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ECONOMIC TALKING POINTS

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Hiring still going strong. Bet on wages to rebound too in coming months.

Many will clearly be perplexed by an apparent dichotomy in December's employment report. Hiring last month was quite strong with payrolls up 252,000 and it followed hefty upward revisions for November and October. The unemployment rate also fell to a six-year low of 5.6%. Moreover, total job growth for 2014 came to 2.95 million, the best year for hiring since 1999.

Chart 1. Unemployment rate, seasonally adjusted, December 2012 – December 2014

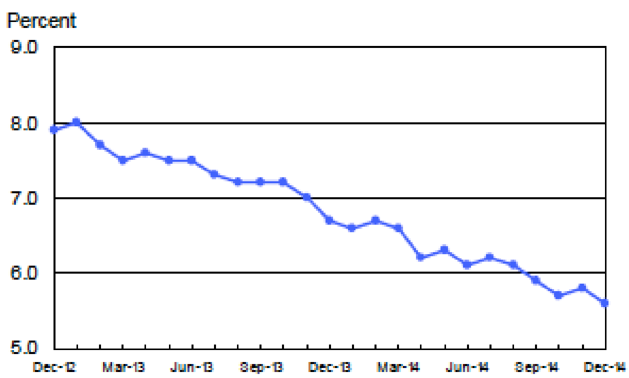
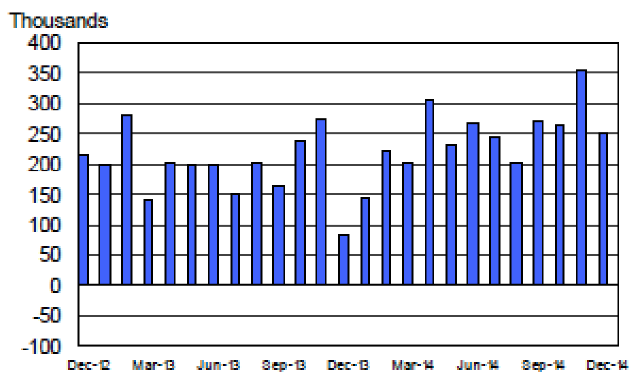


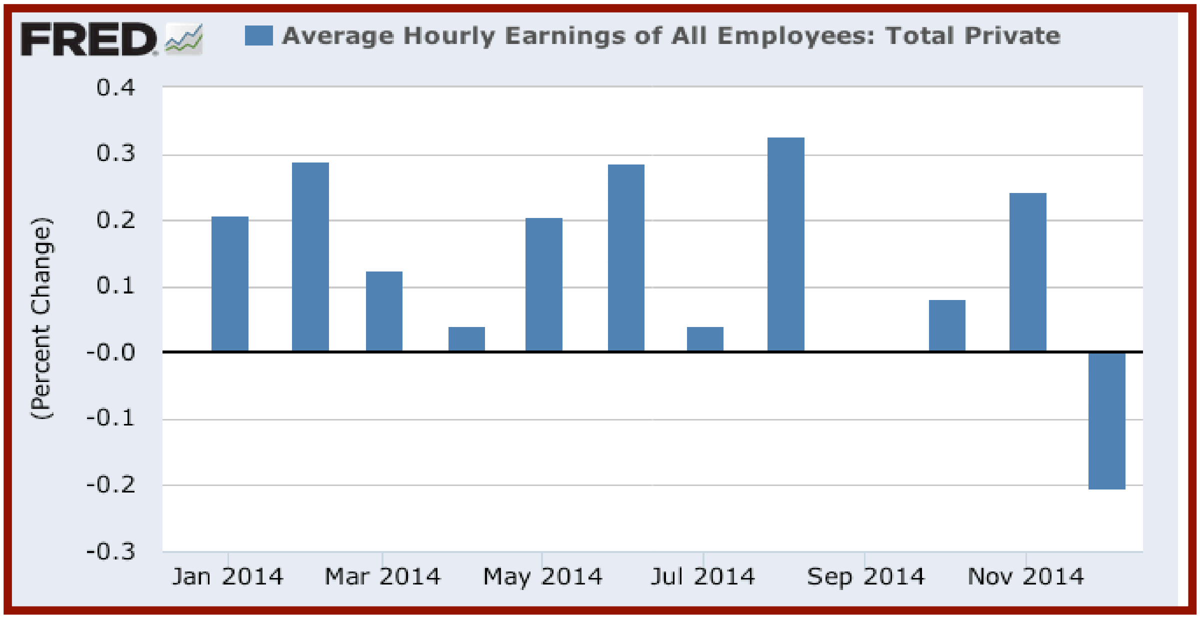
Chart 2. Nonfarm payroll employment over-the-month change, seasonally adjusted, December 2012 – December 2014



