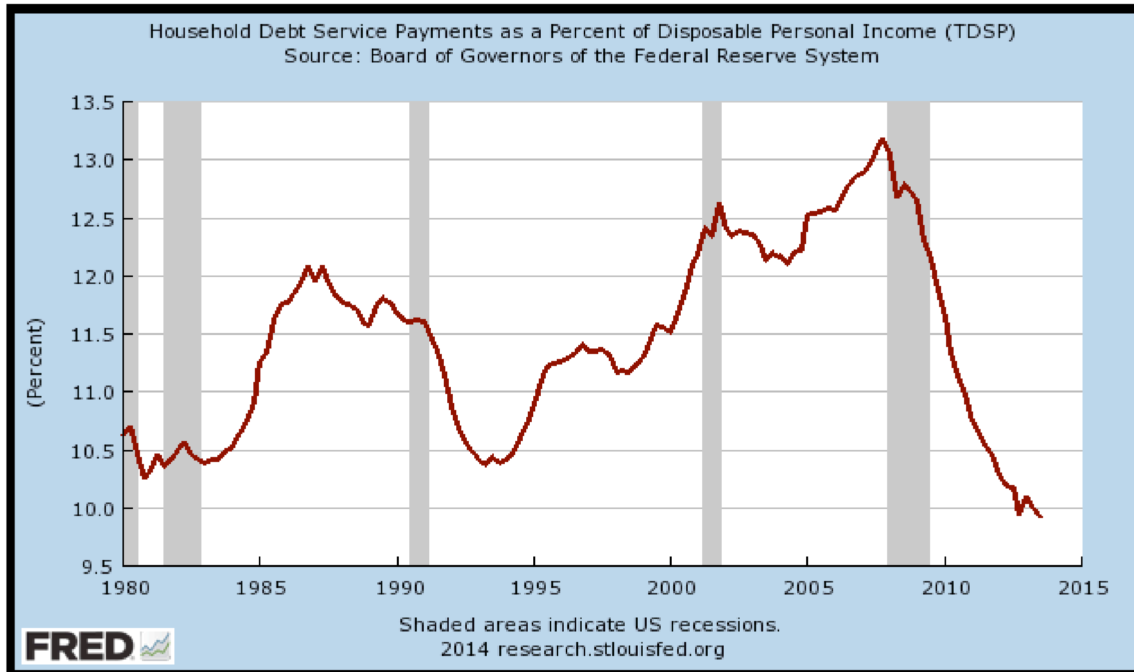
Of course, stronger economic growth does place upward pressure on prices. However, the cost of living will inch up only slowly 2014. What will keep inflation contained are falling energy prices, further competitive pricing in the retail sector, and the continuing investment of technology to boost productivity. **So while both consumer prices and the personal consumption expenditure price index will rise a notch during the year, both are projected to be within the 2% range in 2014.**

Another important contributor to spending will be a further increase in the value of real estate and stocks this year. Together they have already helped push up net household worth to **a record $77.3 trillion dollars** in the third quarter. That will probably jumped to another all-time high in the fourth quarter given how much home and equity prices have climbed in the final months of last year. (We'll get the official results from the Fed on march 6th.) Our expectation is that both sectors will continue to climb in 2014, but at a more subdued pace than 2013. **We project home values (based on the S&P/Case-Shiller Home Price Index) will increase 8.5% and the S&P 500 by 9.6% this year.**

Certainly household finances are in much better shape. After nearly four years of paring down personal debt, the burden of servicing existing loans is now the lowest ever! **Household debt service payments as a % of disposable personal income has plummeted to 9.92%, the lowest ever recorded by the Federal Reserve!** In other words, Americans

now spend less than a dime out of each take-home dollar to service their

mortgage and consumer debt! Even if you add other fixed household expenses ---such as rent, auto lease payments, homeowners' insurance, and property taxes --- the total burden to fulfill those obligations stands at **15.36% of disposable income, the second smallest share in more than 30 years.**



Finally, there remains a lot of pent-up demand by consumer from the years when the job market stagnated, gasoline prices were higher, and Congress was embroiled in political trench warfare. That was not a conducive climate for Americans to shop beyond the essentials. Fortunately, these disincentives to spend have faded and we expect to see some catch-up in expenditures this year. **Real personal consumption will grow by more than a 3% rate this year, compared with an estimated 1.9% in 2013.**

BUSINESS

One maddening characteristic about the recovery up to now has been the sheer disconnect between corporate profits and capital spending. Business investment spending has been consistently depressed, despite hefty profits and the accumulation of a **record $1.9 trillion in corporate cash accounts.** Why have they not put this money to more productive use?

