Northern Trust

U.S. ECONOMIC & INTEREST RATE OUTLOOK

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• Many Moving Parts, but the Engine Is Running Well

The U.S. economy is in a significantly favorable position compared with its peers in the industrialized world, despite a subdued global economy and a strong dollar. The overall outlook for American performance remains positive.

Market expectations of Fed tightening and the continued easy monetary policy stance of the European Central Bank and Bank of Japan will bear on capital flows and currency alignments. Oil prices, the dollar and the impact of these two variables on inflation expectations are also factors that will influence market trends in the months ahead.

The 2.6% increase in U.S. fourth-quarter real gross domestic product (GDP) was a bit disappointing, particularly after a 5.0% jump in the previous quarter. The positive contribution from inventories and the negative impact of a wider-than-expected trade deficit were the major surprises.

Key Economic Indicators

	2014				2015				Q4 to Q4 change			Annual change		
	14:1a	14:2a	14:3a	14:4a	15:1f	15:2f	15:3f	15:4f	2013a	2014a	2015f	2013a	2014a	2015f
Real Gross Domestic Product (% change, SAAR)	-2.1	4.6	5.0	2.6	2.8	3.2	3.1	2.9	3.1	2.5	3.0	2.2	2.4	3.3
Consumer Price Index (% change, annualized)	1.8	3.5	-0.1	-2.5	0.6	2.9	1.9	1.9	1.2	1.2	1.3	1.5	1.6	0.6
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	0.56	0.73	0.96	1.38				0.31*	0.46*	0.91*
10-yr. Treasury Note	2.76	2.62	2.50	2.28	2.00	2.30	2.60	3.00				2.35*	2.54*	2.48*

a=actual
f=forecast
*=annual average

Key Elements of Forecast:

- Consumer spending advanced at an annual rate of 4.3% in the last quarter of 2014, the best showing since 2006. However, spending data on a monthly basis showed an uneven performance. Real consumer spending in December slipped 0.1%, reflecting softer purchases of both goods and services. Low gasoline prices, the pickup in wages evidenced in the latest employment report and continued growth in payrolls point to sustained growth in consumer spending in the quarters to come.

- Business spending fell in the fourth quarter after strong gains in each of the prior two quarters. Moderate growth in business outlays is likely, limited partly due to a reduction in expenditures related to the oil and gas industry. A strengthening of the dollar adversely affects firms with foreign exposure.

- Construction of new homes rose 8.0% in 2014, down from a nearly 19% increase in 2013. Purchases of new homes moved up only 1.6% in the past year after a solid 16.9% jump in 2013. Sales of existing homes fell 3.1% in 2014 versus an almost 9.0% increase in the prior year. All in, this is not satisfactory progress. The significant increase in hiring in recent months and a low-mortgage-rate environment support our expectations of a better housing sector performance in 2015.
- The annualized trade deficit widened by $40 billion in the fourth quarter, reflecting a large increase in imports and a small improvement of exports. A strengthening of the dollar and a stronger U.S. economy are likely to boost import growth and widen the trade deficit further, albeit by a smaller magnitude.
- Recent labor market data have been very positive. Payroll employment averaged 336,000 in the last three months, and hourly earnings show a gradual improvement. A 5.7% jobless rate is within close proximity to the Fed's full-employment estimate. The employment-population ratio recorded a cycle high of 59.3%, and the participation rate also moved up two notches to 62.9% in January. However, the broad measure of unemployment moved up slightly, underscoring the lingering existence of underutilized labor resources.
- The year-to-year change in the personal consumption expenditure price index and the core measure of inflation, which excludes food and energy, stood at 0.8% and 1.3%, respectively, in January. These readings are significantly below the Federal Reserve's 2.0% target. The Fed's latest policy statement notes that inflation likely will decline further before it gradually advances close to the Fed's inflation goal.
- On the downside, the economic situations in the eurozone and China present a risk to headline GDP growth. Developments related to Greece are a source of increased market volatility. Optimists expect a resolution of the Greek crisis, while pessimists have increased the probability of Greece's exit from the eurozone. Further east, the People's Bank of China has lowered reserve requirements and managed a depreciation of its currency in recent months, both of which are signs of Chinese authorities seeking to maintain the recent pace of growth.
- The Fed reiterated that it would remain patient in "beginning to normalize the stance of monetary policy." In the meanwhile, the 10-year Treasury note yield is trading close to 2.0% following the bullish January employment report; it hovered below 2.0% for most of the year and touched a low of 1.68% last week.
- The Fed is on track to begin applying the monetary policy brake in 2015; the March Fed meeting may shed light on the timing of such action. We continue to expect the first interest rate increase in September, given the current low inflation readings and slow international economic conditions.