Yet despite the impressive performance in the labor market, worker pay remains stagnant. December's average hourly earnings actually fell 0.2% last month, the first drop since July 2013, though it did managed to inch up 1.65% for the year as a whole.

If the slack among the unemployed is *really* diminishing, an observation even the Federal Reserve has publically acknowledged, shouldn't we then see an accompanying pick-up in wages? What accounts for this divergence between a clearly resurgent labor market---and these anemic pay increases? How does this impact the outlook for consumer spending and the economy in general?

Lots of questions have emerged from the December employment report.



We can best answer them by first stepping back to look at the broad economic fundamentals.

First, the U.S. economy entered 2015 with lots of forward momentum. Not only is business activity expanding at the best pace we have seen in more than a decade, **but rarely in history has there been such a perfect alignment of positive forces that promises to fuel more economic growth and galvanize employers to accelerate hiring.**

Those forces include:

• Interest rates across the yield curve are at historic lows. Even if the Fed were to begin lifting rates mid-year, we will still have fed funds below inflation! A negative real rate is by definition highly stimulative.

• Oil prices (WTI) have fallen more than 55% in six months, pushing the national average price for gasoline down to $2.17, the lowest since May 2005. Both consumers and businesses greatly benefit from lower energy costs.

• Households and corporations have repaired their balance sheets and are ready to ramp up spending and investments. The Federal Reserve yesterday reported Americans took on an additional $14.1 billion in credit during November (the latest available) --- and that came on top of a $16 billion gain in October. Companies are also moving forward with projects to replace their aging capital stock after years of neglect.

• Inflation is low and stable. The core PCE (personal consumption expenditure) inflation rate --- which the Fed tracks most closely---has been hovering for months around its current level of 1.4%. And while some Fed governors still express concern about the risk of broad deflation, such worries make absolutely no sense!! **Deflation is not possible when you have the world's largest economy expanding close to a 4% pace, with the unemployment rate down to 5.6%, payrolls climbing above 250,000 a month, the cost of borrowing cheaper than ever, and with consumers and businesses eager to increase spending.**

