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Macroeconomic Highlights

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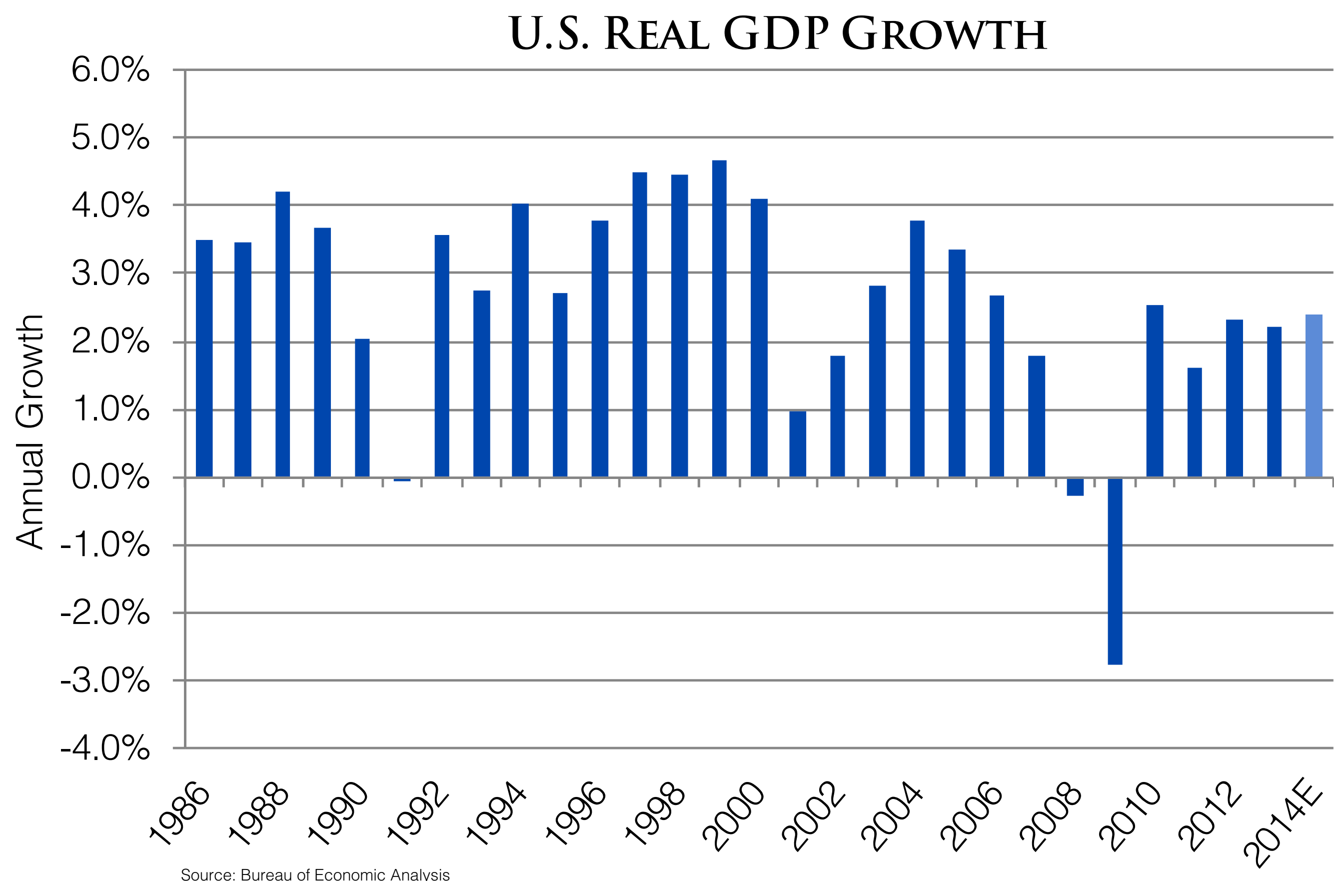
Quarterly GDP Volatility Leads to Modest Annual Growth



Source: Bureau of Economic Analysis

There were wide swings in the quarterly GDP readings in 2014 driven by a harsh winter, a jump in government spending and other temporary factors. As a result, Q1 GDP fell 2.1%, and, at the other extreme, Q3 GDP jumped 5.0%. For all of 2014, however, it looks like the U.S. economy grew close to 2.4% assuming 3.0% annualized growth in Q4, which would be consistent with the moderate 2.3% and 2.2% gains achieved in 2012 and 2013, respectively.

