ECONOMIC OUTLOOK & POLICIES

• In December 1982 the U.S. economy began a unique **Great Expansion** as the young baby-boomers formed households and increased **consumption** and **housing** spending, sustained by **private** and **public debt** and **declining personal saving rates.** Effective monetary policies **slashed inflation** from an 18% annual rate in early 1980 to a relatively stable 2% to 4% pace. **Global** economic activity accelerated in Japan, Europe, and many Emerging Market and Developing Economies thereby creating trade and investment.

• During the next 25 years, the U.S. economy reported sustained growth in **284** out of **300** months (with only two very brief and moderate recessions in July 1990 to March 1991 and March 2001 to November 2001), plus **moderate inflation** and **unemployment** rates, large chronic global **current account deficits**, large chronic **federal government budget deficits**, and flexible **monetary accommodation** relying on traditional policy tools.

• That **Great Expansion** was **shattered** by the **severe economic downturn** that began in January 2008 when the cumulative housing bubble collapsed exposing **systemic** financial system **liquidity** and **solvency** problems (aggravated by hubris, greed, and fraud) that evolved into the global **Great Recession** that became the **"deepest, longest,** and **most diffused"** **economic crisis** since the debilitating **Great Depression** of the 1930s.

• A **"slow, long, and erratic"** economic recovery began in **July 2009**. It was **63 months** old on September 30th when the third quarter ended. During this **disappointing** recovery **average annual real economic growth** has been only **2.2%** compared to a historical cyclical recovery pace of **4.2%.**

• The **consensus** forecast is that the U.S. economy is now in a **New Normal** era with a potential real GDP growth rate of only about **2%** because of the significant slowdown of labor force growth caused by demographic trends, moderate productivity prospects, and the lagged impact of inadequate private and public investments necessary to prepare for the future **integrated** and intensely **competitive** world economy.

• I believe the next decade probably will have a **lower** and **more volatile** average GDP growth rate than during the **Great Expansion** era (3.33%); **higher unemployment** and **underemployment** rates; **higher inflation** rates (potential not immediate); gradually **lower current account deficits** (reflecting global economic competition trends and the truly extraordinary development of domestic energy resources); **chronic government budget stress** caused by the continued unwillingness of the general public and government officials to respond to reality; and an **asymmetric reliance** on **accommodative monetary** policies.

• The **New Normal** probably will continue until the global financial markets apply marketplace **discipline** when the gross national debt ($17.8 trillion) has to be financed with **higher interest rates** during the ominous **"demographic twist"** leading to the extended retirement income and medical care benefit claims of the large baby-boom generation.

Current Economic Trends

• At our shareholders meeting one year ago I **changed** my **near-term** economic outlook:

"After six years of **severe recession** and **disappointing recovery**, the U.S. economy finally is moving into the **expansion** phase, with **robust** and **more balanced economic growth of 3%** projected for 2014 (4th over 4th quarters).

This will be the **"sweet spot"** in the business cycle – when output and employment growth accelerate **before** new **inflation** pressures develop and the next **boom/bust sequence** begins.

Households suffering **"austerity fatigue"** have returned to the **familiar consumption model** of buying new cars and light trucks, houses, consumer electronics, appliances and furnishings, eating out, travel, entertainment, health care, and public transfer payments and services **financed** by **private** and **public debt** with unusually low interest rates.

Dysfunctional fiscal policies have **stabilized** enough to allow governments to "kick-the-can-down-the-road" by **postponing** spending and tax decisions until after the important Congressional elections in 2014 and the contentious presidential contest in 2016. The gross national debt will be over **$19 trillion**, with **rising interest rates,** by that latter target date.

Monetary officials will **cleverly swap** their **unconventional quantitative easing** tactic of **crudely creating money** to pump directly into the financial system to **reflate** the economy – **specifically** financial asset and real estate prices – for an aggressive **"forward guidance"** system by rhetorically **pledging to extend accommodation**."

• My **"robust" 3% real GDP forecast** for **2014** (4th over 4th quarters) **was demolished** when the convergence of severe winter weather and several **puzzling** statistics caused the real GDP figure to **decline** at a **2.1%** seasonally adjusted annual rate during the first three months of this year. That **disappointing** GDP result was then **reversed** during the second quarter when balanced real **growth surged** at a **4.6%** annual rate. The real GDP probably increased at about a **3%** pace during the **third quarter** and a **3%** forecast for the **fourth quarter** is reasonable unless "externalities" explode (wars, ebola panic, stock market prices).

• Therefore, the 2014 GDP growth figure (measured 4th over 4th quarters) probably will be about 21/4% -- **far below** my robust baseline projection of **3%** -- but the U.S. economy now appears to have **followed a 3% growth path since** the severe winter weather and puzzling first quarter results and **that average pace probably will continue into 2015**, with the usual quarterly variations caused by erratic inventory spending and net exports. But this **positive** outlook may once again be **demolished** by **unpredictable externalities**.

• Major sectors of the economy have followed the projected path. **Personal consumption** – approximately two-thirds of the entire GDP – has been the driving force as car and light truck sales have surged and nondurable goods and services have contributed positive gains. **Business fixed investment** has recovered from a weak first quarter and appears to be accelerating. **Residential construction** returned to a moderate growth pace following the negative first quarter results influenced by cold weather. **Net exports** have been a negative factor because stronger domestic growth has increased imports rapidly. The **federal government** sector has been a modest drag on GDP growth but that restraint has eased steadily this year. The **state** and **local government** sector finally has contributed to total GDP growth after several years of negative results.

