ECONOMIC OUTLOOK

REGIONS

January 2014

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Will 2014 Be "The" Year?

When the U.S. economy first started to emerge from the Great Recession, a crowd we quickly came to dub as the "V-shaped knuckleheads" began espousing the view that the economy was about to take off on a rapid recovery because, well, because sharp downturns are always followed by rapid recoveries, hence the "V" in V-shaped recovery. The only thing lacking from this keen and insightful analysis, of course, was an actual analysis of not only where the U.S. economy was but also how it had gotten to that point. Still, ever since the aforementioned knuckleheads began spewing the aforementioned nonsense it seems the end of each year has brought a steady stream of forecasts touting "next year" as "the year" when the tepid recovery would morph into a robust and self-sustaining expansion, with the most bullish calls envisioning four percent real GDP growth and three million net new payroll jobs. The more bullish calls, though not the consensus outlook, nonetheless always seemed to carry a certain popular appeal, perhaps understandable in light of the severity of the 2007-09 recession and the meekness of the subsequent recovery.

As for us, we've been putting out forecasts consistently below the consensus view, let alone the really happy view. Our reward has been to have our competence ("just don't get it") or our temperament ("always so pessimistic") routinely called into question, to which our pat reply has been "yeah, sure, whatever." Well, okay, that has not actually been our pat reply but our pat reply is not exactly suitable for print in a family oriented publication such as this.

From the start, our outlook has been premised on our view that the end of the 2007-09 recession was not an "all's clear" signal for the U.S. economy. Instead, the recession left in its wake some severe structural imbalances to be resolved, and the process of resolving these imbalances was a long-term, not a short-term, process. Included on our list of structural imbalances were household balance sheets in serious disarray, a housing market burdened with bloated inventories of unsold and, later, distressed housing units, an undercapitalized financial sector riddled with bad debt, and fiscal consolidation on the federal, state, and local government levels. It takes a long time to write all of that, let alone to fix all of it. For good measure, throw in an elevated degree of risk aversion and you have a seriously slow recovery on your hands.

Still, by year-end 2012 it was apparent considerable progress had been made in resolving these issues; enough progress to make us comfortable with our 2013 outlook (published in the December 2012 *Monthly Economic Outlook*) that if the first half of 2013 didn't sink the U.S. economy, the second half of the year would be far stronger and set the stage for a solid 2014. In other words, at year-end 2012 we found ourselves almost, but not quite, ready to join the "next year will be the year" chorus, instead opting for the rhythmically challenged but closer to the mark refrain of "the second half of next year will be the year." Or something like that.

Our call for 2013, which was much more aligned with the consensus view, was that the first half of the year would prove challenging as the economy digested nontrivial increases in payroll tax rates, increases in personal income tax rates and tax rates on investment income for upper income households, and the first round of the sequestration spending cuts. These were elements of the widely anticipated and much dreaded "fiscal cliff" that would act as a drag on the pace of economic growth over the first half of 2013, but whose effects were expected to diminish over the year's second half with the economy on firmer footing at year-end.

So, in terms of the question posed at the outset, yes, 2014 will be "the year." There, we've said it. And, frankly, it felt darn good saying so, to the point that had we known how good it would feel to say it, we may have done so back in 2009. Okay, maybe not quite that far back. In any event, as we do each year around this time, we'll look both back and ahead – back to see how we did with our 2013 forecast and ahead to see what we think 2014 has in store for the U.S. economy. We'll do so in the form of questions, nine to be specific, the answers to which will lay down markers for how we expect 2014 to turn out. As we go, we'll look back to some of our 2013 calls and see how they turned out but, by means of a quick summary, we'll simply say if economic forecasting is not a humbling exercise, it should be.

QUESTION 1: Real GDP growth – over or under 3.0 percent? Over. We look for real GDP growth of 3.1 percent in 2014 and 3.2 percent in 2015. In our 2013 outlook we forecast real GDP growth of 1.9 percent for 2013 and 3.0 percent for 2014. As for 2013, the economy was on track for 1.9 percent growth through the first three quarters of the year. We won't have the BEA's first estimate of Q4 2013 until later this month, but even Q4 growth of 3.2 percent as we expect would leave 2013 real GDP growth at 1.9 percent.