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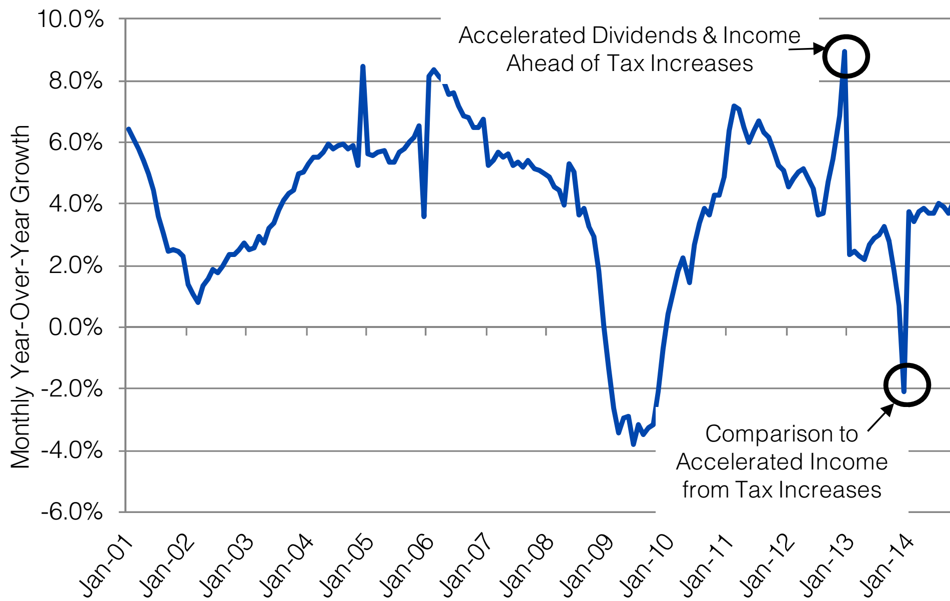
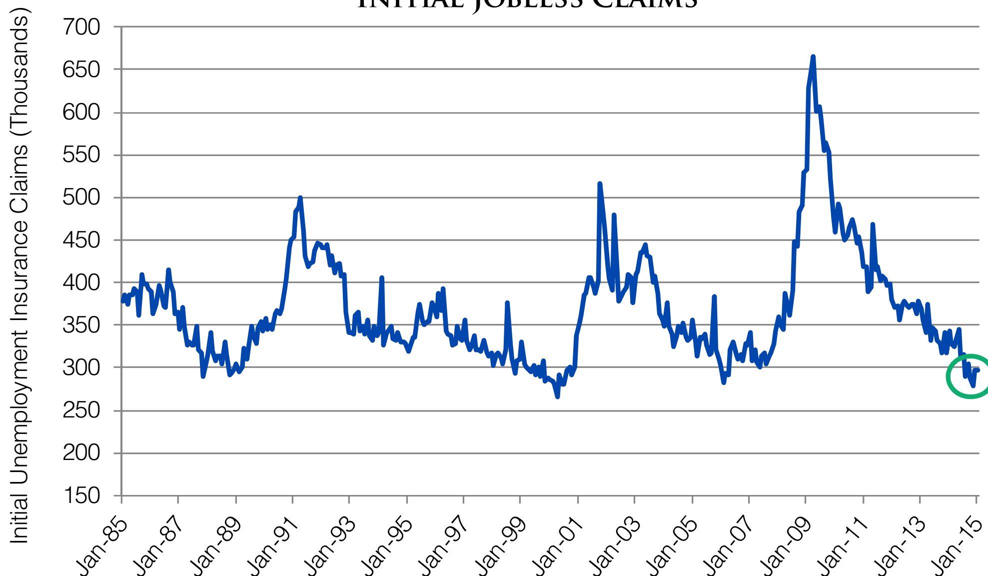
Pickup in Personal Income Growth and Low Layoffs





Income growth picked up throughout 2014. These gains were led by wages and salaries, which are the largest portion of personal income.

As of November 2014, year-over-year personal income growth was above 4.0% and at the highest pace since December 2012.

Weekly initial jobless claims are a proxy for worker layoffs. The measure has continued to slowly move lower. Weekly initial claims average 291,000 in December 2014.

Jobless claims are at a multi-decade low and approaching previous cyclical lows that occurred when the economy was smaller and there were significantly less workers.

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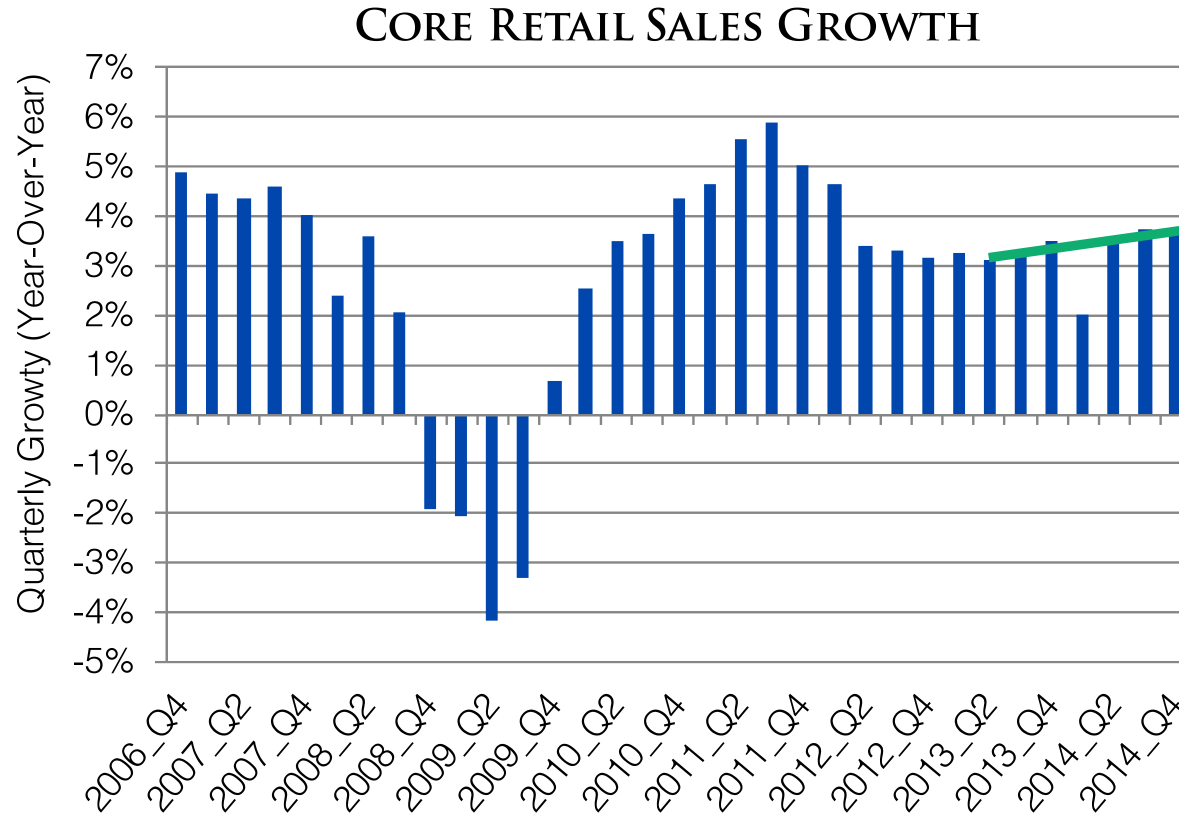
Consumer Spending Sets Up Well for 2015



Consumer spending grew at the end of 2014 as consumers benefitted from a positive fundamental backdrop. Despite the month-over-month decline in core retail sales (ex-gas, ex-autos, ex-building supplies and ex-food services) as of December, year-over-year growth remained a healthy 3.2%, and the average year-over-year growth for Q4 was 3.7%. Looking ahead, stronger income growth along with a positive wealth effect from strong equity and fixed-income returns in recent years should benefit spending by the wealthy – a group that accounts for the majority of consumer spending. In addition, spending should be supported by a strong sense of job security among workers. And all this is before a benefit, albeit marginal, from lower energy prices.

