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Special Edition
CRF News

Focus on the Economy

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CRF's Annual Economic Projections for the New Year

From 4 Venerable Economists

U.S. Macro Outlook 2015: Spirits Unleashed

By Mark Zandi
Moodys.com

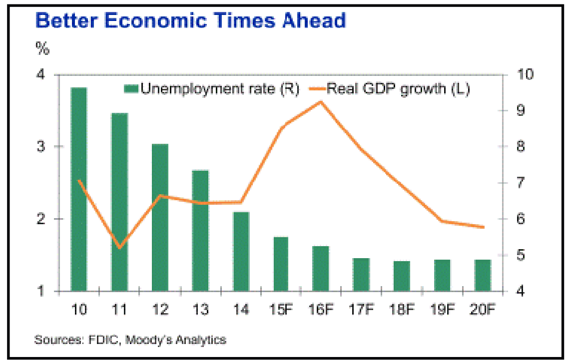
In general, 2014 was a good year for the U.S. economy, and 2015 should be even better.

The most encouraging development of the past year was the rapid decline in joblessness. At the current pace of job growth, the economy is fast

Highlights of What's Inside

approaching full employment. The next critical step in the economy's return to full health is a meaningful acceleration in wage growth, which appears imminent.

Most surprising has been the recent slide in oil prices, which, if sustained, will provide a significant boost to growth. The U.S. produces a lot more oil than it used to because of the shale revolution, and falling prices will take a toll on future energy development, but the country is still a significant net consumer of oil. As consumers put less of what they earn into their gasoline tanks, therefore, the holiday shopping will receive a lift.



Better Economic Times Ahead

Arguably the biggest disappointment in 2014 was the sideways housing market. The surge in mortgage rates in late 2013 and tight mortgage credit hurt home sales and construction. But mortgage rates have receded and the credit spigot has begun to open. Many millennials who have delayed forming households will begin to do so soon as the job market improves, moreover, making housing a more significant source of growth.

The Fed factor

This highlights a key threat to the economy in the coming year; namely, the chance that the Federal Reserve will begin to raise interest rates. The Fed needs to engineer short- and long-term rates higher, consistent with the improving job market, in a way that keeps the housing recovery on track. Policymakers have all the tools they need and have gained valuable experience in communicating with financial markets. Yet the process of normalizing monetary policy may not be as graceful as we hope.

The U.S. is also vulnerable to a softer global economy. With the euro zone and Japan flirting with recession, and China's growth steadily throttling back, the U.S. trade situation will erode. This will be made worse by the recent surge in the value of the dollar, which is sure to continue. If conditions don't get any worse overseas, the U.S. recovery should hold firm. This is a big if.

Weaker potential

The other developing concern is the U.S. economy's weak potential growth rate. Underlying labor-force and productivity growth remains disappointing. Their weakness will help return the economy to full employment more quickly, but if they do not improve, growth will be weaker over the longer term. A persistently low rate of new business formation, which is the fodder for innovation and productivity gains, adds to worries.

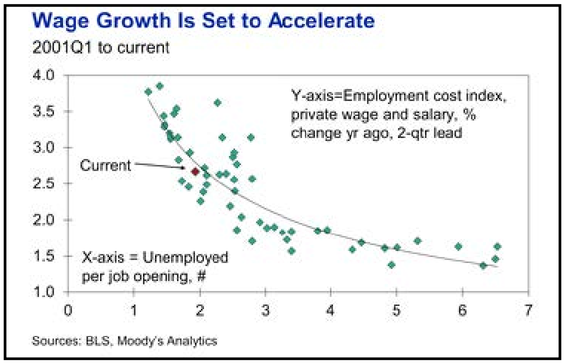
However, it is premature to conclude that the economy's supply side won't come back to life as full employment approaches. The U.S. has a surfeit of potential workers who stepped out of the job market during the tough times; some of them will step back in as wage growth and job opportunities return. Business formation and investment should also recover as the psychological shadow of the Great Recession fades and risk-taking revives.

Wage resurrection

A key missing ingredient to a stronger economy has been real wage growth. Despite the increasingly robust job creation, the economy is still climbing out of the deep hole created by the Great Recession. Unemployment and underemployment are now falling fast, but there is still slack in the labor market equal to approximately 1.25% of the labor force.

At the current underlying pace of job growth—about 225,000 per month—this slack will be absorbed by mid-2016, assuming stable labor force participation. If participation picks up as disenfranchised workers come back into the labor force, the economy will return to full employment by the end of 2016.

Although full employment is still some distance away, wage growth should soon pick up. Data indicate it already has begun to do so. For much of the recovery, wages have grown only about 2% per year, the rate of inflation. This means workers have not been rewarded for increases in productivity, and is why the profit share of national income has risen to a record high.



Wage Growth Is Set to Accelerate

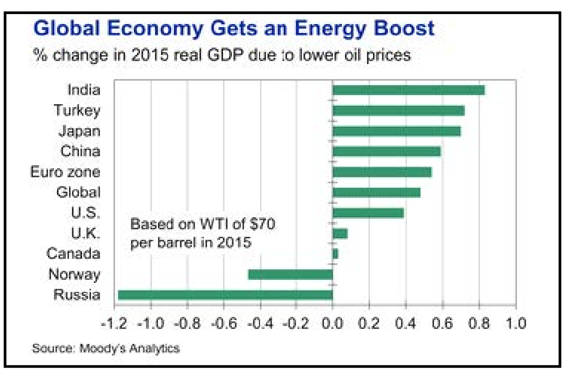
As the economy reaches full employment, pay should grow fast enough to cover both inflation and productivity gains. Assuming underlying productivity growth is near 1.5% per year, nominal annual wage growth should steadily accelerate to 3.5% over the next two years.

Spend versus save

Evidence is mounting that this anticipated acceleration has begun. Wage growth as measured by the employment cost index, the most comprehensive and consistent measure of compensation, hit bottom at 1.5% three years ago. Growth is now definitively above 2%, and the trend lines look good. Wages as measured by data from human-resource company ADP tell an even more positive story.

Stronger wage growth will support stronger consumer spending as long as consumers don't save it all. Given the wealth effects powered by record stock prices and better housing values, saving rates should, if anything, decline. Easier credit and more relaxed consumer attitudes toward borrowing also point to lower saving and greater spending.

Higher wages should also boost consumer sentiment. Perceptions about the economy have been lackluster despite the better job market. Americans judge the economy based on whether their pay is rising faster than inflation, and whether this year's average pay increase was bigger than last year's. This has not been the case until now. Improved moods among consumers could mean more purchases of big-ticket items such as vehicles, whose sales are already back to prerecession levels because of lower gas prices and easy credit. Next could be houses, sales of which have been flat since mortgage rates jumped more than a year ago.



Global Economy Gets an Energy Boost

Energy surprise

Further boosting both consumer spirits and the economy's prospects is the surprising slide in oil prices. At near $60 per barrel, crude prices have fallen about 40% since summer. If sustained, lower prices will lift global real GDP growth rates in 2015 by more than half a percentage point, and just under that in the U.S.

Saudi Arabia is crucial to where oil prices are headed next. The Saudis' decision not to scale back production to offset supply growth in the U.S. and elsewhere was the proximate cause for the plunge in prices. Softer global demand growth and a robust dollar also contributed, but if Saudi Arabia had reined in production as it has in times past, prices would have held firm.