For 2013 we expected real consumer spending to grow at 1.6 percent but it will come in right at 2.0 percent; we look for growth to be closer to 3.0 percent in 2014. Our below consensus forecast of 2.6 percent growth in real business investment in equipment and software was close to the mark with growth tracking around 3.0 percent for 2013; we look for business investment to grow at a rate closer to 7.0 percent in 2014. Government spending will be a mixed bag in 2014 with growth in spending on the state and local levels and a further, albeit more moderate, decline in spending on the federal level. All in all, three percent may not seem much cause for celebration, but after four years in a two percent world, we'll take it.

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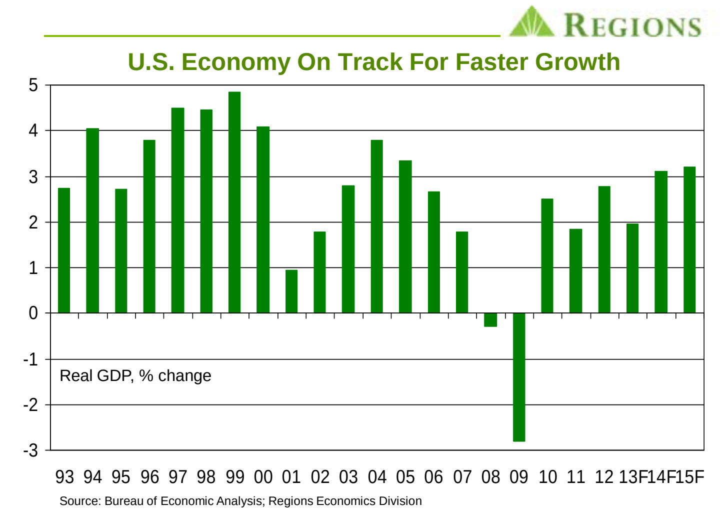

QUESTION 2: The unemployment rate at year-end 2014 – over or under 6.2 percent? Over, but if you think this is a "gimmie" think again. We first thought to set the bar at 6.5 percent – the rate set as a threshold by the FOMC below which the initial hike in the Fed funds rate becomes more likely. That bar, however, seemed a bit too easy to clear, and not simply due to the rapid pace at which the unemployment rate has fallen over recent months. As things stand at the time this piece is being written, the headline unemployment rate (i.e., U3) could be down to 6.7 percent by the end of Q1 without the economy even adding one new job, thanks to the expiration of longer-term federal and state Unemployment Insurance benefits.

Around 1.3 million people were slated to see their benefits end at year-end 2013 as various emergency UI programs funded by the federal government were allowed to expire, and roughly 200,000 people per month will see state benefits run out over the course of 2014. Those drawing UI benefits must, however nominally, be looking for a job and, as such, are included in the labor force. Upon the expiration of their benefits, these people must continue looking for work, must take a job, perhaps a lower wage job they were not previously willing to accept in return for foregoing UI benefits, or they can simply leave the labor force.

There is of course no way of knowing in advance how many will take the "opt out" route. Based on the monthly labor force flow data, however, we put a conservative estimate at 25 percent. If 25 percent of those whose UI benefits expire leave the labor force, that could push the jobless rate down to 6.7 percent at the end of Q1 without allowing for any job growth. It is possible Congress will act early in 2014 to extend emergency UI benefits, perhaps as part of a compromise around extending the federal government's debt ceiling. Even should this happen, however, it is very likely these extended UI benefits will expire at some point over the course of 2014. So even if not in Q1, this issue will push the unemployment rate artificially lower at some point in 2014.

While all of this may seem like policy induced noise, it actually ties in with what, to us, is the most relevant question surrounding the labor market in 2014, i.e., how will the labor force participation rate behave over the course of the year. There is no denying the falling participation rate has accounted for a significant portion of the decline in the unemployment rate since it hit its cyclical peak of 10.0 percent in October 2010. At that point, the participation rate was 65.7 percent compared to 63.0 percent as of November 2013.

