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ECONOMIC TALKING POINTS

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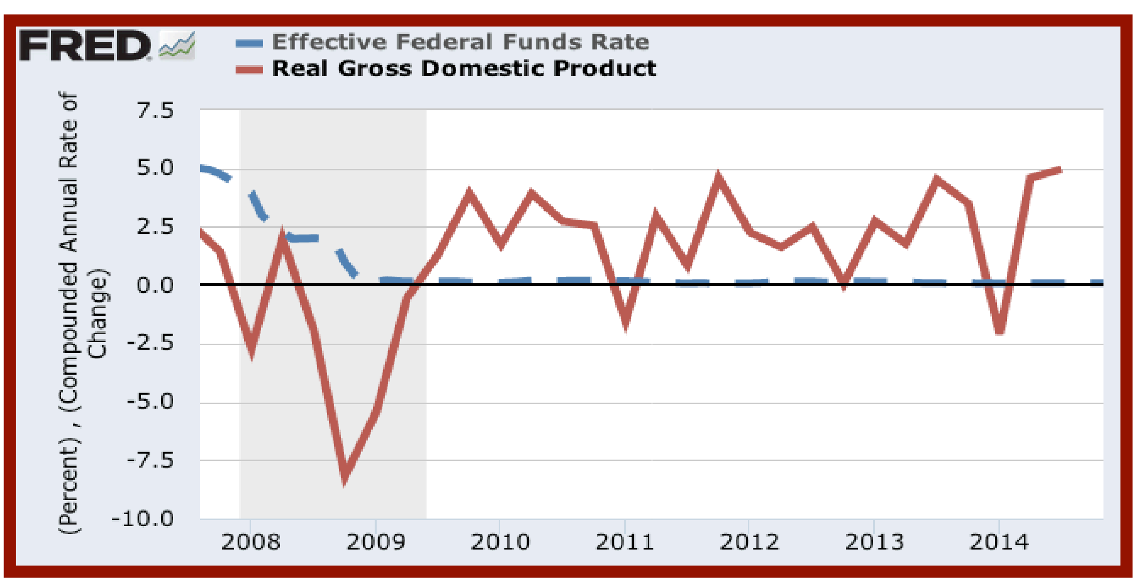
Economy Ends The Year Strong.
But Will It Get The Fed To Act Sooner?

There is a growing sense of absurdity about how the Federal Reserve conducts monetary policy these days. We have the strongest economy in more than a decade, inflation is stable and the jobless rate is just shy of what is considered full employment.

Yet, the Fed continues to pursue an interest rate policy as if it is reacting more to data coming out of Greece, than the U.S.

The strong GDP numbers for the 3rd quarter follows a cascade of other economic stats showing an economy that is clearly, unambiguously, galloping ahead. Growth reached a 5% annual pace during the summer period, an acceleration from the 4.6% rate in the second. If you remove the first quarter's weather-induced contraction, economic activity has been expanding at a 4.4% average since the summer of 2013.



Shoppers are now leading the charge. Households, pleased by the drop in gasoline prices and emboldened by the improvement in labor markets, ramped up spending to a 3.2% rate in the 3rd quarter. Consumer outlays have been accelerating since the start of the year---and it shows no sign of sliding back.

For example, another report out this morning on monthly personal income and spending showed personal consumption expenditures jumped 0.6% in November, up from 0.3% in October, and 0.2% in September.

Just as meaningful in that same release is that household income is getting stronger too. Wages and salaries climbed 4.5% over the past 12 months, more than double the pace of inflation, so Americans are gaining real purchasing power. That helps explain why consumer confidence keeps on soaring. We just saw the Thomson Reuters/University of Michigan index of consumer sentiment index ended 2014 at a seven-year high of 93.6.

Wages and salaries, % change, year-over-year

Source: Bureau of Economic Analysis

The increase in real income, combined with plunging gasoline prices, better job prospects, healthier household balance sheets, greater optimism, and the low cost of credit pretty much assures that consumers will continue to contribute mightily to economic growth in 2015.

To be sure, some sectors of the economy have been lagging.

Housing is certainly one. New home sales fell 1.6% to a weaker than expected pace of 438,000 in November. One big factor behind the lack of vitality in residential real estate has been the difficulty homebuyers experienced obtaining loans. Banks are required to comply with tougher Qualified Mortgage rules, which included a requirement that purchasers come up with 20% of the home price up front. But after hearing complaints from banks and prospective buyers, the FHFA recently eased those requirements. We expect to see a further relaxation of the Qualified Mortgage rules in 2015 and that should stimulate more sales of both new and existing homes next year.

