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ECONOMIC TALKING POINTS

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Troubles in the Middle East --- A Potential Spoiler for the Global Economy?

Before commenting on the final read for 4Q US GDP, there is a more immediate concern that can affect the general economic outlook.

If there was one geopolitical threat that could reverse the decline in oil prices, pummel world equity markets and set back the global economic recovery, it would be a full blown war between Saudi Arabia and Iran. We're no longer talking about these countries relying on proxies to expand their power base in the Middle East. The scenario at risk is one where Saudi forces directly take on those of Iran.

How likely is this to happen? Certainly the odds for such a confrontation have increased the last few days. The fighting in Yemen brings us one giant step closer to such a cataclysm. In a matter of weeks, the civil war in Yemen between the Iran-backed Houthis, a Shiite group, and the Saudi-backed Sunni government of President Hadi has mushroomed into a religious war that now engulfs more than 10 nations.

The looming question now is whether Iran will passively sit back and allow a Saudi- lead multi-nation charge defeat the Houthis? We doubt it. How events evolve the next few days could have a transformative effect on the region, and that in turn could impact the global economy and capital markets.

Some scenarios:

Will Teheran be prepared to send its troops into Yemen and fight alongside the Houthis against Saudi and Egyptian forces? That's unlikely. But Iran could retaliate against the Saudi Kingdom by stirring up trouble on at least three other fronts:

(1) Trigger a more violent uprising in Bahrain, where a Shiite majority feels persecuted by a Sunni-ruled government. It was four years ago when Riyadh, furious at how Iran and Hezbollah had fomented unrest n Bahrain, sent in its own forces to quash the uprising in support of the ruling party.

(2) Iran could direct more resources to Shiite fighters along the Iraq – Saudi border and possibly destroy some of the Kingdom's oil infrastructure. Saudi Arabia is in the process of building a 600-mile wall across its entire border with Iraq to keep out ISIS, AQAP and Iran-backed terrorists, but will this be enough?

(3) Iranian naval forces could choose to interfere with Saudi trade out of Dammam, Jubail and Ras Tanura, all major ports in the Persian Gulf.

Clearly. there appears to be a highly combustible mix brewing in the region, with religious factionalism, blood feuds, money, oil and power reaching a level of intensity that could trigger a much wider conflict. Such an event can disrupt oil, trade and capital flows, potentially derail the global economic recovery. No one should diminish the dangers now forming in that part of the world.

US Economy

Assuming rationality does prevail and tensions subside soon in the Middle East (not an easy analytical transition to make), then we continue to remain optimistic about the US economic outlook.

While the final numbers on 4Q GDP showed no change in the headline, with the economy growing at a 2.2% annual rate, it did provide some encouraging news on the willingness of consumers to spend. Personal consumption expenditures surged at a 4.4% pace the final three months of the year, the fastest we have seen in 8 years!

True, household outlays in the first two months of this new year have been disappointing as we saw from retail sales. But it would be wrong to place too much weight on those soft spending numbers ---and certainly a mistake to conclude they show an economy about to lose steam. This year's first quarter, much like last year's first three months, was affected by an unusually harsh winter. Business investments slowed and many shoppers were kept from stores. Like last year, once the winter season ends we expect consumer and business activity to rebound.

Underlying this optimism is the fact that economic fundamentals continue to look solid. We've listed below some of the positive forces that should support stronger growth this year.

1. The harsh winter did not slow hiring. Nonfarm employment jumped 295,000 in February, even faster than the three-month average of 288,000. In the process, the unemployment rate hit another post-recession low of 5.5%. (Charts 1 and 2.)