It is important to recall the participation rate has been in the midst of a secular decline since early 2000, a function of demographics and shifts in participation amongst females. Since the 2007-09 recession, however, that secular decline has been compounded by what, at first, seemed a cyclical component that would have been expected to reverse as labor market conditions improved (we discussed this issue at length in our May 2013 *Monthly Economic Outlook*). Indeed, such a reversal factored into our forecast for 2013 in which we saw the unemployment rate ending the year above 7.0 percent and averaging 7.6 percent for the year as a whole. Even if the December unemployment rate edges up to 7.1 percent as we expect, that still leaves the annual average at 7.4 percent, below our expectation due to the falling participation rate. So, a key question in 2014 is whether we will see at least a partial reversal of the "cyclical" component of the declining participation rate, or whether there has been a structural change in the participation rate thanks to significant numbers of the long-term unemployed exiting the labor force for good; if the latter, the unemployment rate will fall faster than it otherwise would. This simply illustrates how the answer to Question 2 is less clear cut than it may seem at first glance.

As for nonfarm payroll employment, after losing 8.736 million jobs during the Great Recession and its aftermath, the U.S. economy has added back 7.445 million jobs since payrolls bottomed in February 2010. This leaves nonfarm employment, as of November 2013 (the latest data available at the time of this writing), 1.291 million jobs below the pre-recession peak hit in January 2008. Our expectation for 2014 is average monthly payroll job growth will exceed 200,000 jobs with the level of nonfarm employment topping the pre-recession peak in June.

QUESTION 3: Core inflation in 2014 – over or under 2.0 percent? Over. And under. Wow, with an answer like that, not even we can miss this one. To us, inflation, or the lack thereof, was the surprise story of 2013, even more so than the declining labor force participation rate. Our 2013 forecast called for a 2.2 percent increase in the total Consumer Price Index (CPI) with the core CPI up 2.0 percent. Through November, the total CPI was up 1.5 percent and the core CPI up 1.8 percent. When measured by the Fed's preferred gauge, the PCE deflator, inflation was even tamer, with the total PCE deflator up just 1.1 percent and the core PCE deflator up 1.2 percent through November.

Inflation has been so low the Fed and other central bankers around the globe find themselves in the unfamiliar position of worrying about inflation being too low, not too high. There are, as we discussed at length in our June 2013 *Outlook*, some technical reasons behind low measured rates of inflation. This is especially the case with the core PCE deflator, which puts a higher weight on medical costs, which have been surprisingly well behaved, and a lower weight on rents, which have been posting steady gains that are, in part, responsible for the higher read on core inflation as measured by the core CPI.

