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VIEWPOINT

A Stephens Inc. Economic and Financial Commentary

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The years since the end of the last recession have been a struggle for the U.S. economy. For every upbeat economic story there has been an offsetting report of economic gloom. However slow the economic progress had been, news has gotten better for the economy and battered American workers.

The country experienced two quarters of 4% growth in 2014, but economic headlines are again raising doubts about the “rosy scenario” for 2015 envisioned by many economists. Bloomberg.com recently wrote that the U.S. economic data have been the “world’s most disappointing.”

Let’s look at the state economy and the “buts” that are prompting the recent gloominess in headline news.

- Strong quarterly economic growth in 2014 **but** a disappointing growth report in the last quarter of the year.
- Falling rate of unemployment along with lower jobless claims **but** almost stagnant real wage growth.
- Quiescent inflation **but** a rising fear of deflation due to falling commodity prices, especially energy prices.
- Improving trade deficits **but** concerns about the competitiveness of American exports resulting from a stronger U.S. dollar.
- Strong corporate earnings and stock market returns **but** eroding earnings of American multinational companies because of the stronger American currency.

Economic Growth

"Third Quarter 2014 U.S. Growth Strongest in 11 Years" (Reuters)

"World Bank Cuts Forecast for Global Growth" (The Financial Times)

The two headlines above capture the essence of the economic growth story.

- The U.S. economy is forecasted by the World Bank, the International Monetary Fund (IMF) and many other organizations to grow at just over 3% in 2015, a slight increase from previous forecasts.
- **But**, many major world economies are struggling to generate any positive growth. For example, Japan and the Euro zone have seen little or no growth since the end of the global recession. The World Bank and IMF have lowered their forecasts for the global economy—little or no growth in 2015 (*See Figure 1.*)

Figure 1:
Actual and Forecasted Real Gross Domestic Product for Select Countries (2012 to 2015)

	2012	2013	2014e	2015f
REAL GDP [1]				
World	**2.4**	**2.5**	**2.6**	**3.0**
High income	**1.4**	**1.4**	**1.8**	**2.2**
United States	2.3	2.2	2.4	3.2
Euro Area	-0.7	-0.4	0.8	1.1
Japan	1.5	1.5	0.2	1.2
United Kingdom	0.7	1.7	2.6	2.9
Russia	3.4	1.3	0.7	-2.9

Note: e means estimated and f means forecasted.

Source: The World Bank. *Global Economic Prospects*. (Table 1.1: Global Outlook in Summary). January 2015. Page 4.

A growth rate of 3% in 2015 seems quite reasonable for the U.S. given its recent performance. (*See Figure 2.*) With the exception of weak GDP growth due to unusual weather conditions in the first quarter of 2014 and possibly again in the snowy first quarter of 2015, the economy has demonstrated the ability to grow annually at or near 3%. The United States, and to a lesser extent, the United Kingdom seemed to have sloughed off the ill effects of the last global recession.

Figure 2:
Quarterly Percentage Changes in U.S. Real GDP (Q1 2013 to Q4 2014)

Time Period	Change in Real GDP
2013 Q1	2.7%
2013 Q2	1.8
2013 Q3	4.5
2013 Q4	3.5
2014 Q1	-2.1
2014 Q2	4.6
2014 Q3	5.0
2014 Q4	2.2
Average for the 8 quarters	**2.8%**

Source: Federal Reserve of St. Louis. *National Economic Trends*. January 2015, Page 6.

Reasonably strong growth is still forecast for **many parts of the world — excluding Europe and Japan**. But most forecasting organizations are predicting a slight decrease in the expected rate of global growth. Four months ago the IMF thought that the world output would grow at 3.8% in 2015 and 4.0% in 2016. Now the IMF sees a drop in forecasted global growth of .3% in both years. (*See Figure 3*.)

