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ECONOMIC TALKING POINTS

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A Weak Final Quarter? Yes. Does It Hint of Recession in 2016? No!

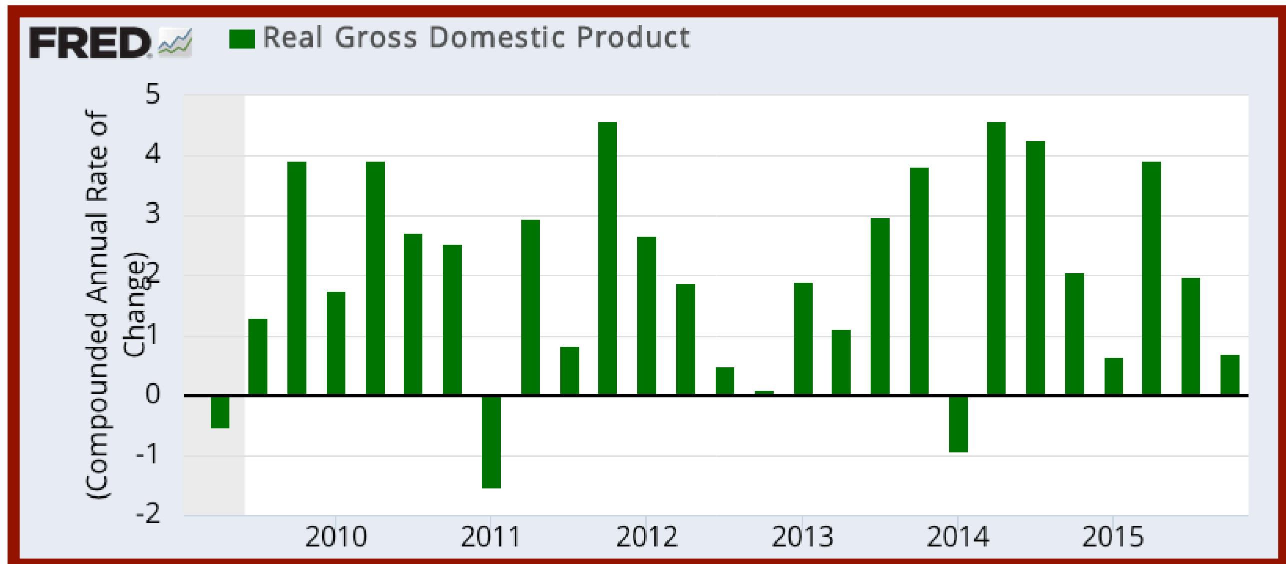
Two conclusions are certain to emerge from the advanced 4th quarter GDP report. One is that the economy was so weak in the final three months of 2015 that it buttresses the argument a US recession is just about unavoidable. So hunker down.

The other conclusion from the latest GDP release could not be more inverse. It solidifies the view that not only is a downturn unlikely, but a more vigorous economic rebound is more likely this year.

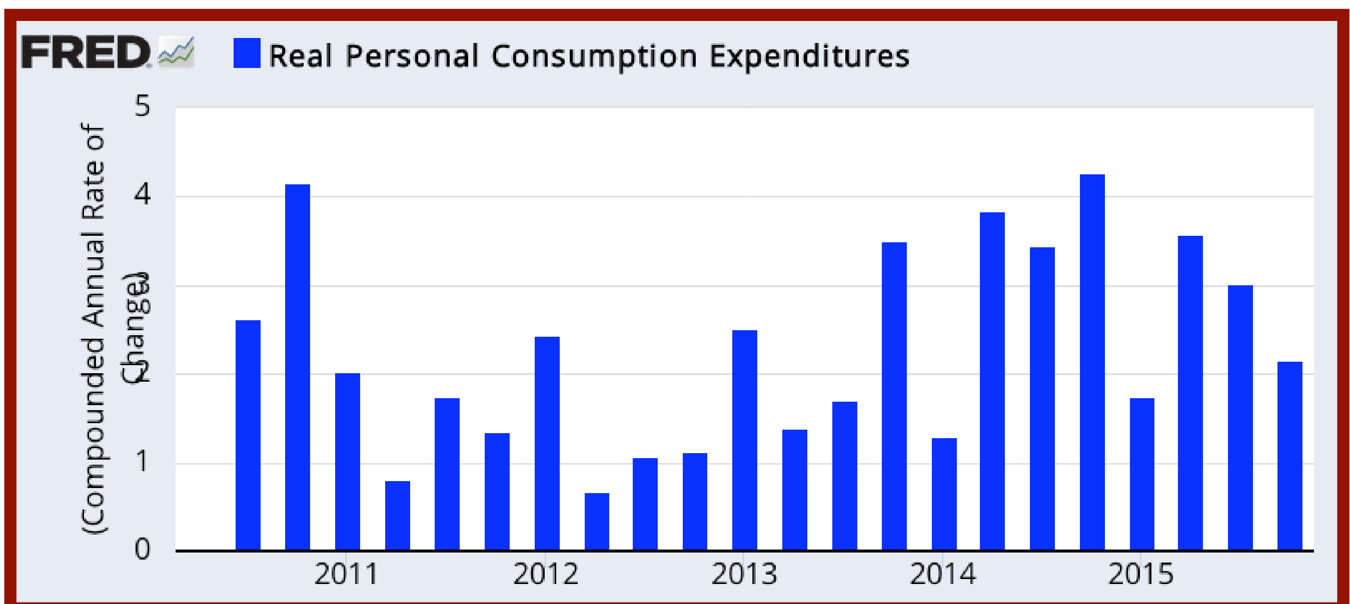
Which of the two opposite interpretations do we believe will prevail? The answer is an easy one to make, the latter.