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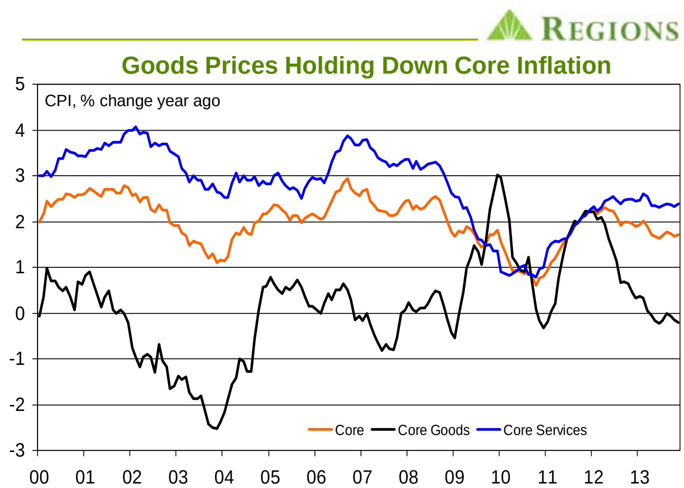
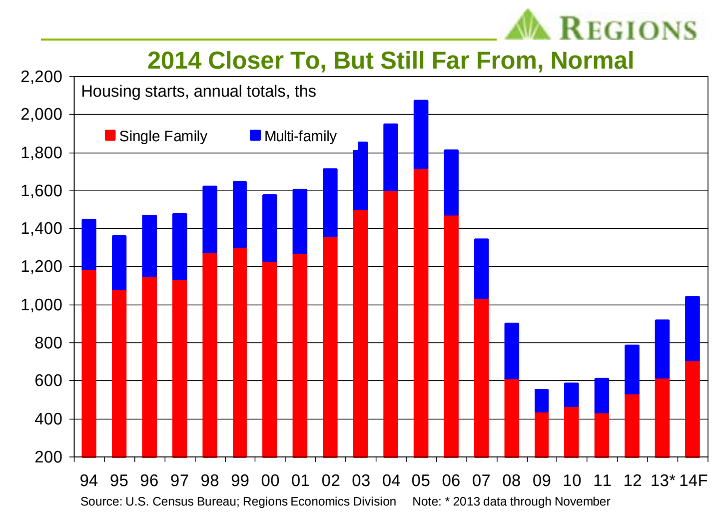
Still, there are more than technical reasons behind low inflation. Price pressures on energy and commodities have eased considerably in what has been a slower global growth environment, an effect magnified by China's transition – still in its infant stages – from an export and domestic fixed investment oriented economy toward a more domestic consumption oriented economy. Slack labor markets, including here in the U.S., have kept wage growth in check, which is significant given labor costs are far and away the single largest component of costs in most industries. Coupled with what has been a prolonged period of tepid growth in final demand, this has kept a lid on price pressures on the retail level.



One largely overlooked factor behind low core inflation is what has been a persistent divergence in trends in prices for core goods and core services, as seen in the above chart. From late 2012 through the present, we have seen easing commodity prices and a firmer U.S. dollar contribute to lower input costs in the manufacturing sector. At the same time, worker productivity in manufacturing has run well ahead of overall productivity growth, contributing to declining unit labor costs. All of these factors have helped contain costs for manufacturers of goods with pricing power constrained by intense global competition. Thus, as of November core goods prices had declined on an over-the-year basis for eight consecutive months, acting as a drag on overall core inflation. At the same time, prices for core (i.e.., non-energy) services have settled into a steady pace of better than two percent gains on a year-over-year basis.

In 2014, we expect weakness in core goods prices to persist as core services prices rise at a faster rate. This will leave core CPI inflation at 2.1 percent for 2014 as a whole. Core PCE inflation will run below 2.0 percent for 2014 as a whole but will be closing in on this threshold by year-end – sooner if medical cost disinflation abates more rapidly than we expect to be the case. Either way, inflation will remain benign in 2014, allowing the Fed to keep their focus on the labor market and overall growth.

QUESTION 4: Housing starts – over or under 1 million units? Over, but single family starts will have to kick into a much higher gear. Our 2013 forecast was for 980,000 housing starts, with 670,000 single family starts and 310,000 multi-family starts. We were fairly close on multi-family starts, which were running at an annual rate of 300,000 units through November. We missed badly on single family starts, however, which were running at an annual rate of 618,000 units through November, even with November's rate of 727,000 units (skewed sharply higher by seasonal adjustment issues).



Our expectation was that a rapidly dwindling inventory of distressed existing homes, overall low inventories of existing homes, improving job growth, slightly less stringent mortgage lending standards, and low interest rates would align to spark a strong rebound in single family starts in 2013. At 618,000 units, single family starts will still have posted a roughly 20 percent increase in 2013, strong to be sure, just not as strong as we expected. Shortages of, and higher costs for, materials and labor acted as a drag on single family construction (single family construction is more labor intensive than multi-family), as did shortages of lots. There were markets in which physical inventories of lots were exceptionally low, and other markets in which the entitlement process was not exactly builder friendly, both of which held down the supply of buildable lots in 2013.

