RAYMOND JAMES

Economic Research
Published by Raymond James & Associates

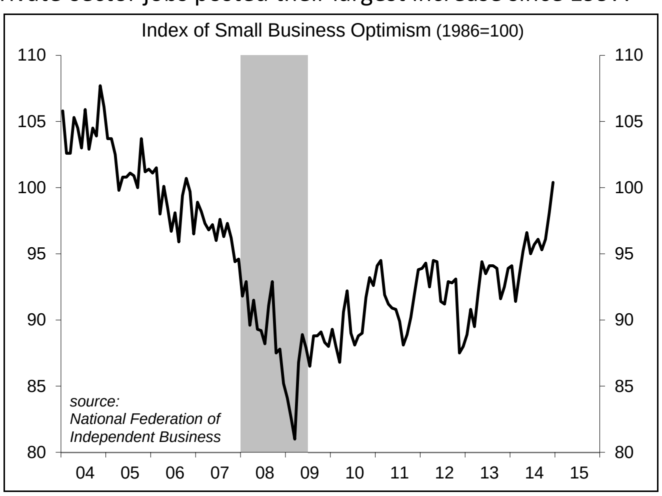
**Scott J. Brown, Ph.D.,** (727) 567-2603, Scott.J.Brown@RaymondJames.com **January 22, 2015**

**Monthly Economic Outlook**

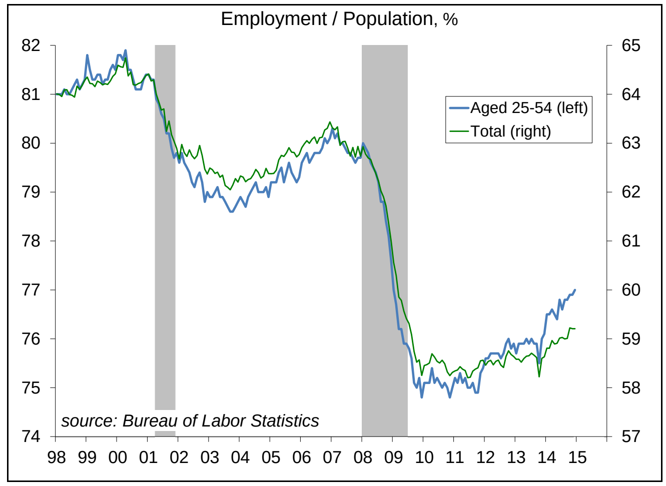
## USA! USA! USA!

- *U.S. economic growth should pick up in 2015, as lower gasoline prices are expected to provide significant support for consumer spending. Importantly, the expansion is now characterized by an improving outlook for small and medium-sized businesses, which should continue to propel economic growth even after gasoline prices stop falling.*
- *The outlook for other advanced economies has softened further and emerging economies are likely to be a bit spotty in 2015. The U.S. dollar should continue to strengthen and a flight to quality is expected to keep long-term interest rates low.*
- *The Federal Reserve is expected to begin normalizing monetary policy in the second half of the year. However, shifting views on the Fed's timing outlook, economic developments outside the U.S., and geopolitical tensions are likely to keep financial market volatility at elevated levels.*

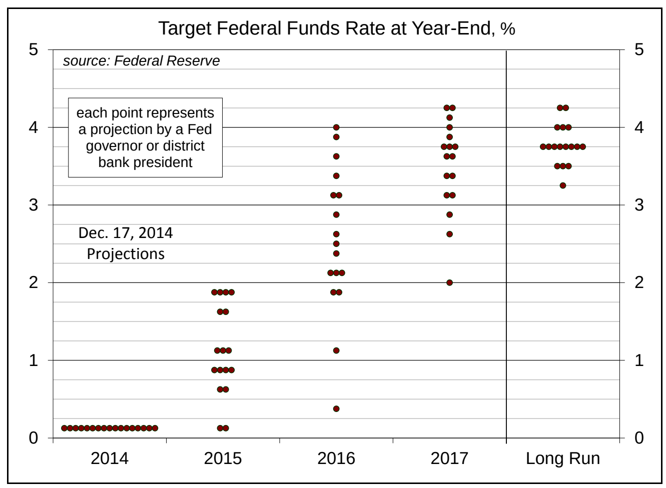
Economic headwinds diminished in 2014, allowing the recovery to gather steam. Most notably, the outlook for small and medium-size firms has improved significantly. These firms were severely credit-constrained during the financial crisis, as banks pulled existing lines of credit. Bank lending to small businesses is still relatively tight, but is gradually getting easier. More importantly, these firms have been reluctant to expand without evidence of a sustained increase in demand. We appear to have finally reached a turning point. Small and medium-size firms typically account for most of the job growth during an economic expansion. In 2014, nonfarm payrolls rose by 2.95 million (+2.1%), the largest annual gain in this century. Private-sector jobs posted their largest increase since 1997.




