U.S. ECONOMIC & INTEREST RATE OUTLOOK

January 2015

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• Carrying Momentum into the New Year

The U.S. economy grew at an impressive pace in the third quarter, and the tally for the final three months of 2014 should continue the positive trend. Looking ahead, U.S. economic fundamentals suggest sustained growth in 2015.

Data covering the final three months of 2014 point to continued forward momentum, albeit at a slower pace when compared with the 5.0% annualized increase in real gross domestic product (GDP) seen during the third quarter. The broad contours of economic growth in 2015 should be quite similar to last year. Consumer spending should lead the way, and government spending is not likely to be a drag on overall economic growth.

Key Economic Indicators

	2014				2015				Q4 to Q4 change			Annual change		
	14:1a	14:2a	14:3a	14:4f	15:1f	15:2f	15:3f	15:4f	2013a	2014f	2015f	2013a	2014f	2015f
Real Gross Domestic Product (% change, SAAR)	-2.1	4.6	5.0	3.1	2.8	2.9	3.0	3.0	3.1	2.6	2.9	2.2	2.4	3.3
Consumer Price Index (% change, annualized)	1.8	3.5	-0.1	-2.2	0.6	2.9	1.9	1.9	1.2	1.2	1.4	1.5	1.6	0.7
Civilian Unemployment Rate (%, average)	6.6	6.2	6.1	5.7	5.6	5.5	5.4	5.3				7.4*	6.1*	5.5*
Federal Funds rate	0.07	0.09	0.09	0.10	0.10	0.10	0.20	0.50				0.11*	0.09*	0.23*
2-yr. Treasury Note	0.37	0.42	0.52	0.54	0.60	0.76	1.04	1.44				0.31*	0.46*	0.96*
10-yr. Treasury Note	2.76	2.62	2.50	2.28	2.20	2.50	2.90	3.20				2.35*	2.54*	2.70*

a=actual
f=forecast
*=annual average

Key Elements of Forecast:

- Consumer spending in the three months ended December is projected to nearly match the 3.2% increase seen in the third quarter. Auto sales are holding at an elevated level (16.8 million units) for two straight quarters. Oil is trading below $50 per barrel versus quotes of around $115 in June 2014. Lower oil prices were expected to give an extra lift to consumer spending in December. But December retail sales excluding gasoline were disappointing and slipped 0.4%. The strength seen in the first two months of the quarter offset the weakness of December data, and the quarterly tally is close to the third-quarter reading (+5.4% versus +5.6%, respectively).

- Strong business spending during the second and third quarters of 2014 helped lift overall growth. Quarter-to-date shipments of non-defense capital goods excluding aircraft, an input for business spending in the GDP report, are weak and have raised expectations of a noticeable deceleration in business equipment expenditures in the final quarter of 2014.

- Sales of existing homes in the October-November period slipped compared with the third-quarter average, while purchases of new single-family homes were noticeably weak. Residential construction outlays in the first two months of the fourth quarter eked out a small increase. Putting these data together, residential investment spending is expected to show only a very modest gain in the last quarter of 2014.

- The trade deficit narrowed significantly during the October-November period. Even with conservative assumptions about a likely widening of the trade gap in December due to the recent strength of the dollar, the trade component should not be a large setback to headline GDP in the fourth quarter.

- Based on available data for October and November, a positive contribution from inventories to real GDP growth in the fourth quarter is a strong possibility.

- Hiring accelerated in the October-December period, placing the quarterly average gain of payrolls at 289,000, the best performance in the entire recovery that commenced in June 2009. The unemployment rate declined to 5.6% in December, down from 6.7% a year ago. Overall, labor market slack continues to diminish.

  Nonetheless, wage growth slipped in December. Typically, strong hiring trends and a low jobless rate should lift wages. There is a host of possible reasons for a lack of acceleration of wages, but more data will be necessary to draw strong conclusions. The low unemployment rate is partly due to a declining participation rate, which adds to the challenge of assessing underlying labor market conditions.

- The downward trend of energy prices and lower import costs, stemming from a strong dollar, have kept inflation below the Fed's 2.0% target. The headline personal consumption expenditure price index dropped 0.2% in November, while core inflation (which excludes food and energy prices) held steady. On a year-to-year basis, overall inflation was 1.2% in November and core inflation was 1.4%. In the near term, additional low inflation readings are certain until oil prices stabilize. A small pass-through to core prices will be visible, but we expect core inflation to move upward over time toward the Fed's 2.0% inflation target.

- Economic developments in the eurozone, China, and Japan are sources of risk that could trim growth in the quarters ahead. However, a strong policy response from the European Central Bank at its next meeting on January 22 could modify growth prospects in the region.

- The two-year Treasury note yield, currently trading at 50 basis points, reflects expectations of slightly tighter monetary policy in the quarters ahead. At the same time, the 10-year Treasury note yield under 2.0% is largely a result of purchasers seeking safe-haven status. We continue to expect the Fed to raise its policy rate at the September Federal Open Market Committee meeting, barring significantly weak economic data between now and then.