It is actually quite surprising how much the "R" word has slipped into conversations lately when virtually none of the traditional triggers that would foreshadow a US recession are present! For one, this business cycle simply looks different from any we have seen in 70 years. With the economy recording just 2.4% growth last year, it means the US has now been operating well below highway speed for a decade. The last time GDP growth exceeded 3% for the year was in 2005! It also explains why the typical precursors of past recessions --- such as rising commodity prices, sharply higher interest rates, accelerating inflation, shrinking excess production capacity and surging wages --- not a single one currently exists! That explains why, unlike the sharp up and down swings we observed in past business cycles, this cycle has shown the most lackadaisical uptrend we have seen in modern history.

In the latest bit of history, the 0.7% growth rate for the fourth quarter is not symptomatic of an economy about to stumble into recession, but rather it shows the effects of an unusually mild winter and, more importantly, an economy that is more integrated than ever into the global marketplace.



For example, consumer spending increased at a slower 2.2% rate in the final period, versus 3.0% during the summer. This step down in spending occurred even though we saw strong employment gains, rising wages, and higher confidence levels in the same final months of the year.



What accounted for the deceleration in household expenditures was one of the warmest winters on records, which reduced seasonal shopping for heavier clothing, heating oil and other items typically bought during cold weather and snow. Secondly, gasoline prices kept plunging, so fewer dollar were needed to pay at the pump. Third, the strong dollar also kept prices down on all kinds of imported goods. (Remember, import prices tumbled 1.2% just in December and 8.2% for the year.) Fourth, Americans chose to ramp up home purchases in the final months and continued to buy autos at a hefty pace (even though it was a touch less than the previous quarter). Spending on such big-ticket items tend to depress other forms of discretionary spending.

The other three main factors that held down GDP growth were business outlays, the high level of inventories, and net exports. Gross business outlays dropped at a 2.5% rate in the final quarter, after slipping 0.7% in the previous period. Virtually every component other than homebuilding showed declines and we have to attribute much of this weakness to weak foreign demand for US products, the strong dollar, and the massive cutbacks in energy and mining investments as plummeting oil prices slashed the incentive to keep up such spending. The latest drop in gross business expenditure (including the change in private inventories) sliced 41 basis points off GDP growth. The deficit in net exports chopped off another 47 BP.

Should the soft GDP performance in the final quarter be viewed as an omen that we're doomed to see anemic growth or a recession in 2016? No, and here's why.

(1) The headwinds from the strong dollar and low oil prices will diminish this year. The dollar's value has been greatly influenced by the divergence in monetary policies among the world's major central banks. But let's keep in mind we now have the most dovish Federal Reserve in history. If you focus primarily on the comments on Janet Yellen, Bill Dudley and Stanley Fischer, it becomes increasingly clear they have little intention of lifting rates again until there is clearer evidence that inflation is moving closer to their 2% target, something that is far from materializing given the free fall in commodity prices and still mighty dollar.

Indeed, we'll stick with our earlier forecast of two rate hikes this year -- at most. The Fed's December dot plot, which saw four rate increases in 2016, had no link to reality.

Also, oil prices are much more likely to firm this year as non-OPEC production diminishes and the global surplus of crude begins to narrow. In addition, we see a better than 50/50 chance that Saudi Arabia and Russia will agree on a small production cut this year to support prices now that both countries are experiencing financial hardship.

(2) While the plunge in stock prices this month certainly put a scare into a lot of people and hyped up talk of a looming recession, the market's performance

should not be construed a recession is near. From our perspective, never have so many stocks, fallen so far, for so few legitimate reasons. Historically low interest rates, cheap energy prices, and the lowest input costs for business in modern history are not – and never will be harbingers of recession.

(3) Moreover, household finances are in the best shape they have been in decades. As we noted earlier, job gains the last two years have been the strongest since the 1990s. Real wages, which ticked up toward the end of last year, is expected to climb even faster in 2016! That's because as the slack in the labor force thins out, nominal wages will climb faster than the cost of living, and that translates into more purchasing power and greater spending in the future. On top of that, Americans have set aside ample funds, with the savings rate up to 5.4% last quarter, compared to 4.7% a year ago.

Particularly noteworthy is that consumer confidence levels in January turned out to be considerably higher than the consensus forecast --- despite all the worries about China's economy, hints of a global recession and the frightful drop in equity values. In fact, surveys showed Americans were quite optimistic about the economic outlook over next six months.