The Saudis appear to believe that the global surfeit of oil is here to stay and the burden of balancing supply and demand must be shared more broadly. They can financially absorb the fall in revenue, at least for a while, given the savings they built when prices were high. A lower global oil price also likely fits their geopolitical strategy. Saudi Arabia's adversaries—Iran, Russia, and the insurgency calling itself the Islamic State—are all suffering badly from the lower prices.

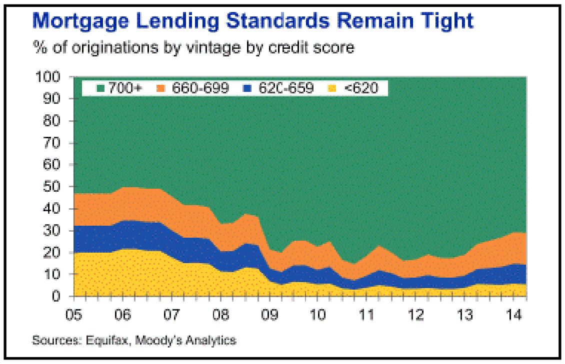
Bottom of the barrel?

We believe oil is close to a bottom, and will slowly climb back to $100 per barrel over the next three years. Lower prices will eventually force cuts in production, mostly where costs are high, such as the North Sea and the Arctic, but even investment in low-cost U.S. shale production will weaken. Lower prices will also prop up oil demand—possibly faster than expected, judging from a recent surge in sales of gas-guzzling SUVs.

The principal economic beneficiaries of this will be consumers, who will enjoy what amounts to a meaningful tax cut. In the U.S., this is expected to equal close to $100 billion in 2015, or 0.6% of income. Global oil-related investment and production will be hurt, but U.S. shale producers, whose average break-even cost is closer to $60 per barrel, should do relatively well. On net, the oil price decline is expected to lift U.S. GDP growth next year by 0.4 percentage point.

Hopes for housing

Housing's recovery has been disappointing, but that is expected to change in 2015. While home sales, construction, prices and rents have come a long way since the housing bust ended three years ago, the market is far from normal, at least in terms of sales and construction. House prices and rents are now roughly consistent with household incomes, but sales are still almost 15% below what would be considered typical, and housing starts are off by one-third. Housing has been held back by a combination of factors. The heretofore tough job market has been hard on millennials, who have been slow to form households. There are more than 3 million more 18- to 34-year-olds living with their parents today than there were prior to the recession. Many of these twenty- and early-thirty-somethings will form households and move into apartments as the job market tightens. Apartment construction is already the bright spot in the housing market, and it is sure to get brighter.



Mortgage Lending Standards Remain Tight
% of originations by vintage by credit score
Sources: Equifax, Moody's Analytics

Tight mortgage credit combined with a previous jump in mortgage rates significantly crimped first-time homebuyers. The lack of first-timers makes it difficult for trade-up buyers to sell their homes, ultimately hurting sales of new homes and single-family construction.

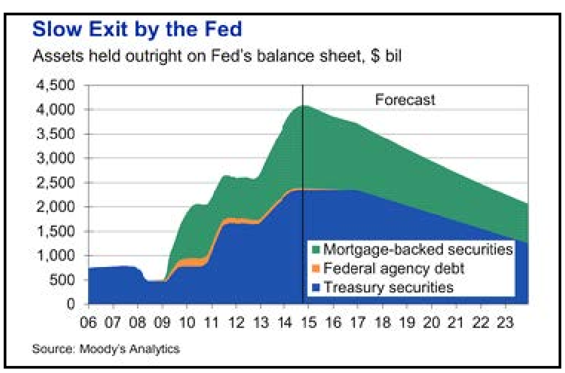
This too should change soon. Mortgage finance giants Fannie Mae and Freddie Mac recently signaled a greater willingness to lend by lowering their minimum down payment requirement from 5% to 3%. They have also relaxed the representations and warranties they require on the loans they buy. This should ease lenders' concerns about being forced to buy back loans that eventually get into trouble, thus encouraging more new lending.

Housing starts are expected to ramp up from just over 1 million units this year to nearly 2 million units in 2017. This is much more than the estimated 1.7 million units required to meet demand in a typical year, and reflects the unleashing of pent-up demand by those millennial households.

The increased construction also represents a lot more jobs. All the current slack in the labor market will be absorbed by stronger housing construction.

Interest rate risk

Forecasting interest rates is generally foolhardy, but a quickly improving economy makes it prudent to prepare for higher rates over the next several years. If everything sticks roughly to script, the Federal Reserve will normalize short- and long-term rates as the job market tightens. More jobs and stronger wage growth will trump the ill effects of higher rates on the housing market and broader economy.



Slow Exit by the Fed
Assets held outright on Fed's balance sheet, $ bil
Source: Moody's Analytics

When the economy is healthy, the federal funds rate should be approximately 4% and the 10-year Treasury yield closer to 5%. While much improved from recent years, the U.S. economy is far from healthy. Full employment is still in the distance, inflation remains stubbornly below the Federal Reserve's target, and the financial system is adjusting to stiffer regulatory requirements and increasingly tough capital and liquidity standards. The Fed's balance sheet is also bloated with Treasury and mortgage securities following several rounds of quantitative easing. This will put downward pressure on long-term rates until these securities mature, which could take until the 2020s. All this suggests that the Fed's normalization of interest rates should occur slowly. Policymakers will begin raising short-term rates in mid- 2015, but rates won't approach 4% until early 2018. The 10-year Treasury yield, currently near 2.25%, won't make it back to 5% on a consistent basis for the foreseeable future.

But bond traders are notoriously fickle, and they may not follow the Fed's script. This could be seen in the summer of 2013, when then-Fed Chairman Ben Bernanke began talking about ending QE. Traders thought Bernanke was signaling an imminent rise in short-term rates, and they sold bonds. Long-term rates jumped.

Investor nerves

Fed officials moved quickly to calm traders' nerves, and bond yields have since receded, but the housing market was hurt badly. Emerging economies that rely on foreign bond investors to fund large current account deficits, such as Brazil, India, South Africa and Turkey, are still struggling with the aftermath of that spike in rates.

Another similarly debilitating surge in long-term rates seems less likely given their decline this year, but it can't be dismissed. As the economy approaches full employment, wage growth picks up and the first Fed rate hike approaches, bond investors may panic again. They may fear that the Fed will be forced to raise short-term rates more aggressively to contain inflation. Housing and the global economy would be hurt, posing a threat to our sanguine outlook.

Given the surprising decline in long-term rates this year, it is also worth considering that they may remain lower longer than anticipated. With the Bank of Japan aggressively buying bonds and the European Central Bank likely to step up its own bond purchases, U.S. long-term rates could also be held down. Stiffer bank liquidity requirements, which require large multinational banks to hold larger and more liquid bond portfolios, may also contribute. Lower than expected long-term rates would be a plus for housing and economic growth.

Overseas trouble

The U.S. economy is less sensitive than most to changes in global conditions, but it isn't immune. And there is plenty of trouble overseas. With the value of the dollar surging, the U.S. trade balance is sure to deteriorate. Global trade, which to date hasn't been a factor in the U.S. recovery, will soon become a meaningful drag.

