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V I E W P O I N T

THE ECONOMY

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SECOND CONSECUTIVE STRONG QUARTER

The Commerce Department announced in late November that U.S. GDP, after revisions, rose at a 3.9% rate in 3Q14. This was an improvement from the 3.5% rate initially estimated in October, but a modest decline from the robust 4.6% growth rate achieved in 2Q14. The number was above our initial forecast for 2.9% growth.

As we typically do for the second estimate, let's take a closer look at key underlying trends (please see Chart 1).

- First, the Consumer. During 3Q, Personal Consumption Expenditures accounted for 69.1% of core demand (which we define as Personal Consumption Expenditures, Information Technology and Intellectual Property spending, Housing, Exports and Government Expenditures). This is above the 10-year average of 68.1% and implies the economy remains dependent on consumer spending for growth.
- Exports appear robust, with a 13.7% share of core demand, versus a 10-year average of 11.8%. Countries that are leading purchasers of U.S. goods include the UK, Canada, Mexico, China and South Korea.
- Spending on Information Technology and Intellectual Property products is picking, up as these items accounted for 10% of core demand versus the 9.4% average.
- Government spending remains weak. Typically, government spending accounts for 19.8% of total demand; however in 3Q14 the share was only 18.5%. We note, though, that spending in all three government categories (Defense, Non-Defense and State & Local) was higher.
- Housing was below-trend as well (3.3% versus an average 4.1%). The housing market has recovered from the collapse of 2008-2009, but growth has been at a fairly moderate pace.

Near-Term Outlook

With the consumer solid and IT spending and exports robust, we expect to see GDP growth range between 2.8%-3.5% into 2015.

Here are details on our assumptions:

We look for somewhat better growth in Personal Consumption Expenditures. PCE increased at a 2.2% rate in 3Q, slightly below the desired growth rate of 2.5%-3.0%. Spending on durables, such as autos, was up a strong 8.7% as annual auto sales have almost recovered to pre-recession highs. Growth in services stalled somewhat, but we would not be surprised to see a spike higher during the holiday season in 4Q. Employment trends (see Chart 2) and consumer confidence have been positive, which bodes well for improved PCE expansion in 2015.

Consumer spending should also get a boost from falling energy and commodity prices (Chart 3). In the wake of the late-November OPEC meeting, in which the cartel decided not to reduce production, oil prices fell below $70 per barrel of West Texas Intermediate crude.

We expect continued strength in spending on IT Equipment and Intellectual Property Products. Growth in these categories averaged 8.5% in 3Q. While that rate is not sustainable, we note that corporate capital spending is rebounding (see Chart 4), which could result in mid-single-

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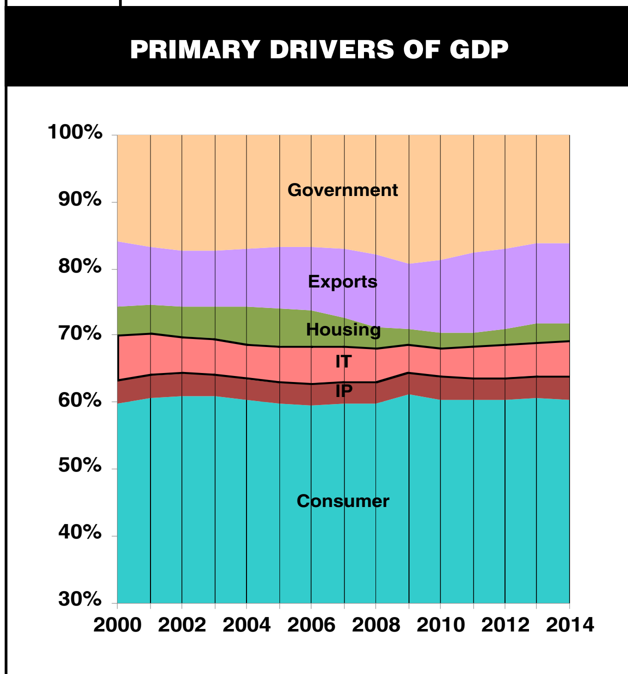
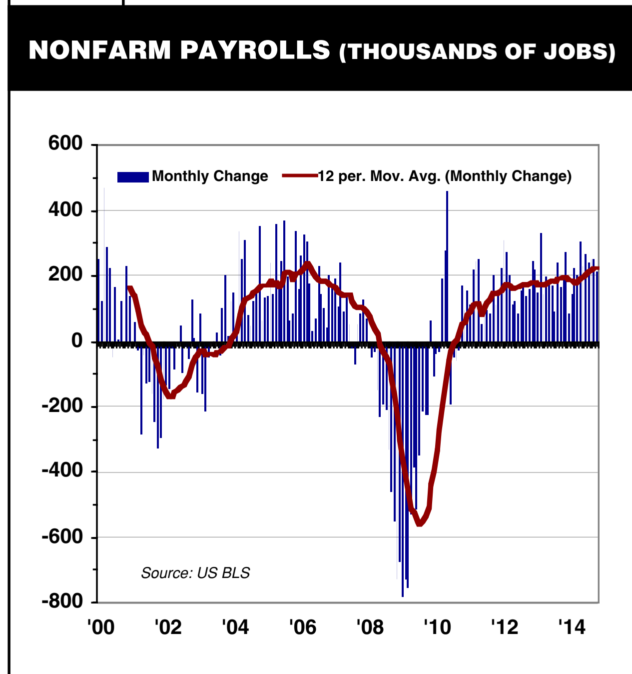
TABLE 1