Figure 3:
International Monetary Fund Projections for Growth

	2013	2014	2015f	2016f
World Output	**3.3%**	**3.3%**	**3.5%**	**3.7%**
Advanced Economies	1.3	1.8	2.4	2.4
Emerging Market and Developing Economies	4.7	4.4	4.3	4.7

Note: f means forecasted

Source: International Monetary Fund. *World Economic Outlook: UPDATE*. January 19, 2015, Page 3.

The downward revision to global growth is tied to a slowdown in Europe, Japan, Russia, Brazil and China among others. The United States is the one large economy where the IMF revised its forecasted growth upward for 2015 by .1% to 3.6%. This upward revision is based on falling energy prices that the IMF thinks will be positive for the American economy because of extra purchasing power for consumers.

Best Guess of U.S. Economic Growth

The U.S. economy should maintain the momentum that it has experienced over the past 24 months. Growth has averaged close to 3%, and we expect that the economy will continue to grow at slightly less than that for the next 12 months — 2.75%. Growth will be aided by low and falling energy prices — except in oil-intensive states like Texas, Oklahoma and North Dakota which we believe will suffer. But on balance, low oil prices combined with the Federal Reserve's low interest rate policy are powerful forces for sustainable growth.

But, it is quite possible that the **first quarter 2015 may be 2% or less** for several reasons:

- Severe weather conditions in much of the country
- Falling consumer confidence since the start of 2015
- Sluggish labor productivity
- Negative impact of the strong dollar on exports

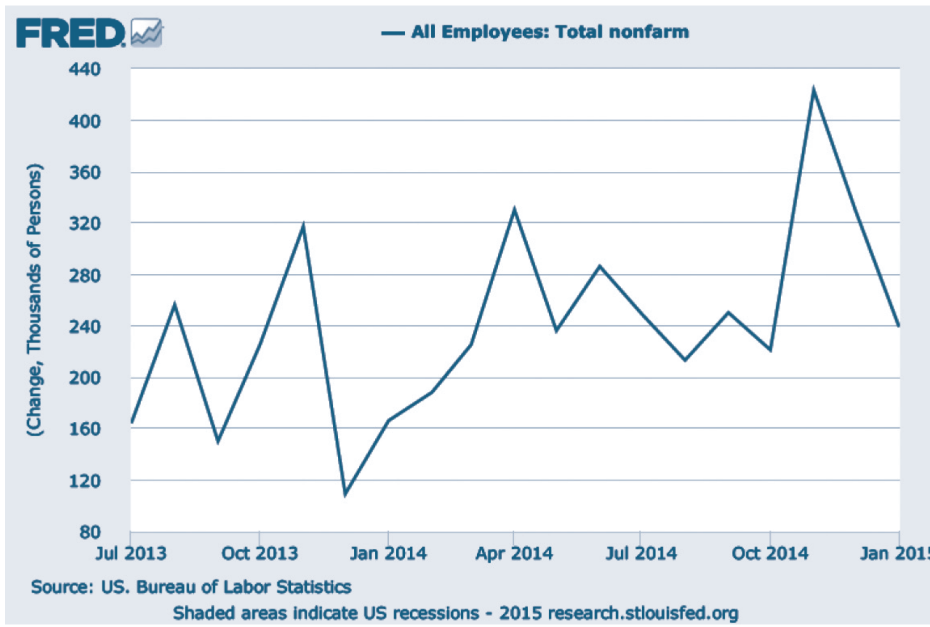
American Employment and Labor Markets

"Job Outlook for 2015: Work Aplenty" (USA Today)

"Solving the Puzzle of Stagnant Wages" (The Wall Street Journal)

The American economy starting in late 2013 produced strong job creation with monthly jobs of about 250,000 additional jobs per month. (*See Figure 4.*) Labor economists and other analysts believe that monthly job creation of about 250,000 is needed to significantly reduce U.S. unemployment. This job creation has helped to reduce the current unemployment rate to 5.5%, a rate consistent with almost full employment.