Chart 1. Unemployment rate, seasonally adjusted, February 2013 – February 2015

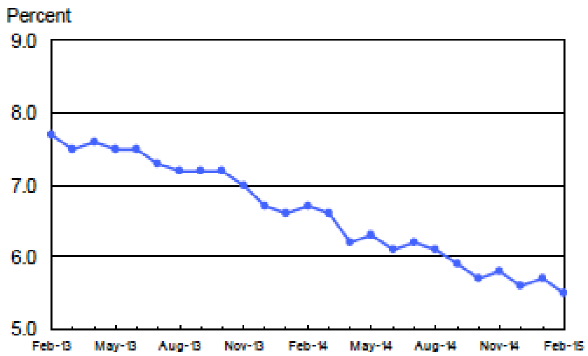
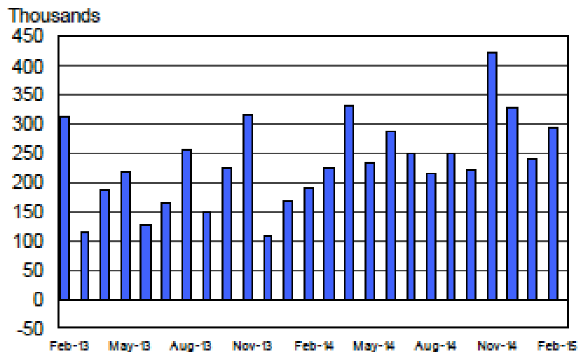
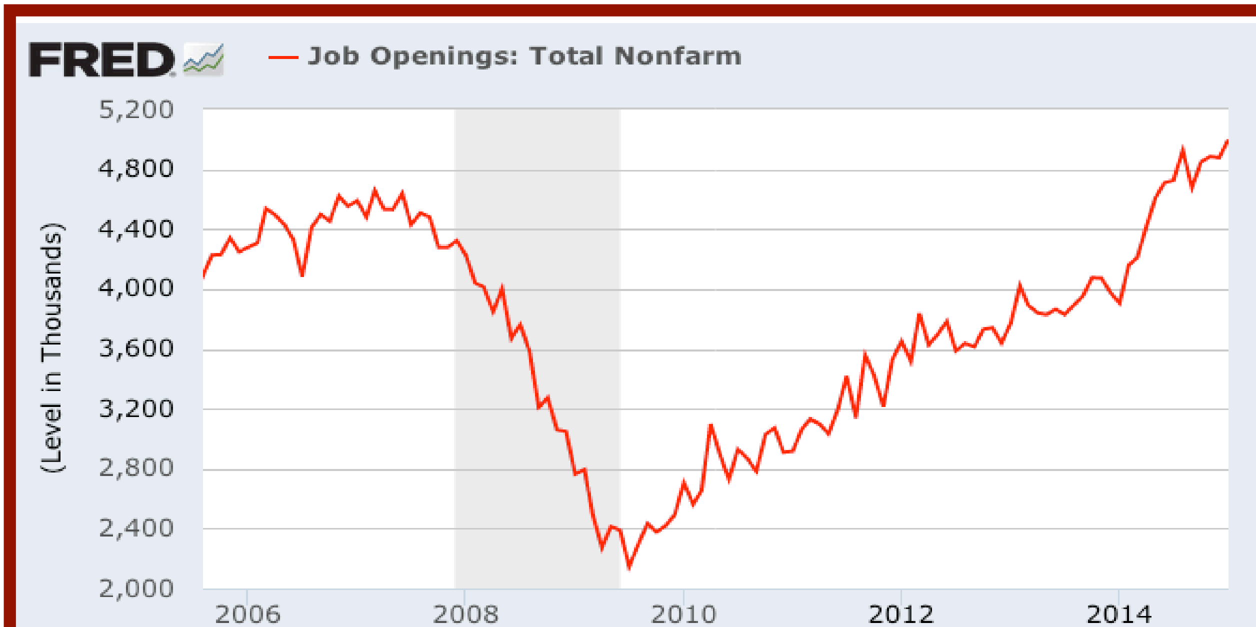


Chart 2. Nonfarm payroll employment over-the-month change, seasonally adjusted, February 2013 – February 2015



