

Economics and Country Risk

US Economic Outlook – How long will the ride last?

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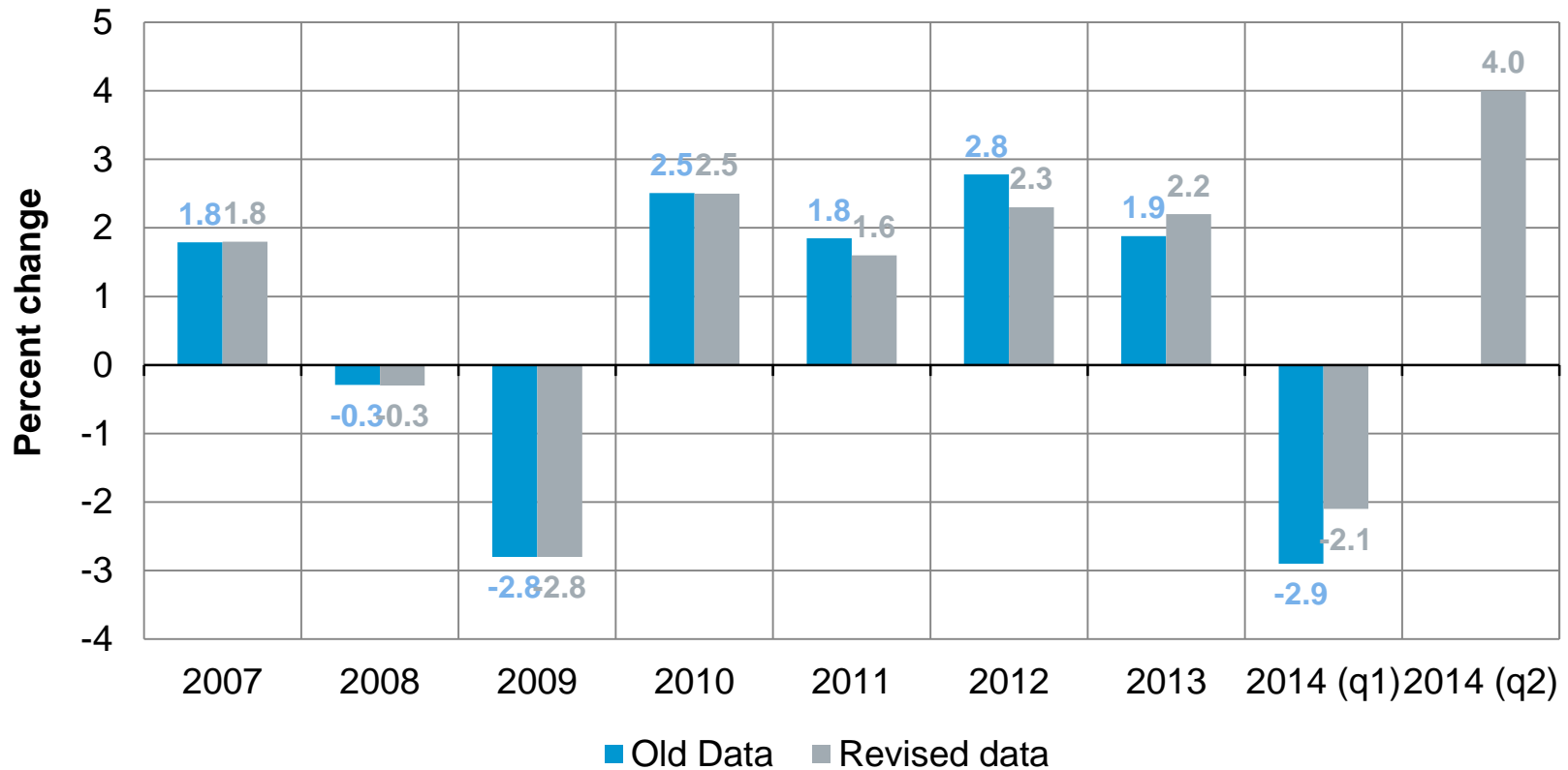
US Economic Overview

Executive Summary

- The weather and inventory induced volatility in q1 and q2 is behind us.
- Continued good economic growth to continue through at least 2015.
- Sector contributions:
 - The consumer will remain the unsung hero in the recovery.
 - Housing will continue to improve, but remain below-par due to structural and demographic issues.
 - Investment spending will also continue to grow, but tech-spending poses measurement problems.
 - Most of the near-term volatility that will come from international trade, but over the long-term, the size of the trade deficit should hold steady.
 - Government spending contributions to growth will remain near zero with little additional federal deficit reduction efforts expected.
- Fed tightening to take place in third quarter of 2015, but period leading up to this event will be fraught with highly speculative gloom-and-doom arguments.
- Key dependencies
 - Improved fundamentals in labor market. Better labor supply. Improved productivity.
 - No economic shocks (e.g., fiscal policy gaffes, international crises turned hot, foreign economic growth to improve).
 - Potential rebound in the US\$ orderly with reasonable import elasticities.
 - No irrational expectations to pending Fed policy moves in 2015.

2013 and 2014 economic growth were recently revised upward.

Real GDP growth

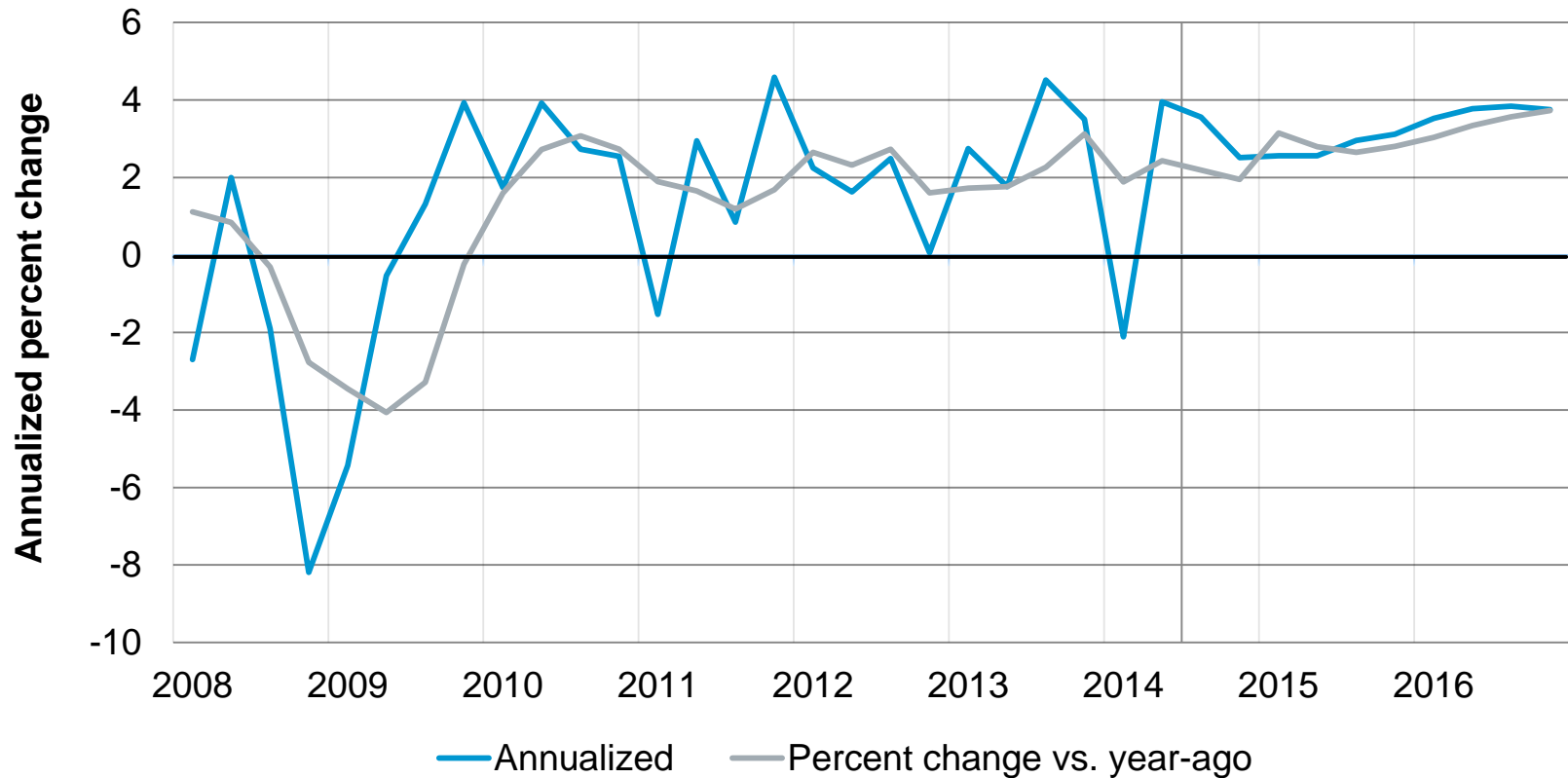


Source: IHS

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Quarter-to-quarter volatility is clouding the big picture, but it's still steady-as-she-goes.

Real GDP growth

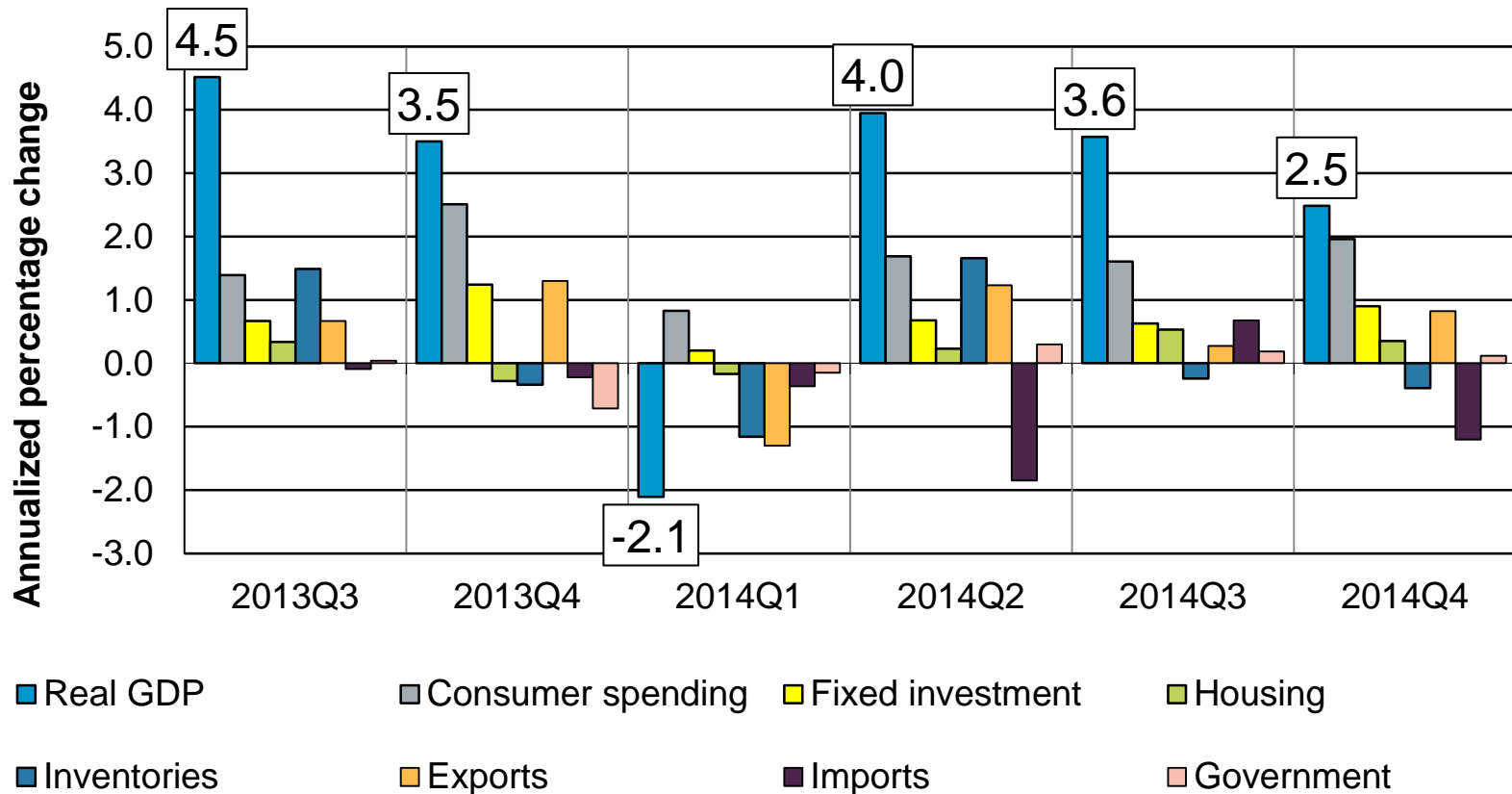


Source: IHS

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Q2 was a payback quarter, with rebounds in inventory growth and exports. Imports remain problematic in the short run.

Real GDP growth

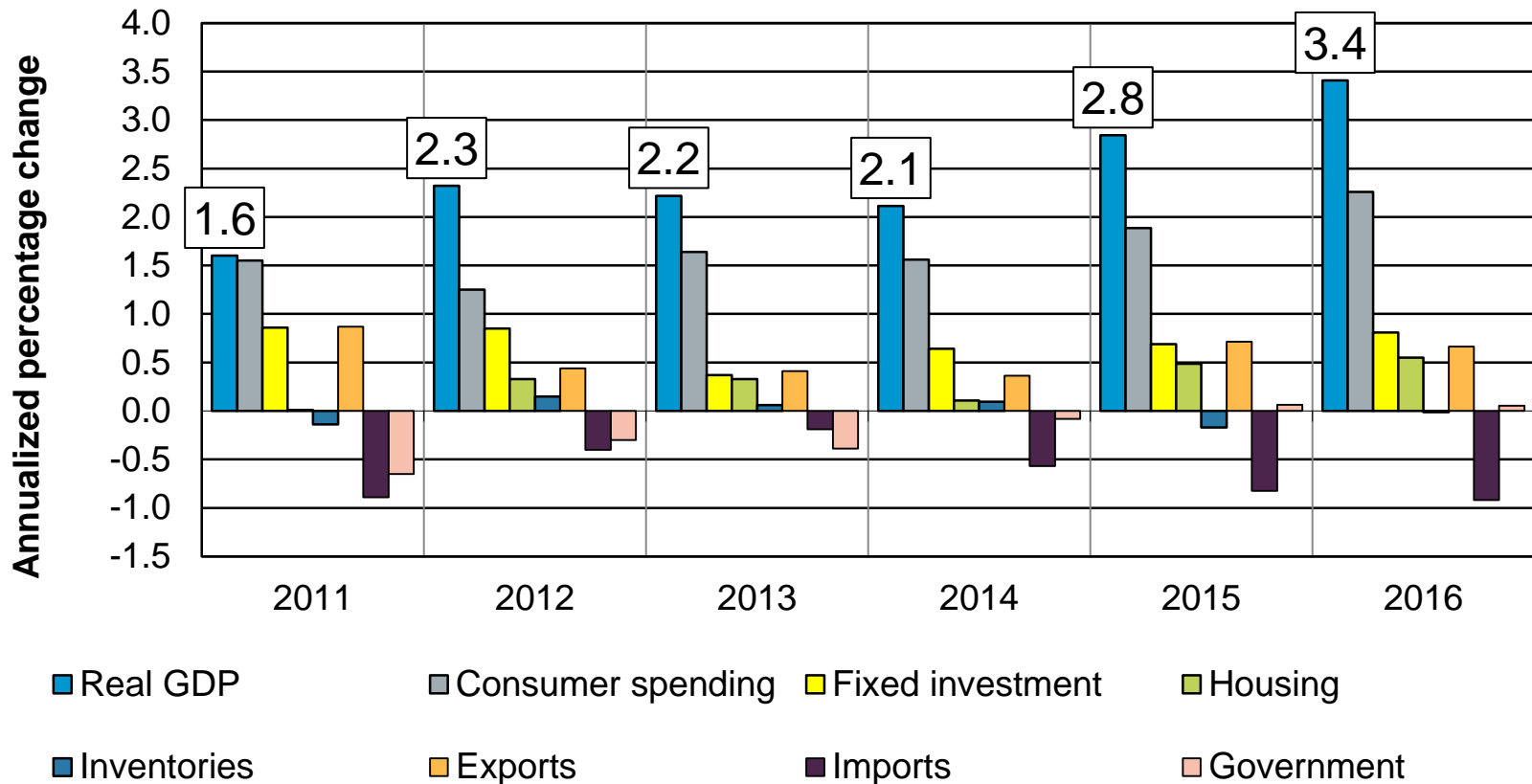


Source: IHS

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Looking forward, we will still be counting on consumer spending to drive the bulk of economic growth

Real GDP growth



Source: IHS

© 2014 IHS

US economic growth by sector

Real GDP and its components

Percent change	2013	2014	2015	2016
Real GDP	2.2	2.1	2.8	3.4
Consumption	2.4	2.3	2.8	3.3
Residential investment	11.9	3.5	15.0	15.2
Business fixed investment	3.0	5.2	5.4	6.3
Federal government	-5.7	-2.4	-0.6	-0.9
State & local government	0.5	0.9	0.9	1.0
Exports	3.0	2.7	5.3	4.8
Imports	1.1	3.5	5.1	5.7

Other key US indicators

Key indicators

Percent change	2013	2014	2015	2016
Industrial production	2.9	3.9	3.3	4.0
Payroll employment	1.7	1.8	1.9	1.9
Light-vehicle sales (Millions)	15.5	16.3	16.7	17.0
Housing starts (Millions)	0.93	1.02	1.30	1.54
Consumer Price Index	1.5	1.9	1.6	1.6
Core CPI	1.8	1.9	1.9	2.0
Brent crude oil price (\$/barrel)	109	109	106	105
Federal funds rate (%)	0.1	0.1	0.3	2.0
10-year Treasury yield (%)	2.4	2.7	3.3	3.7

US industrial production growth

Industrial production

Percent change	2013	2014	2015	2016
All manufacturing	2.9	3.5	3.6	3.9
Motor vehicles & parts	7.8	6.4	4.1	1.7
Computers & electronics	6.9	4.5	7.4	9.4
Electrical equip. & appliances	2.9	3.1	4.9	5.5
Machinery	1.8	6.0	5.3	5.4
Textiles	-0.9	-1.5	-0.2	-0.7
Furniture	3.3	6.5	5.2	3.2
Chemicals	1.3	1.7	2.5	3.2

Employment, Inflation, and Interest Rates

Is the labor market getting tight enough to drive wage pressures?