The answer is simple. CEOs pulled back in recent years because of the uncertainties generated by the paralysis in Washington over tax and

spending policies, government shutdowns, and whether the U.S. would

default on its sovereign debt. Another disincentive was the lack of conviction among consumers to spend. There were also concerns about the economic future of Europe and China, and growing geopolitical threats from Asia, the Middle East and North Africa. Corporate leaders were in no mood to proceed with any major spending program, unless they were convinced such invested capital would earn a sufficient economic return.

We now believe the business climate has brightened considerably, because many of the risks noted above have diminished. For one, the odds of another disruptive bout of political brinksmanship have lessened considerably. For the first time in 27 years, a politically divided Congress managed to pass a bi-partisan budget accord late last year. While that deal is far from comprehensive and leaves much work to be done on tax reform and entitlements, it does at least avert another government shutdown for the next two years. The deal also replaces part of the sequester's automatic spending cuts, which means the fiscal drag on the economy will be less this year than in 2013.

One major cloud that still looms large (as of this writing) is the February 7th debt-ceiling deadline. This issue could revive the great philosophical divide and harsh rhetoric in Congress over whether or not to increase the Treasury's borrowing authority. But we believe it will also be resolved in a timely manner to avoid a funding crisis. **If that is the case, then corporate leaders will be less distracted by Washington and thus able to concentrate more on the organic strength of the private economy.**

Another factor that will embolden the business community is the Federal Reserve's assurance it will keep the cost of borrowing low, even as it scales back, and ultimately ends, purchases of Treasuries and mortgage-backed securities this year. The latest FOMC statement, as well as comments by Ben Bernanke and his successor, Janet Yellen, have repeatedly emphasized that the pace of tapering will be dependent on the strength of the economy and the labor market. **Equally important, they have explicitly said that short term interest rates will remain zero bound zero even after the jobless rate drops below 6.5%, so long as inflation stays under 2.5%.** This strategy, which can be described as "accommodative tapering," has succeeded in calming many money managers and corporate leaders who initially feared that tapering would bring much higher medium and long term interest rates and interrupt the economy's progress. While the Fed certainly wants to see a normalization of interest rates, its priority remains to advance economic activity enough so that firms accelerate hiring.

A third reason why we foresee greater capital expenditures this year is the persistent rise in both consumer confidence and spending, especially when it comes to big-ticket purchases. Even lenders are becoming more forthcoming with loans. The Federal Reserve's latest senior loan officer survey shows that banks have eased their loan standards. This relaxation can be attributed to the fact banks are much better capitalized these days, earned record profits and possess healthier balance sheets with higher quality assets. Topping it off is that the underlying value of the loan collateral (which is usually real estate) has also improved. Thus, we expect to see a hefty pick up in bank loans to both consumers and small businesses.

The residential construction sector, which was at the center of the last financial crisis, has clearly rebounded and we expect to see further improvement in 2014. Rising demand from new household formation, those seeking second homes, growing investor interest in real estate, and finally the replacement of homes lost to inventory will help drive new construction. **Our forecast calls for single-family housing starts to rise to 830,000 this year, with total starts climbing to 1.15 million.**

Given this economic backdrop, real non-residential fixed investments is projected to increase by 7.3% in 2014, compared to 2.5% last year, with residential fixed investments up 14.7% this year, vs. 13.3% % in 2013.