Most worrisome are the euro zone's travails. The single-currency region is flirting with another recession, and its unemployment is already painfully high. Political fissures are widening in nearly all the euro zone's member countries. Euro-skeptic political parties with mixed commitments to meeting their nations' debt obligations are gaining strength. If one of these parties appears set to gain control of a government, global investors could again question the European resolve to keep the euro zone together. Another round of financial turmoil would ensue.

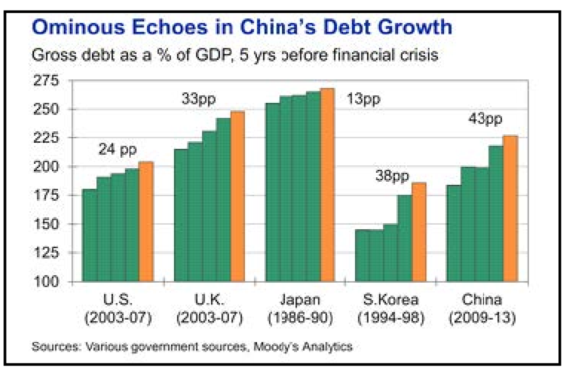
The ECB steps in

The European Central Bank is expected to forestall such a scenario. The ECB has ramped up its bond-buying program in recent months by purchasing covered bonds and asset-backed securities. This won't be enough, however, and the ECB will next buy supranational European bonds, such as those issued by the European Investment Bank. It will be politically harder for the ECB to buy individual nations' sovereign bonds, but it is increasingly likely to do so. While the economic stimulus won't be as large as those provided by quantitative easing in the U.S. and U.K., it could still help by lowering the euro's value and countering deflation fears.

It is a stretch to think the ECB's actions can jump-start the euro zone economy. That requires broad economic and fiscal reform, particularly in France and Italy. It is also reasonable to worry the ECB won't do enough to head off another European debt crisis. That would be a problem for the U.S.

Growth and risk in China

China's struggles to hit its own economic growth targets poses another threat. Chinese policymakers recognize they have significant structural problems, and have been willing to give up some growth to address them. Most notably, Chinese real estate markets are overbuilt, and speculation has been rampant. Many state-owned enterprises are unproductive. Corruption is endemic and environmental degradation epic. Most disconcerting, leverage has soared in China, comparable to other countries that have suffered severe financial crises. Much of this debt is held by local governments and financial institutions that have financed the runaway real estate activity.



Each time reform efforts have hit growth too hard, however, Chinese officials have eased up and provided monetary and fiscal stimuli. Most recently, the Chinese central bank surprised financial markets by cutting rates. China's growth slowdown hasn't been painless, but so far it has been well-managed. That China's financial system is relatively closed and authorities are able to quickly change policy has helped.

Putin's choices

Still, balancing reform and growth isn't easy, and China's managers may stumble. It wouldn't take much of a misstep to undermine already-reeling global commodity markets, weaken fragile emerging economies, and upset financial markets. The U.S. economy wouldn't survive this storm unscathed.

Russia's economic problems are by themselves not a reason to worry, but the pressure they put on Russian President Vladimir Putin could be. Sharply lower oil prices, Western economic sanctions due to Russia's incursion into Ukraine, and the collapsing ruble and resulting higher inflation and interest rates are suffocating Russia's economy. The government's fiscal situation is also rapidly eroding. How Putin will respond to this is difficult to forecast. It is equally easy to imagine him reining in his adventurism or ramping it up. His choices could have large implications for global and U.S. economic growth.

What's the U.S. potential?

As the U.S. economy approaches full employment, attention will shift to the economy's weak potential growth rate—the pace at which the economy can consistently grow without generating inflationary pressures. Since the Great Recession, the economy's estimated potential has been a dismal 1.3% per year. This reflects both lackluster labor productivity growth of 1%, and paltry labor force gains weighed down by falling participation.

A poor potential growth rate has allowed slack in the labor market to be absorbed more quickly. But once full employment is achieved, unless potential picks up, economic growth will slow sharply. This will hurt living standards, particularly for lower-income households, and undermine the government's precarious fiscal situation.

The fall in potential growth rates was in part anticipated. The large baby-boom cohort has begun to retire in recent years, reducing labor force participation. More than half the decline in participation since the recession hit is attributable to retiring boomers. Some of the slowdown is likely temporary, related to the recession and its fallout. Fewer job opportunities have also contributed to lower participation and less foreign immigration, which is important to the growth of the working-age population.

Shadows of the recession

Lagging productivity growth is also probably partly cyclical, reflecting the dark psychological shadow of the recession and uncertainty created by political brinkmanship in Washington. Businesses have been especially nervous, reluctant to use the cash they have built up during the recovery to expand and fund more investment. Entrepreneurs have also been understandably wary about starting businesses. Growth potential is thus expected to revive as the recession fades and full employment approaches. Some signs indicate this may be occurring, as labor force participation has stabilized over the past year despite continued boomer retirements. Foreign immigration should rebound with the better job market, and business confidence and investment have recently been much better. Over the next five years, potential growth should rise to 2.25% per year, equal to 0.75% labor force growth plus 1.5% productivity growth.

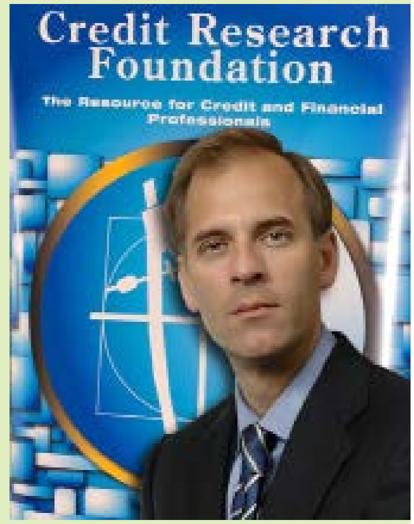
Structural risks

However, there is a meaningful risk that this is overly optimistic. Structural impediments to labor force and productivity growth may not quickly recede. Workers who stepped out of the job market during the tough times may not return, at least not to the degree hoped for. Their skills and marketability may have eroded so significantly that they are unable to find suitable work.

The animal spirits that drive business formation and investment could also remain bottled up. An aging population may prove more of a brake on risk-taking than thought. Entrepreneurs tend to start companies in their thirties, and there is a dearth of thirty-somethings. An even more disconcerting possibility is a downshift in the pace of technological change. Perhaps technologies such as 3D manufacturing, drones and DNA sequencing don't stack up to the productivity-enhancing power of the internet, which fueled growth in the 1990s and early 2000s.

Don't bet against the U.S.

Despite these reasonable concerns, betting against the American economy remains a bad strategy. The U.S. has clearly had a difficult run over the past 15 years, and has been scarred by terrorism, wars and technology and housing bubbles. Lower- and middle-income households have seen living standards decline. But the bad times are likely ending. Many of the economic wrongs have been righted. Households have deleveraged, the financial system has recapitalized, and U.S. businesses have reduced their cost structures and are highly competitive. Serious problems remain and politics complicate our ability to address them. But if history is any guide, we will.



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Economic Outlook Symposium: Summary of 2014 Results and 2015 Forecasts

According to participants in the Chicago Fed's annual Economic Outlook Symposium, the U.S. economy is forecasted to grow at a pace slightly above average in 2015, with inflation ticking lower and the unemployment rate edging down.

by William A. Strauss,
Senior Economist and Economic Advisor

The Federal Reserve Bank of Chicago held its 28th annual Economic Outlook Symposium (EOS) on December 5, 2014. More than 100 economists and analysts from business, academia and government attended the conference. This article will analyze the economy's performance over the past year and then analyze the consensus forecast for 2015 offered from symposium participants (see chart).