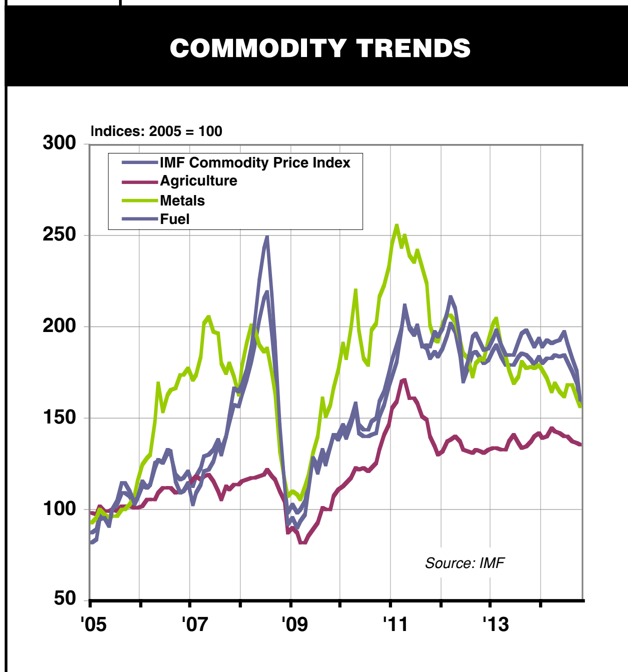
The Consumer, Export and IT sectors are currently leading the economy.

TABLE 2



Payroll growth has been accelerating. This is a positive development for the Consumer sector of the economy.

TABLE 3



Commodity prices, including fuel prices, have been plunging. This trend benefits U.S. industry as well as consumers.

TABLE 4

ISM orders are a leading indicator, and point to solid growth in the next 2-3 quarters.

GDP FORECAST

Revised November 28, 2014

	2012				2013				2014 E				2015 E			
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV
Real Gross Domestic Product	2.3	1.6	2.5	0.1	2.7	1.8	4.3	3.5	-2.1	4.6	3.9	2.8	3.6	3.3	3.3	2.7
Annual:				1.6				3.1				2.3				3.2
Personal Consumption	2.8	1.3	1.9	1.9	3.6	1.8	2.0	3.7	0.8	1.7	2.2	3.0	1.9	2.6	4.6	3.3
Goods	4.7	1.3	3.2	2.9	5.9	1.3	3.5	3.7	2.0	2.7	2.7	2.8	4.0	2.9	3.1	3.3
Durables	10.7	2.3	8.0	9.1	8.5	4.5	4.9	5.7	4.0	5.8	6.0	6.4	6.8	3.5	3.4	3.9
Non-Durables	2.0	0.8	1.1	0.1	4.8	-0.2	2.8	2.7	0.8	1.0	0.8	0.8	2.3	2.5	2.9	2.9
Services	1.8	1.3	1.3	1.4	2.4	2.0	1.3	3.7	1.9	1.9	2.0	1.8	1.7	2.2	2.9	2.9
Gross Domestic Investment	6.9	5.8	1.6	-5.3	7.6	6.9	16.8	3.8	-3.2	17.9	5.0	2.1	-0.1	6.6	2.8	2.9
Fixed Investment	9.1	4.4	3.1	6.6	2.7	4.9	6.6	6.3	4.1	9.5	6.1	3.6	3.0	3.4	3.4	3.4
Non-Residential	5.8	4.4	0.8	3.6	1.5	1.6	5.5	10.4	5.9	9.7	7.3	3.4	2.7	3.3	3.3	3.3
Structures	18.7	10.5	-1.4	-6.7	-11.5	7.3	11.2	12.8	5.1	12.6	1.1	1.2	1.2	2.0	2.0	2.0
Equipment	3.6	1.0	0.7	8.1	4.8	1.5	4.7	14.1	8.6	11.2	10.8	4.1	2.0	4.1	4.1	4.1
Intellectual Property Products	0.7	5.1	2.6	5.1	6.5	-2.0	2.8	3.6	2.3	5.5	6.4	4.0	4.9	3.0	3.0	3.0
Residential	25.5	4.3	14.1	20.4	7.8	19.0	11.2	-8.5	-3.0	8.8	1.1	4.1	4.1	4.1	4.1	4.1
Change in Pvt. Inventories ($BIL)	89.2	56.8	77.2	7.3	42.2	43.4	95.6	81.8	35.2	85	79	70	50	71	68	65
Net Exports																
Exports	1.3	4.8	2.1	1.5	-0.8	6.3	5.1	10.0	-1.8	2.6	1.2	1.7	1.0	1.0	1.7	1.7
Goods	1.5	5.3	2.0	-3.1	-0.9	8.3	5.7	13.6	-3.0	3.4	1.7	1.5	1.0	1.0	1.5	1.5
Services	0.9	3.7	2.3	12.7	-0.8	2.0	3.6	2.3	1.1	1.0	0.2	2.0	1.0	1.0	2.0	2.0
Imports	1.7	4.0	-0.6	-3.5	-0.3	8.5	0.6	1.3	1.2	2.7	-0.2	0.7	2.0	1.2	0.8	1.2
Goods	2.0	4.0	-1.1	-4.8	0.5	8.5	0.1	0.9	0.5	3.0	-0.3	0.4	2.0	1.0	0.5	1.0
Services	0.8	4.0	2.4	3.4	-4.1	8.5	2.8	3.5	4.2	1.4	0.7	2.0	2.0	2.0	2.0	2.0
Gov't Purch.of Goods & Svcs.	-2.7	-0.4	2.7	-6.0	-3.9	0.2	0.2	-3.8	-0.1	-0.1	4.2	2.0	1.0	1.0	1.5	1.5
Federal	-3.0	-0.9	7.5	-13.0	-9.9	-3.5	-1.2	-10.4	-2.6	-2.6	9.9	0.7	0.8	0.8	2.0	2.0
National Defense	-7.4	-1.3	11.9	-20.1	-10.9	-2.1	0.4	-11.4	0.2	0.2	15.9	0.0	0.8	0.8	2.0	2.0
Non-Defense	5.3	-0.4	0.4	0.6	-8.2	-5.8	-3.9	-8.6	-7.0	-7.0	0.4	2.0	0.8	0.8	2.0	2.0
State & Local	-2.6	0.0	-0.6	-0.8	0.3	2.7	1.1	0.6	1.6	1.6	0.8	2.7	1.1	1.1	1.1	1.1
Addendum:																
GDP Price Deflator (implicit)	2.2	1.5	2.0	2.0	2.0	2.0	1.8	1.5	2.0	1.7	1.6	1.8	2.0	2.0	2.0	2.0