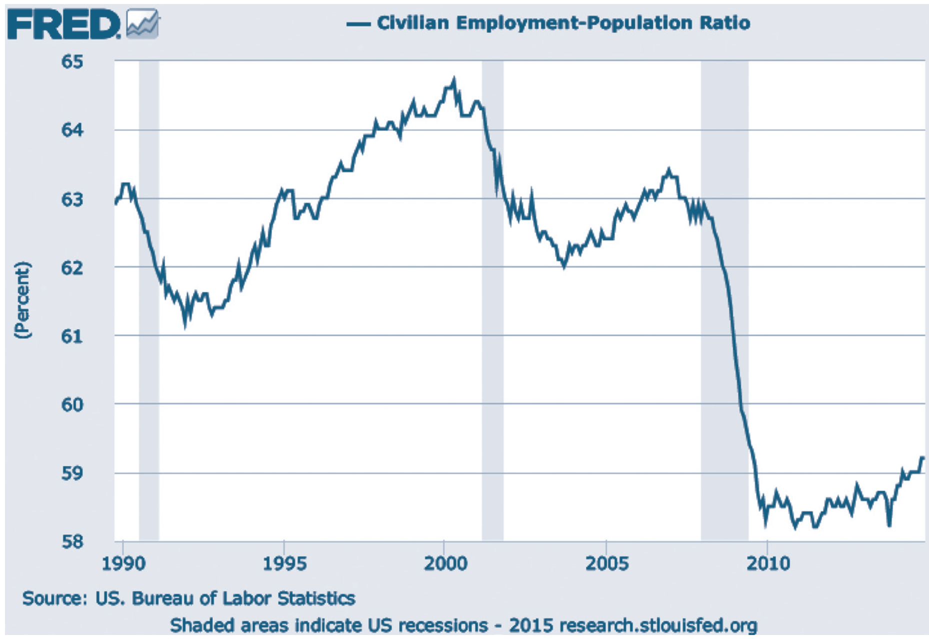
Figure 4:
Monthly Change in Non-farm Payrolls (July 2013 to January 2015)



Source: Federal Reserve of St. Louis. Extracted from the Federal Reserve Economic Database (FRED). March 19, 2015.

Strong job creation, a low unemployment rate and a low level of initial jobless claims all indicate a healthy U.S. labor market. **But** a less encouraging dimension to this labor market is that the percentage of working-age people in the workforce is near a multi-decade low. (*See Figure 5.*) The civilian employment-to-population ratio measures the percentage of individuals age 16 to 64 who are currently employed compared to the total number of individuals in that population. This ratio remains at a very depressed level.

Figure 5:
Civilian Employment-Population Ratio (1990 to Present)



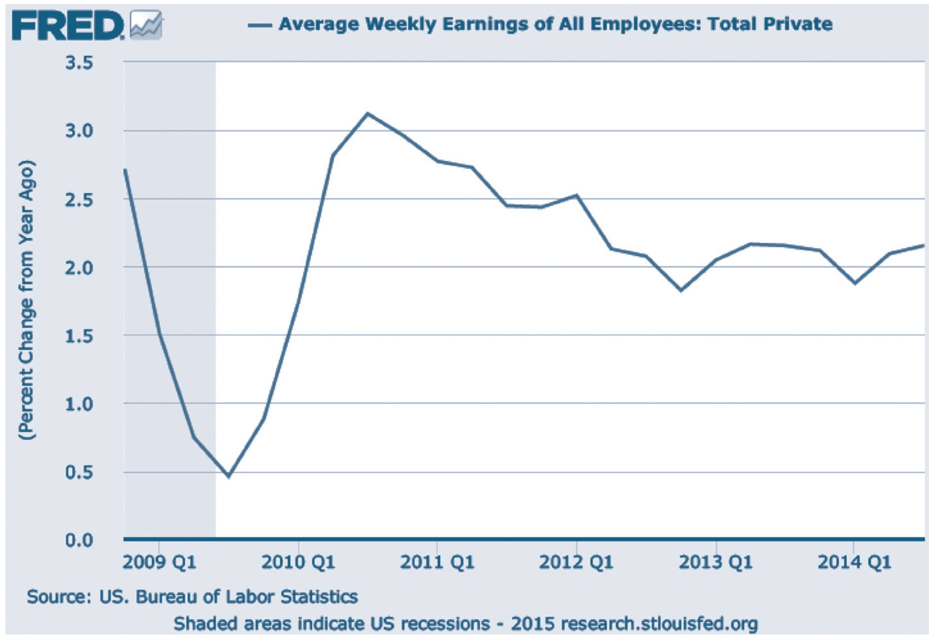
Source: Federal Reserve of St. Louis. Extracted from the Federal Reserve Economic Database (FRED). March 3, 2015.