With these constraints having lifted – to varying degrees in different markets – we expect to see single family construction kick into that higher gear in 2014. Sure, higher mortgage interest rates will have an adverse impact, but we expect improved rates of job and income growth as well as a more restrained pricing environment to carry the day, or, the year, leaving single family starts above 700,000 units in 2014. Add in our expectation for around 330,000 multi-family starts, and this gives us our 2014 forecast for 1.040 million total housing starts. Keep in mind, however, that a "normal" year would have starts at around 1.5 million units. So, while 2014 will bring us closer, it will still leave us far from normal in terms of new residential construction, one reason we and most other analysts see the housing market recovery as having legs that will carry it well beyond 2014.

QUESTION 5: Will the Fed put a stop to its large-scale asset purchases in 2014? Yes, with a vote to end "QE-3" completely coming at the July FOMC meeting. At their December 2013 meeting the FOMC voted to begin dialing down the rate of asset purchases by $10 billion per month, beginning in January 2014.

Many analysts expect tapering to proceed at this same pace, i.e., monthly asset purchases reduced in $10 billion increments, over the course of 2014. We see a firmer tone of economic growth as giving the FOMC the latitude to step up the pace of tapering and, as such, see the asset purchases ending sooner.

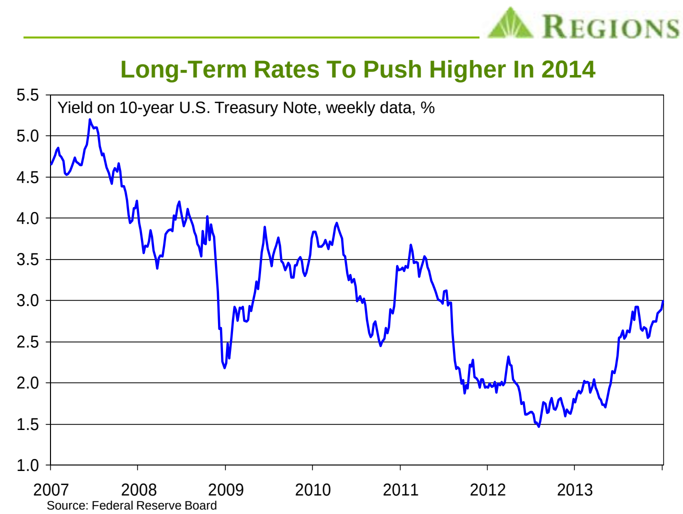
Whether it comes in July or later in the year, the FOMC will at some point in 2014 vote to end the asset purchases. Do not, however, take this to mean monetary policy won't remain highly accommodative. After all, when all is said and done with QE, the Fed's balance sheet will be over $4 trillion and, more significantly, as altered at their December 2013 meeting, the FOMC's forward guidance now implies the Fed funds rate will be on hold for longer than had previously been expected.

This, in our view, will be the Fed's bigger challenge in 2014 – managing expectations around the path of the Fed funds rate and, in turn, influencing the behavior of long-term interest rates. Think about it this way – if the economy evolves as we expect it will over the course of 2014, market expectations of an initial funds rate hike will be pulled forward and long-term rates will trend higher. In such a scenario, how would the Fed react – would they double down on forward guidance, alter the unemployment rate threshold, prolong the asset purchases even further beyond their useful shelf life, or just give in and soften the forward guidance (i.e., suggesting a hike in the funds rate will come sooner than the present guidance suggests)? Of course, they could simply opt to stick with their forward guidance and their 6.5 percent unemployment rate threshold as they now stand. After all, there is no time frame attached to "well past the time when the unemployment rate declines below 6.5 percent" and the Fed could simply look the other way as the jobless rate falls for the wrong reasons (such as people exiting the labor force or settling for part-time jobs) and that threshold is crossed more quickly than is now baked into their own forecast.

The point here is the Fed is by no means on auto pilot in 2014, and we expect a good deal of volatility in long-term rates in an environment in which the yield curve continues to steepen. We have repeatedly cautioned the waters on the way out of QE are just as uncharted as were the waters on the way in, which is true from the Fed's perspective as well. Indeed, one of our downside risks for 2014 is a spike in long-term interest rates in reaction to Fed policy – not the most probable scenario, but one we won't totally rule out. So, in short, Question 5 may be the easiest question pertaining to monetary policy in 2014 to answer.