• The **headline** and **core** (food and energy prices deleted) **CPI** price indexes increased 1.7% during the last 12 months, slightly below the **2%** forecast. The cumulative effects of **decelerating global growth** – particularly in several Emerging Economies and Europe – and **abundant supplies** of petroleum, food, and other raw materials have **curtailed** the inflation pressures. During the last 12 **months** petroleum prices (West Texas intermediate) have **declined** 19% to the $82 zone, despite geopolitical crises and wars in many major producer nations, and *The Economist* commodity-price index (dollar index) has **declined** 5.1%, with food prices down 4.6%, non-food agricultural products down 18.8%, and metals up 0.3%. **Moderate labor costs** also have held down inflation pressures. Europe and Japan continue to face difficult **disinflation** risks because prevailing demand and supply factors have neutralized their aggressive monetary and fiscal stimulus actions.

• My baseline forecast one year ago anticipated a continued decline in the unemployment rate resulting in a **6½% average** for the year and a figure close to **6% by yearend**. The average unemployment rate during the first ~~seven~~ nine months of 2014 has been **6.3%** and the September rate declined to **5.9%.** This positive trend reflects the **faster creation** of new payroll jobs (average 213,000 per month during the last twelve months) and the decline of the labor force **participation rate** to **62.7%** in September – the lowest figure reported since 1977.

• The international **current account deficit** has stabilized at about **2½%** of GDP, as originally projected, as the remarkable surge in domestic energy resource development has increased petroleum product exports and restrained crude petroleum imports.

• The **FY 2014** federal budget **deficit declined** to **$483.4 billion** (2.8% of GDP) far below my estimate of $600 billion and the **FY 2009 deficit** of **$1.413 trillion** (9.8% of GDP). **Spending** increased only 0.8% to $3.504 trillion because of strict caps on discretionary outlays (defense and domestic programs), mandated by legislation in 2011 and 2013, while **revenues** surged 9% to $3.021 trillion (including large payments from Fannie Mae, Freddie Mac, and the Fed). The **CBO** now projects a **cumulative $7.2 trillion gap** for **FY 2015-2024**.

• **Summary**: The U.S. economy **now appears** to be **tracking** the **3%** projected growth path since the surprising negative figure reported for the first quarter. **Inflation** pressures remain moderate given the sluggish increase in labor costs, weak global demand, and abundant supplies of labor and material resources. The **unemployment rate** has declined steadily to the 6% zone as expected because of the strong creation of new payroll jobs

and the unusually low participation rate. The **federal budget deficit** has declined sharply – in absolute terms and relative to the GDP – and **fiscal** debates remain dormant pending the upcoming political elections. The mandated spending and tax restraint effects on the GDP gradually are easing. **Monetary** policy gradually has phased out the third version of its unconventional quantitative easing program, which is projected to end this month, and emphasized the **"forward guidance"** that the "zero boundary" policy interest-rate target will continue until fundamental growth and employment targets **clearly** are achieved.

First Look at 2015

• **More of the Same: I expect real GDP growth to continue in the 3% zone; inflation to remain moderate in the 11/2% to 2% range; the unemployment rate to continue to decline, but at a slower pace, to the 51/2% zone as the participation rate stabilizes and workers return to the labor force as job prospects improve; the international current account deficit to remain stable in the 21/2% of GDP zone; the FY 2015 federal budget deficit to remain in the $500 billion zone; monetary policy to remain basically accommodative, with no change in the "zero boundary" policy interest rate target until at least mid-year given the modest inflation outlook and uncertain employment and income risks caused by global economic and geopolitical issues.**

• Personal **consumption** will continue to be the driving force in overall economic growth, particularly car and light truck sales and services. The **ability** of households to spend (job and income gains) and **willingness** (consumer confidence, rising consumer debt, and low personal saving rate) will sustain solid growth. **Business fixed investment** will continue to grow at a cautious pace. **Residential construction** will slowly increase to meet the pent-up demand created by new household formations. **Net exports** will continue to be a small negative factor as the relatively faster growth rate in the United States draws in imports. The fiscal drag of restrained government spending will continue to ease. The FY 2015 **federal budget deficit** will remain in the $500 billion range as political tensions continue policy gridlock. **Monetary** policy officials will monitor economic growth, employment and unemployment conditions, the forex status of the U.S. dollar, and the results of fiscal policies to determine the timing of future policy adjustments. **I believe the Fed will be very cautious in changing policies because the majority of the FOMC believe that accommodative policies can increase growth without igniting inflation; the benefits of more growth exceed the costs of potential inflation; promoting faster growth is the best and fastest way to return to traditional policy tools; and it is better to error on the side of prolonged accommodation rather than premature tightening.** Most political and economic officials and analysts continue to **support** this viewpoint.

• The **major risks** to this forecast include: continued deceleration of **global economic activity** thereby limiting trade and investment; a major slowdown of economic growth and/or serious credit crisis in **China**; **geopolitical** and **military** crises; global **supply-side, weather** and **health** shocks; **stagnant personal income gains** may erode household spending; excessive **fiscal restraint**; reactions to premature and/or excessive **monetary policy tightening**; **oil price** shocks; and large negative **"demographic twist"** fiscal and labor-force effects of the rapid acceleration of the baby-boom generation retirements.