The U.S. economy entered the sixth year of its expansion in the third quarter of 2014. While the nation's real gross domestic product (GDP) is at its highest level in history, the rate of economic growth since the end of the Great Recession in mid-2009 has been very restrained. During the 21 quarters following the second quarter of 2009, the annualized rate of real GDP growth was 2.3% - roughly in line with the long-term historical rate of growth for the U.S. economy.

Economic growth was quite volatile during much of 2014. At 3.5% in the fourth quarter of 2013, the annualized rate of real GDP growth fell to -2.1% in the first quarter of 2014; then it rose to 4.6% in the second quarter before moving down to 3.9% in the third quarter. The fluctuation in growth rates during 2014 was due in large part to two temporary factors - extreme winter weather and a downward inventory correction. However, over the first three quarters of 2014 combined, the annualized rate of real GDP growth was a moderate 2.1% - close to the annualized growth rate during the first 21 quarters of the current expansion. Additionally, at 2.4% in the third quarter of 2014, the year-over-year rate of economic growth was not much stronger.

The economy continued to increase employment in 2014, with more than 2.6 million jobs added in the first eleven months. By May 2014, the more than 8.7 million jobs lost over the period February 2008 through February 2010 had finally been recovered. Moreover, in November of 2014, the unemployment rate stood at 5.8. Even though the working-age population (16 and older) had increased substantially since early 2008, the labor force gains were far more restrained by comparison, leading to a drop in the labor force participation rate (i.e., the proportion of the working-age population that is employed or jobless and actively seeking work). According to the U.S. Bureau of Labor Statistics (BLS), the labor force expanded very little between February 2008 and November 2014: On net, just over 2.7 million individuals joined the labor force during this span, translating to an annualized gain of 0.3%. However, the working-age population increased by more than 16.0 million people over the same period, which translates to an annualized increase of 1.0 percent. So, given the recent decline in labor force participation, the slack in the labor market remains quite large despite the job gains of last year. In addition, significant labor market slack is indicated by the still outsized number of part-time workers who desire full-time employment. Finally, some workers may not have obtained jobs that utilize their specific skills - another factor contributing to labor market slack.

Forecasts from the 28th Annual Economic Outlook Symposium

	2013 (Actual)	2014 (Forecast)	2015 (Forecast)
Real gross domestic product[a]	3.1	**2.1**	**2.7**
Real personal consumption expenditures[a]	2.8	**2.0**	**2.6**
Real business fixed investment[a]	4.7	**5.2**	**4.2**
Real residential investment[a]	6.9	**2.4**	**7.5**
Change in private inventories[b]	81.8	**65.0**	**50.0**
Net exports of goods and services[b]	−384.0	**−415.0**	**−432.9**
Real government consumption expenditures and gross investment[a]	−1.9	**1.2**	**0.9**
Industrial production[a]	3.3	**4.1**	**3.0**
Car and light truck sales (millions of units)	15.5	**16.4**	**16.8**
Housing starts (millions of units)	0.93	**1.00**	**1.14**
Unemployment rate[c]	7.0	**5.8**	**5.6**
Consumer Price Index[a]	1.2	**1.8**	**1.7**
One-year Treasury rate (constant maturity)[c]	0.12	**0.11**	**0.47**
Ten-year Treasury rate (constant maturity)[c]	2.75	**2.36**	**3.00**
J. P. Morgan trade-weighted dollar index[a]	3.5	**2.3**	**0.5**
Oil price (dollars per barrel of West Texas Intermediate)[c]	97.39	**80.00**	**83.84**

[a]Percent change, fourth quarter over fourth quarter.
[b]Billions of chained (2009) dollars in the fourth quarter at a seasonally adjusted annual rate.
[c]Fourth quarter average.

The year-over-year rate of inflation, as measured by the Consumer Price Index (CPI), was 1.7% in October 2014 - somewhat higher than the 1.2% inflation rate of 2013. Inflation remained low in 2014, in part because of the collapse in the price of oil. For instance, the price of West Texas Intermediate oil fell from roughly $97 per barrel in the fourth quarter of 2013 to about $76 per barrel in November 2014. Developments like this in the energy sector - along with the slack in production, the labor market and other parts of the economy - have continued to keep inflationary pressures low.

For the first ten months of 2014, industrial production grew at an annualized rate of 3.8% - nearly a full percentage point above its historical growth rate. Light vehicle sales (car and light truck sales) rose to 15.5 million units in 2013 - an 8% increase over the previous year's sales of 14.4 million units. For the first eleven months of 2014, light vehicle sales increased to average 16.4 million units (seasonally adjusted annual rate), registering a 6% improvement from 2013.

The housing sector contributed little to the economic expansion through the third quarter of 2014. Over the 21 quarters following the end of the Great Recession in mid-2009, residential investment contributed just 0.1 percentage points toward the overall economy's annualized growth rate of 2.3%. Housing starts rose to 0.93 million units in 2013 - a gain of 19% from 2012. Housing starts increased further in 2014: The annualized rate of housing starts was 1.00 million for the first 10 months of 2014 - up 11% relative to the same period in 2013.

Economic outlook for 2015

The consensus forecast for 2015 from symposium participants is for the pace of economic growth to be somewhat above the historical average. In 2015, the growth rate of real GDP is expected to be 2.7% - an improvement from the projected 2.1% rate for 2014. The quarterly pattern reveals a fairly solid performance for real GDP growth throughout 2015; its annualized rate is forecasted to edge higher over the year. Given that the economic growth rate is predicted to be only somewhat above its historical average, the unemployment rate is expected to only edge lower, moving down 0.2 percentage points over the year, to 5.6% in the final quarter of 2015. Inflation, as measured by the CPI, is predicted to tick lower from an estimated 1.8% in 2014 to 1.7% in 2015. Oil prices are anticipated to remain low; they are predicted to average almost $84 per barrel in the final quarter of 2015. Real personal consumption expenditures are forecasted to expand at a rate of 2.6% in 2015. Light vehicle sales are expected to rise to 16.8 million units this year; this increase is roughly in line with the growth in overall consumer spending. Real business fixed investment growth is anticipated to slow to a still solid growth rate of 4.2% in 2015. Industrial production is forecasted to see its growth rate moderate to 3.0% this year - close to its historical average.

The housing sector is predicted to continue its fairly slow march toward normalization in 2015. Real residential investment is forecasted to improve to a rate of 7.5% in 2015. Housing starts are anticipated to rise to 1.14 million units in 2015 - well below their 20-year annual average of roughly 1.35 million.

The one-year Treasury rate is expected to rise 36 basis points to 0.47% in 2015, and the ten-year Treasury rate is forecasted to increase 64 basis points to 3.00%. Both the trade-weighted U.S. dollar and the nation's trade deficit (net exports of goods and services) are predicted to be largely unchanged in 2015.

Conclusion

In 2014, the U.S. economy expanded at a pace roughly in line with the historical average. The economy in 2015 is forecasted to grow at a slightly faster rate than it did in 2014. The housing sector is predicted to continue to improve in 2015, as are light vehicle sales. The unemployment rate is expected to edge lower by the end of 2015, and inflation is predicted to remain low.