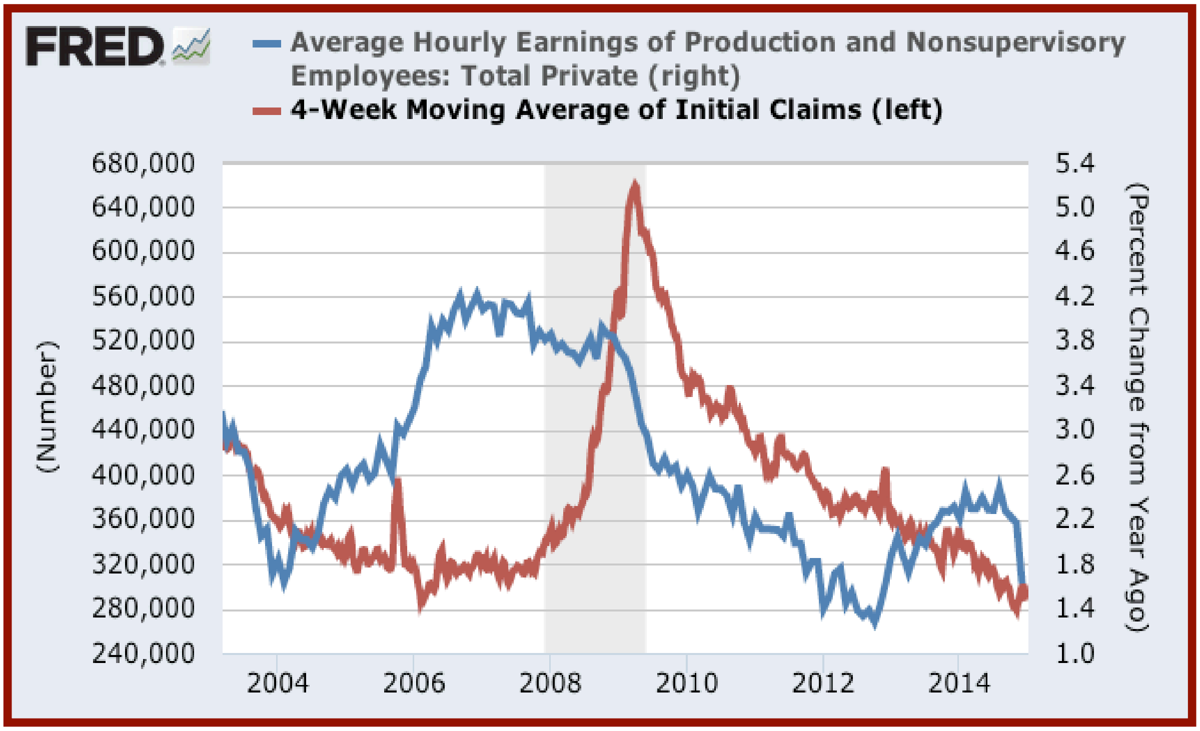
Frankly, **if these factors do not set the stage for more sustainable economic growth, higher inflation, faster hiring, and ---yes--- even larger wage increases, then we have to go back to the drawing board and revisit everything we know about how economies work.**

Fortunately, a closer look at this jobs report suggests wages are about to rebound. One of the best leading indicators of this is the ratio of unemployed to job openings. That is, how many unemployed Americans are competing for each available job. In December, there were ***fewer than 1.8 people*** vying for each job. (It was as high as 7 competing for each position during the low point of the last recession.) Typically, the threshold that leads to an acceleration in pay begins once the jobless slack shrinks to where 2 people are available for each job. It explains in part why December's **average weekly pay** for the year climbed by 2.5%, the biggest annual increase of any month in 2014.

Another promising sign is that the economy is generating enough new jobs to keep up with population growth. The employment-population ratio stood at 59.2% in December, unchanged from the two previous months, but higher than 58.6% of a year ago. Now some may argue that a great percentage of those employed are **part time for economic reasons**, where the pay tends to be less substantial. But the data shows the opposite. The percentage of employment that make up this part time category has been in decline. Just 4.6% of total employment are part time workers for economic reasons versus 5.4% a year ago.

There are other promising signs of higher average hourly wages in the coming months.

• More firms will find it necessary to hike pay in order to retain their existing workforce. That explains why claims for unemployment benefits have averaged below 300,000. **There is a perfect inverse correlation that shows once benefits drop to this low level, wages shortly turn higher. We will see that turning point this quarter.**



• The median number of weeks the unemployed are out of work dropped to 12.6 last month, the lowest since March 2009.

• The collapse in energy prices and strong domestic growth have also incentivized foreign companies to relocate to the US with their factories and gear up hiring. In addition, US firms that have outsourced their plants to other countries are now returning to the States to take advantage of lower energy bills vibrant American demand.

So while the average hourly component from this otherwise bullish jobs was disappointing, we remain confident the annual increase in pay will approach 3% by the end of 2015.

Bottom line:

We have to look past the latest weakness in average hourly pay. Under no circumstances does it reflect an economy that is faltering. Wages and salaries have always been viewed as a lagging indicator. But the long-awaited inflection point is near.