The unemployment rate fell to 5.6% in December, down from 10.0% in the early stages of the recovery. However, much of that improvement reflects a decrease in labor force participation. There is still a lot of slack in the job market.



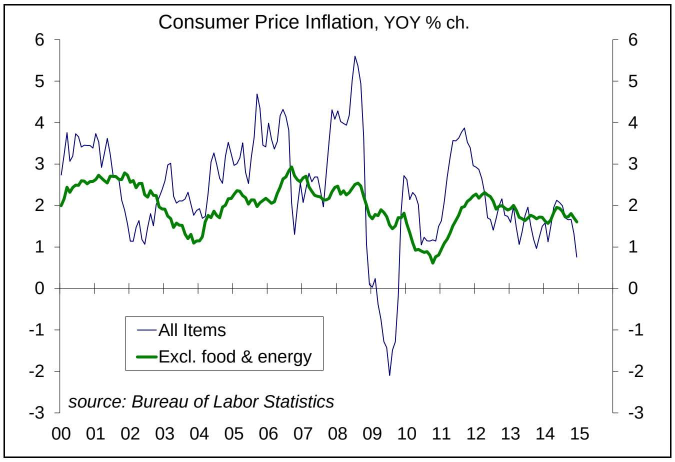

Some of the decrease in participation reflects the aging of the population. However, the employment/population ratio for the prime cohort, those aged 25-54, is still far below where it was before the recession. That suggests that Federal Reserve policymakers need not be in a hurry to begin raising short-term rates. However, the trend is higher, making it appropriate for officials to consider when to take the foot off the gas pedal.




At the mid-December policy meeting, senior Fed officials agreed that the decision to begin raising short-term rates will be data-dependent. However, there was no consensus on where the overnight lending target rate would be at the end of the year (and implicitly, when the first rate hike would come). In its policy statement, the Federal Open Market Committee removed the *"considerable time"* phrase, and replaced it with language suggesting that it can be *"patient"* in deciding when to tighten, quickly adding that this shift in phrasing reflected absolutely no change in the policy outlook. Some Fed officials are more patient than others, of course, but most appear to be in the later-rather-than-sooner camp.



**International Headquarters:** The Raymond James Financial Center | 880 Carillon Parkway | St. Petersburg, Florida 33716 | 800-248-8863




The fall in gasoline prices has pushed overall inflation lower. Next month, the January CPI is likely to be reported as nearly unchanged from a year ago. Core inflation, which excludes the volatile food and energy components, rose 1.6% over the 12 months ending in December and we could see the sharp drop in oil and gasoline feed through indirectly to lower core inflation in the near term. Bear in mind that the Fed's chief inflation gauge, the core PCE Price Index, is trending about 0.3 percentage point lower than the core CPI y/y (+1.4% for the 12 months ending in November, vs. the Fed's goal of 2.0%). Fed officials view the drop in energy prices as *"transitory,"* but low inflation may delay the initial rate hike.

One of the key elements missing in the 2014 expansion was a broad-based pickup in wages. Average hourly earnings rose just 1.7% over the 12 months ending in December. Lackluster growth in average wages is one more indication of slack in the job market and has been a restraining factor for consumer spending over the last year (which, in the aggregate, has been more than offset by the strong pace of job growth).

The drop in gasoline prices has helped boost real earnings in recent months. Bear in mind that we have yet to see the full impact of lower gasoline prices, which is most beneficial to the middle class. For a typical household, the drop in gasoline prices should free up about $750 over the course of 2015. That's money that will be mostly spent on other things, and there will a multiplier effect. Of course, gasoline prices are not going to fall forever. Hopefully, we'll see some increase in wage growth in the second half of 2015.

The rest of the world's problems will have some negative effects on the U.S. economy. We're likely to see a loss in foreign earnings for U.S. firms that do business abroad due to slower revenues and a stronger dollar (a lower dollar value for any given level on earnings in euros). The energy sector has been a rapidly-growing area of the U.S. economy in recent years, but it still accounts for a very small fraction of the overall job market. A reduction in energy structures and equipment is expected to subtract from GDP growth in the near term. Yet, these negatives are expected to be easily offset by the positive benefits to consumers and businesses (from lower oil prices).

While the U.S. economic outlook is looking better all the time, unsettled conditions elsewhere are likely to contribute to a high level of financial market volatility. The European Central Bank has finally launched quantitative easing. However, one of the key takeaways from the U.S. experience is that, while QE may be helpful, it is very confusing for investors.