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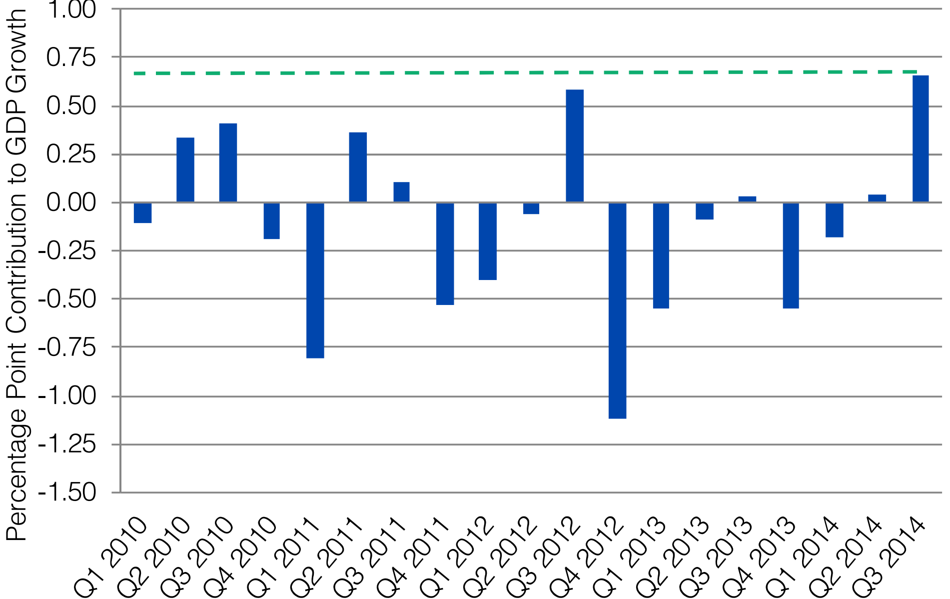
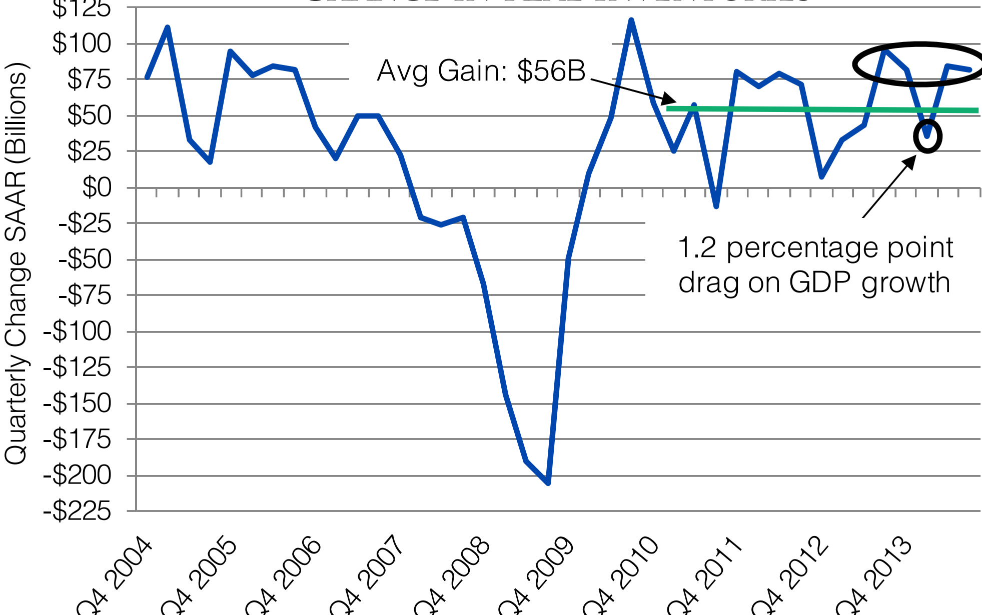
Sources of Q3 GDP Boost Likely to Reverse





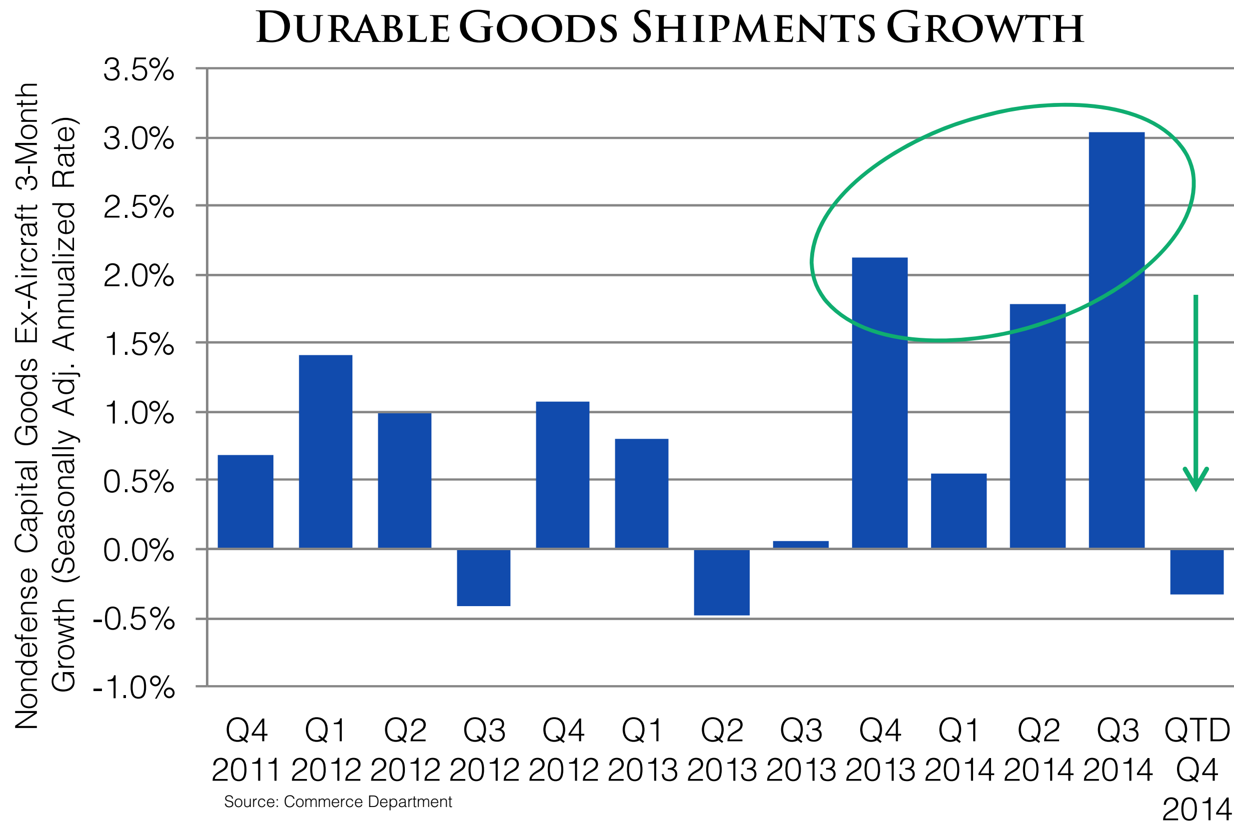
Federal government defense spending contributed 0.7 percentage points to GDP growth in the third quarter of 2014. This was the largest contribution from this category since Q2 2009.