QUESTION 6: Yield on the 10-year U.S. Treasury note – over or under 3.70 percent at the close on 12/31/2014? Above. Okay, so our 2013 forecast was, um, just a tad off – our forecast for year-end 2013 was 2.51 percent while the reality is the yield on the 10-year note ended 2013 at 2.99 percent. In our defense, when we made our 2013 call late in 2012 the yield on the 10-year note was hovering around 1.80 percent and, in all honesty, our 2013 forecast felt somewhat on the aggressive side. The same could be said about our 2014 call, but, again, in our bigger picture view of how the U.S. economy will perform in 2014, long-term rates have only one direction to go, and that is up.

So the real question is how fast and how far. As noted above, we expect a considerable degree of volatility around long-term rates in 2014 as the Fed navigates its way out of QE in what will be a rising long-term rate environment. And, if the economy surprises to the upside, a year from now yields on the 10-year U.S. Treasury note could be flirting with 4.00 percent.



QUESTION 7: A year of fiscal policy peace in 2014? Yes, but that doesn't mean there won't be the usual needless drama along the way. Nothing like a looming election to bring some semblance of order to the nation's capital, not in the sense of both sides wanting to point with pride to some legislative achievement that has improved the lot of citizens from coast to coast, but rather in the sense of neither side wanting to be blamed for things having gone wrong. Either way, we'll take it, which pretty much sums up the reaction to the recent budget accord – neither side particularly liked it, but at least it bought a year of fiscal policy peace.

One element of the December 2013 budget agreement was a softening of the round of sequestration spending cuts set to kick in this year, which reinforces the view of a smaller fiscal drag in 2014 than in 2013. And, to the extent the budget accord removes uncertainty from the equation, including that stemming from the possibility of another shutdown of the federal government (partial or otherwise), that will be a positive for the economy in 2014. Sure, there is the matter of the federal government debt ceiling to be addressed in Q1 but that will likely be dealt with fairly quickly, though not without a dose of the usual needless drama referenced above – any compromise could include an extension of extended UI benefits (see Question 2).

Of course, a temporary fiscal policy truce is not the same as a meaningful solution to the nation's more pressing fiscal policy issues – tax reform, entitlement reform, and a long-term budget. As for 2014, health care, specifically, the Affordable Care Act, will take center stage in the build up to the mid-term elections. One side will be hoping it works well, at least relatively well, so they can embrace it and use it against those who did not go along with it. The other side will hope it fails, the more miserably the better, so they can use it against those who voted it into law. In other words, by time the mid-term elections are over with, the squabbling over fiscal policy seen in 2013 will seem like the good old days. With that in mind we'll get an early start on our 2015 predictions by saying the fiscal follies will return then.

QUESTION 8: The Euro Zone – nothing but good news in 2014, right? Wrong. Sure, we've heard the news – the recession is over and the Euro Zone economy is set to grow again in 2014, so what could go wrong? In a word, plenty. Robust economic growth can cure plenty of ills, but growth at a limping along rate of around 1.0 percent, not so much. In our view, there is too much complacency when it comes to the downside risks in the Euro Zone and the tepid growth likely to be seen in 2014 won't do much to bring down what remain severely elevated unemployment rates or do much to facilitate deleveraging and badly needed reform in the financial system in an atmosphere in which fiscal austerity continues to rule.

We were never in the camp that predicted the demise of the euro, but we did expect at least one member nation drop out and the euro to survive as a leaner, meaner currency; we also predicted the ECB pledging to do whatever it takes to preserve the euro would at some point have to give way to the ECB actually doing whatever it takes, so we admit to a grudging admiration on that front. Still, we do not expect 2014 to pass without more worrisome headlines from the euro zone that could, if only briefly, roil the financial markets. And, as a side note, rather than shrinking, the Euro Zone is now bigger as Latvia was officially welcomed in on January 1. Of course, from many still-struggling Euro Zone members, that may take the form of an ironic *Stepford Wives* "now you're one of us" kind of welcome. As such, we have no predictions on whether, a year from now, Latvia will be praising or cursing their decision to join.