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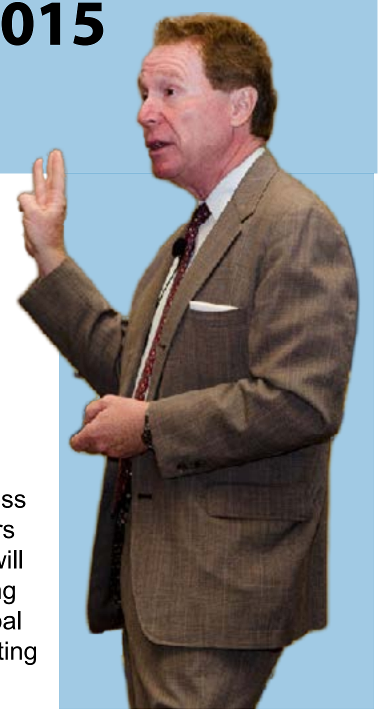
His research papers include analysis of the manufacturing sector, the automotive sector, the Midwest regional economy, the trade-weighted dollar, business cycles, and Federal Reserve payments operations.

Mr. Strauss has been interviewed on numerous television and radio shows and quoted in the major business magazines and newspapers. He has also provided testimony concerning manufacturing issues to the U.S. Senate.

Somewhat Better Prospects for 2015

by Dan North
Euler Hermes



Since the end of the Great Recession, US real GDP growth has averaged a mere 2.3% annually, just half the rate of previous recoveries. After four straight years of disappointing growth, prospects for 2015 look somewhat brighter, although not as strong as anyone would like. As always there are positive and negative forces acting on the economy, but Euler Hermes forecasts that the positives will prevail and produce 2.9% GDP growth in 2015 – still not stellar, but an improvement nonetheless.

As always, consumption is critical to the outlook since it accounts for around 70% of GDP, and prospects for the consumer are somewhat encouraging. Consumer confidence has been rising on a very slow trajectory since the end of the recession, but it has now reached levels signaling more optimism. The Conference Board's Consumer Confidence measure is hovering around the 90 level, which indicates a stable economy. The University of Michigan's Consumer Sentiment survey surged ahead in the first half of December from 88.8 to 93.8, the highest since January 2007. And the National Federation of Independent Business (NFIB) Small Business Optimism survey rose to 98.1 in November, returning to its average for the first time since before the recession, and attaining the highest reading since February 2007.

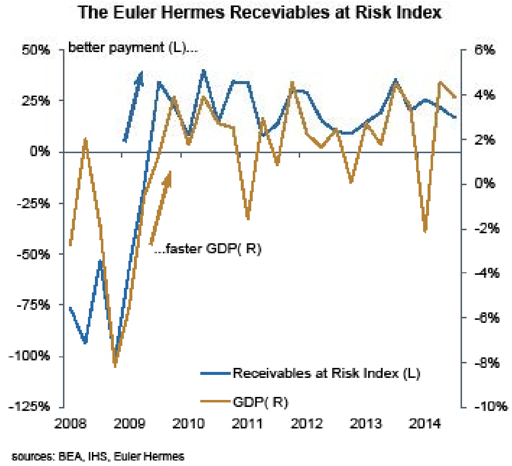
What's driving all the optimism? An improving labor market is providing the most significant boost. The economy has created a robust 241,000 jobs per month in 2014, the unemployment rate has dropped from 6.6% to 5.8%, and weekly jobless claims have dropped from 350,000 to under 300,000. Furthermore, the Conference Board survey reported that the percentage of respondents who said jobs were plentiful were near highs of the recovery, and the percentage of respondents who said that jobs were hard to find fell to near lows of the recovery. Similarly, the Small Business Optimism Survey has been recording improving views on employment throughout 2014. Confidence and optimism surveys tend to lead the economy, and as such are currently pointing to continued recovery in 2015.

Growth in 2015 will also be supported by the unexpected drop in oil prices of nearly 50% since June. The 30% drop in gasoline prices alone could provide an additional 0.3% of GDP growth. Falling gasoline prices have already boosted auto sales and will doubtless continue doing so into the new year. Falling prices for diesel fuel, jet fuel and heating oil will also contribute to a more positive outlook.

Further supporting the economy, monetary policy set by the Federal Reserve will remain highly accommodative in 2015. Expectations are that the Fed will start to raise the overnight Fed Funds rate in Q2-2015, increasing it gradually through the rest of the year. However that path will still leave the Fed Funds rate near historically low nominal levels, and after inflation it will still likely be negative. And it is quite certain that the increase in the Fed Funds rate will not stall the economy since the Fed always waits to make sure the economy is strong enough to endure higher interest rates. Furthermore this dovish Fed is particularly aware of the fragile nature of this recovery. In addition, the massive amounts of excess reserves created by four years of Quantitative Easing (QE) will remain largely intact, providing enormous liquidity to the global financial markets and supporting asset prices.

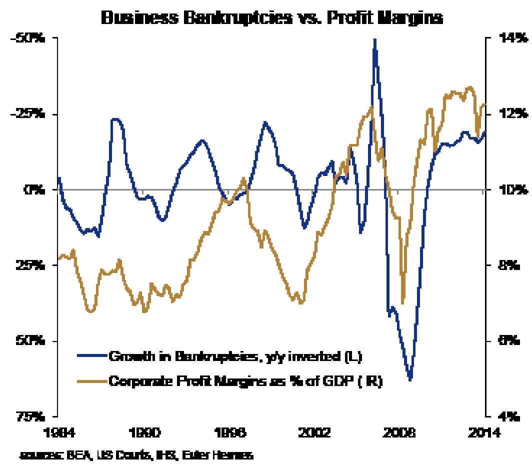
Manufacturing will continue to be a driver of the economy as the manufacturing success story in the US just keeps getting better. Since the end of the recession, Unit Labor Costs (ULC) have risen at a very slow pace across all industries, gaining only 5% during those five and a half years. But in the manufacturing sector, ULCs have actually fallen 5% over that period, continuing to drive down the cost of manufacturing in the US, whereas labor costs in China are rising. In addition to the rapidly improving labor cost situation, the Institute of Supply Management (ISM) manufacturing index has been above the 50 level, indicating expansion for 18 consecutive months, and stood at a very strong 58.7 in November. The critical "new orders" component of the index set a blistering 66.0 pace that month. Manufacturing industrial production was running at a 4.8% y/y pace in November vs. the long-term average of 2.5%. November capacity utilization was 78.4%, compared to the recession low of 63.9%; it was the highest in seven years. New orders for durable goods were growing at a 5.5% y/y rate in October vs. a long-term average of 3.9%, while new orders for non-defense capital goods excluding aircraft, a leading measure of business spending, were setting a red-hot 8.2% pace vs. the long-term average of 3.6%. In addition to manufacturing, particularly favorable sectors include autos, which are benefiting from strong demand due to the age of the fleet and falling gas prices, and chemicals which continue to benefit from low natural gas prices.

Positive GDP growth is also forecast by Euler Hermes' new proprietary economic indicator, the Receivables at Risk Index. The Index is based upon thousands of monthly past due payment reports from our clients who are on the front lines of business, and who can give broad and deep information on payment behavior. The Index is highly correlated with GDP growth as shown in the chart, and in fact can lead GDP growth. Its current level indicates that past due payment behavior remains much better than the average since 2008, showing that relatively few firms are experiencing financial distress leading to late payment, and therefore forecasting continued economy-wide growth.