Liberals and conservatives can argue endlessly over the causes of the precipitous drop in the number of employed individuals. Conservatives will argue that regressive policies of the Obama administration and previous Democratic Congresses contributed to a drop in the employment ratio. Liberals argue that the deep recession and slow recovery caused by the Bush Administration policies are to blame, and that Republicans have exacerbated income inequality in the United States.

In reality about one half of the drop in the ratio is likely due to a shift in American demographics: A large population of baby boomers has retired and thus withdrawn from the labor force. An additional one-quarter of the drop in ratio is due to pockets of weakness in the economy that has induced potential workers to give up searching for employment. The remaining one-quarter is due to a variety of factors including high rates of government-approved disability payments, greater time spent in educational endeavors and family issues that prevent gainful employment.

Another issue that concerns economists in the current labor market recovery is the very modest increase in compensation for workers. One generally thinks of a robust recovery generating compensation increases for workers that are greater than cost of living increases. Yet solid real wage growth (after inflation) simply has not occurred in this recovery. (*See Figure 6.*) Wage growth is about in line with price increases meaning that workers' real earnings are stagnant.

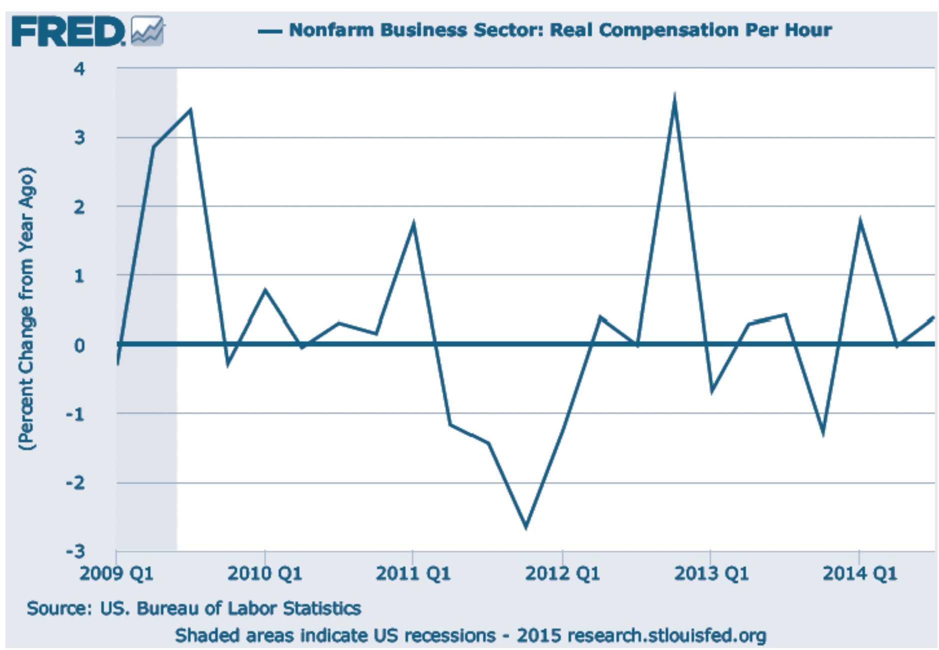
Figure 6:
Average Weekly Earnings For All Private Sector Employees (Q1 2009 to Q4 2014)



Source: Federal Reserve of St. Louis. Extracted from the Federal Reserve Economic Database (FRED). February 3, 2015.