(4) The government also passed to fairly large spending bills in December, specifically the $1.1 trillion Omnibus Budget Act and the Highway Authorization Act. They cleared the path for $80 billion in additional spending the next two years, split evenly between defense and not defense spending. In addition, the Omnibus Budget Act contained a raft of tax credits that should facilitate more cap ex spending by business. Both of these measures should add about 0.4% to GDP growth in 2016.

(5) Finally, the odds have improved that with the ECB and the Bank of Japan charging negative interest rates on reserve deposits, financial institutions will be more inclined to lend to consumers and businesses, which should help to revive growth in their respective economies.

<u>Bottom line</u>:

The slowdown in the fourth quarter did not come as a surprise to anyone, nor do we expect subsequent revisions to materially change that weak performance. But we certainly do not see this as foreshadowing an actual economic downturn this year.

Look, the physics that drives business cycles have not changed. Consumers remain in charge and they now have the resources and confidence to ramp up spending this year. Nor can businesses continue to ignore replacing their aging capital stock, which now averages more than 20 years old. Postponing such investments will slow productivity growth, hurt their competitiveness, and ultimately drive investors away. Last, Washington took impressive action in December with significant new projects to rebuild the country's infrastructure and granted private businesses a slew of incentives to boost investments as well. For these reasons we project the US economic growth to accelerate to 3% this year, and then ease slightly to 2.8% in 2017.

Key Economic Forecasts

- Actual
- Forecast

United States

	I 2015	II 2015	III 2015	IV 2015	I 2016	II 2016	III 2016	IV 2016	I 2017	II 2017	III 2017	IV 2017
Real Gross Domestic Product (GDP):												
%	0.6	3.9	2.0	0.7	2.6	3.2	3.1	2.7	2.2	3.2	3.1	2.8
Personal Consumption Expenditures:												
PCE	1.8	3.6	3.0	2.2	2.5	3.5	3.2	2.9	2.8	3.2	3.0	2.8
Inflation, end of period, year-over-year:												
CPI %	-0.1	0.1	0.0	0.7	0.8	1.2	1.5	1.6	1.6	1.9	2.2	2.3
Unemployment Rate (end of period):												
%	5.5	5.3	5.1	5.0	4.9	4.8	4.7	4.5	4.5	4.4	4.2	3.9
Non-farm Payrolls, monthly avg. thousand:												
	195	231	174	284	240	245	250	265	250	240	220	210
Treasury 10-yr Note Yield % (end of period)												
	1.93	2.38	2.06	2.27	2.20	2.45	2.55	2.78	3.00	3.10	3.15	3.30
Federal funds rate % (end of period)												
	0.13	0.13	0.13	0.38	0.63	0.63	0.63	0.88	1.13	1.38	1.63	1.88

GDP Growth - Global Economy

Country	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
US	1.8	-0.3	-2.8	2.5	1.6	2.2	1.5	2.4	2.4	3.1	2.8
Eurozone	2.6	0.6	-4.1	1.7	1.4	-0.6	-0.4	0.9	1.3	1.6	1.8
United Kingdom	3.1	0.6	-5.2	1.7	0.7	0.3	1.8	3.0	2.3	2.5	2.6
Japan	2.1	-0.7	-5.4	4.6	-0.4	1.6	1.5	-0.1	0.6	1.0	0.6
Canada	2.7	0.7	-2.8	3.2	2.5	1.7	2.0	2.4	1.1	1.8	2.1
India	9.1	8.8	6.3	8.4	8.6	6.7	4.9	7.4	7.3	7.5	7.8
China	14.2	9.6	9.2	10.5	9.5	7.8	7.7	7.3	6.9	6.5	6.5
Brazil	5.7	5.1	-0.3	7.5	2.7	0.9	2.3	0.1	-3.5	-1.8	1.1
Mexico	3.3	1.4	-4.7	5.2	4.0	3.9	1.4	2.1	2.3	2.4	2.8
Australia	4.0	2.3	1.2	2.8	2.6	3.6	2.4	2.7	2.3	2.8	3.2
Russia	8.1	5.6	-7.9	4.0	4.3	3.4	1.3	0.6	-3.6	-1.0	0.3
World	5.4	1.6	-1.9	4.2	3.0	2.6	2.9	3.0	2.8	3.1	3.7

Key Currency Values

	End 2008	End 2009	End 2010	End 2011	End 2012	End 2013	End 2014	End 2015	End 2016	End 2017
USD/Yen	91	93	81	77	87	105	119	120	121	130
Euro/USD	1.40	1.43	1.34	1.29	1.32	1.37	1.21	1.09	1.11	1.18

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	End 2017
Crude oil per barrel	46	78	95	107	111	111	58	38	53	67
Gasoline	1.61	2.57	3.00	3.27	3.30	3.32	2.26	2.00	2.28	2.55

Major Stock Indexes

	End 2013	End 2014	End 2015	% Change '15	End 2016	% Change '16
DJIA	16,577	17,823	17,425	-2.2	18,261	4.8
S&P 500	1,848	2,059	2,044	-0.7	2,150	5.2
NASDAQ	4,177	4,736	5,007	5.7	5,307	6.0
RUSSELL 2000	1,164	1,205	1,136	-5.7	1,227	8.0

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