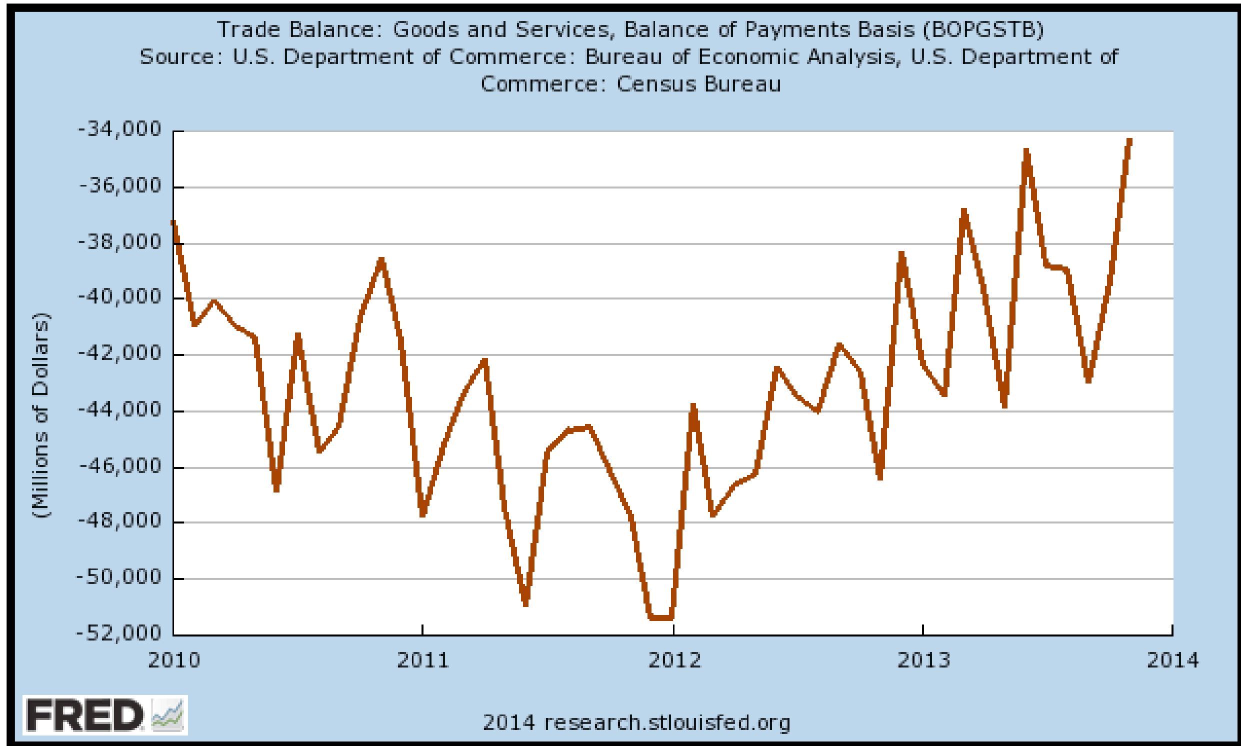
EXPORTS

The US will also gain from a pick up in the international economy this year, with greater shipments of US goods and services going to Europe, Japan, China and several emerging nations.

The Eurozone in 2014, for example, will experience its first year out of recession since 2011, though growth is still expected to be below the pace of most other industrial nations. Nevertheless, the EZ has turned the corner. Labor market conditions have stabilized. The southern European countries, which have endured painful reforms, are now more competitive and that has heightened investor interest. Purchasing power in the region has also returned and this augurs well for consumer spending. Most important, the European Central Bank has firmly indicated it will keep rates low to prevent deflation and support economic growth. All this means the viability of the single currency system is now greater than ever. In fact, with the beginning of this New Year, the EZ just welcomed its 18th member, Latvia.

Simply put, Europe as a whole is moving in the right direction with Germany, the UK, Belgium, Ireland and Switzerland taking the lead.

US trade balance improves as oil imports drop and demand for US goods



Despite recent signs that China's economy is cooling a bit, we expect policymakers will succeed in keeping quarterly growth rates this year and next between 7.25% to 8.25%. It is true that even this is among the slowest in the last two decades. But a manageable slowdown in the pace of growth is desirable. The reckless explosion in credit and needless build-up of excess capacity across nearly two dozen industries have put its economy close to overdrive, leaving both debt and inflation at dangerously high levels.

But China's new leaders appear determined to remedy this by permitting market forces to play a greater role in shaping their economy, a clear admission that the state does not allocate capital well. They are clamping down on the borrowing binge by local communities, where debt has now ballooned to $3 trillion. In addition, they have introduced reforms that would loosen controls on its currency and interest rates. The objective here is clear: China wants to reduce the government's footprint on the economy and is willing to implement a new business model by giving the private sector more latitude.

However, a word of caution is needed. While the Communist Party leadership has taken steps to liberalize the economy, they are at the same time making sure that this relaxation should not be construed as a willingness by the government to tolerate more political dissent. Yet market reforms that permit greater economic freedoms will inevitably lead to a bolder, more assertive population. If they crack down with an iron fist, it can undermine foreign investor confidence in the country and even raise the risk of a hard landing for its economy. Clearly, the next five to ten years will be the most critical in its history.

At least for this year and next, we see China's economy expand annually by about 8%. This growth will be driven by higher wages, which will fuel more household spending, stable inflation, the government's investments in urbanization, greater foreign capital inflows (as China allows more convertibility of the Yuan), and rising exports.