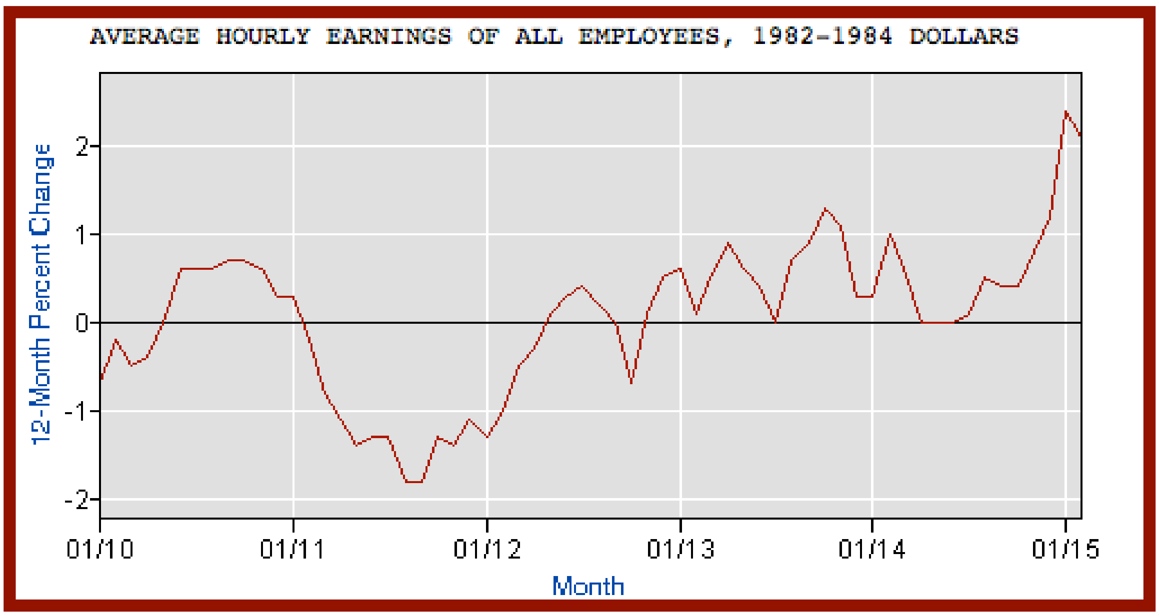
2. Companies also ramped up the number of positions they are seeking to fill to 5 million, the most in 14 years! (Chart 3)