Are there some wild cards out there that might derail this expansion, stall hiring and pay increases?

Of course there are. Listen to the news and you can hear the geopolitical pot boiling furiously. For example, will Russia's Vladimir Putin raise the stakes and threaten a NATO country next? Could ISIS be eyeing the oil fields in southern Iraq or inside Saudi Arabia? What if Greece does leave the euro? Will the confrontation between Israel and Iran heat up? Could there be a military confrontation in the western Pacific as China and other nations in that region claim ownership of oil rich islands and seabeds in the East and South China Seas? Does the terrorist strike in Paris signal the start of a new wave of such attacks in the West?

There is no scarcity of exogenous threats looming over the economy. For now, however, the chance of an eruption of such magnitude that will disrupt this US economic expansions is very remote.

All the major metrics suggest the US economy will continue to grow an average of 3.4% the next two years. This will translate in to greater employment, rising household income, more consumer spending, larger capital investments, and bigger profits. Indeed, we still believe the economy could be in the middle of what could become the longest expansion in history.

United States

	I 2014	II 2014	III 2014	IV 2014	I 2015	II 2015	III 2015	IV 2015	I 2016	II 2016	III 2016	IV 2016
Real Gross Domestic Product (GDP):												
%	-2.1	4.6	5.0	3.7	3.3	4.8	4.0	2.8	2.8	3.2	2.7	2.8
Personal Consumption Expenditures:												
PCE	1.2	2.5	3.2	3.0	2.5	3.4	3.1	2.9	2.5	2.8	3.0	3.0
Inflation, end of period, year-over-year:												
CPI %	1.5	2.1	1.7	1.5	1.7	1.8	1.8	2.0	2.1	2.1	2.2	2.4
Unemployment Rate (end of period):												
%	6.7	6.1	5.9	5.6	5.6	5.3	5.3	5.4	5.5	5.3	5.3	5.3
Non-farm Payrolls, monthly avg. thousand:												
	189	267	239	289	240	270	255	275	235	245	250	250
Treasury 10-yr Note Yield % (end of period)												
	2.72	2.52	2.51	2.17	2.48	3.00	3.33	3.49	3.55	3.60	3.70	4.10
Federal funds rate % (end of period)												
	0.25	0.25	0.25	0.25	0.25	0.50	1.00	1.50	2.00	2.50	3.25	3.50

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	2.4	3.8	2.9
Eurozone	2.6	0.6	-4.1	1.7	1.4	-0.6	-0.4	0.5	1.1	1.7
United Kingdom	3.1	0.6	-5.2	1.7	0.7	0.3	1.8	3.0	2.4	2.9
Japan	2.1	-0.7	-5.4	4.6	-0.7	1.6	1.5	1.2	1.5	1.8
Canada	2.7	0.7	-2.8	3.2	2.5	1.7	2.0	2.2	2.5	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	1.5	2.2
Mexico	3.3	1.4	-4.7	5.2	4.0	3.9	1.1	2.7	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	3.8	4.2

Key Currency Values

	End 2008	End 2009	End 2010	End 2011	End 2012	End 2013	End 2014	End 2015	End 2016
USD/Yen	91	93	81	77	87	105	119	125	110
Euro/USD	1.40	1.43	1.34	1.29	1.32	1.37	1.21	1.18	1.26

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

	End 2008	End 2009	End 2010	End 2011	End 2012	End 2013	End 2014	End 2015	End 2016
Crude oil per barrel	46	78	95	107	111	111	58	80	90
Gasoline	1.61	2.57	3.00	3.27	3.30	3.32	2.26	2.70	2.85

Major Stock Indexes

	End 2012	End 2013	End 2014	% Change '14	End 2015	% Change '15
DJIA	13,104	16,577	17,823	7.5	19,300	8.3
S&P 500	1,426	1,848	2,059	11.4	2,199	6.8
NASDAQ	3,019	4,177	4,736	13.4	5,157	9.1
RUSSELL 2000	849	1,164	1,205	3.5	1,277	6.0