Stagnation is also evident in total compensation of workers. Total compensation is a broad measure of worker pay that **includes both wages and benefits**. (*See Figure 7.*) Since the end of the last recession real hourly compensation has risen on average at a rate of less than 1% per year. Such a modest increase is hardly indicative of a robust economic recovery.

Figure 7:
Nonfarm Business Sector Real Compensation Per Hour (2009 to 2014)



Source: Federal Reserve of St. Louis. Extracted from the Federal Reserve Economic Database (FRED). February 3, 2015.

Best Guess on Labor Markets

I think we will continue to see positive reports on unemployment and initial jobless claims numbers in 2015. We believe the unemployment rate will remain between 5.0% and 5.8%, and initial jobless claims will be low by recent standards. Yet under the surface the labor participation rate should continue to be at or near a multi-decade low. In addition, there will likely be little or no **real** increases in worker compensation. With low oil prices, oil-producing states such as Texas, North Dakota and Oklahoma will likely experience lower employment numbers. The oil and gas industry could become a somewhat isolated drag on employment rather than a source of American growth.

Inflation/Deflation in the U.S. Economy

"Inflation Becoming Job No.1 for Fed" (Barron's)

"Deflation Is Testing Central-Bank Doctrine" (The Wall Street Journal)

One of the more certain qualities of the domestic and international economies is the lack of inflation. When the global economy is awash in idle labor and surplus capital as it is now, inflation will not be a pressing issue in 2015 and probably beyond. (*See Figure 8.*) Inflationary pressures are muted throughout the industrialized world.

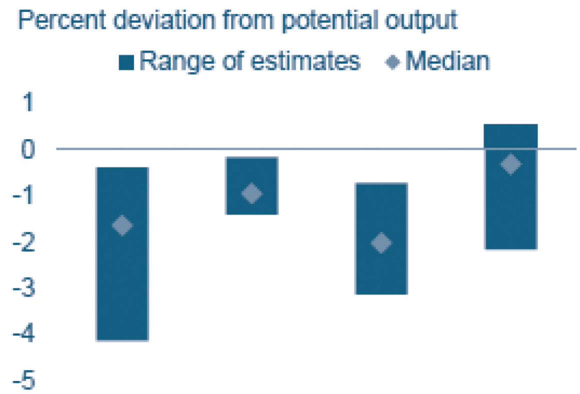
Figure 8:
Consumer Prices in 2014 for Select Industrialized Countries

Country	Price Change
United States	1.5%
Japan	2.7
Britain	1.4
Canada	1.9
Euro Area	-0.6

Source: The Economist. Economic and Financial Indicators. February 7, 2015. Page 84.

But low inflation persists in part because there is a significant gap between actual and potential output for most of the industrial world, according to the World Bank. (*See Figure 9.*) These gaps have continued since the last recession, and they translate into soft prices for both labor and capital, which generates downward pressure on consumer prices.

Figure 9:
Output Gap (Potential Output Greater Than Actual Output) for Select Industrial Areas of the World



Source: The World Bank. Global Economic Perspectives. (Figure 1.4.B. Output Gap, 2014). January 2015. Page 6.

Best Guess on U.S. Price Changes

When the Federal Reserve began printing money in 2008 to stimulate the economy during and after the recession, an expectation arose that prices might escalate as a result of the Fed's expansionary monetary experiment. This outcome has not occurred. Massive amounts of capital are sitting idly on the Fed's balance sheet—unused by commercial banks for loans. Inflationary prices are not on the horizon in the United States or the other industrialized countries. Inflation of less than 2% is likely for the remainder of 2015 with a real likelihood that yearly inflation will be as low as 1%. Underemployed labor and idle capital are no precursors to serious inflation.