QUESTION 9: What are the risks to our 2014 outlook that could cause growth to come in below, or above, our forecast? We ask this question with each forecast; the difference this time around is the risks are much more balanced between the downside and upside risks, unlike the past several years when the downside risks dominated.

As to what we see as the main downside risks, we'll start with policy risks which, with the course of fiscal policy pretty much set, are much less threatening as we head into 2014 than was the case heading into 2013. There are still downside risks associated with monetary policy, particularly the rate at which the Fed exits from QE, how it manages a bloated balance sheet, and how the Fed guides the financial markets as to the future course of policy. And, however the Fed addresses these issues, the reaction in the financial markets and subsequent impact on the economy remain to be seen. As we see it, the risks posed by monetary policy are, at this point, asymmetric, i.e., skewed to the downside – it's hard to imagine a changing monetary policy regime making the economy grow faster than it otherwise would, but quite plausible to worry a changing monetary policy regime may cause growth to be slower than it otherwise would be.

The same can be said about what we see as a second downside risk – regulatory risk. We think this to be a concern that does not get nearly enough attention, but consider all of the ways in which the regulatory landscape has changed of late, from the financial system to the housing market to the health care system, just to name a few. With many of these regulatory changes either just having taken or just about to take effect, the reality is no one can say for certain how they will impact the economy's performance – and, yes, one can actually raise that point without passing judgment on the regulations themselves. Again, though, the brave new regulatory landscape will at best not materially detract from economic growth; the downside risk is the new regulatory changes will act as a more severe drag on growth than we at present expect to be the case.

Aside from policy and regulatory risk, the downside risks mainly come from abroad. We continue to see nontrivial downside risks from Europe (see Question 8). Then of course there are the usual suspects, i.e., geopolitical tensions that, should they erupt into open conflicts, could have adverse impacts on U.S. and global economic growth, whether in the form of higher energy prices or frozen financial markets. While the Middle East seems to always be the starting point in the list of global hot spots – at present, think Israel and Iran – considering the ongoing tensions between China and Japan, or between South Korea and North Korea, for instance, Asia is also a source of concern.

As to the upside risks, it is not at all hard to imagine growth outperforming our expectations in 2014. It has been, literally, years since we've said that out loud, let alone committed it to print but, nonetheless, there it is. Think back to the structural imbalances outlined above (Page 1), and consider how much progress has been made in resolving these issues. Household balance sheets, while not receiving a clean bill of health, are at least in better condition than has been the case since well before the 2007-09 recession, with more than manageable debt service burdens. Fiscal consolidation on the state and local government levels has run its course, and tax revenues on the state level – mainly tied to personal income tax and sales tax – are rising while tax revenues on the local level – mainly tied to property tax – have stabilized and should soon begin rising steadily. This, of course, does not mean state and local governments are about to embark on a spending and hiring binge, but we do expect some growth in spending that will add to top-line GDP growth. Likewise, the housing market will continue to add to top-line GDP growth, and to a greater degree in 2014 than in 2013.

To these factors add what remain healthy corporate balance sheets and the makings are there for an upside surprise. The catalysts for such an upside surprise would be improved consumer and business confidence and freer flows of credit. Simply put, confidence can be a powerful stimulant and, over four years away from the end of the Great Recession, both business and consumer confidence remain exceptionally low despite both having trended higher over recent months. Increased confidence would mean faster growth in spending on the part of consumers and faster growth in hiring and investment on the part of firms, all of which would mean faster top-line growth. A key piece of this puzzle is credit flowing more freely than has been the case. To some extent, this is where the new regulatory environment may come into play in terms of the flow of credit via the banking system, but another wild card here is the nonbank sector, which could facilitate credit flowing more freely to both the household and business sectors. This is not to say the nonbank lending sector can, or should, return to its former size and stature (it probably can't and hopefully won't), but it just simply being a more significant player than has been the case in recent years would likely act as a meaningful tailwind to growth in 2014.

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