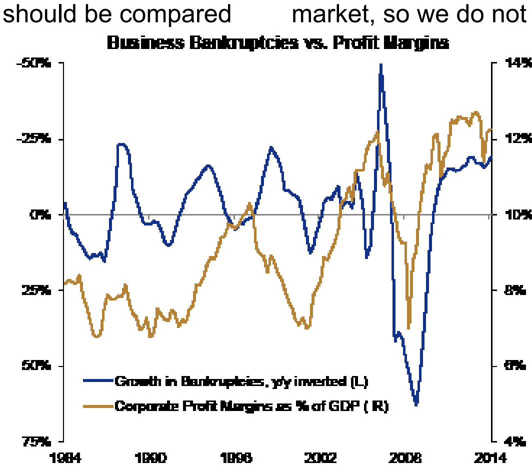


The newly elected Republican majority in Congress is viewed as more pro-business, and as such is likely to push for passage of such issues as the Keystone XL pipeline and corporate tax reform. However, as shown by the recent budget deal, there is little likelihood of spending reductions, which may temporarily support GDP growth, but will do nothing to reduce the gross debt/GDP ratio below its very high level of 104%. Entitlement reform is badly needed to manage this debt level, yet it's unlikely that Congress will touch that issue until after the 2016 elections.

Finally, business bankruptcies which soared during the recession have been dropping steadily since, and are expected to fall another 6% in 2015. No doubt the improvement in bankruptcies has been supported by near-record high gross profit margins as shown in the chart. Corporations are operating in a period of modest economic growth with high productivity and low wage growth, the perfect combination for high margins, and we expect these conditions to continue in 2015.



But these margins also raise questions of sustainability which underlie the headwinds keeping the economy from growing at a rate closer to the long-term average of 3.3%, much less the recovery average of 4.6%. High margins are supported in part by a lack of corporate investment, particularly in labor. While it is true that the economy has created jobs at a rapid clip this year, it is still well short of where it should be compared to prior recessions. For example, as shown in the chart, since the Great Recession started in 2008 the economy has now gained 1.7 million jobs, whereas in the recession of 1981 it had gained 13 million jobs by this point; in other words, we are still 5-10 million jobs short of where we should be at this stage in the business cycle. This shortfall is a result of three structural unemployment issues. First, the labor force participation rate has plummeted from 66.2% before the recession to 62.8% now, in part due to the fact unemployment benefits became so generous as to provide disincentives to work, and in part due to the demographic problem that Baby-Boomers, who are retiring at the rate of 10,000 per day, can't be replaced fast enough. Secondly, the job openings rate is actually quite high historically at 3.3% suggesting that the unemployment rate should be about 4.5%. Yet the unemployment rate is still at 5.8%, an unusual condition which suggests that employers are looking for one set of skills while potential employees are offering a different set of skills – a skills mismatch. And finally, the proportion of those unemployed for more than six months remains very high, rendering those people virtually unemployable. These three pillars of structural unemployment cannot be rapidly fixed by either monetary or fiscal policy, and they are perhaps the most significant impediments to growth.



The housing market has also not been much help in the recovery and we don't expect to see it provide a relatively strong contribution in 2015 either. While housing activity did recover with the recession, it has stalled since mid-2013. Since then, housing starts, permits and new home sales have all been highly erratic. While it is true that existing home sales have shown some consistency and were growing at a 2.9% y/y rate in October, it is new homes which generate construction jobs and consumer demand for home furnishings. Similarly, household formation has dropped 75% since the peak of the housing bubble. Part of this dramatic reduction arose from the very high unemployment rates of young adults who might normally have been in the housing market, but instead chose to live with parents or friends. Even though unemployment rates are now dropping in this segment, incomes are still not growing fast enough to lure these people into the housing market, so we do not expect to see a large enough increase in household formation in 2015 to provide a significant boost to the economy.

Finally, exporters will also face challenges in 2015. As the Federal Reserve leans towards tightening monetary policy, central banks in Europe, Japan, and China (together representing about half of global GDP), are leaning towards accommodation, boosting the value of the US dollar. The dollar is expected to appreciate on the order of 3% in 2015 on top of the 5% appreciation it has already experienced over the past year. Naturally a stronger dollar makes US exports less competitive. And of course exports are dependent on the strength of the global economy, which is about to enter its fourth consecutive year of lackluster growth. This combination is likely to hold 2015 nominal export growth to approximately 5% vs. the average of 6.5% over the past 20 years.

While Fed actions heavily influence the value of the dollar, the Fed's mandate is to balance unemployment vs. inflation. During 2015, we expect to see unemployment fall, but at a much slower pace than over the last year, perhaps levelling off around 5.5%. It's most likely that jobs will continue to be created at a robust pace in 2015, but that in turn will draw job seekers into the market who will initially be counted as unemployed, offsetting the job gains to a certain extent and keeping sharp moves in the unemployment rate in check. Similarly, inflation is unlikely to exceed 2% for two reasons. First, falling energy costs will put downward pressure on prices, and second, slack in the labor market will hold wage growth and its resultant influence on consumer prices down.

Overall, the balance of positives and negatives acting on the economy suggest real US GDP will grow 2.9% in 2015. Falling energy prices, accommodative monetary policy, strength in manufacturing and the Euler Hermes' Receivables at Risk Index all suggest continued momentum into 2015, but constraints to growth will arise from a sputtering housing market and challenges to exporters. Yet it is the labor market which holds the key explaining why GDP growth will be positive but below average. Employment is improving, which is boosting confidence, income, consumption and the entire macroeconomy. Yet employment has also lagged badly during the recovery, leaving us 5-10 million jobs short of where we should be at this point in the business cycle. When there aren't enough people working, the growth rates of income, consumption and GDP will all be held below average.

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As an economist he has appeared on CNBC, Fox Business News, France 24, and Bloomberg Radio and Television. He has been quoted by Barron's, Business Week, Paris Le Monde, Tokyo Nikkei, the New York Times and the Wall Street Journal. After having predicted the 2008/2009 recession and its implications accurately, he was ranked 4th on Bloomberg's list of the 65 top economic forecasters in 2010.

2015 Economic Projections of Chris Kuehl

It seems that analysts always want to start their assessment of the coming year with some qualifiers regarding how treacherous it can be to do much in the way of prediction. Each year there are assertions as to why this particular year is going to be challenging and tricky to forecast and 2015 is no exception. What makes this year a bit more unusual than others is that there is one specific reason for special concern for the performance of the 2015 economy and it comes from the ranks of the credit managers.

The data that has been released from various agencies and think tanks concerned with the economy have been almost glowing of late – good retail numbers stemming from the fact that consumers were finally willing to spend, and had more in their pockets due to the lower price of fuel. There were good numbers as far as employment was concerned and durable goods numbers were buoyed by demand for cars and appliances. Granted, housing data was still pretty weak but it hadn't cratered. This would have led to some rosy predictions for the coming year and indeed some economists are looking at the strong GDP growth in Q2, Q3 and probably Q4, and expecting the same or better in 2015. That might yet happen but there is something that is not trending in this positive direction and that is worrying.

