U.S. ECONOMIC & INTEREST RATE OUTLOOK

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• Taking Stock of 2014

Excluding the impact of the "polar vortex" on first quarter real gross domestic product (GDP), business activity advanced at an impressive pace in 2014. If our forecast for the fourth quarter is accurate, the U.S. economy's real GDP will show a 3.5% average gain in the last three quarters of the year. This performance stands out among its peers and we are projecting a similar economic momentum for 2015.

The recent decline in oil prices has not prompted substantial adjustments to our outlook. While lower prices are beneficial for consumers, we expect more modest investments in U.S. energy infrastructure. The net of the two might be a slight positive for growth, but not a significant one.

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	3.9	2.6	3.1	3.0	3.1	3.2	3.1	2.2	3.1	2.2	2.3	3.2
Consumer Price Index (% change, annualized)	1.8	3.5	-0.1	1.2	1.8	1.8	2.0	2.1	1.2	1.7	1.9	1.5	1.7	1.6
Civilian Unemployment Rate (%, average)	6.7	6.2	6.1	5.8	5.7	5.6	5.5	5.4				7.4*	6.2*	5.6*
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	0.50	0.56	0.71	0.96	1.36				0.31*	0.45*	0.90*
10-yr. Treasury Note	2.76	2.62	2.50	2.35	2.50	2.70	2.90	3.20				2.35*	2.56*	2.83*

a=actual
f=forecast
*=annual average

Key elements of the forecast:

- Real consumer spending is projected to grow at an annual rate of 2.5% in the fourth quarter compared with a 2.2% increase in the third quarter. Auto sales rose sharply in November after a nearly steady reading in October. In spite of this, auto sales in the fourth quarter are unlikely to exceed the third-quarter average.

  Despite the setback in the first quarter, growth of consumer spending in 2014 will almost match the 2.3% increase seen in 2013. Consumer fundamentals (wealth, wages and leverage) all look favorable heading into the new year.

- Sales of existing homes and new homes rose modestly in October. Year-to-date, the increase in housing sector activity is small compared with 2013, and lending conditions do not support expectations of strong sales next year. Mortgage rates remain attractive now, but the Federal Reserve's plan to normalize monetary policy presents a risk of higher mortgage rates much later in 2015.

- Business equipment spending is expected moderate in the fourth quarter following strong second- and third-quarter readings. The outlook for capital spending in the Business Roundtable CEO Economic Survey supports this. Based on the forecast for the fourth quarter, business equipment spending is likely to record a stronger performance in 2014 than in 2013.
- A likely drop in defense spending after a significant third-quarter gain will reduce overall federal government outlays in the fourth quarter. For the year, government spending, inclusive of federal, state and local components, is projected to be almost flat after three consecutive years of declines.
- Payroll employment shows a consistently positive trend, with the November payroll increase of 321,000 representing the tenth straight monthly gain above 200,000. The November jobless rate at 5.8% is down from 7.0% a year ago. Should this pace be sustained, the unemployment rate should get close to the Fed's long-run unemployment range of 5.2% to 5.5%.
- Inflation, as measured by the year-to-year change in the personal consumption expenditures (PCE) price index, has remained about 50 basis points below the Federal Open Market Committee's (FOMC's) 2.0% target since May 2012. The core inflation measure, which excludes food and energy, also has held below the Fed's target. With economic growth expected to exceed potential, inflation should approach this target in 2015.
- The Fed is projected to stay the course of current monetary policy until September 2015. The FOMC meeting next week is likely to conclude with new forward guidance replacing the current stance of maintaining the low federal funds rate for a "considerable time."
- The 10-year Treasury note yield stood at 3.04% on the last business day of 2013; as of this writing, it is trading around 2.25%. The "taper tantrum" resulted in a steepening of the yield curve in 2013. However, the bond market's reaction to the actual reduction of asset purchases and its termination has been more contained.
- Likely headwinds from Europe and China remain on the radar screen. Mario Draghi, president of the European Central Bank (ECB), stated that the ECB is closely examining additional measures to support economic activity and lift inflation. Chinese authorities are taking steps to curb financial excesses, while economic data point to softening economic conditions.