Defense spending was a material drag on growth in Q4 of each of the last three calendar years after the category added to growth in Q3 – as it did in 2014.

Inventories have grown at a strong pace over recent quarters and have been additive to GDP growth. Inventory gains were $80 billion or higher four of the last five quarters, compared to an average of $56 billion since 2011.

Inventory growth slowed to 35.2 billion in Q1 of this year, which detracted 1.2 percentage points from GDP growth that quarter. Inventory growth would need to be $82 billion again in Q4 for inventories to be a neutral contributor to Q4 GDP growth.

Business Investment Growth Stalled in Q4



Business CapEx growth improved in 2014 as businesses invested in technology and traditional business equipment. However, as of November, seasonally adjusted Nondefense Capital Goods Ex-Aircraft (NDCGXA) shipments, which are a proxy for business CapEx spending, were on pace to decline compared to the prior quarter. This would be the first decline in six quarters and indicates business investment is unlikely to contribute to economic growth like it has in past quarters.

We continue to believe that the conditions are in place for businesses to invest, particularly in technology which is less exposed to energy related spending. These investments should drive earnings growth even in a moderate economic growth environment, but the overall pace of CapEx growth is likely to moderate in the period ahead.

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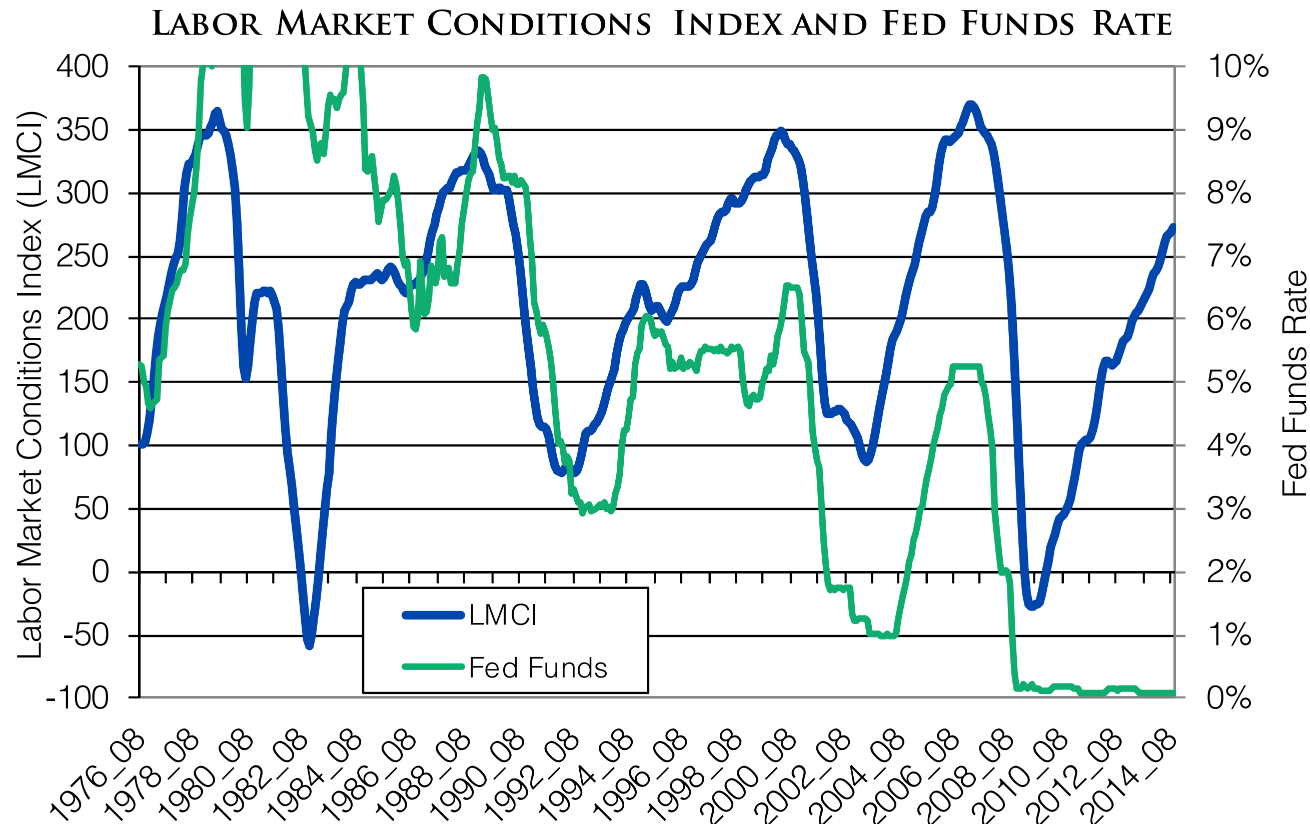
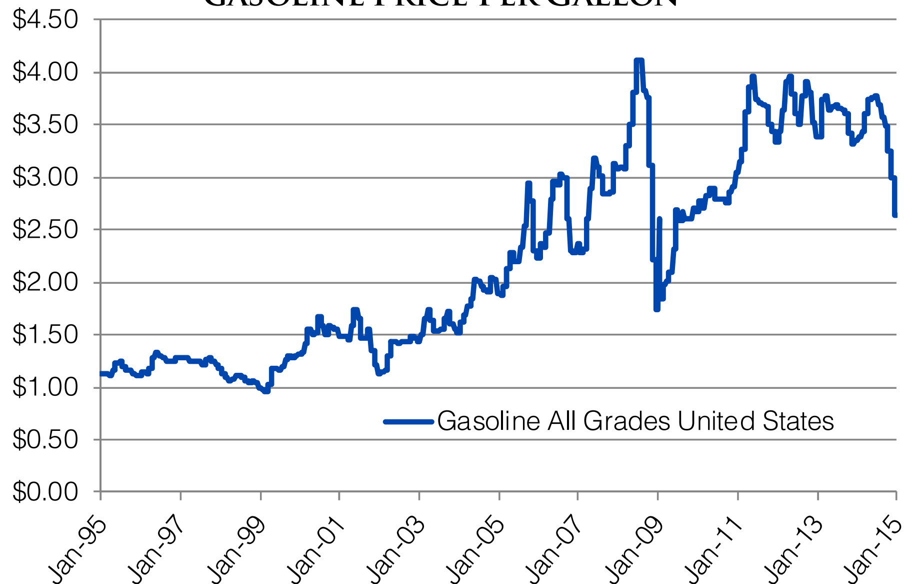
Labor Market Healing Sets the Table for Interest Rate Normalization