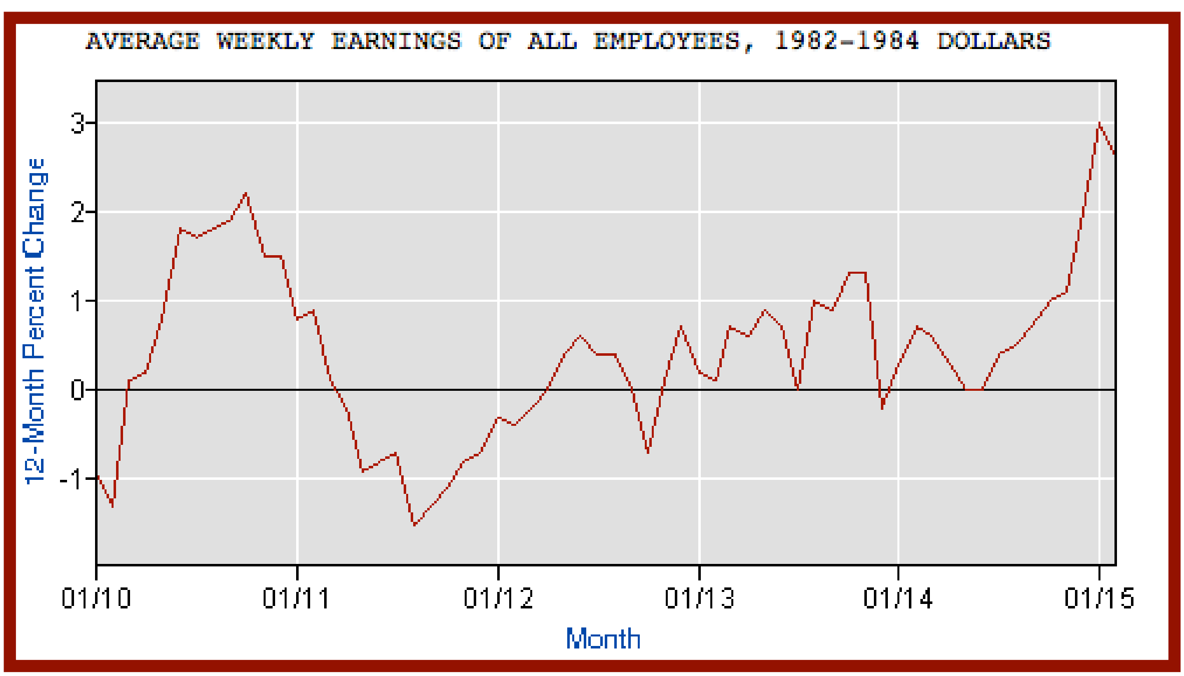


3. New claims for unemployment benefits just dropped to 15-year lows.

3. Confidence in the job market has risen to a point where 2.8 million people in January voluntarily left one position because they expected to find a more lucrative position elsewhere, the most in six years!

4. Real average hourly earnings has risen 2.1% over the year. Real average weekly pay climbed 2.6% over the same time frame. Would we like to see these numbers higher? Of course, but let's not forget this still represents an increase in purchasing power. (Charts 4 and 5)





5. Banks are also more forthcoming with credit. Commercial and industrial loans have been climbing at double-digit annual rates the first two months of the year.

6. We continue to enjoy cheaper fuel prices, with retail gasoline still more than a dollar less than a year ago. Given the glut in oil inventories, we see little chance of a sharp upturn in prices through the summer.

7. Federal Reserve officials have said that while they may end its zero bound interest rate policy this year, further increases in the fed funds rate will occur very gradually, and not sequentially with each FOMC meeting. Indeed, we expect to see the real fed funds rate to remain negative this year and only marginally positive the next two years. It really is a misnomer to describe these rate hikes as "tightening" when all the Fed is trying to do is simply normalize rates where it neither stimulates nor restrains economic activity.

8. US consumer sentiment (based on the University of Michigan survey) did slip a bit this month to 93, compared with 95.4 in February. But let's keep this in perspective. The average level of confidence this quarter turned out to be the highest in a decade. The latest decline was likely due to a slight uptick in gasoline prices and higher heating bills because of the severe weather. The setback in optimism is expected to be temporary and certainly not indicative of an economy losing steam.

9. We also see some encouraging numbers on the housing front. New and existing home sales were up in February. Among our favorite forward-looking metrics is the ratio of permits to starts, which was 1.22 in February. In other words, there were 1.2 permits filed for future construction for every start now. (For all of last year, that ratio stood at 1.04.) The increase in the ratio tells us builders have some catching up to do. Another leading data point is the number of pure lots sold to homebuyers. It jumped to an annual rate 168,000 in February, the strongest in 9 months. A sold lot leads to new construction in the weeks ahead.

10. Finally, we do expect to see the European economies show fresh vitality later this year now that the ECB unleashed its QE policy, and as the countries benefit from a sharply devalued euro and low fuel prices. German consumer confidence, for example, just surged to its highest in 13 years! Our forecast for growth in the EZ has been revised from 1.2% to 1.6% this year and that should eventually provide the US economy with yet more lift in the second half as exports begin to pick up.

Again, the one glaring threat to this upbeat assessment for the US is if the conflict in the Middle East explodes into a paroxysm of violence.

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