Job creation and the unemployment rate

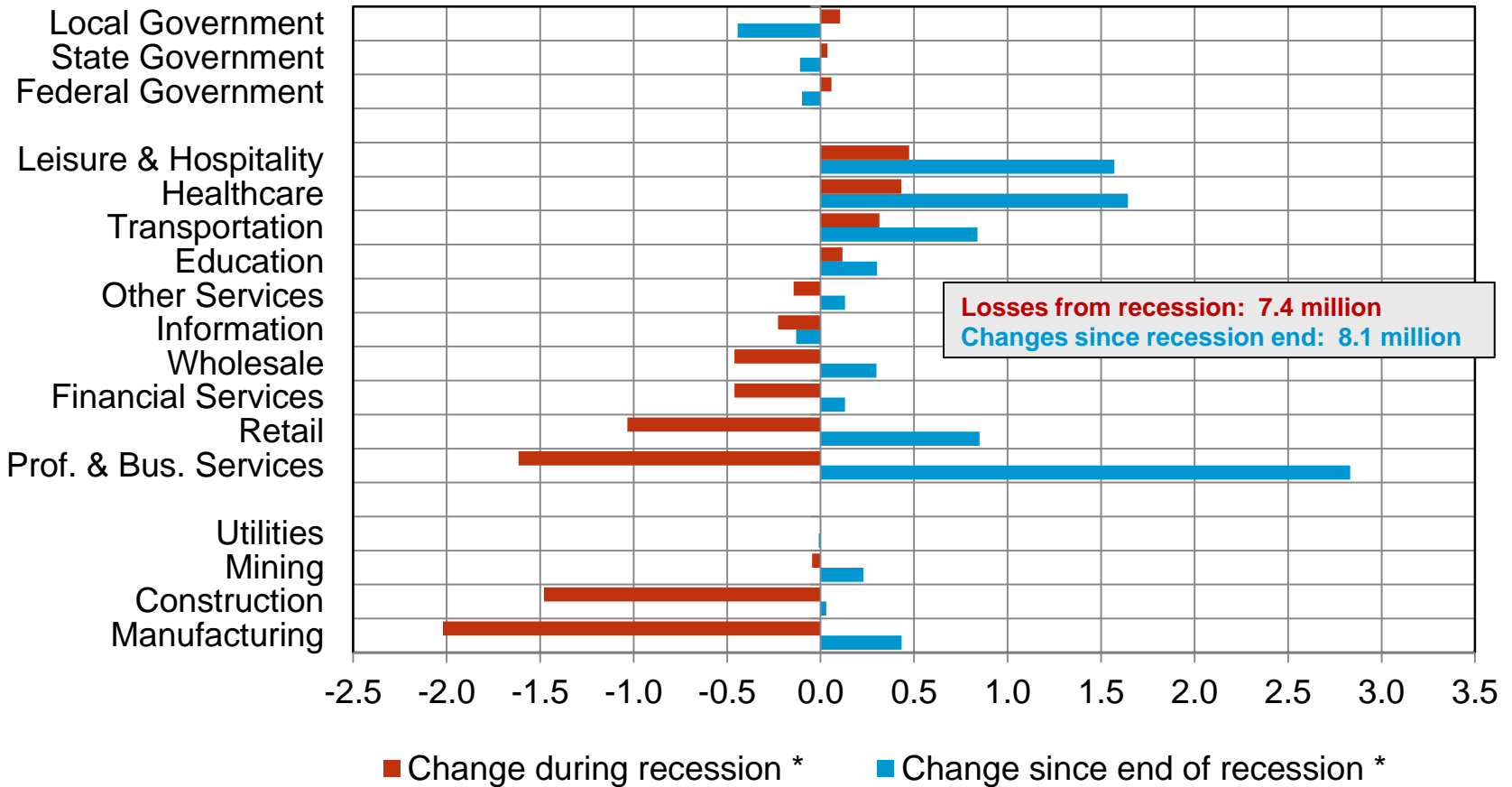


Source: IHS

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Only the services areas are materially adding jobs

Employment before and after the recession (millions)



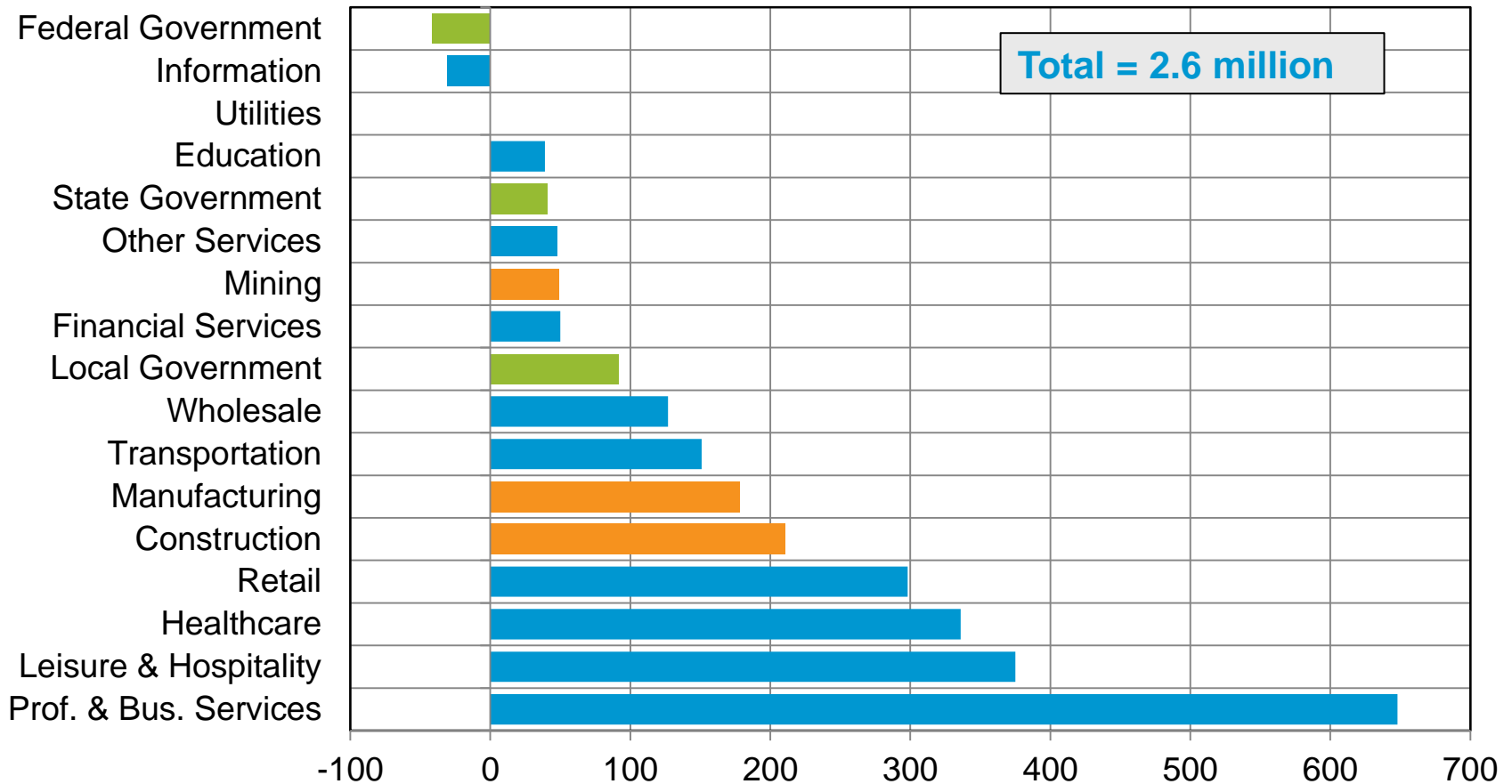
*=Recession period: December 2007 through June 2009

Source: IHS

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Job growth in the construction and manufacturing sectors has accelerated, but is still sub-par

Growth over the past 12 months (000s)

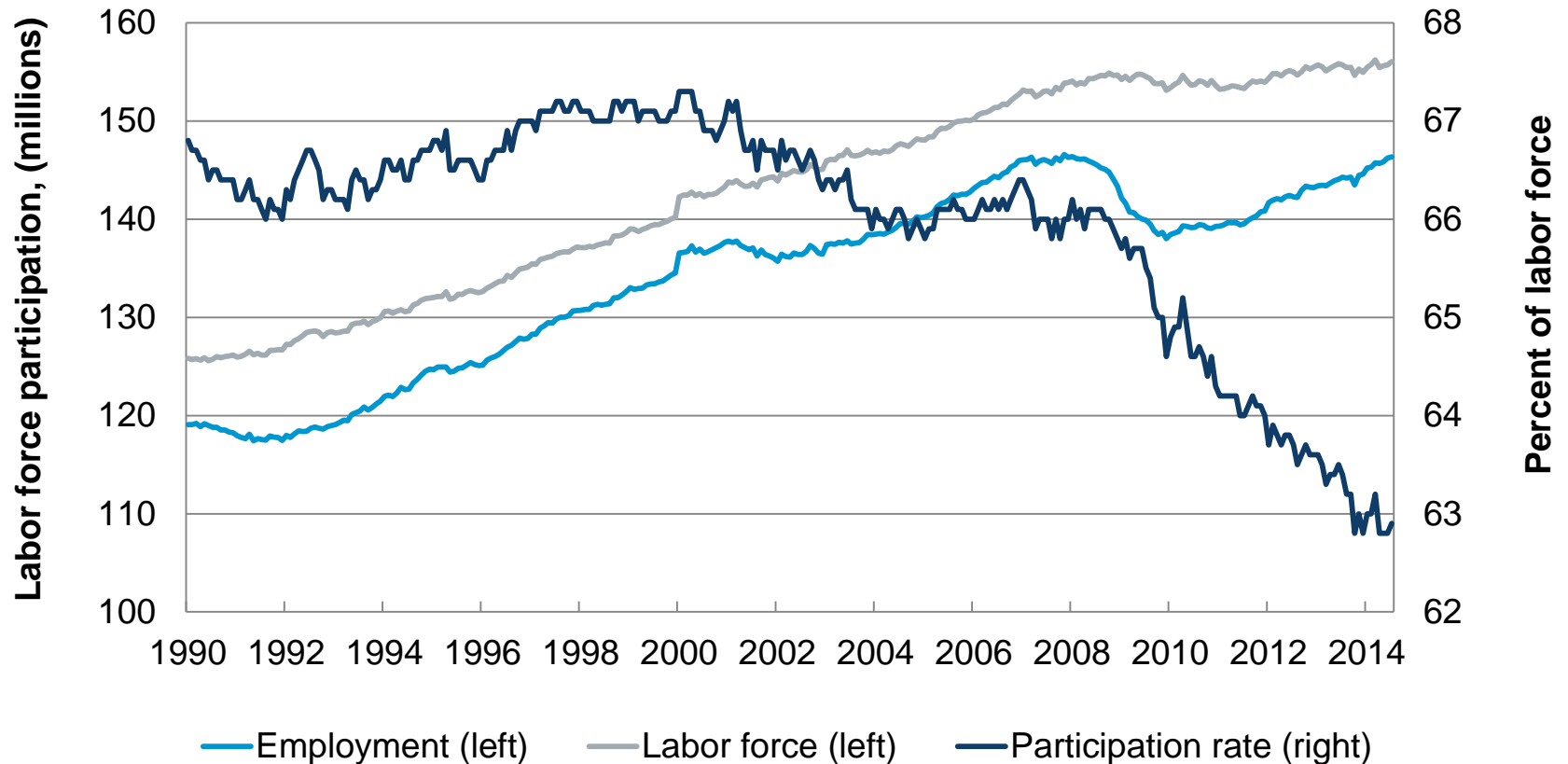


Source: IHS

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About 3% of the working age population has dropped out of the labor force since the end of the recession

Employment and labor force (left axis), labor force participation rate (right axis)

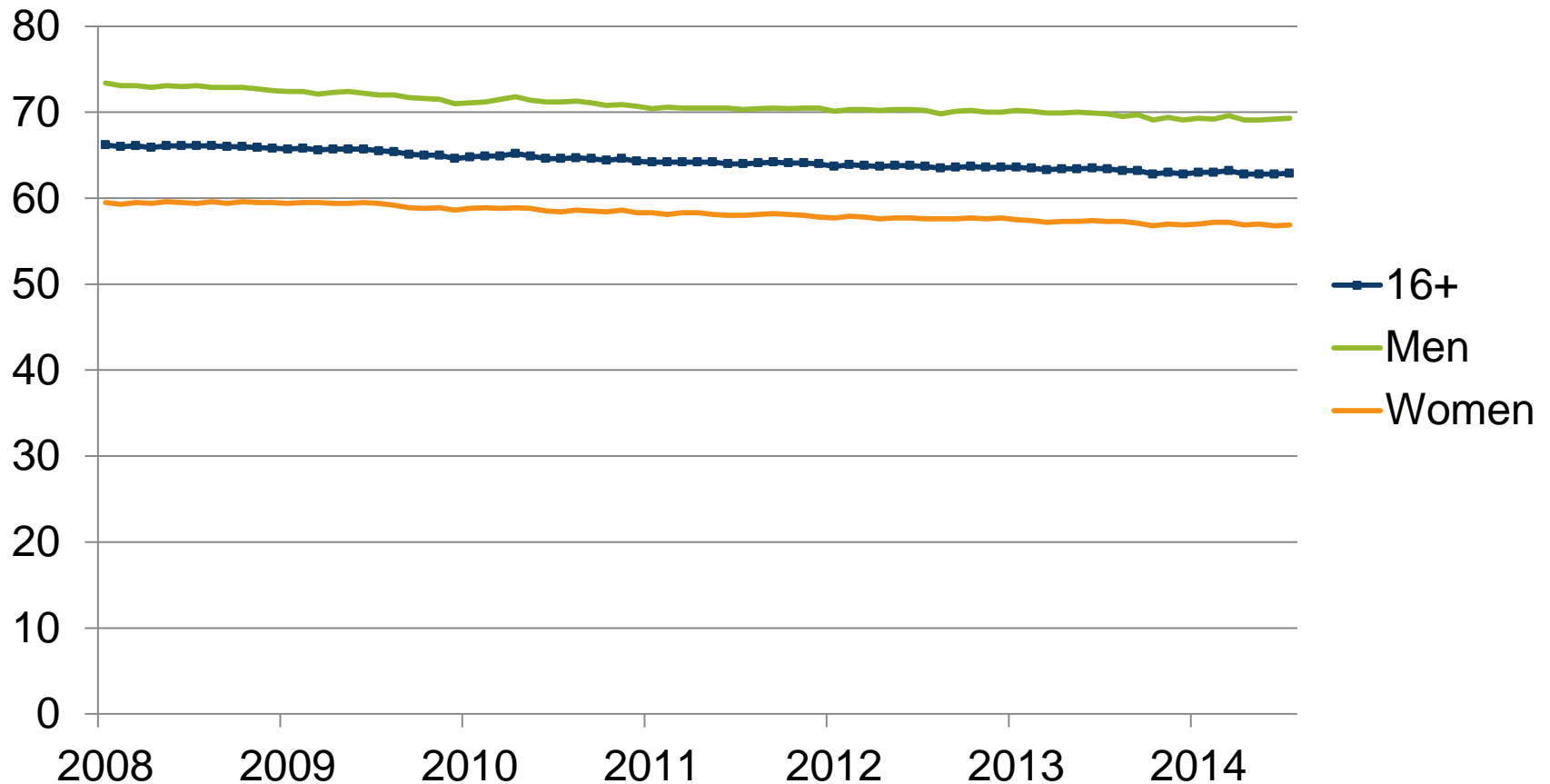


Source: IHS

© 2014 IHS

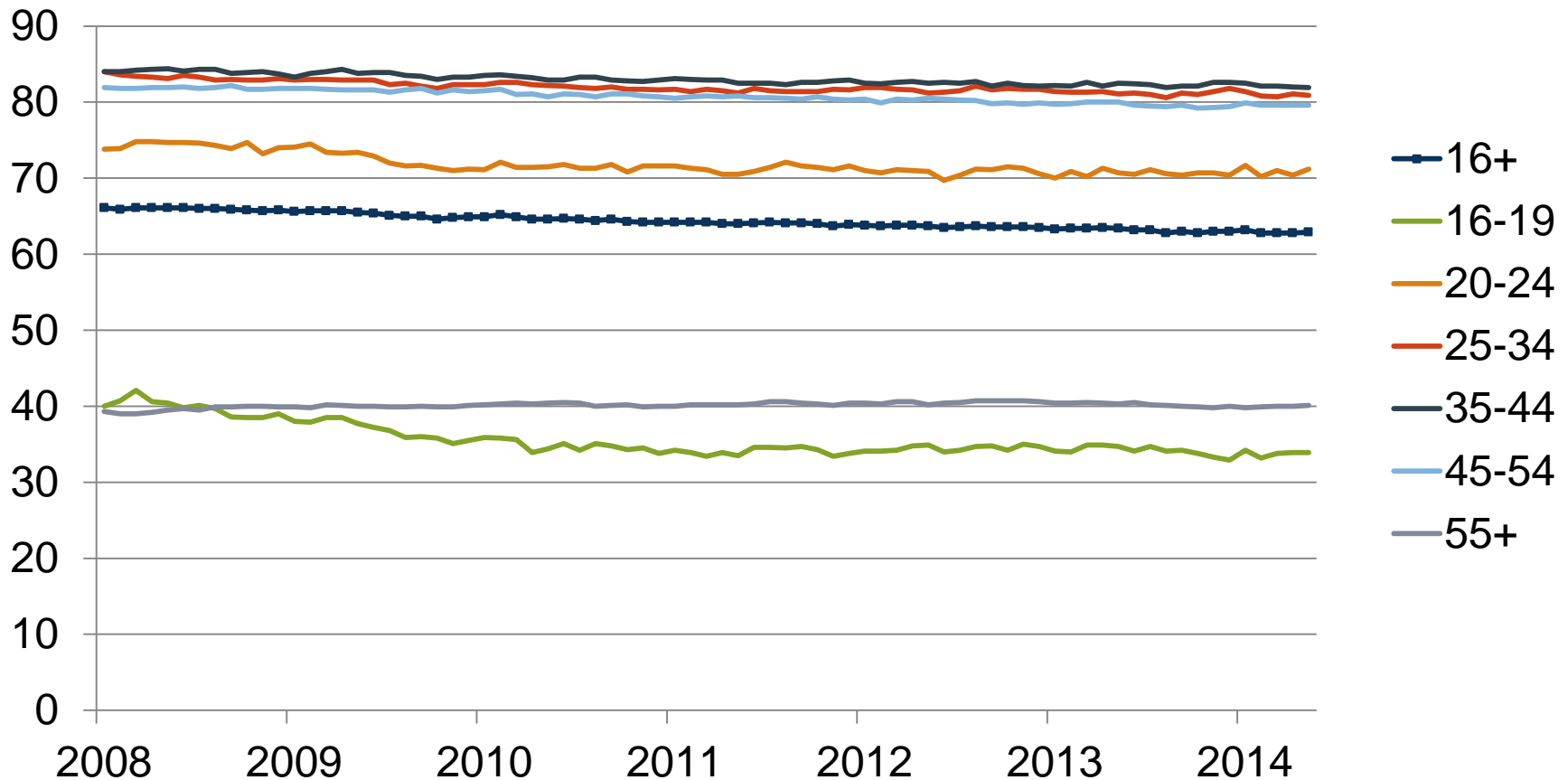
Both genders are participating in the reduced participation rates.