The Credit Manager's Index is something I work on every month and it has a track record going back almost a decade. The collection of data from the National Association of Credit Management is modeled on the system that is used by the Institute for Supply Management to produce the Purchasing Managers Index, and it has many of the same virtues as well as limitations. The idea is that one polls those that are "in the trenches" to get a sense of what is actually happening in the economy from one month to the next. By tracking the purchasing managers, one gets a sense of what is being bought and sold, and with that data it is possible to get a read on manufacturing as well as the service sector. By tracking the credit decisions being made every day one gets a read on what creditors are feeling and what kind of shape their industries are in. For many years now the CMI has been predictive in the sense that it nearly always sends the same signals that the PMI will send a month later, and that makes sense given the order of things in a given company. Most of the time the credit manager will make their decision before the purchasing manager makes theirs.

The latest version of the Credit Managers Index shows a distressing trend that matches up with some other concerns that have been troubling analysts of late. The problem lies in what is described as the non-favorable factors – those that describe the state of creditors. These are the measures of how many accounts are out for collection, how many accounts are in dispute, the level of customer deductions, the bankruptcy filings and dollars exposed – the bad news side of credit management. The fact is that growth data is still pretty good as there have been good sales months and there have been steady increases in the amount of credit given. Unfortunately the number of credit applications approved have been trending down through the whole of 2014. This basically means that fewer customers are getting credit but they are getting more of it.

This paints a picture of economic fragility and that is not a good thing given the expected shocks of the coming year. The average company is not in great financial shape and is struggling to pay its bills and grow. This is coming at a time when costs have been very low. Inflation is next to non-existent as the latest data shows that real inflation is less than 2% and core inflation is at about 1.5%. Even those that are computing inflation in an alternative system based on 1990 numbers are getting rates that are only at about 5% compared to the nearly 10% levels they saw in 2008. The Federal Reserve has come as close as they dare to deciding that inflation is not a threat. The latter part of the year featured a radical drop in the price per barrel of oil and subsequently the price of gas at the pump, another major cost saving development. The question is how long this lasts. If the inflation rate moves up in the coming months it will put a great deal of additional pressure on companies that are struggling anyway. At the same time it puts pressure on those that have given these companies credit as they will be paid in money that is not worth as much as when it was offered. This is the period during which banks and other lenders get very uncomfortable and this tends to dry up credit – at the precise moment that many companies are in desperate need of it.

There are aspects of growth that could create concern as well – again relating to inflation. In the last few months there has been some improvement in the labor situation as there have been more jobs added and the unemployment rate has been falling – at least at the U-3 level. There are still concerns about the workers that have dropped out of the hunt as they may have become unemployable. They may not have the skills needed to get back into the workforce or they may have been out of a job too long and are now considered high risk hires. Those that are starting to hire more aggressively are more likely to poach a worker from another company as they are to hire somebody with no experience. The bulk of the hiring of late has either been the brand new worker with some level of education or that experienced candidate, and that can add to the inflation fear as they will have to offer more money to the employee to jump ship while at the same time paying their own employees more so they will not be tempted to leave.

The bottom line is that inflation is likely to be a bigger issue this coming year – even without a gain in the price of commodities. Right now it seems unlikely that the oil price will start to surge but all it would take is some geopolitical turmoil (Libyan fighting in the week after Christmas was enough to cause a short term spike) or weather or the deliberate decision on the part of the oil producers to cut back to cause oil to go back up. The price of farm commodities was down due to an unusually benign year for growing in the US, and that is unlikely to be repeated. Demand for industrial metals are down but as the economy recovers there will be higher prices for steel, aluminum, copper and the rest.

The threat of inflation is certainly not the only thing to be concerned with in 2015 but it is something that few have dealt with in many years, and many companies really don't have a plan in place for when this occurs. The other threats that could loom large in the coming year include an extended and deep recession in Europe that is combined with a much stronger dollar. It will not be the dollar gaining as much as it will be the other currencies weakening still further – either way the US export markets shrink and that is not something that can be tolerated all that well. If the Federal Reserve sticks to its plan to raise rates by the end of the second quarter or the start of the third, the dollar will spike even further as investors will flock to the only major currency offering a return.

The credit industry has been noticing just how weak the economic recovery has been thus far. This means the economy will have a very short leash. At the first sign of overall distress it is likely there will be credit restrictions of some kind. The banks are in much the same mood and have become highly risk averse over the last few years. Some of this is the result of the new regulations that came with the Bank Reform Act, but much of it is due to the sense that banks behaved recklessly in the period prior to the 2009 recession and they do not want to be in that position again.

Five Fearless Forecasts

On the basis of these warnings and signals at the end of 2014 it seems there are five prognostications that would make some sense. The first is that interest rates will likely start to rise by the middle of the year – in part because the Fed really can't afford to back away from its assertions unless there is some compelling reason not to, and that is not expected. Look for the rates to go up by very small amounts – a quarter point or half point at a time. By the end of the year the rates may be up to around 1%.

The second prediction is that inflation will be up by the end of the year – closing in on the 2% limit the Fed set as the preferred level. There will not be all that much energy applied to reducing the rate of inflation in the beginning as most will welcome the boost this brings to the economy as wages and prices start to increase. The reaction to inflation is far likelier in 2016.

The third prediction is that employment numbers will not improve much in the coming year. Now is the time that the discouraged workers should be coming out of the woodwork to seek jobs, but that has not been happening thus far. It seems that those without jobs right now are without the skills needed to land one and they can't get back into the workforce without training. The US is going to be facing labor shortages in many key areas and very quickly. If this is not to become extremely costly there will need to be more imported workers with those skills and that will set off an intense political debate that will last into the 2016 election.

