



KEY ECONOMIC ISSUES: A BRIEF REVIEW AND UPDATE

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Summary and Major Conclusions

Traditional economic factors are positive for equity markets: The trend in corporate earnings is modestly higher for both 2014 and 2015; a tightening of monetary conditions is at least several years into the future; and most investors remain underinvested in stocks. Rebalancing of household and pension portfolios from fixed-income to equity funds will reinforce the favorable economic trends in support of common stocks.

- The objective of this week's *Economic Perspective* is to provide a capsule summary of key issues and trends in the outlook. The upcoming *Quarterly Economic Review* in early October will provide an in-depth analysis of many of these same key economic and investment issues.
- Actual growth in real GDP continues to fall short of more optimistic forecasts. However, ongoing rehabilitation of crucial sectors - households, real estate, banking, labor markets, and state and local governments - increases the likelihood of strengthening economic growth during 2014 and 2015.
- Transition from a weak and fragile recovery to a traditional self-reinforcing business cycle expansion appears to be imminent. Compared with an average annual pace of 2.2% over the past four years of recovery, real GDP growth could reach 3.5% and 4% in 2014 and 2015, respectively.
- An analysis of underlying conditions strongly suggests that the expansion is at an early phase, and that this cycle could extend for several more years. Massive underemployment and underutilization of productive resources are most relevant in this regard.
- Primary engines of US economic growth in future years will likely be residential construction, manufacturing, business capital investment, energy production, and export trade. Growth in consumer spending is likely to mirror that of overall GDP. Primary laggards will be the government and broad service sectors.
- Despite volatile data in recent months, the labor market continues to heal. Jobless claims have declined to a six-year low, while layoffs are at an all-time low. As business firms increase hiring, monthly gains in nonfarm payrolls will strengthen, unemployment will drift lower, and wage rates will improve.
- The thrust of Federal Reserve policy will shift gradually over the next two years, but will remain accommodative until 2015. A reduction in the monthly pace of bond purchases should begin later this year and continue through much of 2014. A new rate tightening cycle will be implemented slowly beginning in 2015.
- Risks associated with the looming debt ceiling and bipartisan agreement on a new budget for the new fiscal year have escalated in recent days. The ultimate outcome is unclear at this time and a government shutdown is becoming increasingly likely, with potentially profound implications for financial markets.
- The direction of financial markets will be determined by the pace of economic growth. Common stocks should perform best in future years in an environment of accelerating GDP growth. Conversely, rising credit demand and tightening monetary conditions will exert upward pressure on interest rates and downward pressure on bond prices.

This week's *Economic Perspective* provides a capsule summary of key issues and variables associated with the outlook for the economy and financial markets over the next two years. As opposed to the normal in-depth analysis, this report is designed to serve as a brief reference for both the overall outlook as well as an update of critical variables in the economic and investment outlook.

US Economic Growth - Despite remarkable consistency and sustainability, the pace of the economic recovery has consistently disappointed, especially in recent quarters. However, underlying economic and financial conditions are steadily improving with the passage of time, thereby laying a solid foundation for more robust growth in future years. The most notable sectors in the healing process include real estate, manufacturing, banking, households, and the labor market.

- **Growth Outlook** - Improving fundamentals will become increasingly evident in quarterly GDP data. Compared with an average annual pace of 2.2% over the past four years of recovery, real GDP growth should begin to accelerate to 3.5% in 2014 and to 4% in 2015. Widespread underutilization of productive resources along with a large pool of underemployed workers increases the odds of an extended period of economic expansion.

Consumer Spending - Private consumption has been a persistent drag on GDP growth during the recovery phase, constrained by sluggish job growth, depressed wages, and a protracted deleveraging cycle. A reversal of each of these factors should boost spending in future years.

- **Consumption and GDP** - However, an outright boom is highly unlikely: Consumer spending should expand at a moderate 3% average annual rate over the next two years, which should lag growth in overall GDP. Faster growth in total GDP will be derived from key non-consumer areas, namely housing, business capital investment, manufacturing, export trade, and commercial construction.

Housing - Despite growing concerns regarding rising mortgage rates, the outlook for the housing market remains positive because of powerful offsetting factors: A steadily improving labor market; increasing availability of credit; a near record affordability index; and a potentially rapid rebound in household formation.

- **Supply and Demand** - The current very favorable supply/demand balance has lifted homebuilders' confidence to the highest level in eight years. The bottom line is that a multi-year recovery in housing lies ahead, which could add 0.5 percentage points to real GDP growth in each of the next three years.

Corporate Profits - Although corporate earnings have stabilized at record levels in recent quarters, the outlook for future growth remains favorable. In the absence of a rising trend in labor costs, business firms should be successful in maintaining profit margins at current record levels. Resumption of revenue growth will occur in conjunction with more rapid growth in the global economy. Following low single-digit growth in recent quarters, corporate profits should rise by 8-10% in each of the next two years.

Export Trade - US exports have performed well in recent years, with annual growth in excess of overall world trade. The slowdown in recent quarters can be attributed to purely cyclical factors relating to profound weakness in domestic demand in Europe, China, Asia, Latin America, Canada, and the UK. Growth in US exports should begin to accelerate in future years in response to more rapid growth in world trade.

Consumer Inflation - The outlook for inflation remains favorable for both 2014 and 2015. Compared with an average of 2.0% over the past decade, consumer inflation has declined to close to 1.0% over the past year. A massive output gap, an absence of wage pressures, a firm US dollar, and weakness in money and credit are all supportive of continued low inflation. Although a cyclical bottom is at hand, inflation is likely to rise to only 2% in 2014 and 2.5% into 2015. Wage inflation is also extremely well contained.