Japan will face several economic and geopolitical risks this year. We expect to see growth decelerate from about 2% in 2013 to 1.7% this year, and then an even slower 1.3% pace in 2015.

The government of Shinzo Abe has worked hard to re-energize the Japanese economy after nearly two decades of poor growth, deflation, and deteriorating demographics. While Abe has put in place a three-pong strategy to kick-start the economy, the results will likely be disappointing. Two of the three policies introduced, greater fiscal spending and a highly accommodative monetary policy have been implemented. But the government has fallen far short on the critical third strategy, which was to carry out necessary but politically difficult agricultural and labor market reforms.

Also hindering growth is the reluctance of companies to raise employee pay at a time when the Bank of Japan has successfully nudged inflation higher. This will cut into the purchasing power of households and slow future spending.

But the single largest factor that will affect Japan's economy this year is the hike in the consumption tax in April from 5% to 8%. That will be followed by another scheduled increase to 10% in 2015. The problem is that when Japan implemented such a sales tax hike in 1997, the loss of disposable income helped trigger a recession. Can this happen again?

While we do expect to see the economy contract in the second quarter, GDP growth will be in positive territory for the year. Keeping it above water will be the weak yen, which should support exports, and the government's own plan to beef up spending to help offset the restrictive effects of the consumption tax.

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So, What Could Go Wrong This Year?

UNITED STATES

1. Probability 20%: A Stunned Fed

The Federal Reserve is caught off guard as the economy bounces back far more vigorously. Demand for credit surges. Banks rush to draw down excess reserves and convert those funds into more profitable loans. Inflation expectations pick up and cause 10-yr Treasury bond yields to climb rapidly. The Fed, under pressure to respond, rushes in and terminates QE purchases earlier than planned. It also raises deposit rates on excess reserves to slow loan growth and issues a warning that the benchmark short-term rate may increase much sooner.

In spite of these efforts, investors fear the Fed has lost control of the inflation threat posed by all the quantitative easing. Worried the FOMC will act to sharply and abruptly tighten monetary policy, investors exit the stock market. Equities plummet 15% to 20% in value. The rise bond yields lifts mortgage rates and chokes off the housing recovery. Consumers curb spending and the economy slides back to its previous lackluster pace, if not recession.

2. Probability 40%: Washington and the midterm elections

As we approach the November midterm elections, when all 435 seats in the House and 33 in the Senate are up for grabs, any semblance of bi-partisanship in Washington breaks down. The rancor sets off another brutal political food fight. Alarmed by the breakdown in governing, both businesses and consumers put the brakes on growth by scaling back spending and investing in the second half.

INTERNATIONAL

1. Probability 35%: Debt Trap in China

The country suffers a financial meltdown as the pile up in local government and company debt becomes unmanageable with the loosening of interest rates. This leads to massive losses and defaults, and sets off another global financial crisis that is larger than the Asian crunch of the late 1990s. Global liquidity quickly disappears and the world economic recovery loses steam.

2. Probability 45%: Iran's IRG Make a Power Grab

Iran's most elite military force, the Islamic Revolutionary Guards (IRG), vigorously rejects the nuclear diplomacy initiated by President Hassan Rouhani. Moreover, the IRG believes Iran's new president is working behind the scenes to reduce both the political influence and budget of the paramilitary force. The powerful militant group has warned they will not tolerate either action and charged that Rouhani has been "infected by Western doctrine" and is now straying from the 1979 Islamic Revolution's fundamental tenets.

In the middle of this feud is Iran's Supreme Leader Ayatollah Ali Khamenei, who has so far mildly supported the P-5 + 1 talks on nuclear issues, but is also carefully supportive of the IRG. This delicate balancing act by Khamenei cannot last very long. The distrust between Rouhani and Mohammad Ali Jafari (who commands the IRG) is certain to get worse in the coming months. Someone will have to give ground.

Should a major schism erupt between the government and the country's paramilitary force, it could destabilize a nation that's on the edge of achieving nuclear military capability, heighten tensions in a region already plagued by extreme violence, and drive oil prices above $130 bbl. Together, these events can easily stagger the global economic recovery.

3. Probability 50%: The Syrian, Egyptian and Iraqi conflicts engulf more of the Middle East

We have assigned our highest threat probability to the risk that Islamic terrorism will spread this year to other key countries in the Middle East, including Saudi Arabia, Jordan and possibly even Israel. With regional violence spiraling out of control, pressure will build for the US and other world powers to intervene more assertively. However, since this is ultimately a brutal religious clash between, as well as within, radical Shiite and Sunni groups, we see little chance of success in reducing the bloodshed. Should the crisis worsen in this important theater, it could drive energy costs much higher, disrupt capital and trade flows, and very quickly undermine investor and business confidence around the world.