Labor force participation rates (% of labor force)



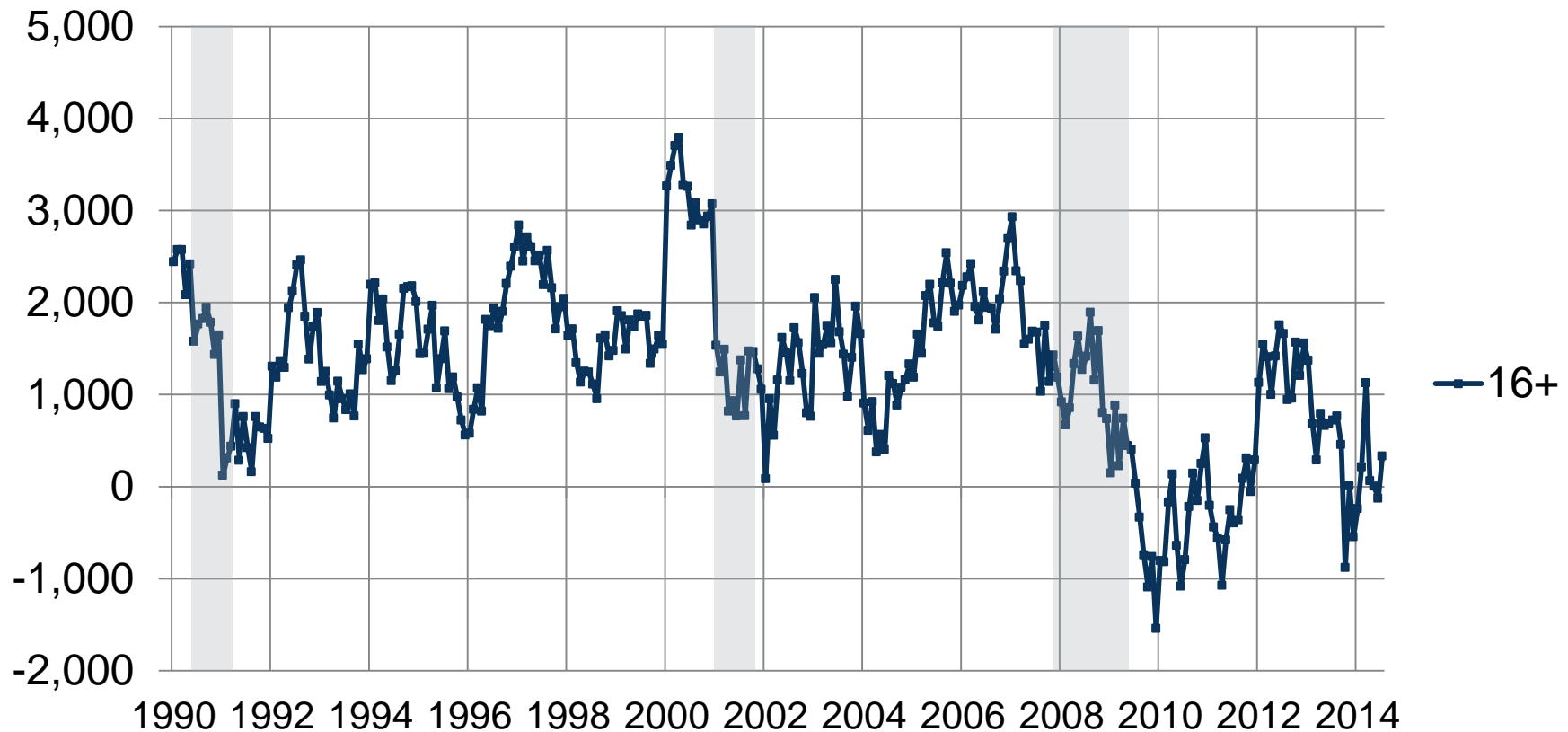
All age cohorts under 55 y.o are participating in the reduced participation rates.

Labor force participation rates (% of labor force)



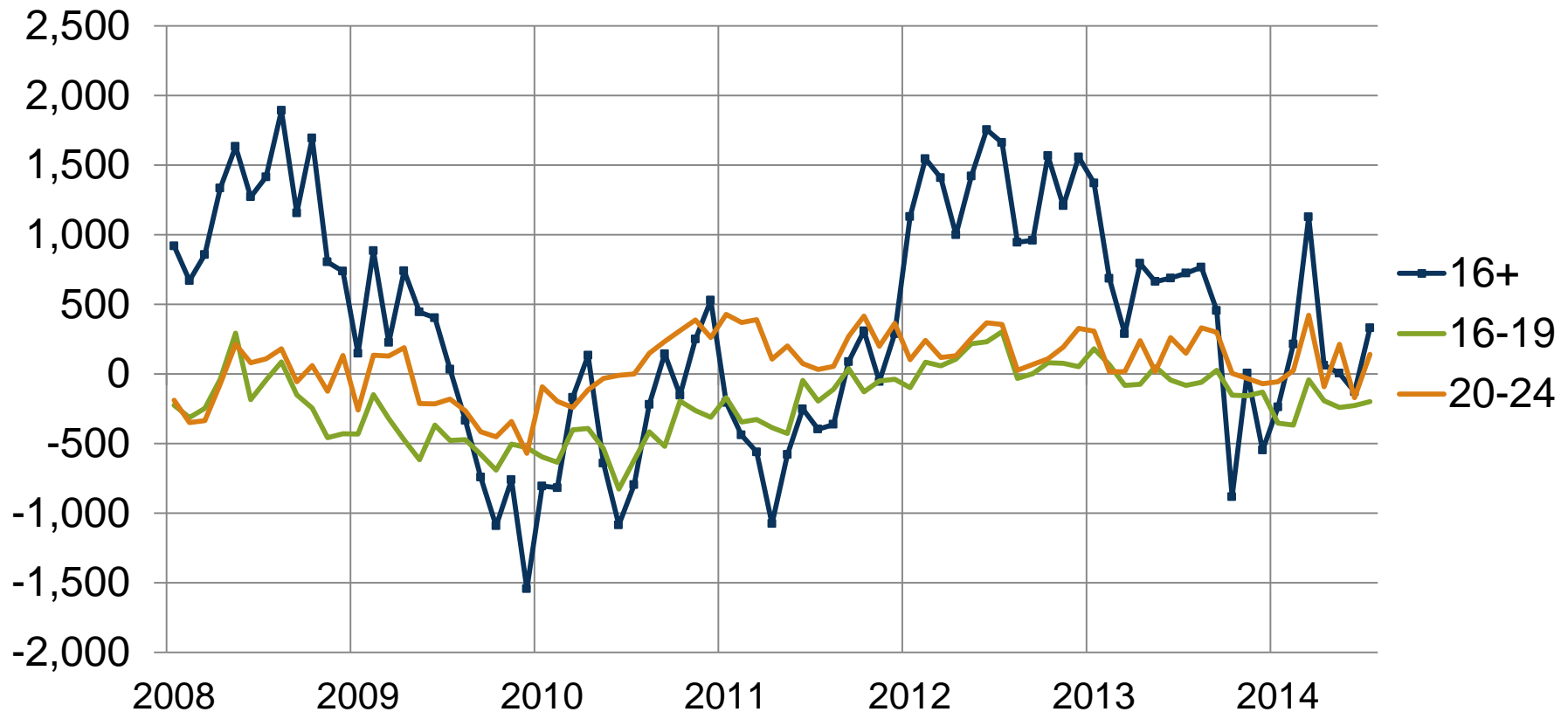
The hunt for the lost labor force begins.

Absolute labor force growth (12-month change, 000s)



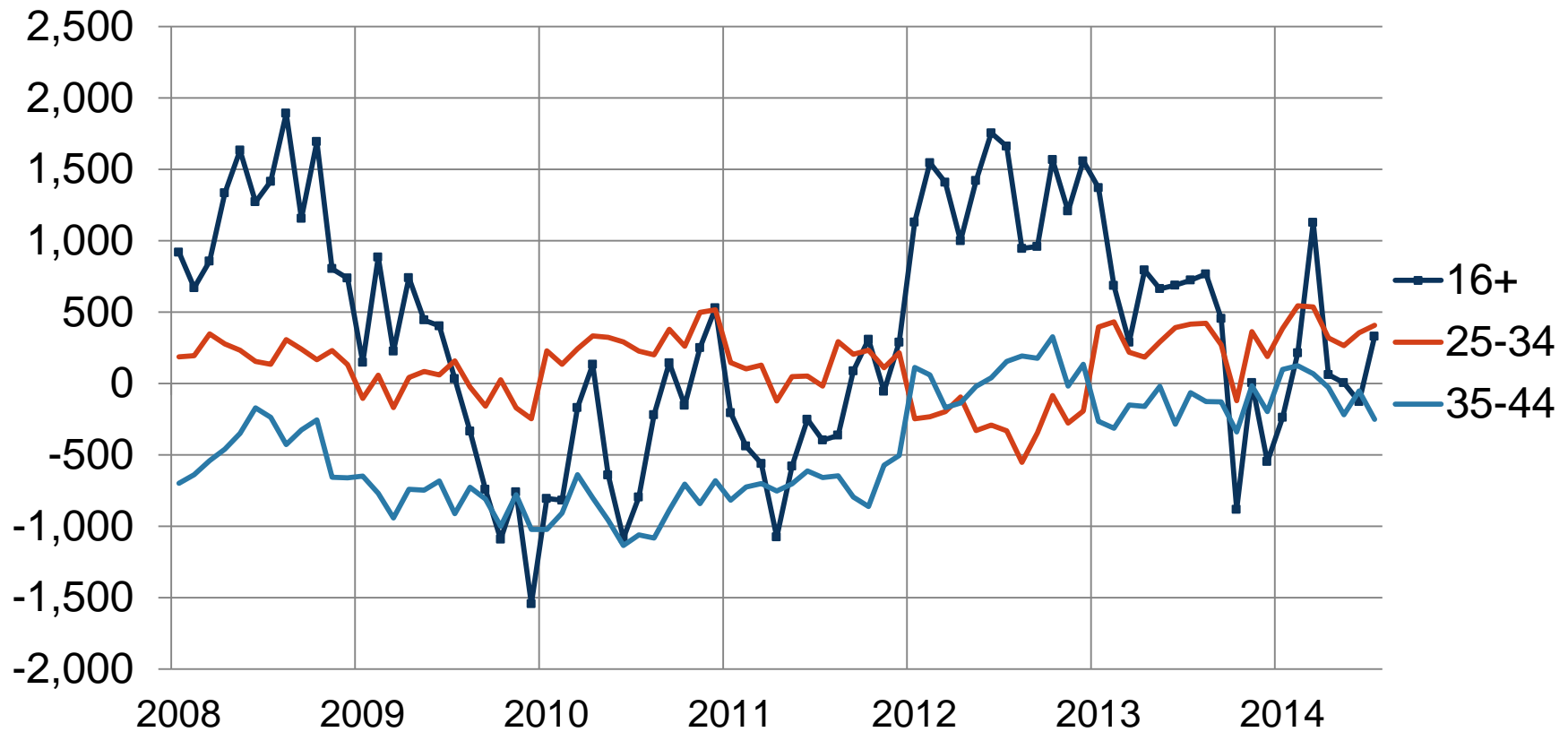
The teenage labor force contributed to immediate post-recession decline in labor force growth.

Absolute labor force growth (12-month change, 000s)



And so have those in the 35-44 year-old cohort.

Absolute labor force growth (12-month change, 000s)



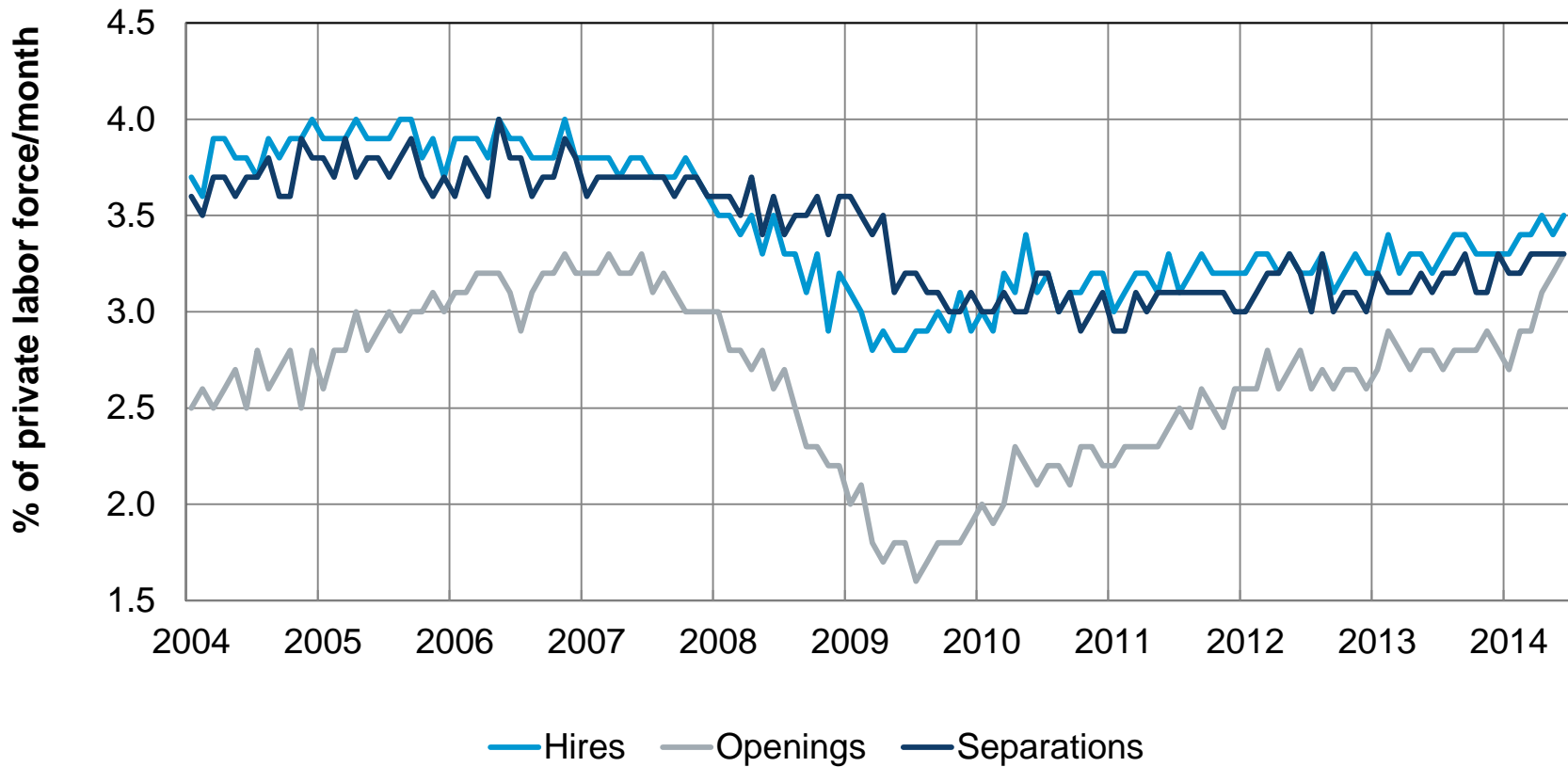
But the 45-54 year-old cohort has been shrinking since 2010.