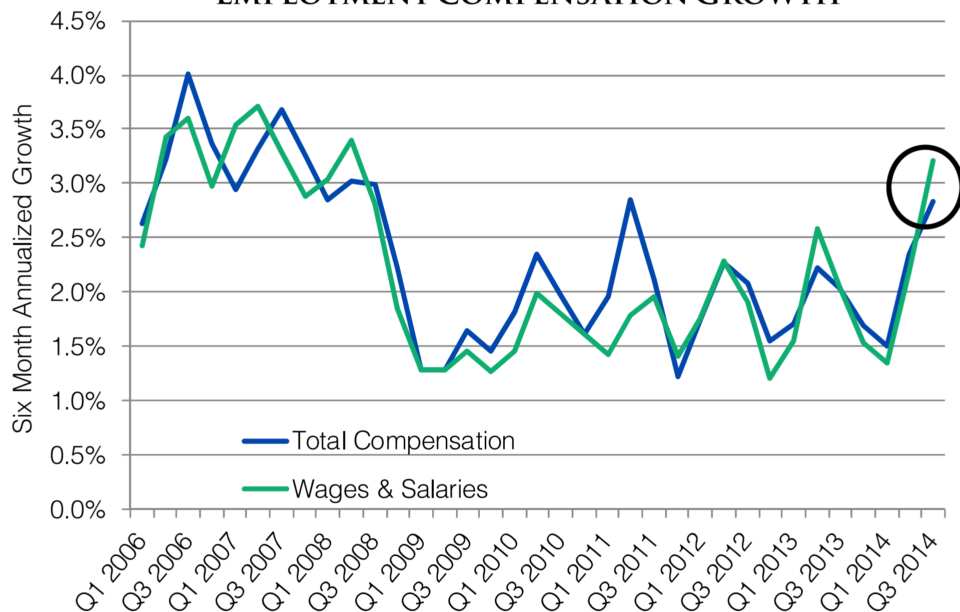


Fed Chair Janet Yellen has argued one needs to look at factors beyond the unemployment rate to assess the labor market. The Labor Market Conditions Index (LMCI) is a factor model of 19 indicators developed by the Fed that attempts to summarize labor market conditions.

The LMCI has risen in recent quarters as a broad set of labor market indicators have improved. The timing of higher long-term interest rates remains uncertain, but we believe the risk to interest rates is to the upside.

Countervailing Inflation Pressures





Inflation should remain below the Fed's 2% target as lower energy prices weigh on both headline inflation and to a lesser degree on core inflation through lower input costs.

At the same time, deflation should be less of a concern in the U.S. than abroad as the one-time-fall in energy prices will be offset in part by higher employment compensation costs and imputed rent costs, both of which are bigger drivers of price changes than oil prices.

Total compensation costs in Q2 and Q3 2014 increased at the fastest two-quarter pace since the same quarters in 2008.