How long can U.S. strength last? Measuring the degree of slack is problematic, but GDP currently appears to be at least 3% below its potential. Thus, we could see a few years of strong growth as that slack is taken up. The Fed must consider the end game, and engineering soft landings often proves to be difficult. There's no need to hit the brakes, but the Fed ought to begin taking the foot off the gas pedal in 2H15.

| | 1Q14 | 2Q14 | 3Q14 | 4Q14 | 1Q15 | 2Q15 | 3Q15 | 4Q15 | 1Q16 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| GDP (↓ *contributions*) | -2.1 | 4.6 | 5.0 | 2.8 | 2.8 | 2.9 | 2.9 | 2.7 | 2.6 | 2.2 | 2.4 | 3.2 | 2.7 |
| *consumer durables* | 0.2 | 1.0 | 0.7 | 0.5 | 0.5 | 0.5 | 0.4 | 0.4 | 0.4 | 0.5 | 0.5 | 0.5 | 0.4 |
| *nondurables & services* | 0.6 | 0.8 | 1.5 | 1.6 | 1.6 | 1.6 | 1.4 | 1.4 | 1.4 | 1.2 | 1.2 | 1.5 | 1.4 |
| *bus. fixed investment* | -0.1 | 1.2 | 1.1 | 0.4 | 0.5 | 0.8 | 0.7 | 0.6 | 0.6 | 0.3 | 0.6 | 0.7 | 0.7 |
| *residential investment* | -0.2 | 0.3 | 0.1 | 0.4 | 0.5 | 0.4 | 0.3 | 0.3 | 0.2 | 0.3 | 0.1 | 0.4 | 0.2 |
| *government* | -0.2 | 0.3 | 0.8 | 0.1 | 0.3 | 0.3 | 0.3 | 0.2 | 0.2 | -0.4 | 0.0 | 0.3 | 0.2 |
| Domestic Final Sales | 0.7 | 3.4 | 4.1 | 3.1 | 3.5 | 3.6 | 3.2 | 2.9 | 2.8 | 1.9 | 2.3 | 3.4 | 2.9 |
| *exports* | -1.3 | 1.4 | 0.6 | 0.6 | 0.2 | 0.2 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 |
| *imports* | -0.4 | -1.8 | 0.2 | -0.6 | -0.7 | -0.7 | -0.7 | -0.6 | -0.6 | -0.2 | -0.6 | -0.6 | -0.6 |
| Final Sales | -1.0 | 3.2 | 5.0 | 3.1 | 3.0 | 3.2 | 2.9 | 2.7 | 2.6 | 1.8 | 2.2 | 3.4 | 2.7 |
| *ch. in bus. inventories* | -1.2 | 1.4 | 0.0 | -0.3 | -0.2 | -0.2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 | -0.1 | 0.0 |
| Unemployment, % | 6.7 | 6.2 | 6.1 | 5.8 | 5.5 | 5.4 | 5.3 | 5.2 | 5.1 | 7.4 | 6.2 | 5.4 | 5.3 |
| NF Payrolls, monthly, th. | 190 | 267 | 239 | 289 | 185 | 230 | 210 | 200 | 190 | 194 | 246 | 206 | 208 |
| Cons. Price Index (q/q) | 1.9 | 3.0 | 1.1 | -1.2 | -2.7 | 1.7 | 1.8 | 1.8 | 1.9 | 1.5 | 1.6 | 0.1 | 1.9 |
| excl. food & energy | 1.6 | 2.5 | 1.3 | 1.4 | 1.2 | 1.7 | 1.8 | 1.8 | 1.9 | 1.8 | 1.7 | 1.6 | 1.9 |
| PCE Price Index (q/q) | 1.4 | 2.3 | 1.2 | -0.4 | -1.6 | 1.5 | 1.6 | 1.6 | 1.7 | 1.2 | 1.3 | 0.4 | 1.7 |
| excl. food & energy | 1.2 | 2.0 | 1.4 | 1.3 | 1.4 | 1.6 | 1.6 | 1.6 | 1.7 | 1.3 | 1.4 | 1.5 | 1.7 |
| Fed Funds Rate, % | 0.07 | 0.09 | 0.09 | 0.10 | 0.15 | 0.20 | 0.28 | 0.74 | 1.23 | 0.11 | 0.09 | 0.34 | 1.97 |
| 3-month T-Bill, (bond-eq.) | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 | 0.3 | 0.8 | 1.3 | 0.1 | 0.0 | 0.3 | 2.0 |
| 2-year Treasury Note | 0.4 | 0.4 | 0.5 | 0.5 | 0.6 | 1.2 | 1.6 | 2.0 | 2.4 | 0.3 | 0.5 | 1.4 | 2.6 |
| 10-year Treasury Note | 2.8 | 2.6 | 2.5 | 2.3 | 2.1 | 2.5 | 2.7 | 2.8 | 3.1 | 2.4 | 2.5 | 2.5 | 3.2 |