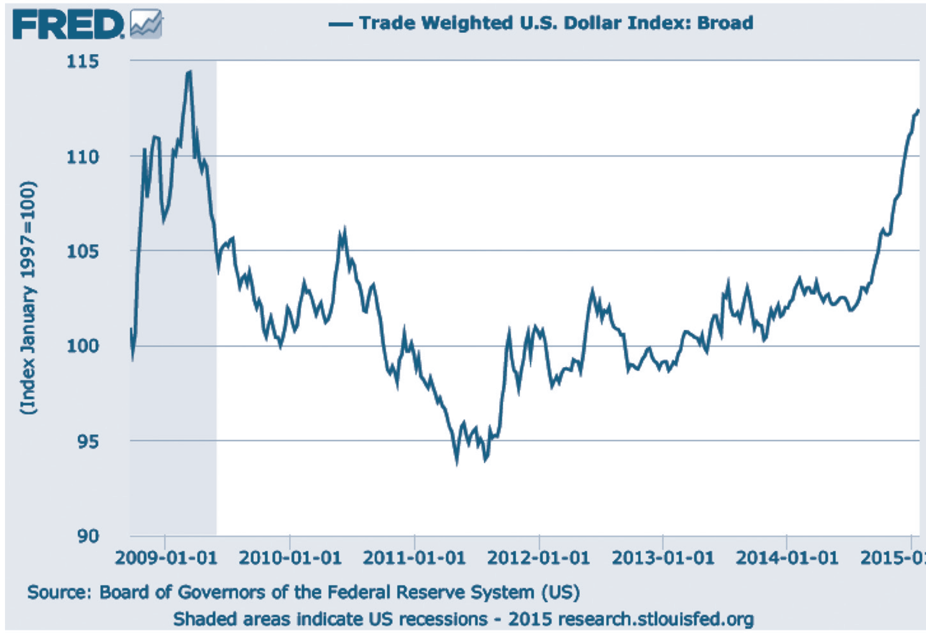
American Trade Conditions and the Dollar

U. S. Dollar Surges to 11 Year High (The Wall Street Journal)

The Strong U. S. Dollar Is Always Good, Except When It Isn't (The New York Times)

The U. S. dollar has been buffeted by a number of significant factors over the past six years. In the depths of the last recession global investors rushed to the safety of the U. S. dollar driving its value upward. (*See Figure 10.*) As the crisis subsided and the Federal Reserve printed massive amounts of money driving down interest rates to stimulate the economy, the dollar began to drop for several years bottoming out in 2011.

Figure 10:
Trade Weighted U.S. Dollar Index (2009 to Present)



Source: Federal Reserve of St. Louis. Extracted from the Federal Reserve Economic Database (FRED). March 8, 2015.