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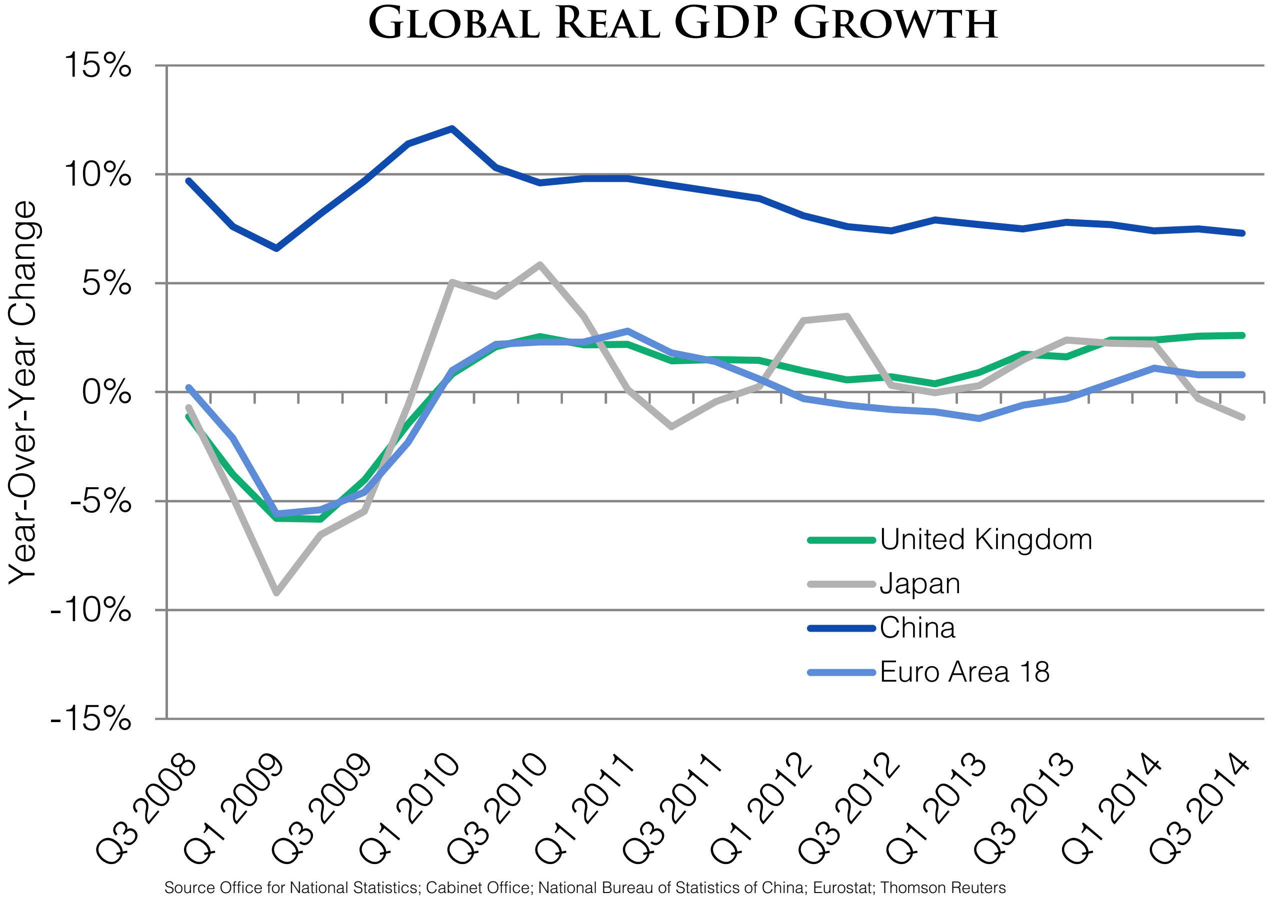
Subdued Global Growth



Source Office for National Statistics; Cabinet Office; National Bureau of Statistics of China; Eurostat; Thomson Reuters

Economic growth decelerated in the Euro Area and Japan last year as these economies experienced weak consumption growth and slow investment. The U.K. continues to be the highlight among developed countries outside the U.S. Chinese growth has slowed, but it continues to be strong in absolute terms and relative to commodity oriented emerging market economies like Russia and Brazil.

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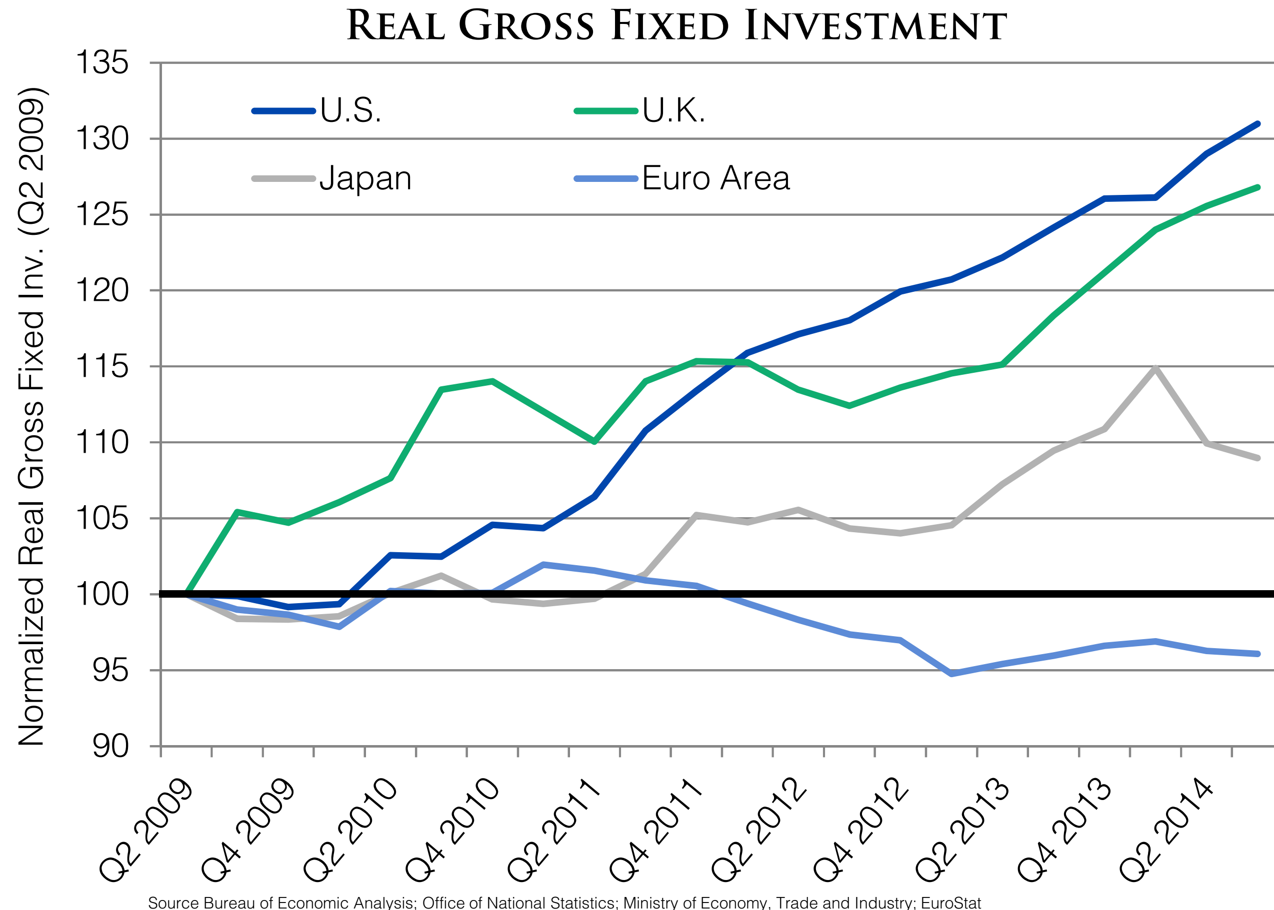
Bifurcated Investment Picture



Investment in the U.S. and the U.K. has outpaced levels of investment in Japan and the Euro area since the financial crisis. Japanese investment picked up in 2013, but has deteriorated after the consumption tax increase in April of last year. Euro area real investment has declined since early 2009 as slow and even negative economic growth together with weak global competitiveness of Euro-based businesses have limited fixed investment.