4. Probability 30%: Hostilities Break out Between China and Japan Over Islands in the ECS

Compounding Japan's economic difficulties is the dangerous escalation in tensions with China over who owns some key resource-rich islands and seabeds in the East China Sea. Neither country shows any sign of backing down (as of this writing). Nor are there any plans to resolve this through direct negotiations. Thus the risk of miscalculation increases. Both

countries are boosting their naval presence in the area. China has gone even further by announcing an air defense zone over the disputed islands. Will this end with a shooting war between the world's second and third largest economy? The probability of such a confrontation has increased from 20% last year to 30% at the start of 2014.

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Key Economic Forecasts

- Actual
- Forecast

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United States

	I 2013	II 2013	III 2013	IV 2013	I 2014	II 2014	III 2014	IV 2014	I 2015	II 2015	III 2015	IV 2015
Real Gross Domestic Product (GDP):												
%	1.1	2.5	4.1	2.8	3.0	3.8	3.4	3.2	2.8	3.6	3.1	3.0
Personal Consumption Expenditures:												
PCE	2.3	1.8	2.0	3.0	3.2	3.6	2.8	2.9	2.7	3.3	2.9	2.8
Inflation, end of period, year-over-year:												
CPI %	1.5	1.8	1.2	1.3	1.5	1.8	2.0	2.2	2.2	2.4	2.5	2.8
Unemployment Rate (end of period):												
%	7.6	7.6	7.2	7.0	7.1	6.9	6.7	6.4	6.4	6.2	6.0	5.9
Non-farm Payrolls, monthly avg. thousand:												
	207	182	167	205	215	225	240	250	250	260	230	220
Treasury 10-yr Note Yield % (end of period)												
	1.9	2.5	2.6	3.0	3.3	3.5	3.8	4.0	4.0	4.3	4.7	5.0
Federal funds rate % (end of period)												
	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.5	1.0	1.5

GDP Growth - Global Economy

Country	2007	2008	2009	2010	2011	2012	2013	2014	2015
US	1.8	-0.3	-2.8	2.5	1.8	2.8	2.6	3.4	3.1
Eurozone	2.6	0.6	-4.1	1.7	1.4	-0.6	-0.2	1.0	1.5
United Kingdom	3.1	0.6	-5.2	1.7	0.7	0.1	1.6	2.6	2.7
Japan	2.1	-0.7	-5.4	4.6	-0.7	1.4	2.0	1.7	1.3
Canada	2.7	0.7	-2.8	3.2	2.5	1.8	1.7	2.7	3.0
India	8.9	6.1	8.6	10.5	6.3	3.2	5.0	5.5	6.1
China	14.2	9.6	9.2	10.5	9.3	7.8	7.6	7.9	7.9
Brazil	5.7	5.1	-0.3	7.5	2.7	0.9	2.4	2.6	3.7
Mexico	3.3	1.4	-4.7	5.2	4.0	3.9	1.8	3.4	4.0
Australia	4.0	2.3	1.2	2.8	2.6	3.6	2.4	2.8	3.2
Russia	8.1	5.6	-7.9	4.0	4.3	3.4	1.5	2.3	2.8
World	5.4	1.6	-1.9	4.2	3.0	2.6	2.8	4.1	3.8

Key Currency Values

	End 2008	End 2009	End 2010	End 2011	End 2012	End 2013	End 2014	End 2015
USD/Yen	91	93	81	77	87	105	110	100
Euro/USD	1.40	1.43	1.34	1.29	1.32	1.37	1.40	1.45

Oil (Brent spot) & Gasoline (Average retail unleaded, $)

	End 2008	End 2009	End 2010	End 2011	End 2012	End 2013	End 2014	End 2015
Crude oil per barrel	46	78	95	107	111	111	99	93
Gasoline	1.61	2.57	3.00	3.27	3.30	3.32	3.20	3.18

Major Stock Indexes

	End 2011	End 2012	End 2013	% Change '13	End 2014	% Change '14
DJIA	12,218	13,104	16,577	27	18,470	11.4
S&P 500	1,258	1,426	1,848	30	2,025	9.6
NASDAQ	2,605	3,019	4,177	38	4,777	14.4
RUSSELL 2000	741	849	1,164	37	1,347	15.7

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