Employment - US labor market conditions remain mixed: Layoffs have declined to a record low, while new hiring activity remains depressed. The result has been a consistently lackluster monthly pace in net new job creation over the past several years, and a surplus of underemployed workers. The most likely outcome is a continued gradual strengthening in the labor market, but at a moderate pace and accompanied by chronically high underemployment.

Federal Reserve Policy - Last week's FOMC meeting provided strong evidence that US monetary policy is likely to err on the side of ease for the foreseeable future. In sharp contrast to market expectations, the FOMC announced no change in the pace of its monthly bond buying program of \$85 billion. The Fed statement cited concerns over current economic trends, most notably rising mortgage rates, mixed monthly housing data, sluggish employment conditions, and unusually low inflation, as well as potential risks associated with the 2014 federal budget.

The most plausible assumptions regarding the future thrust of policy are as follows:

- Policy will remain **accommodative** for the next year.
- The FOMC will withdraw extraordinary monetary stimulus at a **gradual pace**.
- The FOMC will likely end **quantitative easing** by the middle of next year but not begin a new **rate tightening cycle** until 2015.
- The pace of tightening will be **"data dependent"** - the thrust of Fed policy will be dictated by the strength of incoming economic data.

Nonetheless, the enormous operational and technical challenges involved in a Fed exit strategy should not be minimized. Execution of the Federal Reserve's normalization of monetary policy is a critical variable in the outlook for financial markets, and periods of market instability are likely along the way. The imminent replacement of Ben Bernanke as Federal Reserve chairman will only compound the uncertainty over the future direction of policy.

Interest Rates - The three-decade downtrend has ended and an extended period of rising interest rates lies ahead. Accelerating economic growth, rising credit demand, increasing inflation, and a multi-year monetary tightening cycle will combine to exert upward pressure on borrowing costs over a several year period.

- **Rate Forecast** - As measured by the ten-year US Treasury note, rates should end this year close to 3%, rising to 3.75% in 2014 and to 4.5% in 2015. The already steep yield curve will steepen even further over the next year, followed by a multi-year flattening trend as the rate tightening cycle unfolds. Credit spreads in the corporate bond market should gradually tighten over the next two years, consistent with a strengthening economy.

Fiscal Policy - Political developments relating to the 2014 budget and debt ceiling constitute a major wildcard in the outlook. Failure of Congress to enact new legislation authorizing government spending for the new fiscal year beginning on October 1 could result in a disruptive government shutdown. In addition, the need to lift the debt ceiling later next month could engender profound financial market uncertainty. Finally, continued austerity with respect to federal spending would be a negative for both the economy and financial markets.

- **Policy Outlook** - A bold and aggressive posture adopted by House Republicans in recent days has increased the likelihood of a government shutdown on October 1. Risks associated with the looming debt ceiling have also increased, although political compromise at the eleventh hour will likely prevent an unthinkable default on US debt. On balance, fiscal policy developments are almost certain to trigger at least a temporary setback in global financial markets in future weeks.

World Economy - Following a period of weakness, there is some preliminary evidence that the world economy is stabilizing, which implies faster growth during the 2014-2015 period. However, a cyclical recovery will in all likelihood be sluggish and uneven. The IMF's July update assumes world GDP growth of 3.1% in the current year and 3.8% in 2014.

- **All Regions Improving by 2015** - The eurozone appears to be stabilizing at a very depressed level, while the Japanese economy has begun to respond to an easing of monetary, fiscal, and currency policy. Most importantly, recent data from China offers some encouragement that its economy may be in recovery mode. Faster growth in each of these regions should provide solid support to the key developing economies of Asia and Latin America.

Commodities - The commodity supercycle that began in the early 2000s appears to have run its course: Major shifts in both supply and demand imply a more challenging environment ahead. Commodity prices have languished in recent years and are 20% below the cyclical peaks of early 2011.

- **Supply and Demand** - Demand will be impacted by a slower pace of global economic growth, more moderate growth in world trade, much slower growth in China, and a more resilient US dollar. Capital investment and mining activity have strengthened significantly in recent years, implying a steady rise in capacity. Real commodity prices are likely to trend lower over the next five years.

Fixed-Income Markets - A long-term secular bear market in bonds is already underway, and could persist over a multi-year period. Steadily rising interest rates will exert relentless downward pressure on bond prices, producing negative rates of return during each of the next three years.

- **Negative Rates of Return** - Following a negative total return of 3.5% in the current year, bond investors are likely to suffer further losses of 3% in each of the next several years, as measured by the Barclays Capital Aggregate Bond Index. The yield curve will continue to steepen in future months but will begin a flattening trend during the final months of 2014 that should persist through 2016.

Equity Market - The current cyclical bull market in common stocks has been one of the most powerful on record, with compound annual rates of return exceeding 22.5% since the lows of March, 2009. The path of least resistance for the equity market is upward in an environment of sustained economic growth and reasonable market valuation, with prospective annual rates of return in the high single digits.

- **Fundamental Factors** - Traditional economic factors are positive for equity investing: The trajectory for corporate earnings is modestly higher in both 2014 and 2015; an effective tightening of monetary conditions is at least several years into the future; and most investors remain underinvested in stocks.

The Great Migration - Over the past fifteen years, fixed-income assets held by households and retirement funds surged from only \$4.7 trillion in 1998 to a staggering \$12.1 trillion in 2013, or 35% of total invested assets. A shift in asset class allocation will trigger a gradual but steady migration out of fixed-income and into equity funds over the next five years, and reinforce the favorable fundamental trends in support of common stocks and negative fundamental trends for bonds.



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