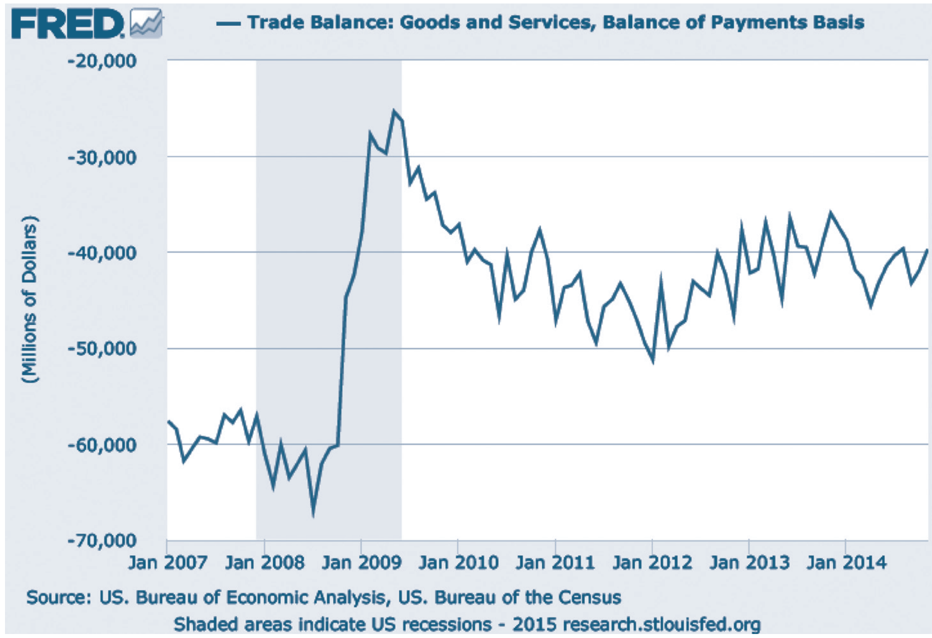
As the American economy demonstrated significant resilience relative to its major trading partners, international currency investors began buying U.S. dollars. The dollar appreciated against most of the world's major and minor currencies. And investors are continuing to buy U.S. currency and the dollar continues to appreciate in value.

This appreciation of the dollar is a double-edged sword for America:

- Foreign goods become relatively less expensive for our U.S. consumers resulting in an increase imports.
- **But** American goods become less competitive especially in Europe and Japan resulting in a decrease in U.S. exports to foreign markets.

The net result is a larger trade deficit—in a normal recovery. However, in the current American economic recovery something unexpected is occurring (*See Figure 11.*)

Figure 11:
Trade Balance: Goods and Service, Balance of Payments Basis (2007 to 2014)

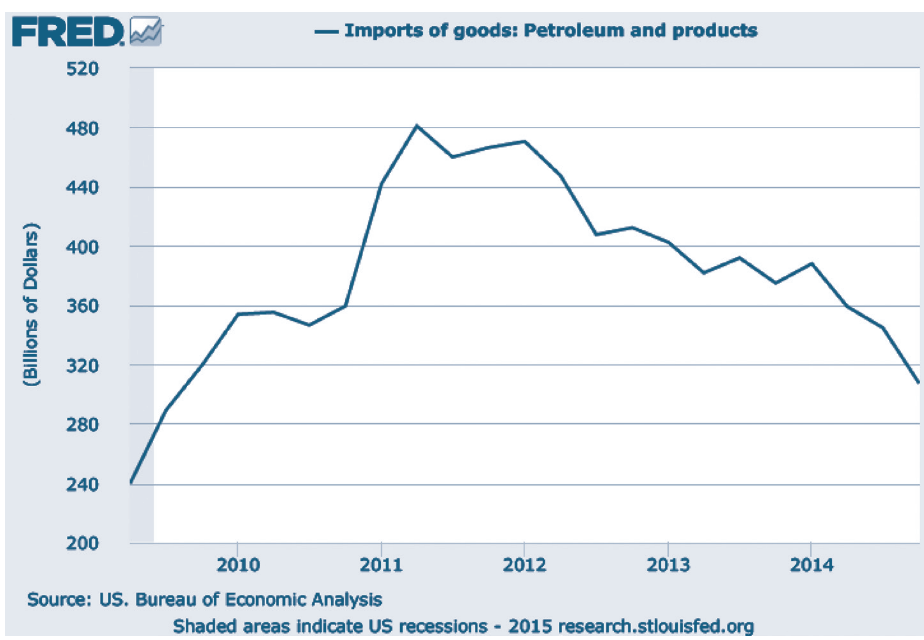


Source: Federal Reserve of St. Louis. Extracted from the Federal Reserve Economic Database (FRED). March 8, 2015.