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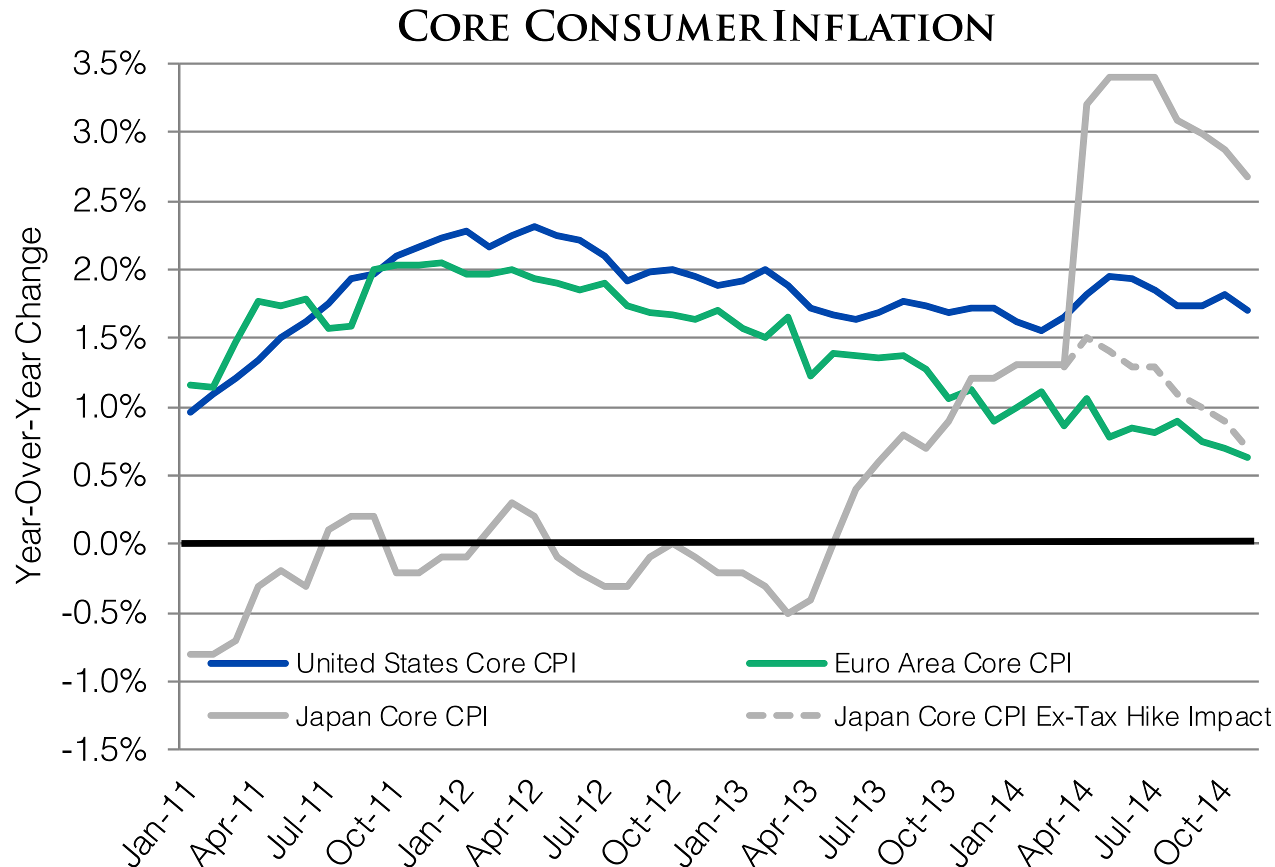
U.S. Inflation Tracks Above Europe & Japan



Source Bureau of Labor Statistics; Eurostat; Statistics Bureau, Ministry of Internal Affairs & Communication; Thomson Reuters

Core inflation, which strips out more volatile components, has trended lower across Europe and in Japan. The jump in inflation in Japan last spring was driven by the April consumption tax increase. Low levels of inflation together with slow growth have set the table for highly accommodative policy from the European Central Bank and the Bank of Japan. U.S. core inflation has been steady, but is still below the Fed's 2% inflation target.