Absolute labor force growth (12-month change, 000s)



Structural unemployment? Hiring and separations remain flat, while openings are back at pre-recession rates

Labor market mobility characteristics

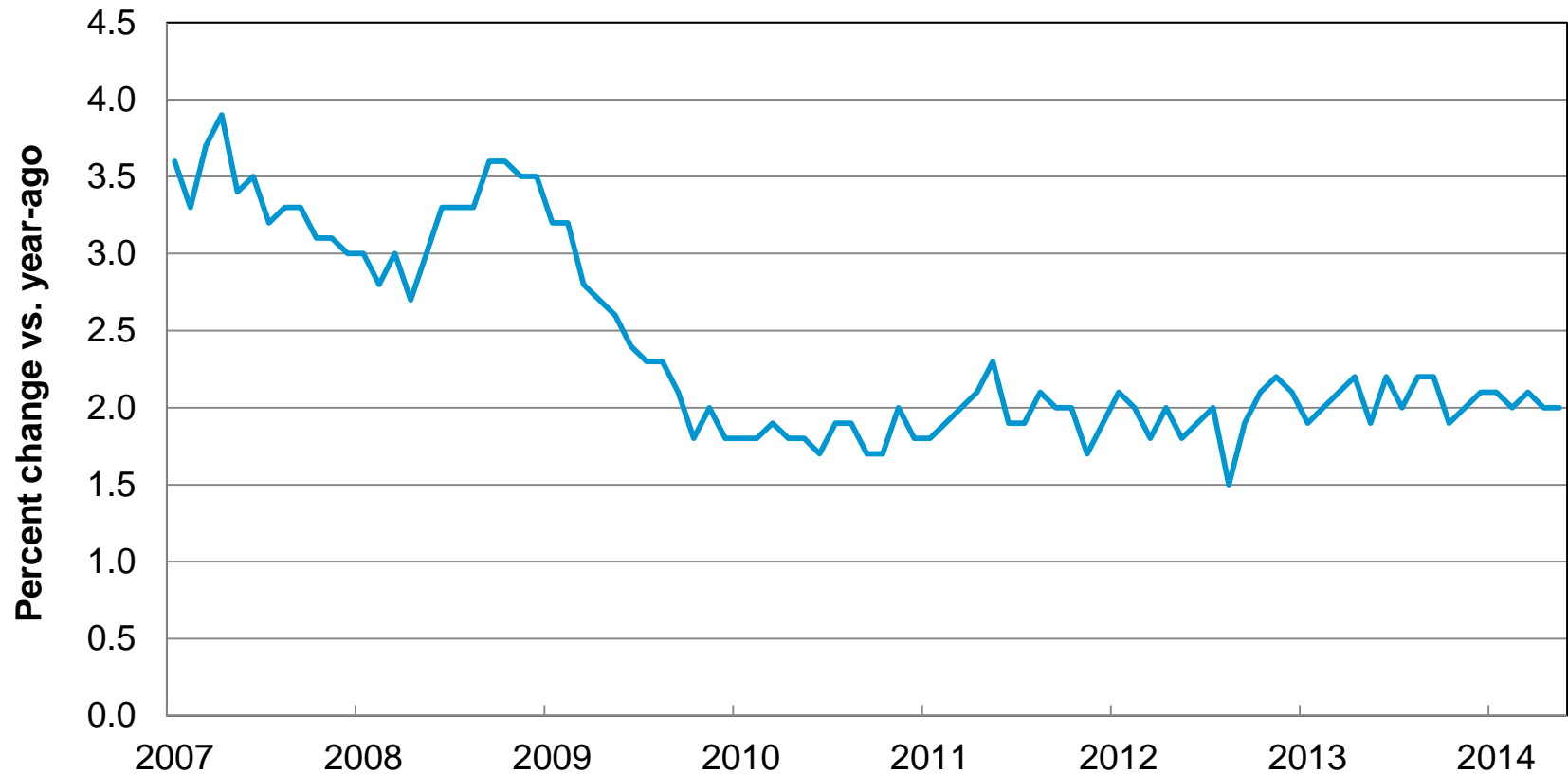


Source: IHS

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No discernible inflation pressures here...

Average hourly earnings

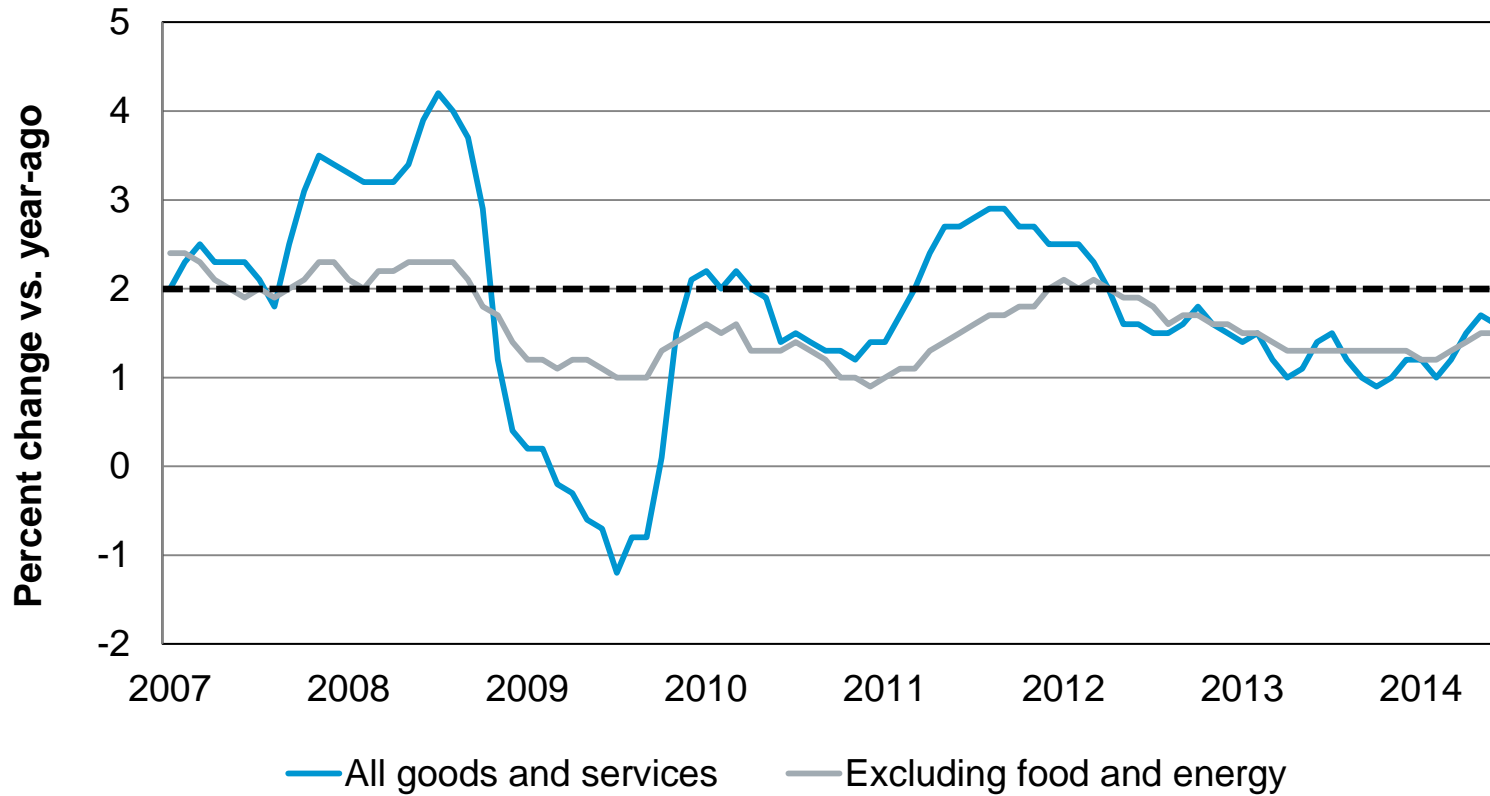


Source: IHS

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But here? In 2015?

Personal consumption deflators

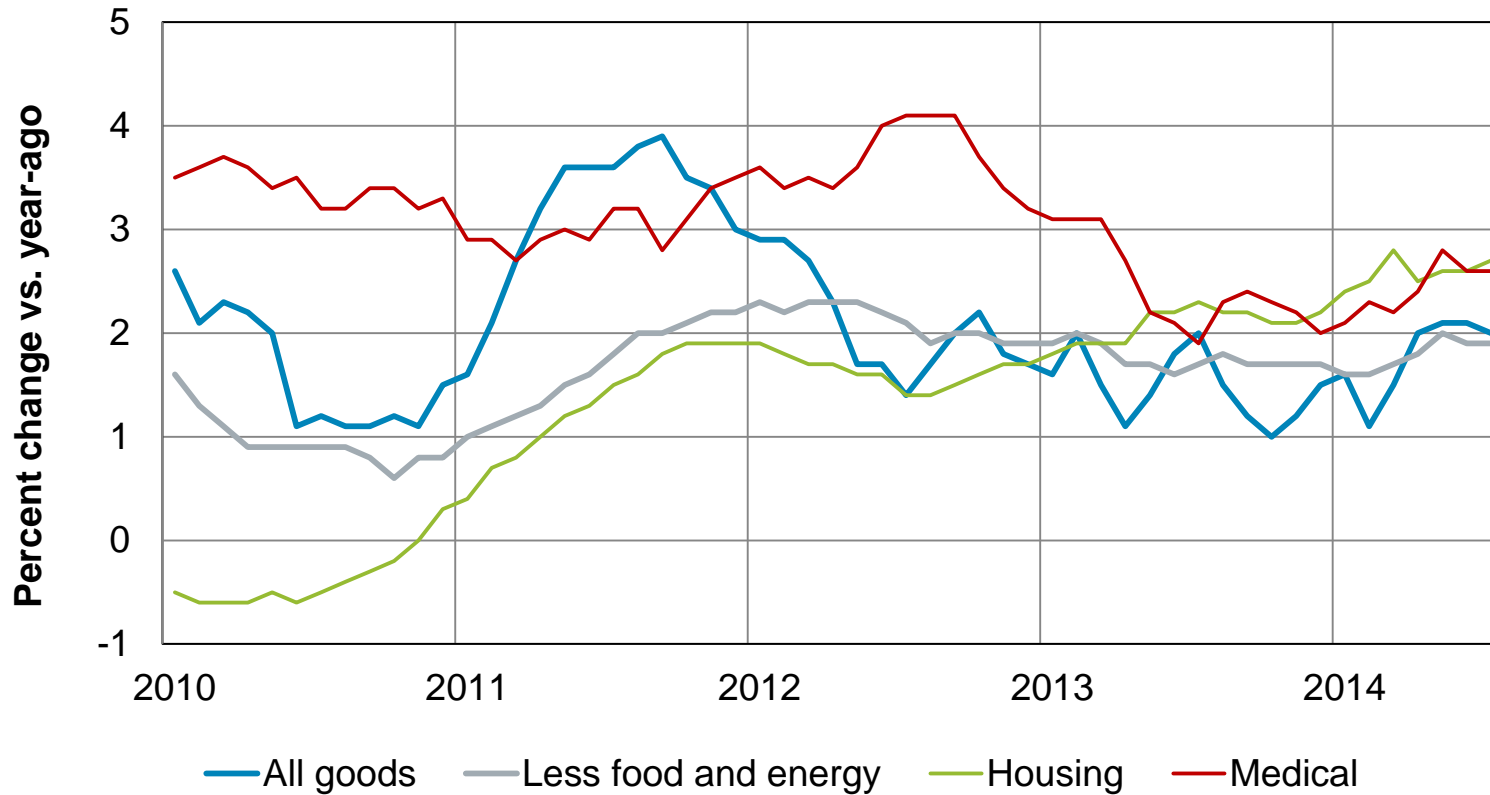


Source: IHS

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If inflation accelerates, housing and medical care will probably be among the drivers.

Consumer price indexes

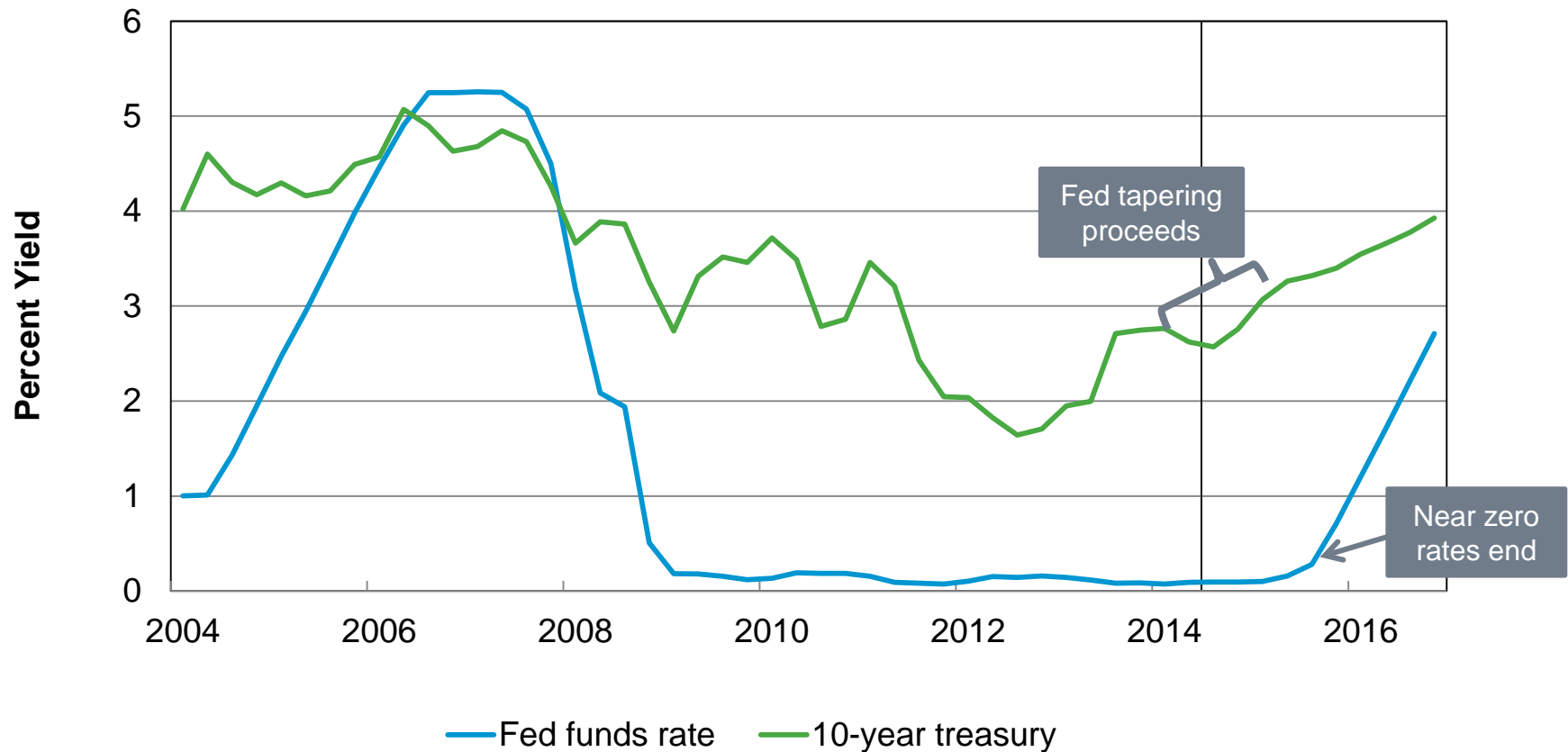


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Monetary policy status quo maintained through mid-2015, although long-term rates will rise as expansion gathers steam

Interest rate outlook

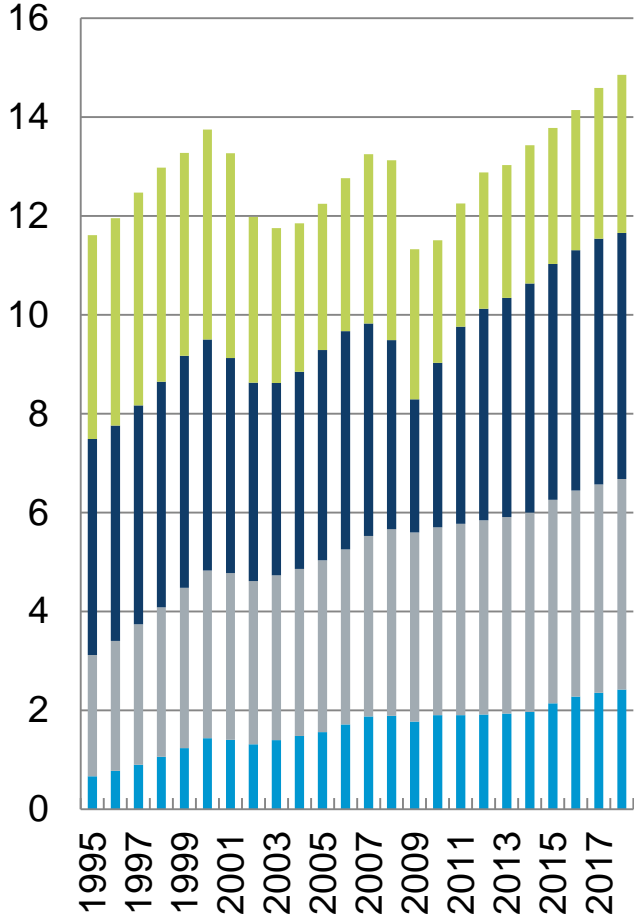


Source: IHS

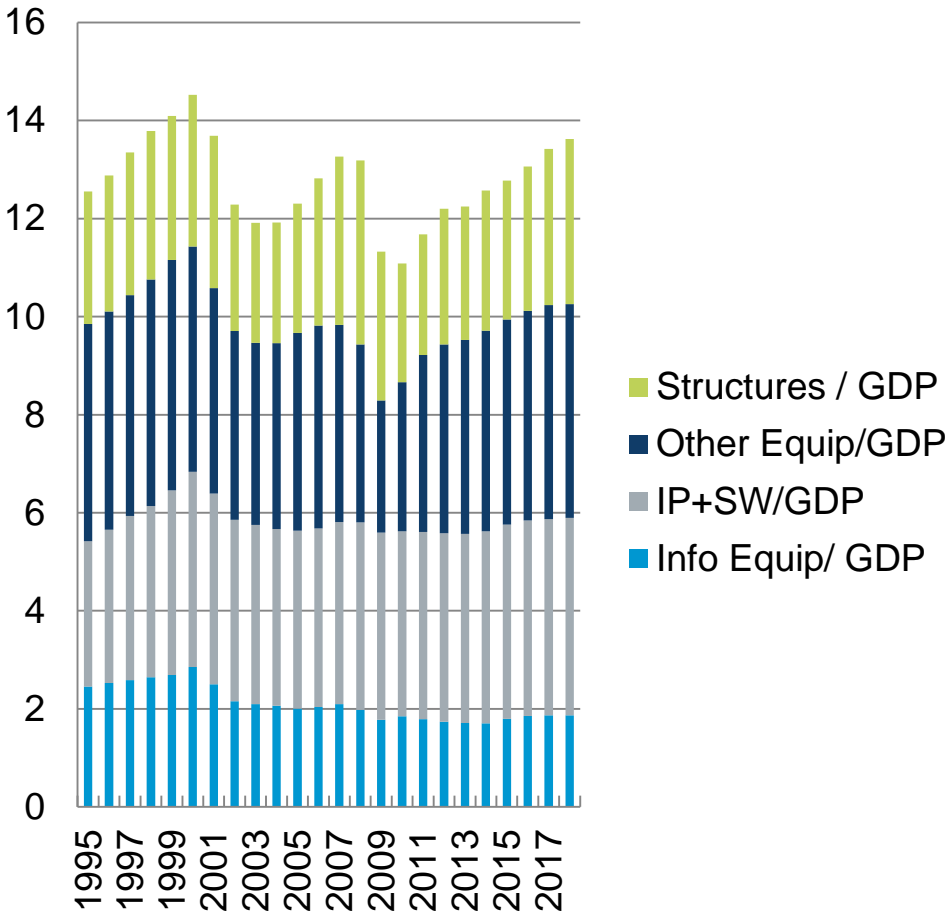
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Investment spending will continue to grow, but much more the “real” side than nominal spending.

