Northern Trust

U.S. ECONOMIC & INTEREST RATE OUTLOOK

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• Closing the curtain on 2013

Economic growth in 2013 started slowly but seems to be closing the year well. The tone of incoming economic data in the United States has changed for the better, led by factory activity and payroll employment. The likelihood of a Congressional stalemate and another federal government shutdown looks small as we write this month's update on the economy.

U.S. real gross domestic product (GDP) in the fourth quarter is projected to grow less than 1.5% after a 3.6% increase in the third quarter. While this appears to be a big step back, the fourth quarter will be limited by a significant drag from inventories, which shot up to $116 billion in the third quarter. The underlying strength of consumption is sound, and the drag from government austerity is declining.

Key Economic Indicators

	2013				2014				Q4 to Q4 change			Annual change		
	13:1a	13:2a	13:3a	13:4f	14:1f	14:2f	14:3f	14:4f	2012a	2013f	2014f	2012a	2013f	2014f
Real Gross Domestic Product (% change, SAAR)	1.1	2.5	3.6	1.2	2.6	2.9	3.1	3.1	2.0	2.1	2.9	2.8	1.7	2.6
Consumer Price Index (% change, year-over-year)	2.1	1.0	1.7	1.0	1.8	1.9	2.0	2.2	1.9	1.2	2.0	2.1	1.5	1.7
Civilian Unemployment Rate (%, average)	7.7	7.6	7.3	7.1	7.0	6.9	6.8	6.7				8.1*	7.4*	6.8*
Federal Funds rate	0.14	0.12	0.08	0.10	0.10	0.10	0.10	0.10				0.14*	0.11*	0.10*
2-yr. Treasury Note	0.27	0.27	0.37	0.30	0.50	0.70	0.90	1.10				0.28*	0.30*	0.80*
10-yr. Treasury Note	1.95	2.00	2.71	2.65	2.74	2.88	3.01	3.21				1.80*	2.33*	2.96*

a=actual
f=forecast
*=annual average

Key elements of our forecast

- A pickup in consumer spending is nearly certain after a tepid 1.4% increase in the third quarter. Robust auto sales in November support this forecast. Net worth of households as a percent of disposable income rose to a new post-recession high of 615% in the third quarter, which is within reach of the historic high of 662%. This trend in wealth accumulation is a net positive for consumer spending.

- Equipment and software spending is predicted to reverse course after a disappointing steady reading in the third quarter. Non-financial corporations were in a comfortable position, with their liquid assets accounting for roughly 50% of their short-term liabilities in the third quarter compared with the historical median of 29%. Surely, this large cash position should be put to use in the quarters ahead.

- The partial federal government shutdown prevented data collection for housing starts; data for September through November are scheduled for publication on December 18. Sales of new homes moved up roughly 26% in October following a nearly 17% drop in the third quarter. The strength in homes sales should be viewed with caution because a 4.5% decrease in the price of a new home partly helped to propel sales. Sales of existing homes have risen in only one out of the last five months. The upward trend of existing home prices is an encouraging aspect of this market. Overall, housing sector sales data call for close tracking.

- The export index from the ISM factory survey has a strong positive correlation with the change in exports in the GDP report. The October-November readings of the export index indicate further growth in exports following gains in the second and third quarters of the year.
- The budget conference committee of 29 members from the Senate and the House is expected to reach an agreement by December 13. This is a soft deadline, as the current continuing resolution expires on January 15. The discretionary spending cap could be raised to $1 trillion in fiscal year 2014 from the sequester-related level of $967 billion. If this turns out to be the final compromise, it would be mildly positive for GDP. While there is no grand bargain on entitlements and taxes in sight, the news from Washington suggests that fiscal uncertainty could fade.
- Inflation in the United States is subdued. The personal consumption expenditure price index and the core price gauge, which excludes food and energy, posted year-to-year gains of 0.7% and 1.1%, respectively, in October. These readings are far short of the Federal Reserve's target of 2.0%.
- The November employment report, inclusive of a noticeable increase in payrolls and a lower unemployment rate, presents a case for the Fed to reduce its asset purchases. There is a strong possibility the tapering announcement could take place at the close of the December 17-18 Fed meeting. Additionally, the Fed is likely to modify its forward guidance to assure markets that tightening of monetary policy is farther away despite the decision to reduce asset purchases.
- The 10-year Treasury note yield has moved up nearly 20 basis points following the Fed's decision in September to postpone tapering, which reflects market expectations of continued forward economic momentum. So far, economic data only partially validate this outlook.
- The ingredients are in place for stronger economic growth in 2014 after three years of only 2% growth. It remains to be seen if the Fed shares this optimism and takes the step of reducing the financial accommodation that has been in place for the better part of five years.