In the current recovery the trade deficit has stabilized at about $40 billion per month or about $500 billion on an annual basis. Why? The cost of energy for the United States has shrunk. (*See Figure 12.*) This shrinkage is attributable to two factors:

- Falling oil prices and a decrease in the U.S. dollar-denominated cost of imports of petroleum products.
- Increased U.S. oil and gas production which is replacing foreign energy.

Figure 12:
Imports of Petroleum and Refined Products in U. S. Dollars (2009 to 2014)



Source: Federal Reserve of St. Louis. Extracted from the Federal Reserve Economic Database (FRED). March 8, 2015.

Overall the strong U.S. dollar is positive for the American economy. The dollar's strength allows Americans to purchase foreign products at lower prices, and these lower import prices help to keep U.S. prices in check.

But, the strong dollar is a drag on the profitability of American multinational corporations. Profits earned abroad are worth less when converted to U.S. dollars, especially with the current weakness in currencies such as the euro and the Japanese yen. This earnings headwind will linger for U.S. multinational companies as long as the dollar continues to appreciate. For investors in U.S. multinational companies, this outcome is undesirable.

The dollar situation is reversed for European and Japanese companies with significant U.S. operations. Corporate profits are enhanced by the strong dollar when those earnings are repatriated to their home countries.

Best Guess for the U.S. Dollar and American Trade

We believe the U.S. dollar will remain strong in 2015 against major currencies such as the Japanese yen and the euro. We think the dollar will continue to strengthen during the year. The Federal Reserve will almost certainly raise short-term interest rates in 2015 which will provide additional support for the American currency. The U.S. trade deficit, an ever-present reality, will not balloon because the price of imported oil will remain relatively low by recent standards.

Final Thoughts

The American economic recovery that began in July 2009 is unlikely to be derailed in 2015. From a statistical viewpoint it is not the strongest recovery of the last 50 years, but conditions are positive for moderate growth.

- **Economic Growth:** Growth over the next four quarters will be between 2.5% and 3%. However, weak energy prices will be a drag on growth in the once booming shale oil and gas sector of the economy.
- **Prices:** Inflation will be between 1% and 2% aided by low energy prices and a strong dollar.
- **Monetary Policy:** The Federal Reserve will be cautious in raising short-term interest rates because of low inflation. Nevertheless investors should expect an increase in short-term interest rates by the Federal Reserve by late summer or early fall.
- **Employment:** Labor conditions will continue to improve. The American unemployment rate will finish the year at less than 5.7% with strong demand for workers in most labor markets.
- **Trade and the U.S. Dollar:** The trade deficit will not disappear. But it will be modest and manageable by historic standards—about $500 billion per year or 3% of American output. With an almost certain prospect for higher American interest rates, the U.S. dollar will remain strong against most major currencies in 2015. The dollar strength will create a headwind on the profitability of large American multinational companies that have significant international operations.

The current recovery remains intact. Yet this recovery is the only one in the past 70 years that did not experience at least one "four quarter period" with growth of more than 4%. The current six-year recovery's strongest four quarter growth was just 3.1%.

As a new baseball season begins it is appropriate to describe the current recovery as one with a scorecard of singles and a shortage of extra base hits. Games can be won with singles, but double, triples and home runs make the job a lot easier.

Tax reform and regulatory simplification would help boost the U.S. economy—the extra base hits we need to win the game.

Thomas Goho, Ph.D. is Chief Economic Consultant for Stephens Inc. He also serves as the Co-Director of Stephens University at Wake Forest University. Tom enjoys a successful career in both education and business. He served as a professor of finance, Wayne Calloway School of Business and Accountancy, Wake Forest University for 30 years. Before retiring in 2007, Tom was the first to hold the Thomas S. Goho Chair of Finance. Tom also served on the Board of Directors of the Wells Fargo Family of Mutual Funds for 20 years, and also was on the Board of Directors of Lifepath Funds of Barclay's Bank. A former Certified Financial Planner, Tom earned his BS and MBA from Pennsylvania State University and his Ph.D. from the University of North Carolina-Chapel Hill.

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