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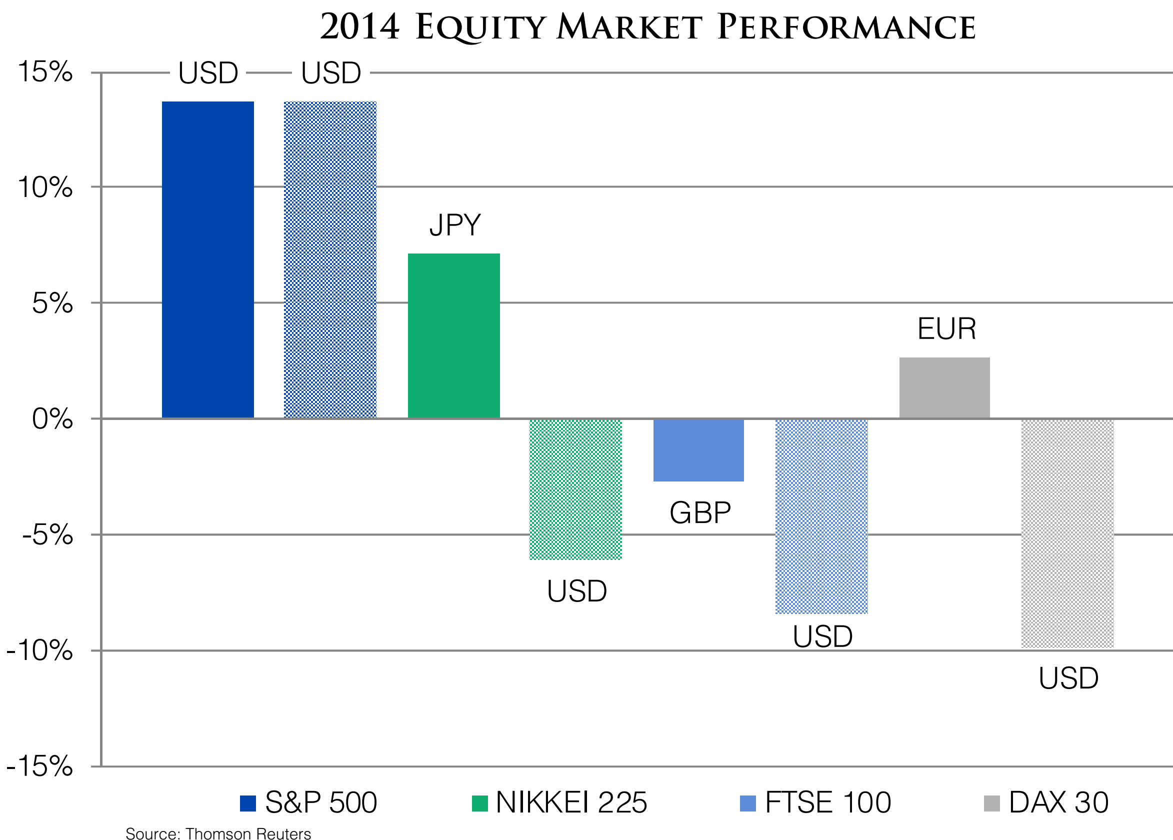
Strong Dollar Undercuts International Returns



International equities underperformed the S&P 500 in 2014 with muted returns in developed markets like Japan (Nikkei 225), the U.K. (FTSE 100) and Germany (DAX 30). International equity returns last year looked even worse in dollar terms as the Euro and Yen fell substantially compared to the U.S. dollar. The U.S. dollar will likely remain strong compared to these developed market currencies in 2015.

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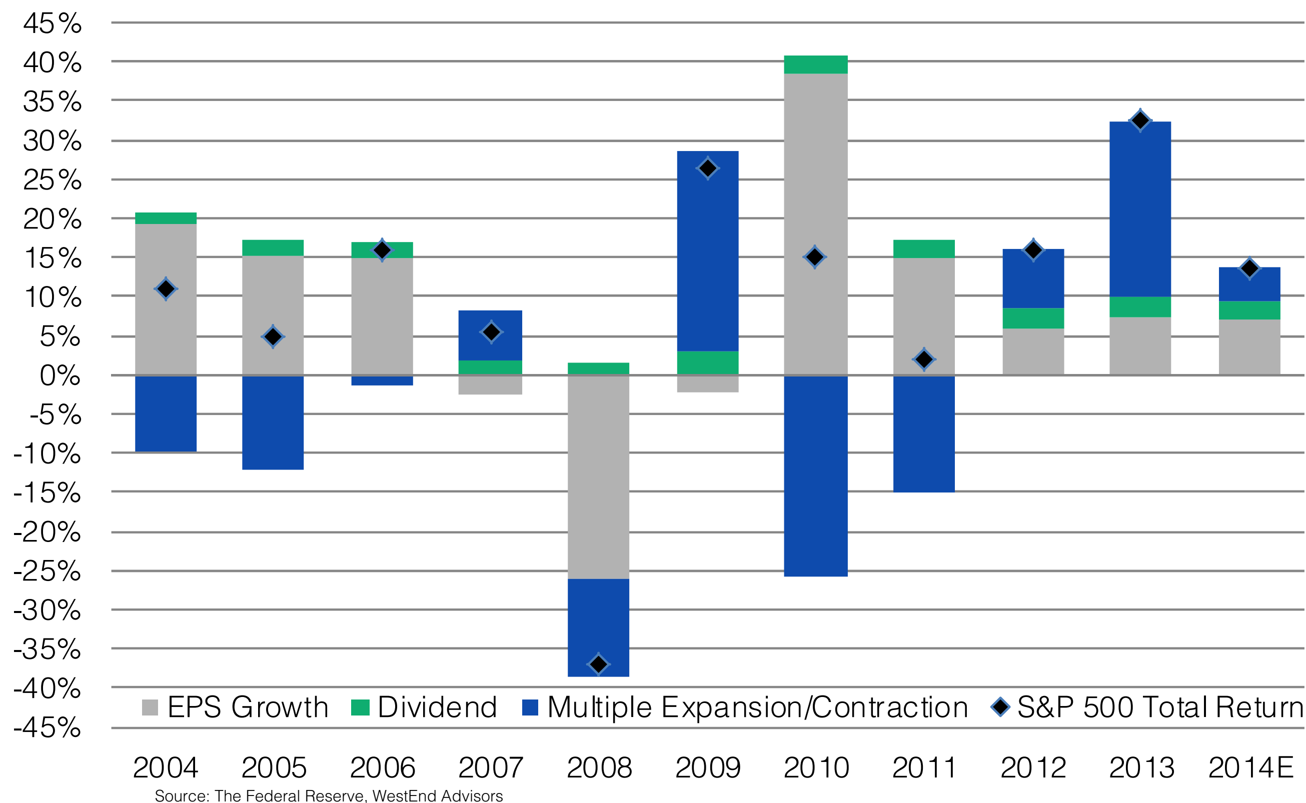
Drivers of S&P 500 Annual Returns



The S&P 500 Index has generated double-digit total returns for the past three years (2012 to 2014), even as earnings for companies in the Index have grown at a moderate, mid-single digit pace over that time. Accommodative monetary policy by the Fed, including QE, and lower interest rates likely contributed to this multiple expansion as investors were willing to pay more for company earnings growing at a modest rate in an extraordinary interest rate environment. In 2004 and 2005, S&P 500 earnings grew at a double-digit pace annually and outpaced the total return for the market. Tighter monetary policy from the Fed was a factor in the multiple contraction over this two year period.

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