Real spending (% of GDP)



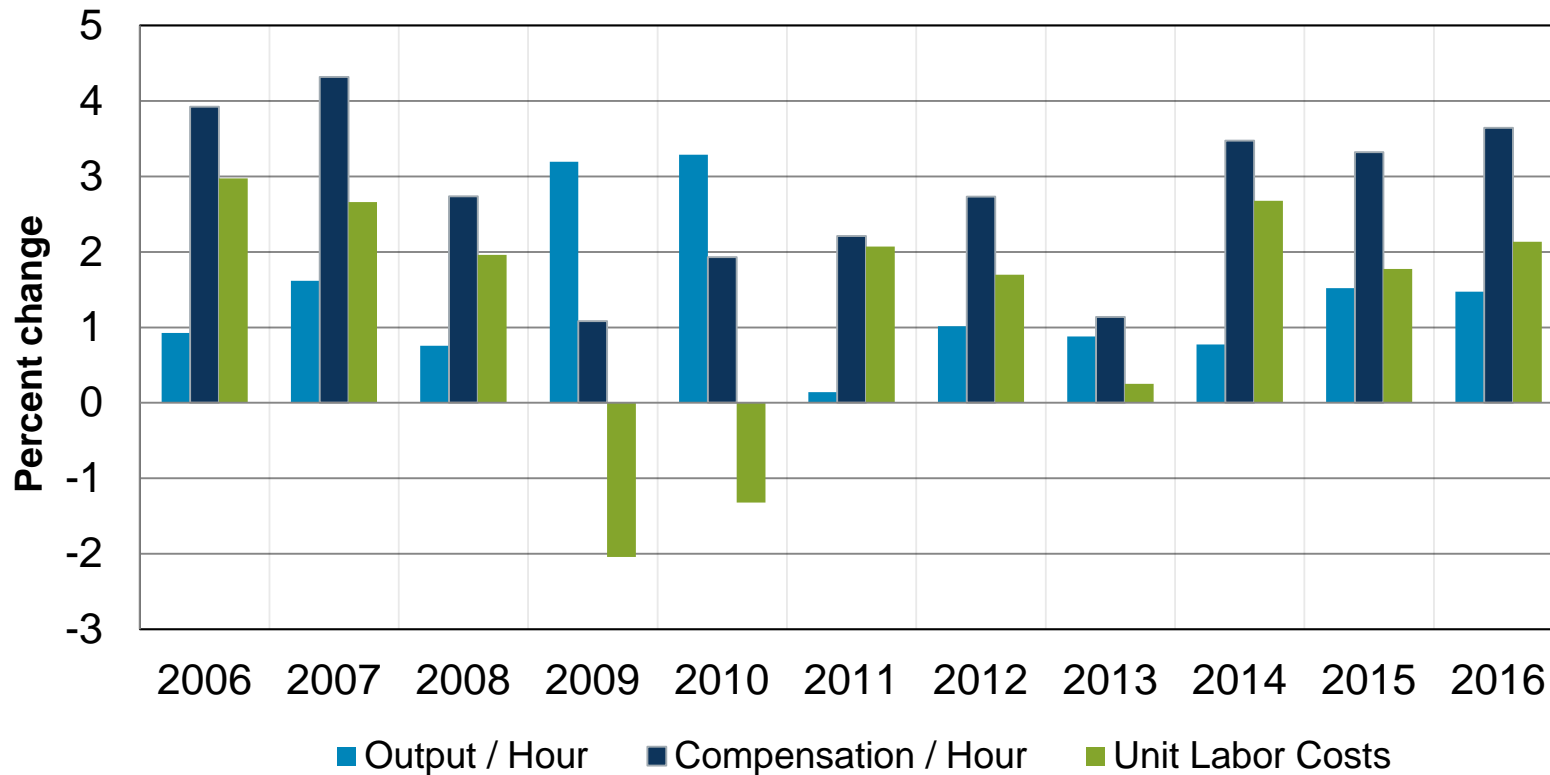
Nominal spending (% of GDP)



Productivity must increase if compensation grows.

Economic efficiency and costs

$$\text{Output / Hour} = \text{Compensation / Hour} - \text{Unit Labor Costs}$$

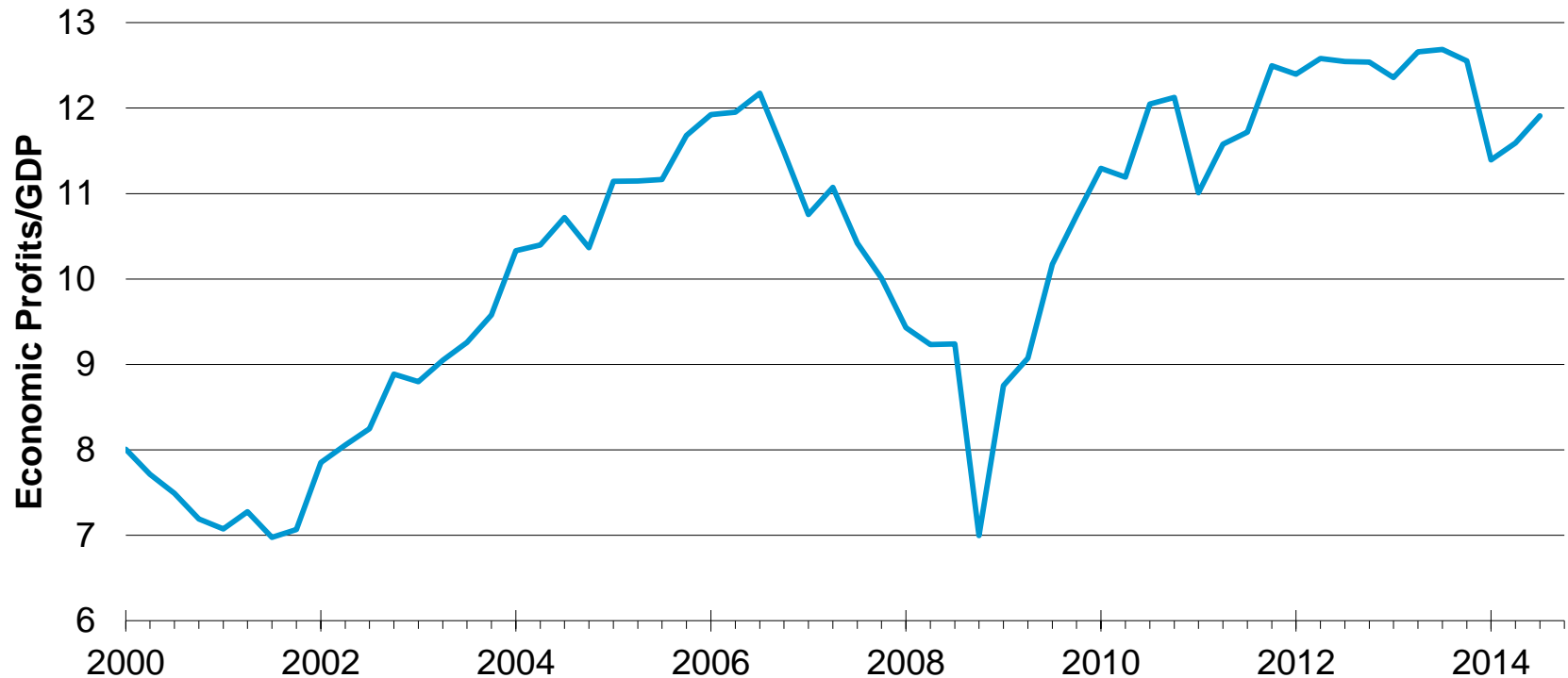


Source: IHS

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Corporate profit margins remain near all-time highs, despite weather-driven drop in 2014Q1.

Profit margins



NIPA corporate profits are pre-tax and include capital consumption adjustment and inventory valuation adjustment
Source: IHS

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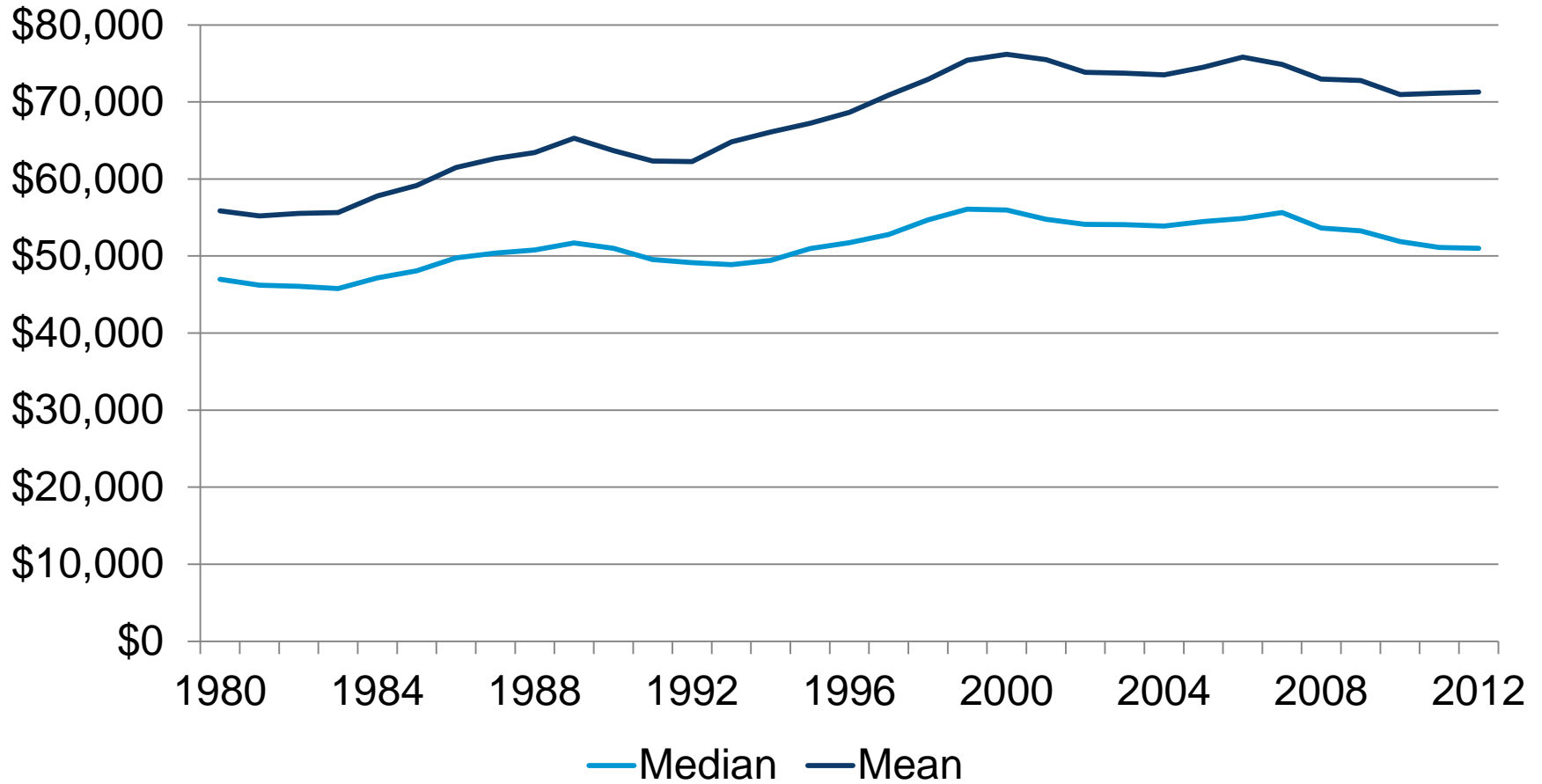
The consumer, consumer markets and the emergence of payroll cycle economics

Consumer spending: Positives beginning to outweigh the negatives.

<u>Negative Forces</u>	<u>Positive Forces</u>
Slow wage growth	Pent-up demand for durable goods (autos)
Debt burdens still high	Jobs growth picking up
Student loan debt on the rise	House prices rising
Low fertility rates and population growth rates	Debt burdens lower
Real median household income flat, income inequality up	Household asset values surpassed pre-crisis levels (for some)
Poverty rates elevated	E-commerce retail sales gaining share of retail trade
Food prices creeping up	Back-to-school retail sales looking solid but not as strong as last year

Household median and mean incomes have been stagnant for more than a decade.

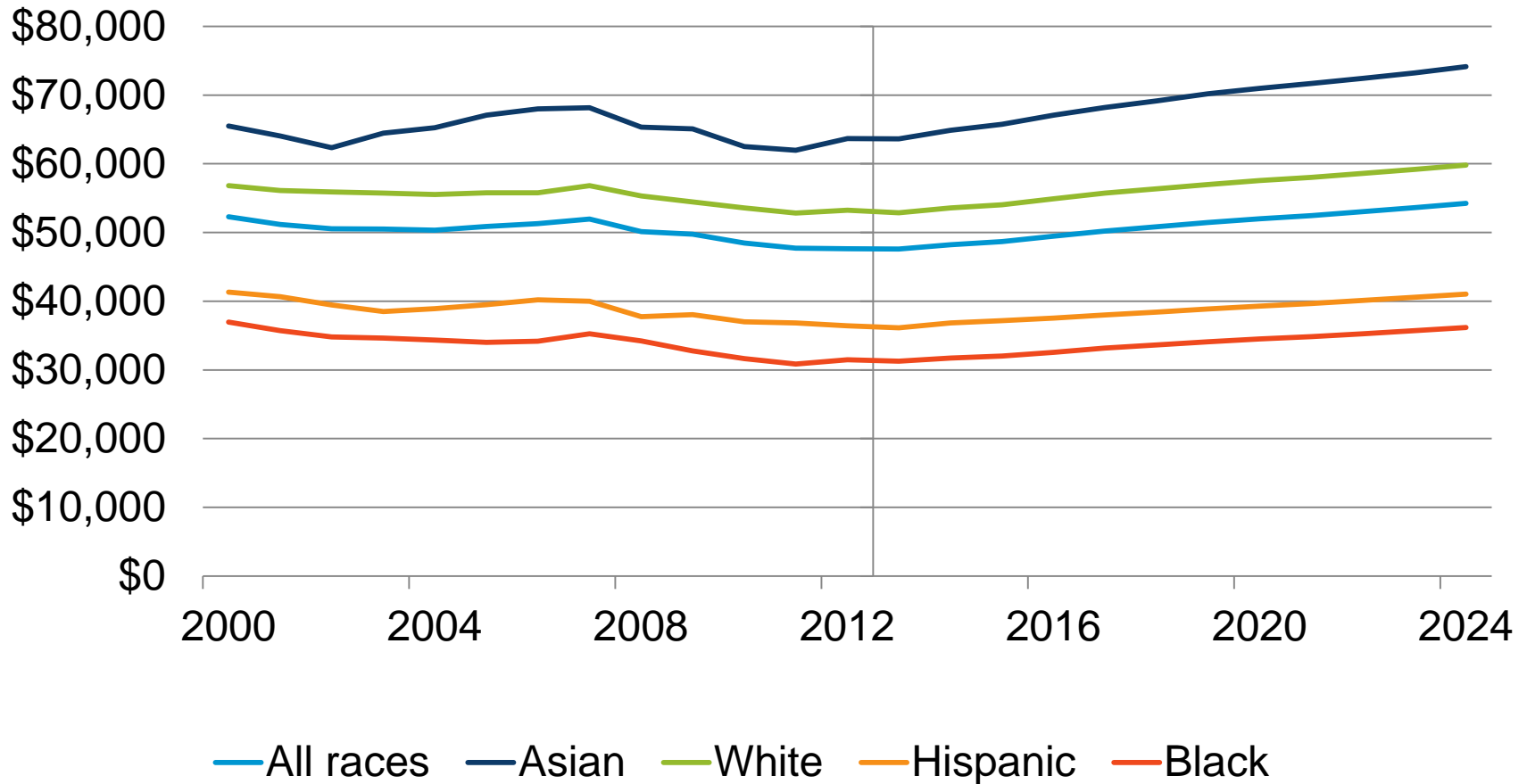
2012 dollars



Source: US Census: Income, Poverty and Health Insurance Coverage in the United States

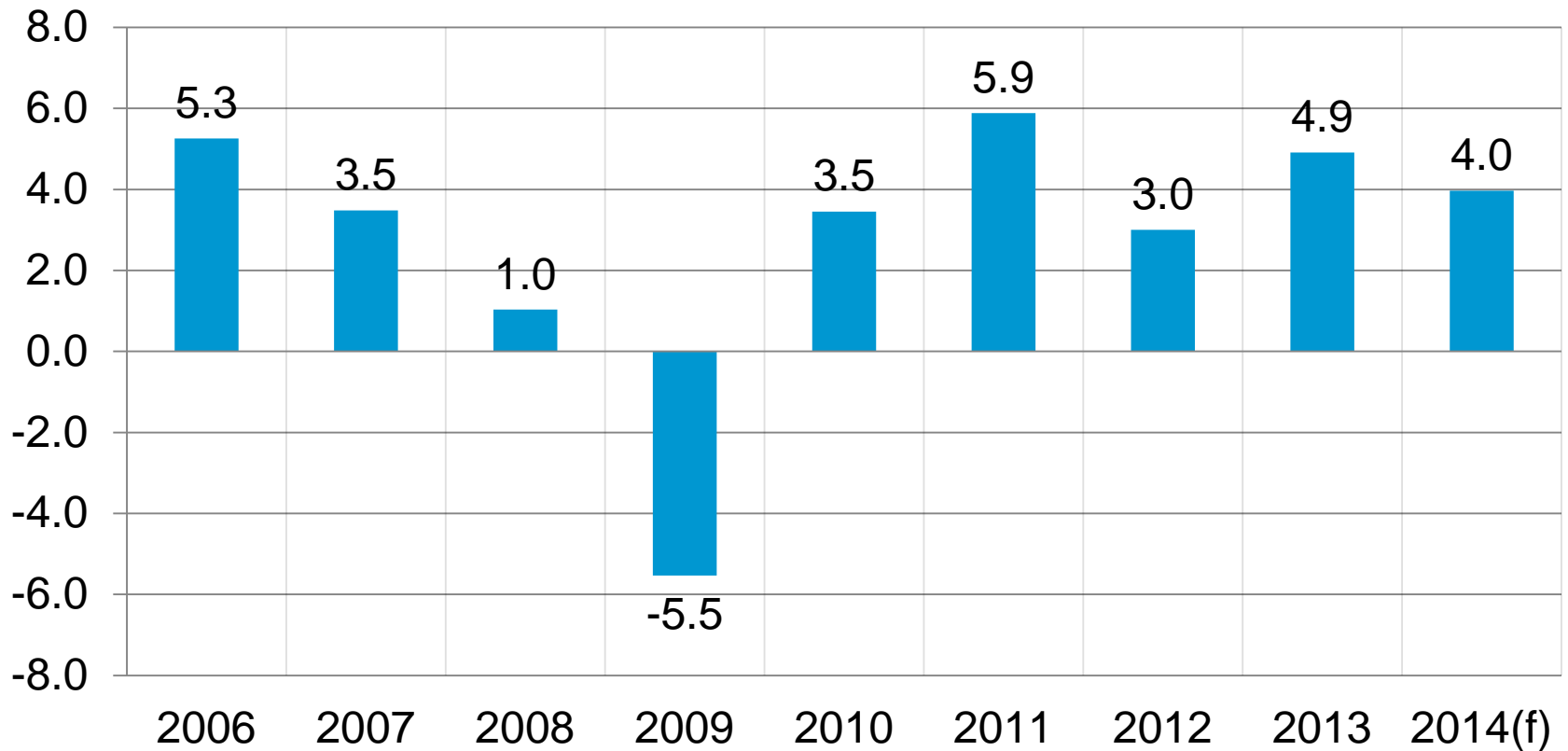
Income inequalities among ethnicities is expected to widen.