(continued from page 1)

digit growth in IT Equipment for the next 2-3 quarters. We expect businesses to continue to invest in R&D and "cloud" services, and for consumers to slowly shift purchases away from "goods" and toward "experiences" as the recovery continues.

The housing market continues to improve, as residential investment advanced 2.7%. This segment, which had accounted for more than 5% of GDP in 2005-2006, can move the needle for the economy for a few more quarters at least, as the housing recovery has lagged the auto recovery.

The import-export equation appears set to remain a GDP driver for the U.S. economy, too. Imports declined in 3Q as U.S. oil production has risen, and we are modeling only slow growth in imports going forward. U.S. manufacturers, meanwhile, are benefiting from lower gas prices and are able to offer more-competitive prices in global markets. We are forecasting mid-single-digit growth in exports into 2015.

Government spending has finally turned positive after years of cutbacks, and should contribute to growth into 2016, an election year.

For details of our estimates, please see the GDP Forecast Table.

Our estimates are generally in line with the Federal Reserve's recently published economic projections for 2014-2017. The Fed forecasts that the central tendency for economic growth is 2.0%-2.2% in 2014; 2.6%-3.0% in 2015; 2.5%-3.0% in 2016 and 2.3%-2.5% in 2017. The ranges for the Fed's estimates are 1.9%-2.4% in 2014; 2.2%-3.6% in 2015; 2.2%-3.2% in 2016 and 2.0%-2.6% in 2017. The Fed's longer-run GDP forecast for the U.S. economy is 1.8%-2.6%.

Risks of Recession

We note that our current estimates do not call for a recession in the U.S. through 2015. We believe that key indicators — jobless claims, consumer confidence, housing starts, the steep yield curve and a decline in the budget deficit — are positive enough to keep the economy on a growth track.

The Federal Reserve has taken advantage of the current conditions and wrapped up QE3. While reduced Fed support could be a risk to growth, the central bank has often stated that its actions will be "data-dependent." As such, we expect the Fed will refrain from aggressively raising interest rates if economic growth falls back toward the 2.0% rate. With 10-year Treasury rates now near 2.3%, interest rates are hardly spiraling out of control.

Our interest rate forecasts call for the Fed to begin to tighten monetary policy in the middle of 2015. We anticipate that the central bank will move at a moderate pace, and that the federal funds rate could be 2.0% by the end of 2016. We expect longer-term rates to rise along with short-term rates, but likely at a slower pace. Our preliminary forecasts for the 10-year yield in 4Q16 calls for a range of 3.25%-3.75%. Thus, within two years, the yield curve could be flattening.

Other risks to growth include volatile oil prices that could spike higher on geopolitical developments; a weaker-than-expected recovery in China; additional economic trouble in Europe; a rapidly rising dollar that limits export growth; an unexpected stumble in the housing market; or deflationary conditions — which in our view the Fed fears more than a period of rising prices.

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