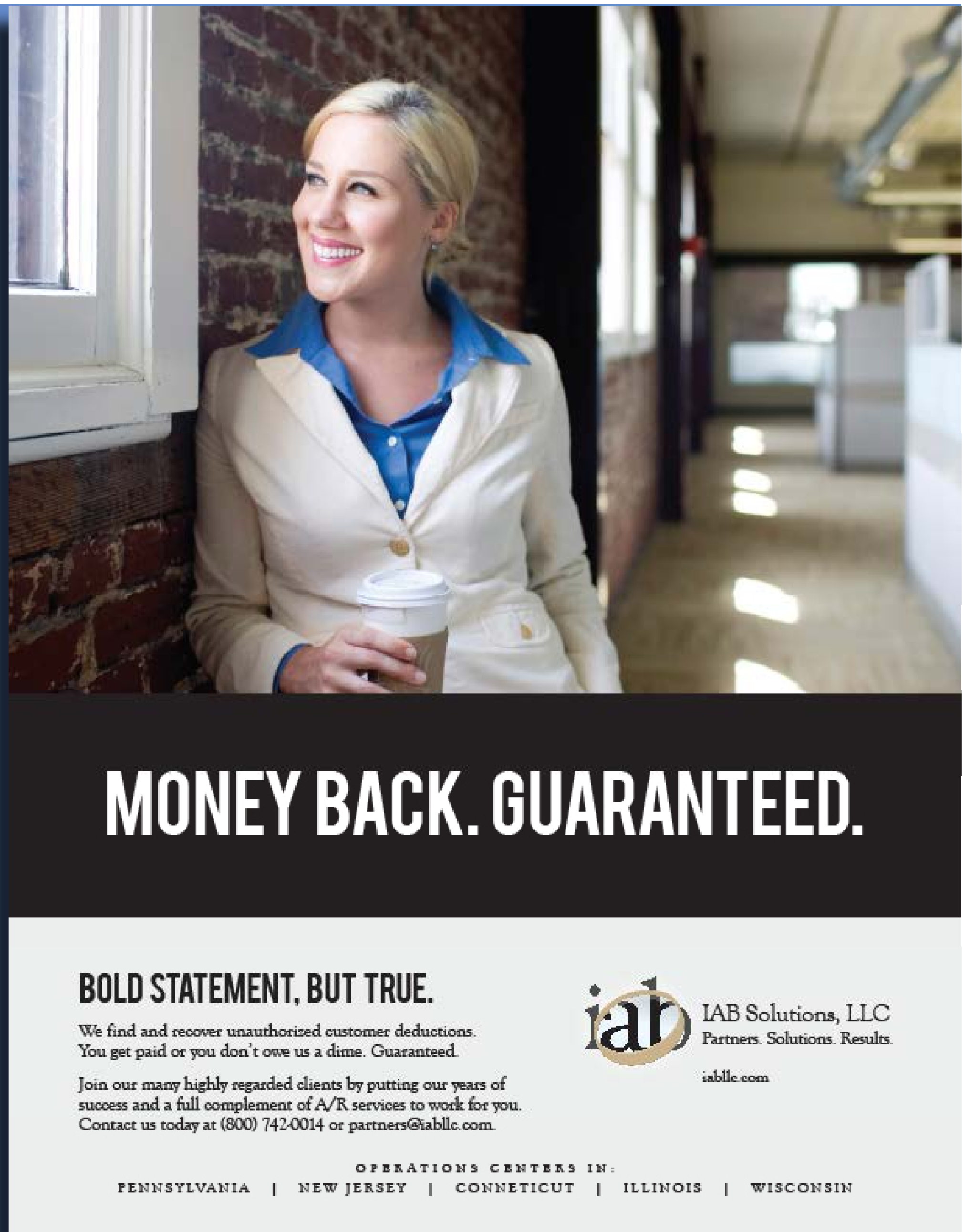
The fourth prediction is that the dollar gains will be sufficient to reduce the level of exports and expand the trader deficit to numbers not seen since the recession started. For the last few years the US has been able to sell overseas aggressively as the dollar was weak. At the same time the weak dollar meant that imports were not that cheap. Today the dollar has gained enough that the consumer is seeing more inexpensive imports at the same time that US exporters are struggling to find markets. The US is not likely to see an imbalance like that in the 1980s, but it will look worse than it has since 2008.

The fifth prediction is that capital spending will decrease a little. That trend started in the middle of last year as many companies are still not using their existing capacity efficiently. The rate of capacity utilization has been stuck just beneath normal levels, and until that rate is close to 85% again, there is not much incentive to do more. At the same time there are polls that suggest that this will be the year that companies try to hire more people – reflecting the issue noted above. The quest for the right workers will prove frustrating and expensive.

In general it is expected that 2015 will be a good year but few are expecting great. The economy is weaker than many realize and it will not take much to push parts of the economy into reverse.

***Chris Kuehl** is the co-founder (with Keith Prather) and Managing Director of Armada Corporate Intelligence, a company created in 1999 to provide strategy foundation, competitive intelligence, business analysis and economic forecasting for corporate clients.*

Armada's clients include YRC Worldwide, TranSystems, Spencer Fane Britt and Browne, KPMG, Hallmark International, Weitz Industrial among others.



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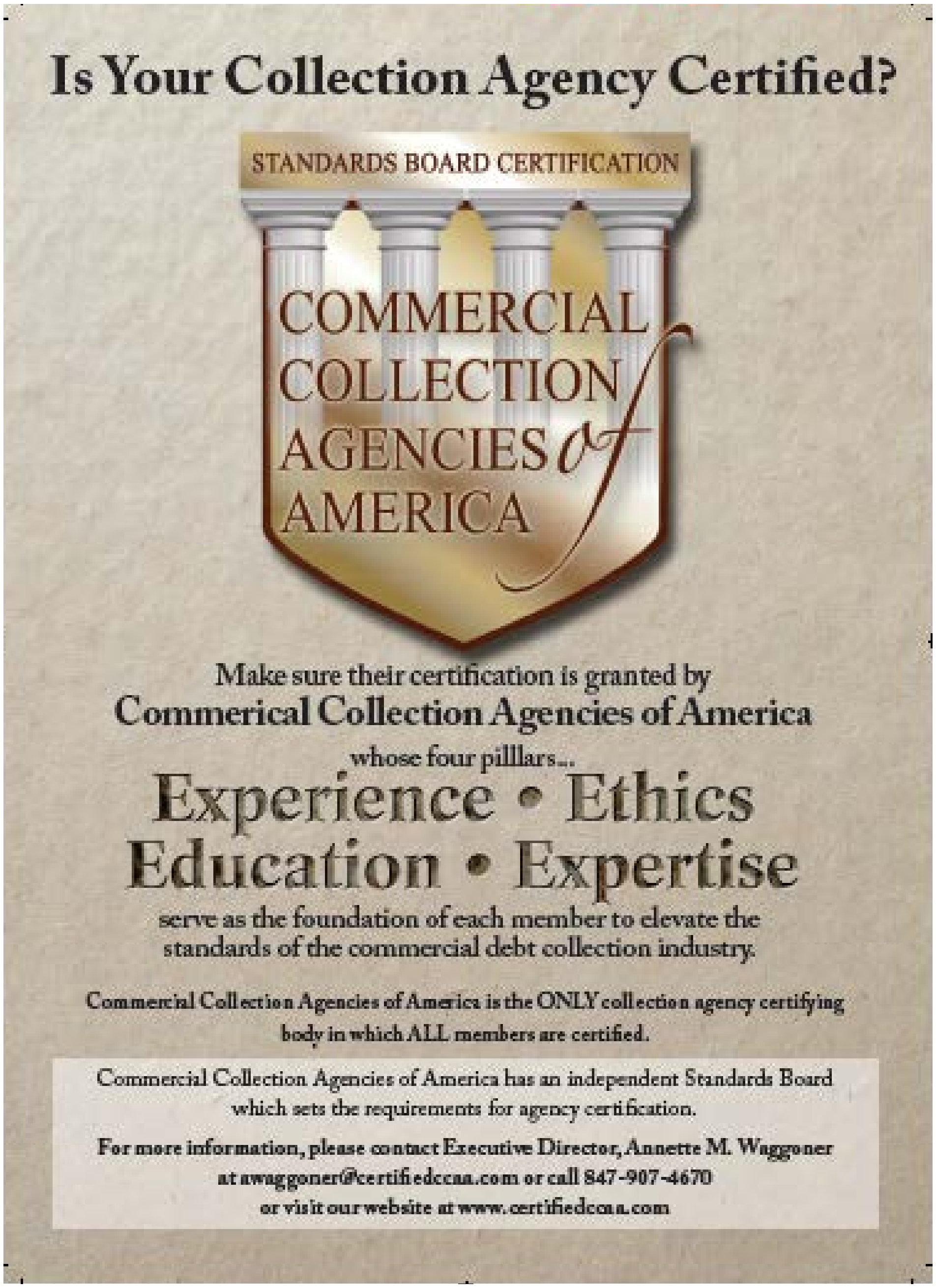
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