Median household income, real 2009 US\$ measure



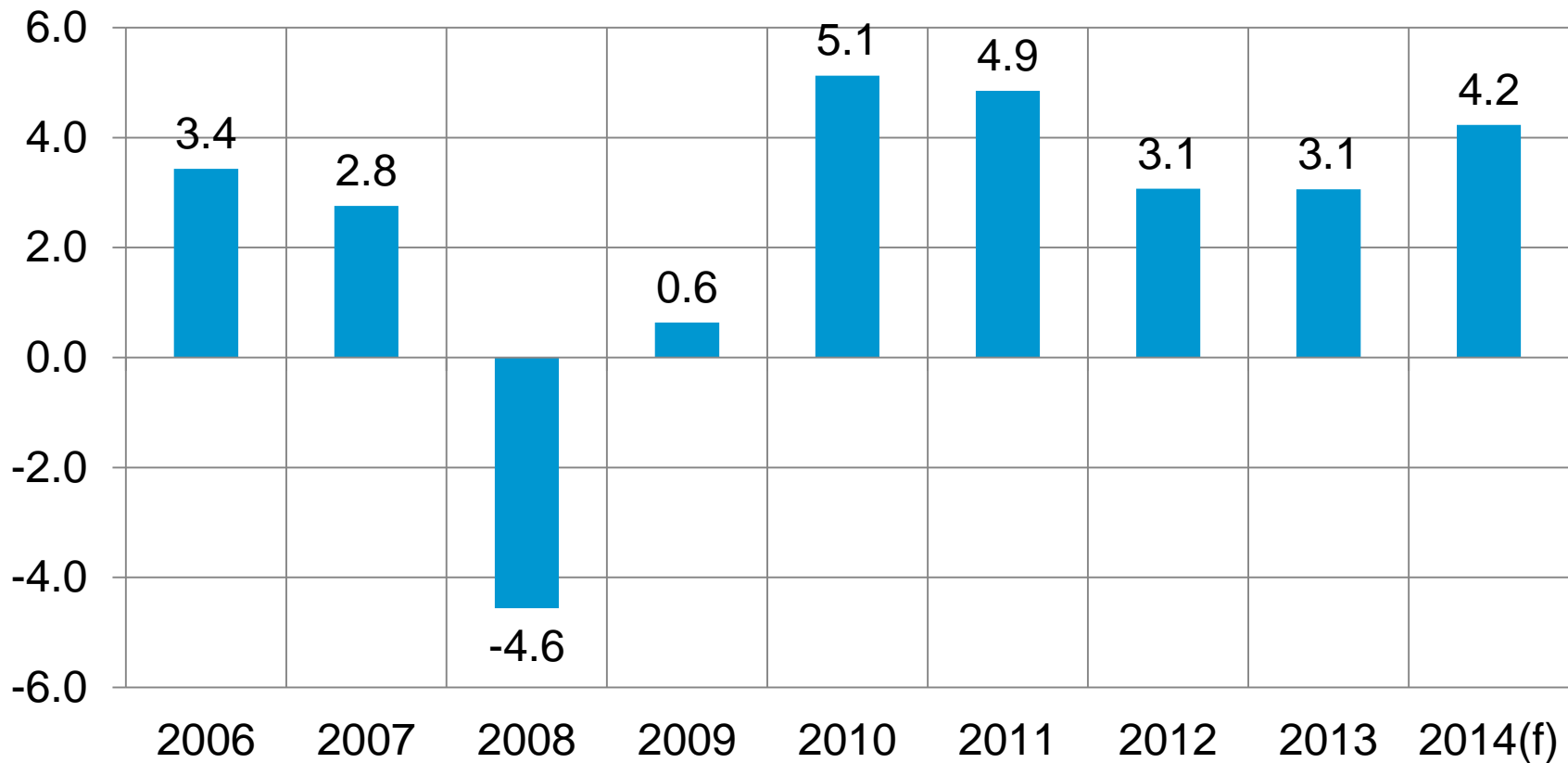
We give the back-to-school season this year a B+.

Back to school retail sales growth, %, excludes motor vehicles, gas and food)



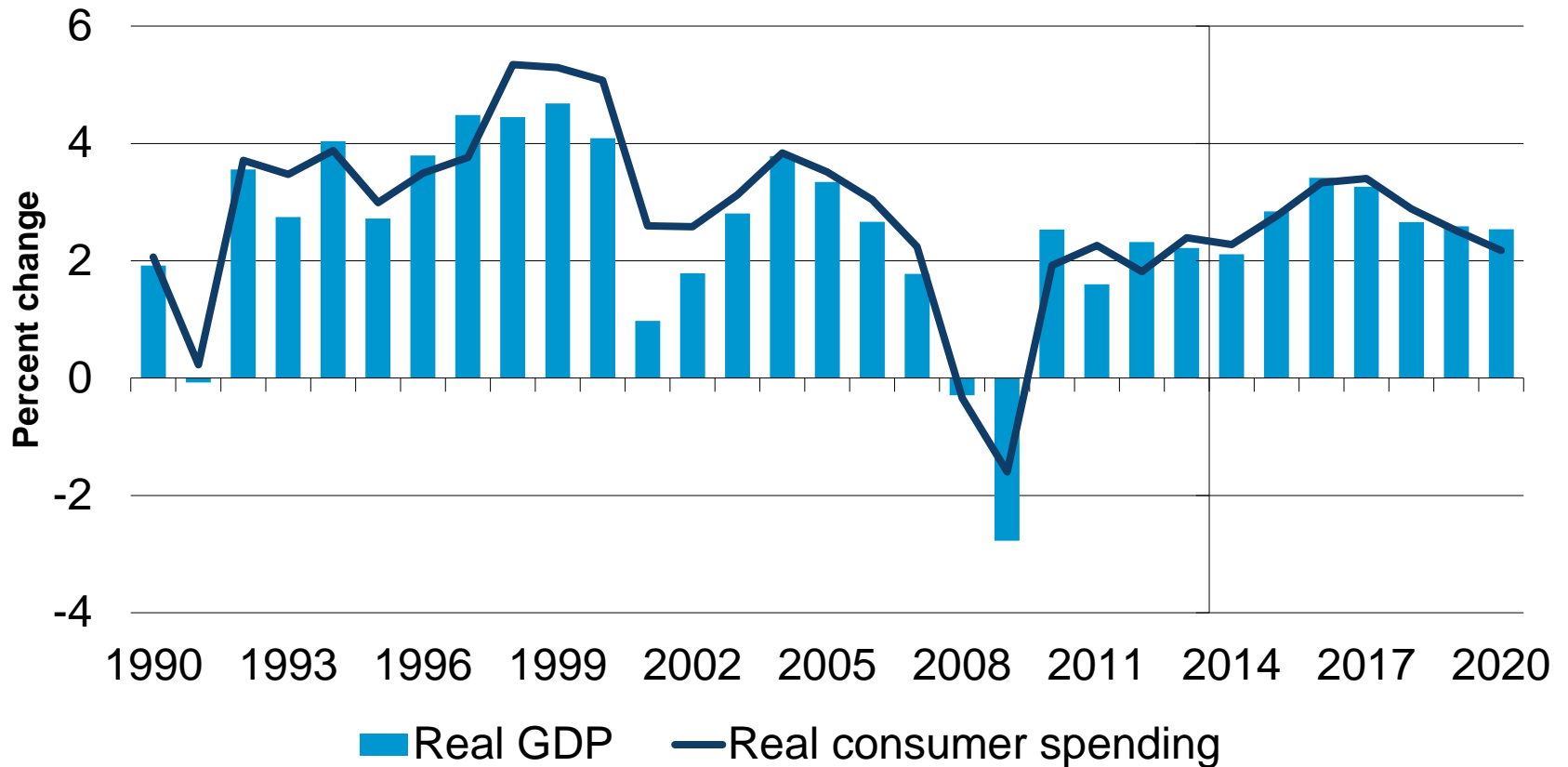
The holiday season in 2014 is expected to outpace the last two years.

Not seasonally adjusted retail sales November – December, percent change y/y



Resilient consumer spending is the unsung hero in the current economic environment.

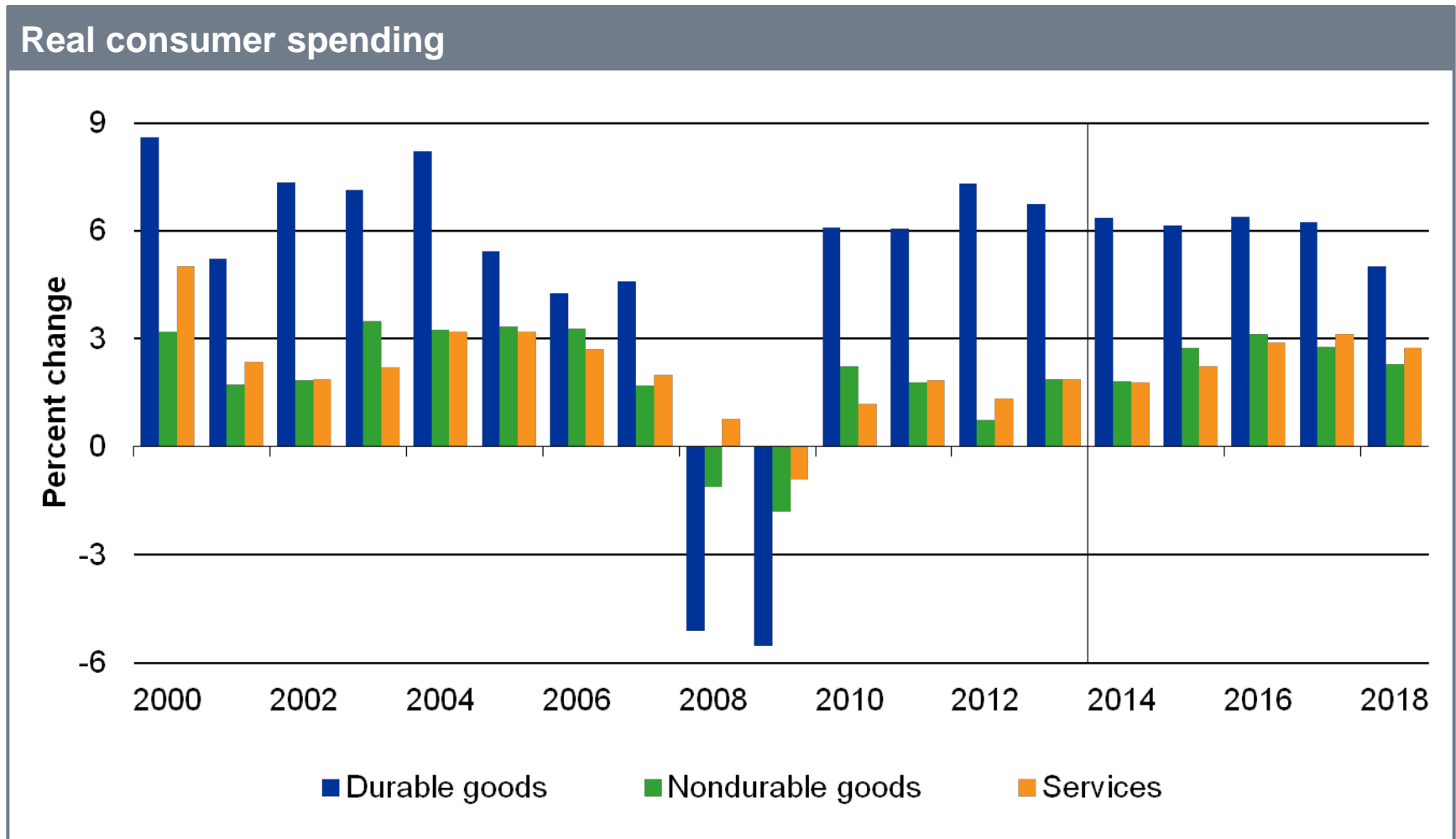
Real GDP and consumer spending



Source: IHS

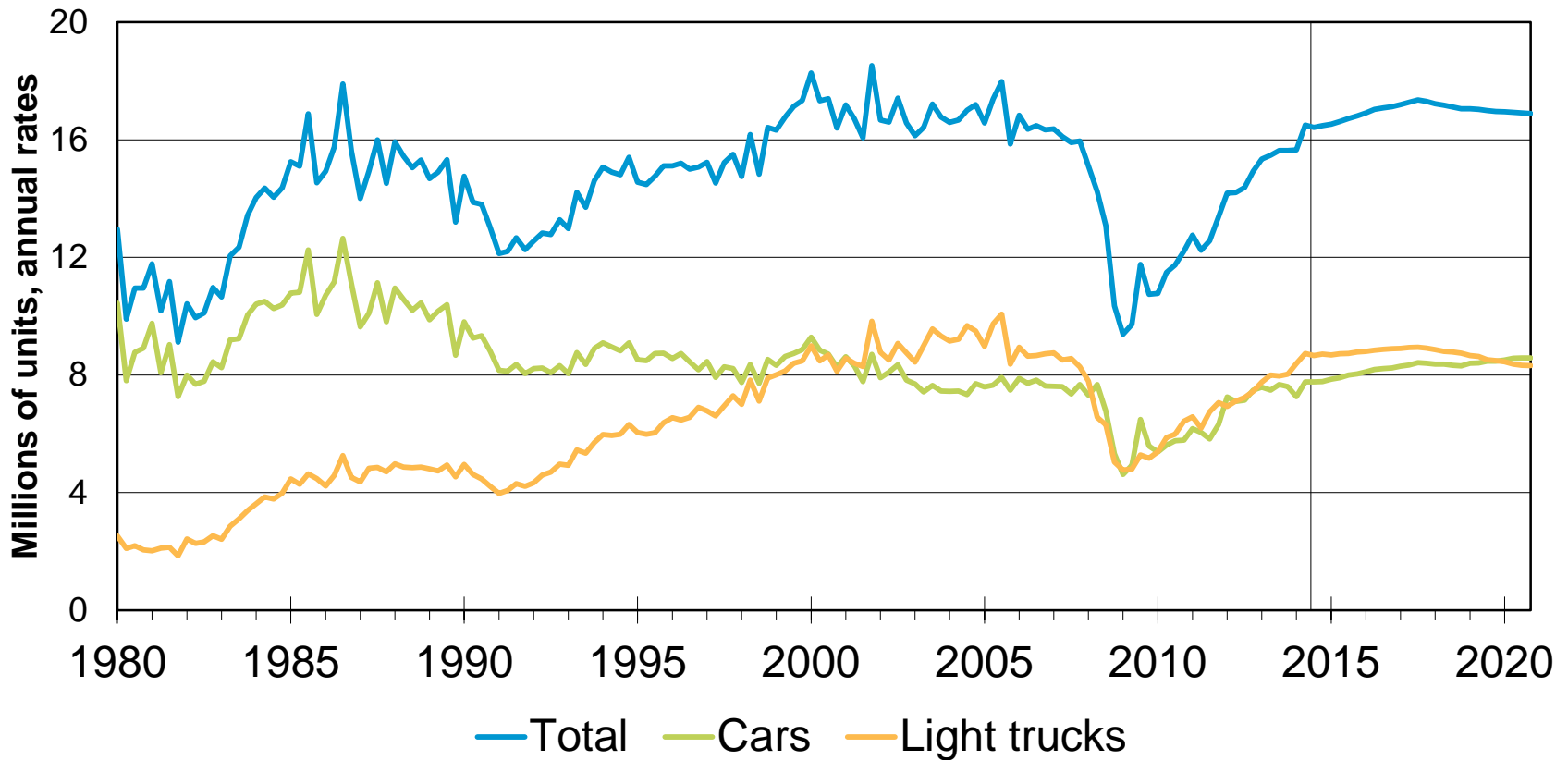
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Durable goods lead growth in consumer spending



US light-vehicle sales hold at near pre-recession sales rates.