Nor were we terribly concerned by the softness in durable goods orders. The highly volatile series showed new orders fell 0.7% in November. But this was due in large part to an 8.1% drop in bookings for defense capital goods. If you focus on core business spending (capital goods minus aircraft and defense), orders were unchanged last month. However, even that has to be questioned against the backdrop of ISM's manufacturing index, which showed November being the most active in three years. Moreover, the Federal Reserve's own industrial production numbers leaped last month by the most seen in two years!

What does all this mean for future Fed policy?

The case gets stronger each day for the Fed to move up the date to lift short term rates. We are now projecting the first rate hike will come no later than April, though frankly it should be sooner.

The goals for instituting a zero interest rate policy have been achieved. Both of the Fed's mandates --- to keep inflation stable and help promote full employment --- are now in place. Though some at the Fed still believe the risk of deflation is too great, we see no such threat. Chronic deflation is not possible with a strong economy; it would defy the laws of physics.

First, it is important to make a distinction between good and bad deflation. The former takes places when prices fall as a result of technological innovation that leads to a supply shock. That is what we have today with respect to energy prices. Its decline will reverberate through other parts of the economy and lower production costs. Nothing wrong with that. Everyone benefits!

Bad deflation occurs when prices fall because of a profound drop in domestic demand. A country in severe recession or depression may see the cost of goods plummet. But the latter is certainly not what is going on in the US economy today and a central bank that is truly data dependent should recognize that.

Insofar as the job market is concerned, all the Fed can ever do is work to reverse cyclical unemployment, which it has done. What they cannot do by themselves is correct structural unemployment. Resolving labor problems that stem from either a mismatch or an atrophy in skills can only be addressed through fiscal, not monetary policy. Congress and the White House have to get on board with programs that help finance retraining programs, for example.

This is not about Fed bashing.

We give the Bernanke /Yellen Fed great credit for resuscitating the US economy after the financial crisis nearly tipped it into depression. Low interest rates and QE have helped revive manufacturing, allowed households and businesses to repair their balance sheets, and restored enough confidence in the economic outlook to allow employers to accelerate hiring. We believe the Fed's work is now done!

It's time to transition monetary policy more towards what the economic and inflation climate will be 12 to 18 months from now, when Europe, Japan and the emerging nations are likely to come back on line and drive up the price of both oil and labor.

Key Economic Forecasts

- Actual
- Forecast

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):												
%	2.7	1.8	4.5	3.5	-2.1	4.6	5.0	3.7	2.9	3.5	3.4	3.3
Personal Consumption Expenditures:												
PCE	3.6	1.8	2.0	3.7	1.2	2.5	3.2	3.2	4.0	3.4	2.8	3.1
Inflation, end of period, year-over-year:												
CPI %	1.5	1.8	1.2	1.5	1.5	2.1	1.7	1.8	2.0	2.3	2.5	2.6
Unemployment Rate (end of period):												
%	7.6	7.6	7.2	6.7	6.7	6.1	5.9	5.8	5.5	5.3	5.1	4.8
Non-farm Payrolls, monthly avg. thousand:												
	206	201	172	198	189	267	240	275	250	265	250	250
Treasury 10-yr Note Yield % (end of period)												
	1.9	2.5	2.6	3.0	2.7	2.5	2.5	2.5	2.8	2.9	3.2	3.5
Federal funds rate % (end of period)												
	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	1.25	1.75

GDP Growth - Global Economy

Country	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
US	1.8	-0.3	-2.8	2.5	1.6	2.3	2.2	2.8	3.1	3.3
Eurozone	2.6	0.6	-4.1	1.7	1.4	-0.6	-0.4	0.4	1.1	1.7
United Kingdom	3.1	0.6	-5.2	1.7	0.7	0.3	1.8	3.0	2.6	2.9
Japan	2.1	-0.7	-5.4	4.6	-0.7	1.6	1.5	1.2	1.0	1.7
Canada	2.7	0.7	-2.8	3.2	2.5	1.7	2.0	2.3	2.7	2.9
India	9.1	8.8	6.3	8.4	8.6	6.7	4.9	5.5	6.5	7.0
China	14.2	9.6	9.2	10.5	9.3	7.8	7.7	7.1	6.9	6.7
Brazil	5.7	5.1	-0.3	7.5	2.7	0.9	2.3	0.3	1.2	2.2
Mexico	3.3	1.4	-4.7	5.2	4.0	3.9	1.1	2.4	3.5	4.1
Australia	4.0	2.3	1.2	2.8	2.6	3.6	2.4	2.6	2.7	3.0
Russia	8.1	5.6	-7.9	4.0	4.3	3.4	1.3	-1.5	-4.0	1.0
World	5.4	1.6	-1.9	4.2	3.0	2.6	2.9	2.9	3.2	3.6

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