Light-vehicle sales

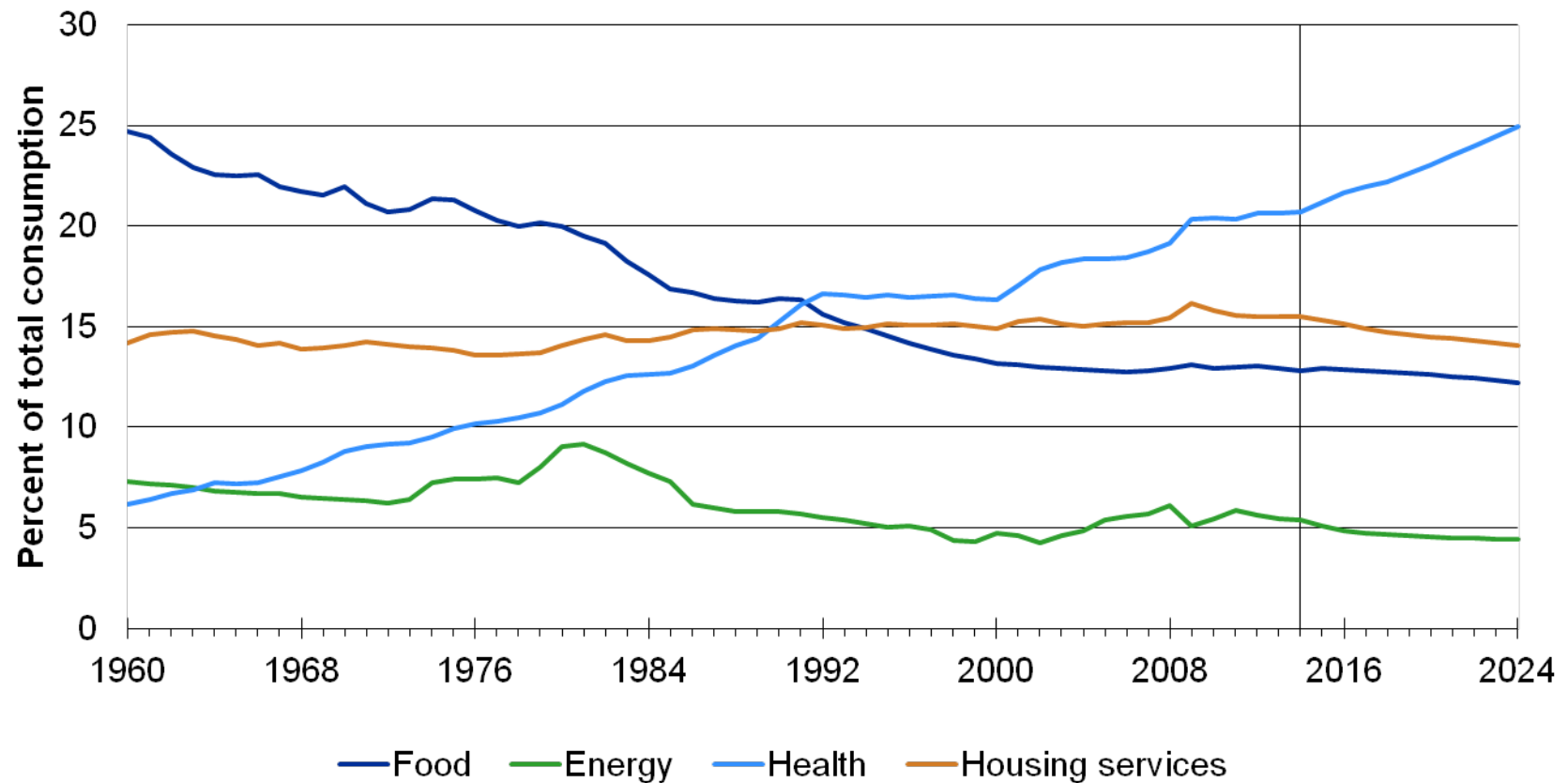


Source: IHS

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Healthcare will take a rising share of personal consumption expenditures in the decade ahead

Personal consumption by category (nominal)



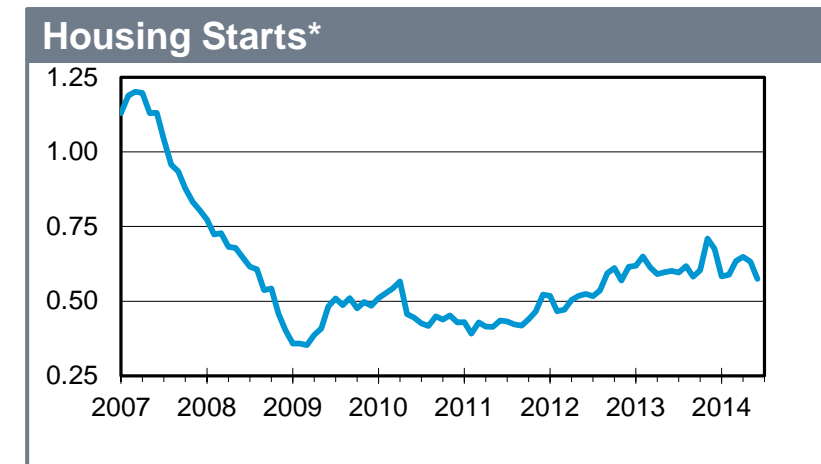
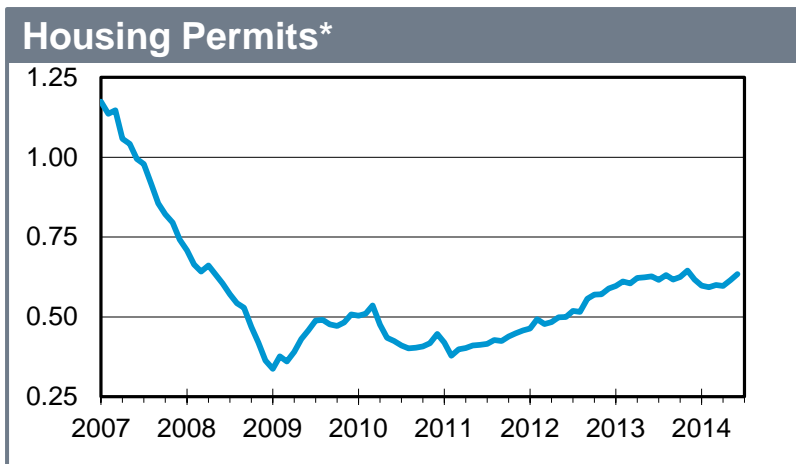
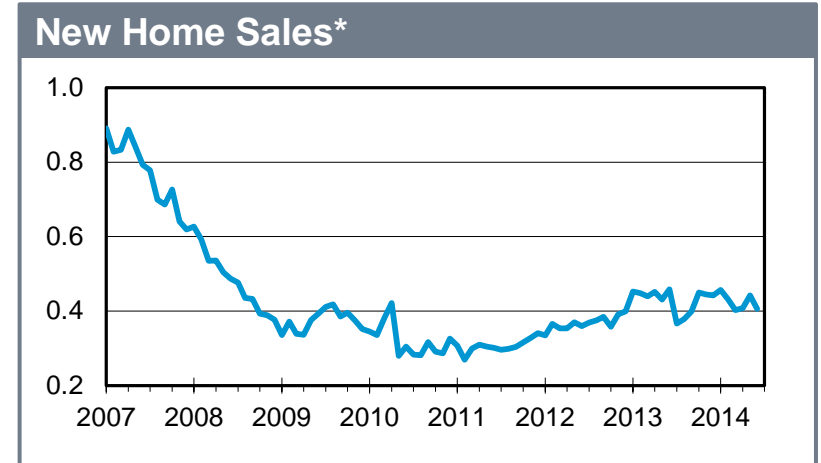
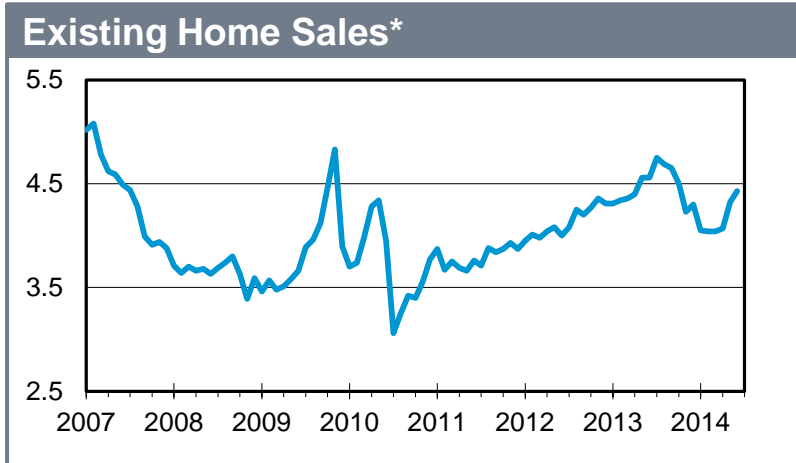
Housing and Construction

The housing recovery should be here, but...

Pluses
Reasonable mortgage rates
Decent job creation
Consumer deleveraging helps affordability
Recent history of price appreciation
Rental markets tight, helping spur multi-family starts

Minuses
Adverse household formation among under-35 and 35-44 y.o. households.
Greater perceived risk of holding real estate
Higher input prices for builders squeezing margins
Shortage of buildable lots
Very stringent lending standards for builders and buyers
Job mobility stuck at recession levels
Significant student loan burden
Lack of distressed properties for sale, especially impacting investor demand
Household formation may have slowed

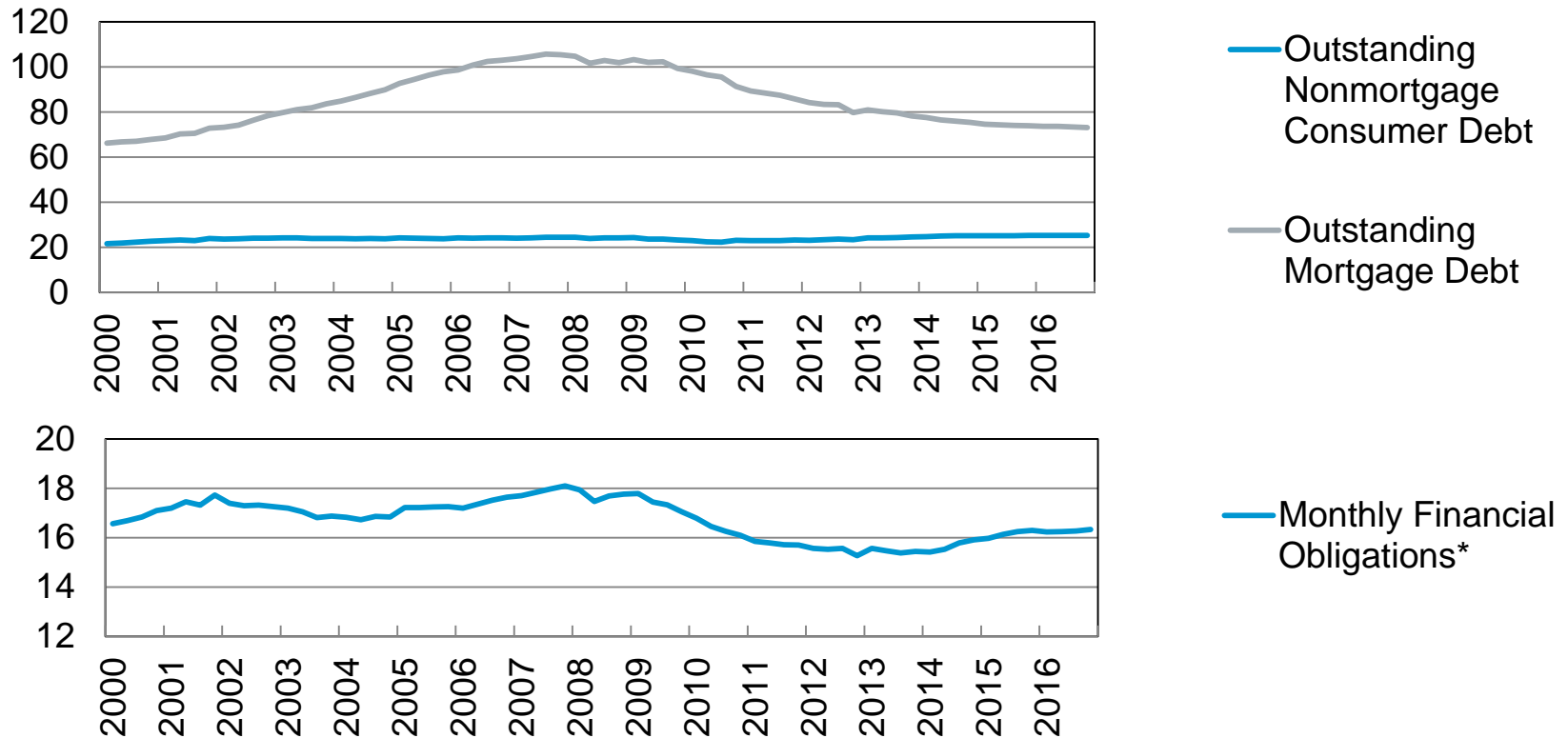
Single-family housing indicators: Also improving, but slowly



*Millions, SA
Source: IHS

Overall mortgage debt has come down, but financial obligations* will increase as interest rates increase.

Share of disposable income (%)

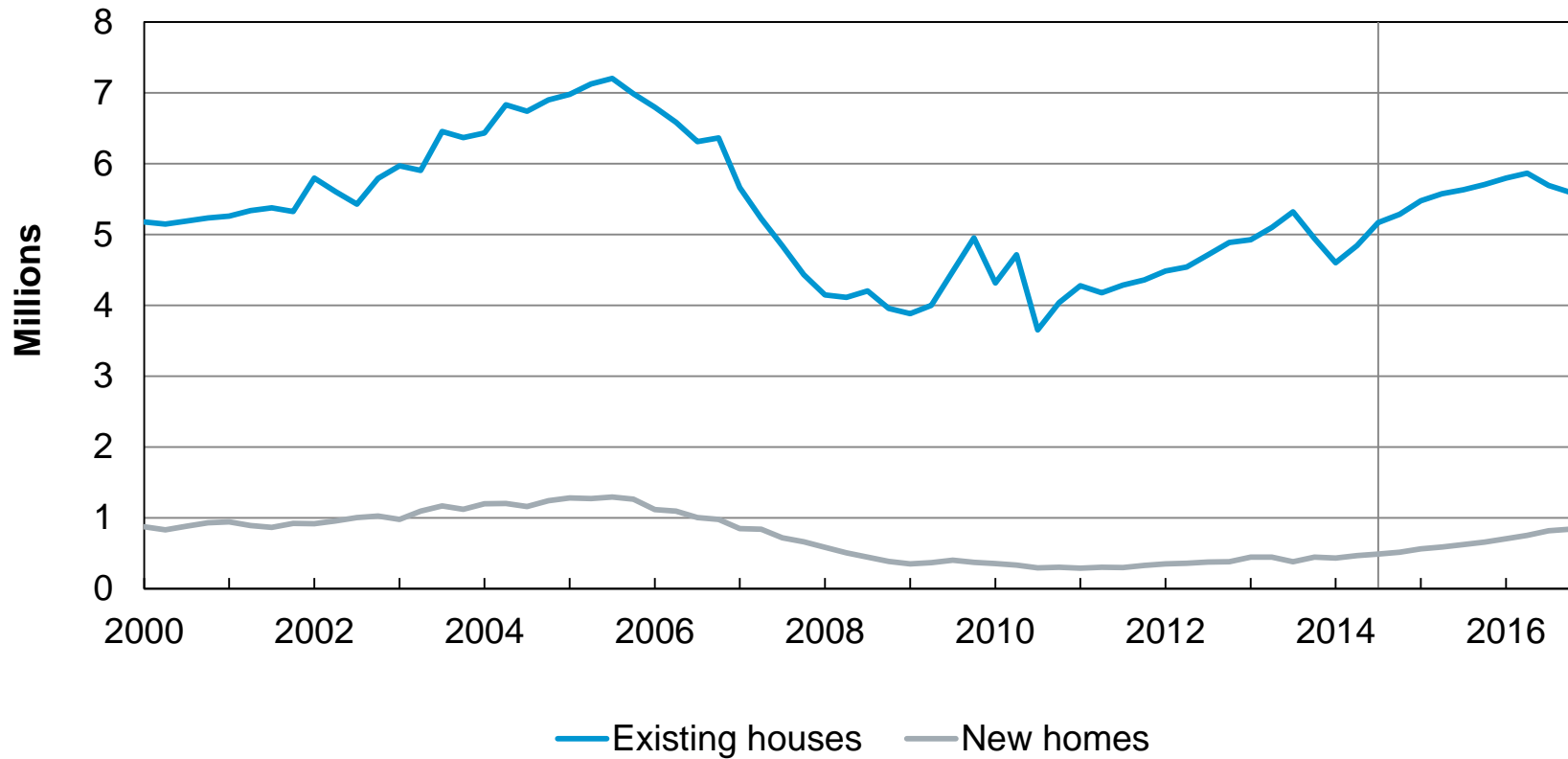


Interest payments, rent, auto lease payments, homeowners' insurance and property tax
 Source: IHS

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The rebound in home sales has been solid, but pre-recession levels will not be re-attained.

Home sales

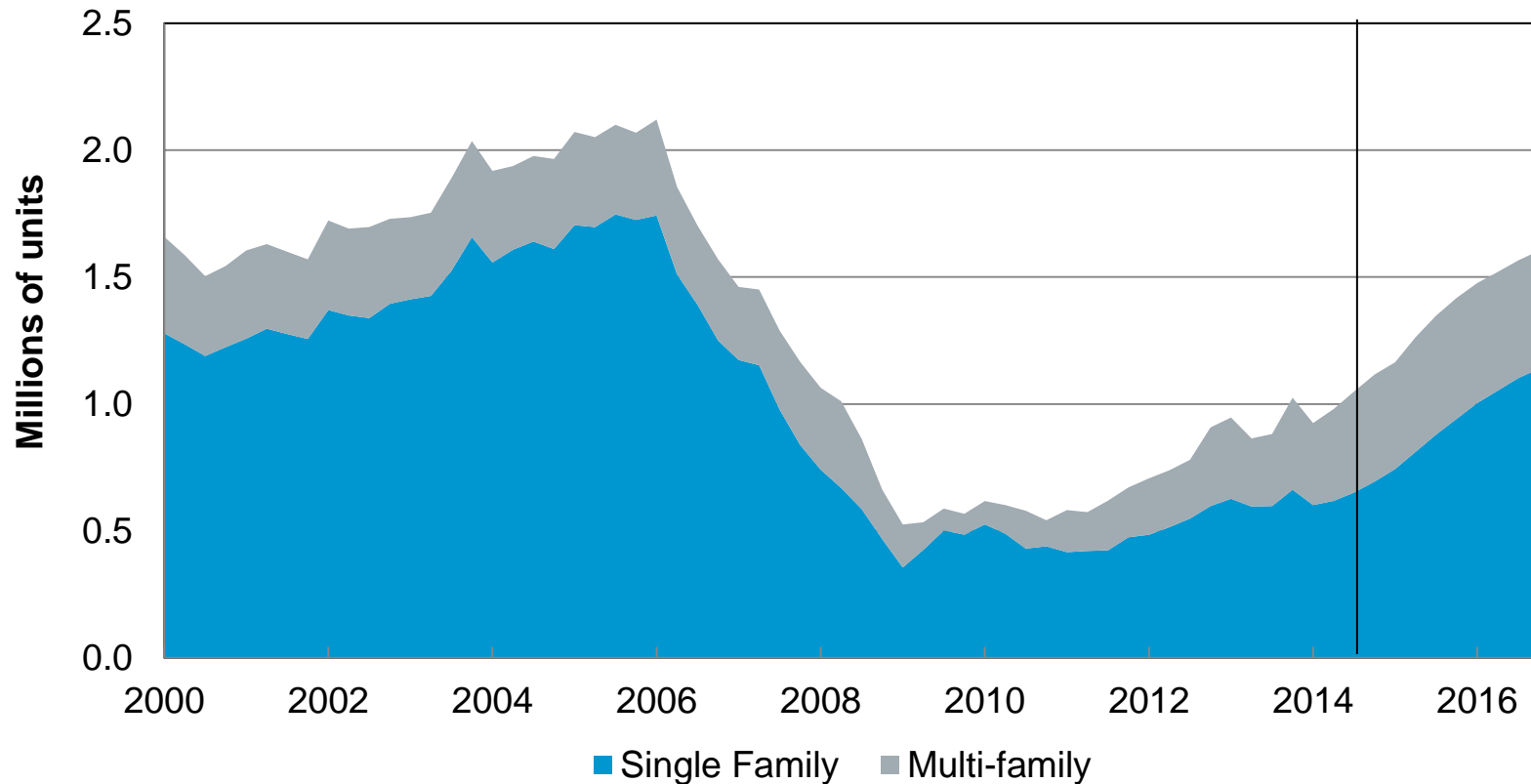


Source: IHS

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Housing picks up, but not back to last decade's peaks; share of multi-family increases.

Housing starts

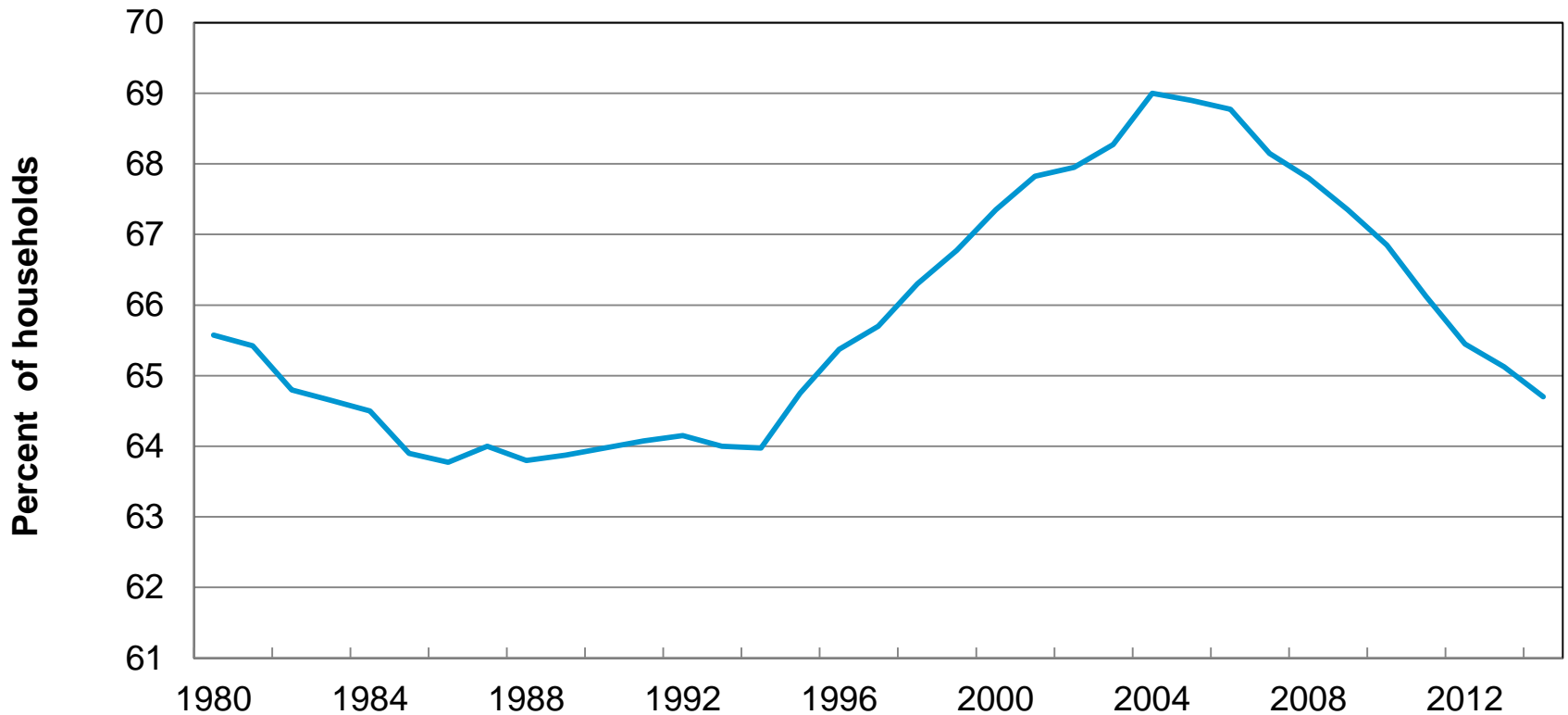


Source: IHS

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Over the past ten years, 4% of all households have sold their homes without buying anew

Homeownership rates

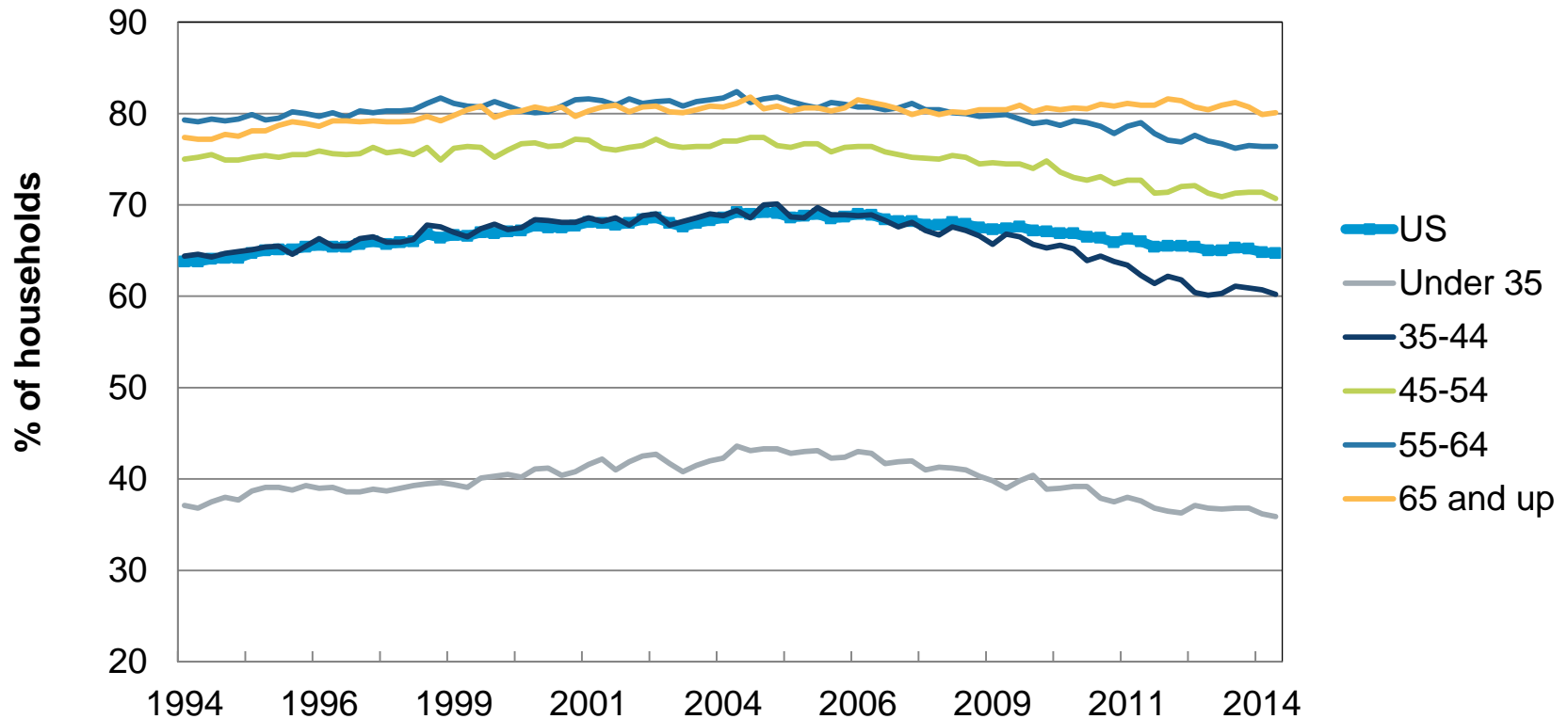


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Homeownership rates are dropping for all age cohorts except maybe 65+

Homeownership rates by age cohort

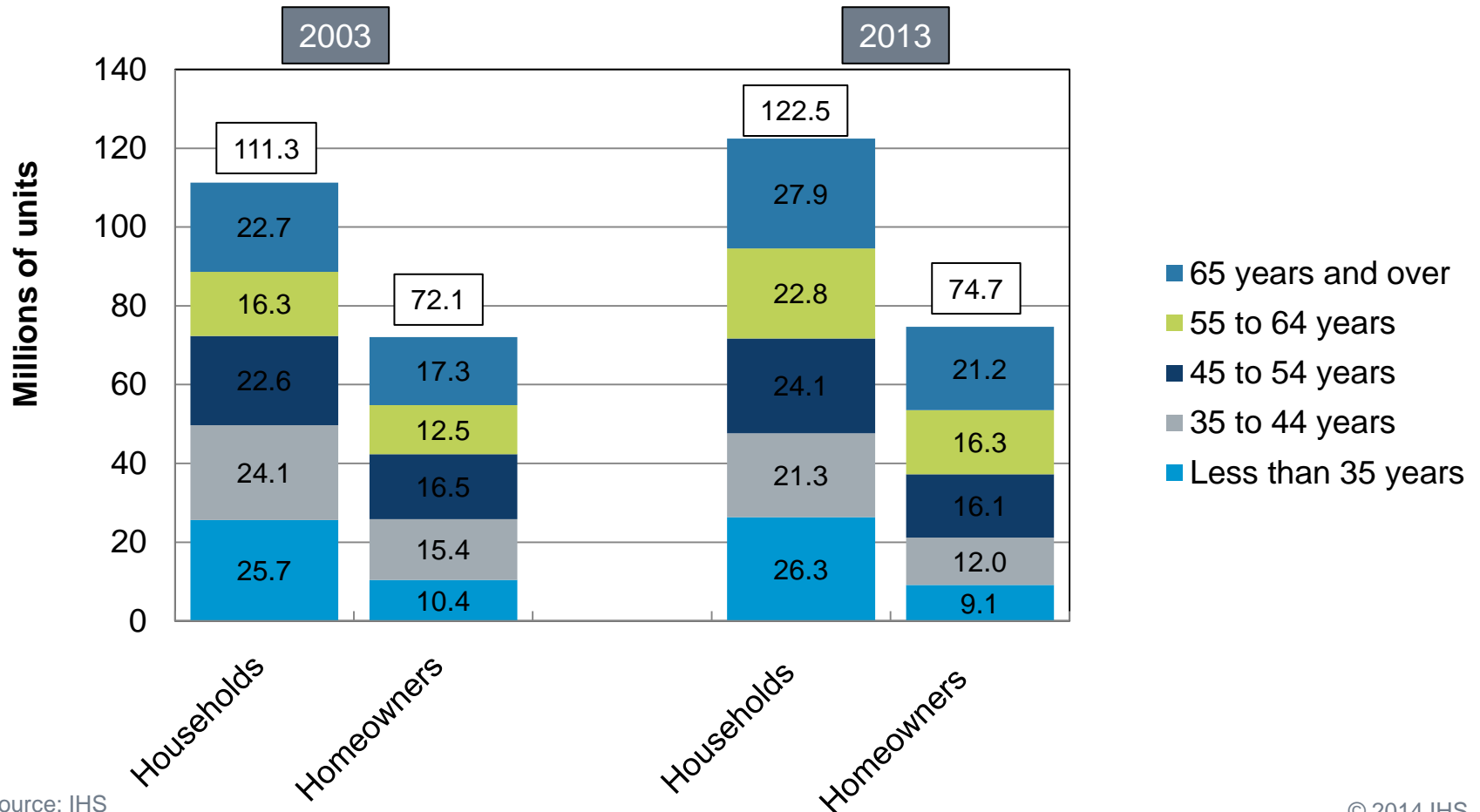


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Homeownership has dropped precipitously among the 35-44 and less than 35 age cohorts.

Number of households or homeowners

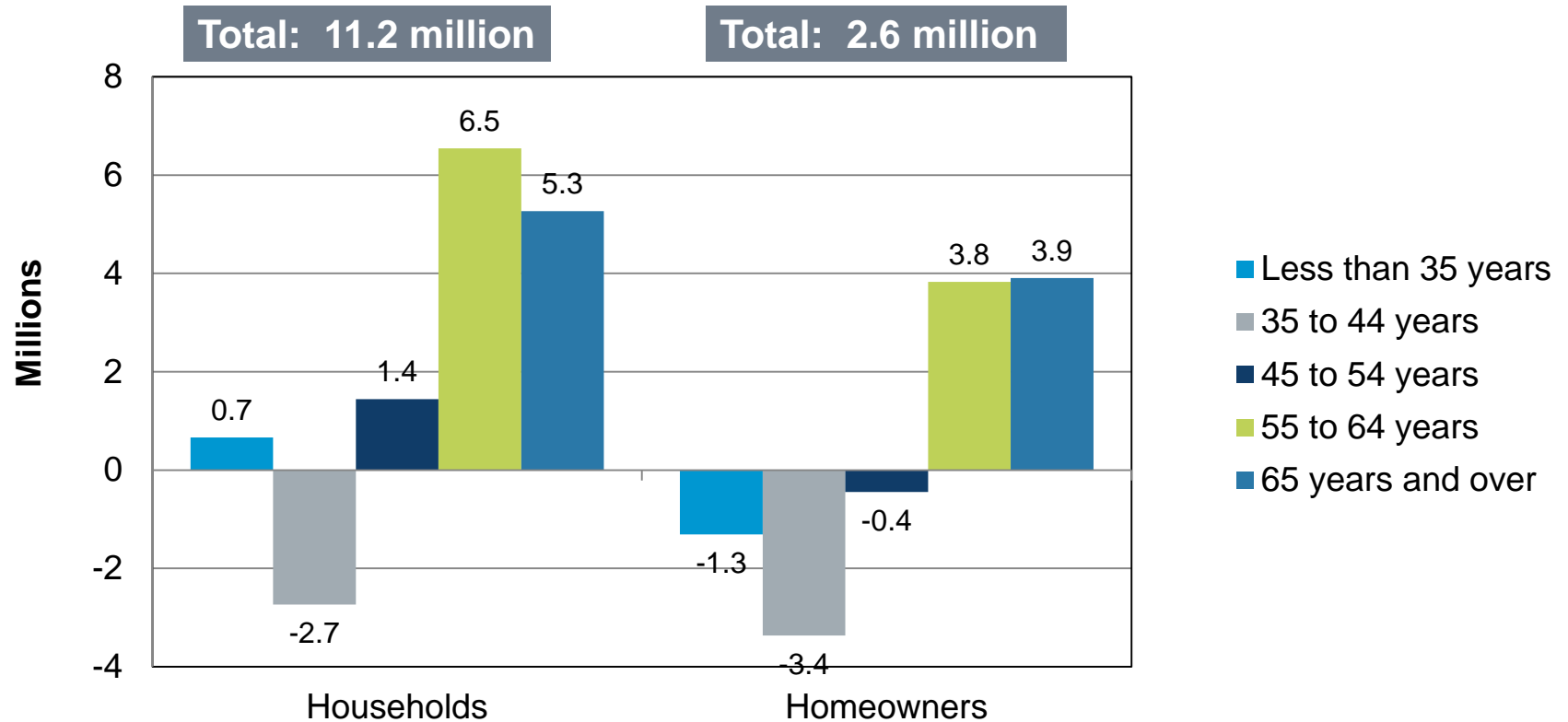


Source: IHS

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Homeownership has dropped precipitously among the 35-44 and less than 35 age cohorts

Change in the number of households or homeowners, 2003-2013

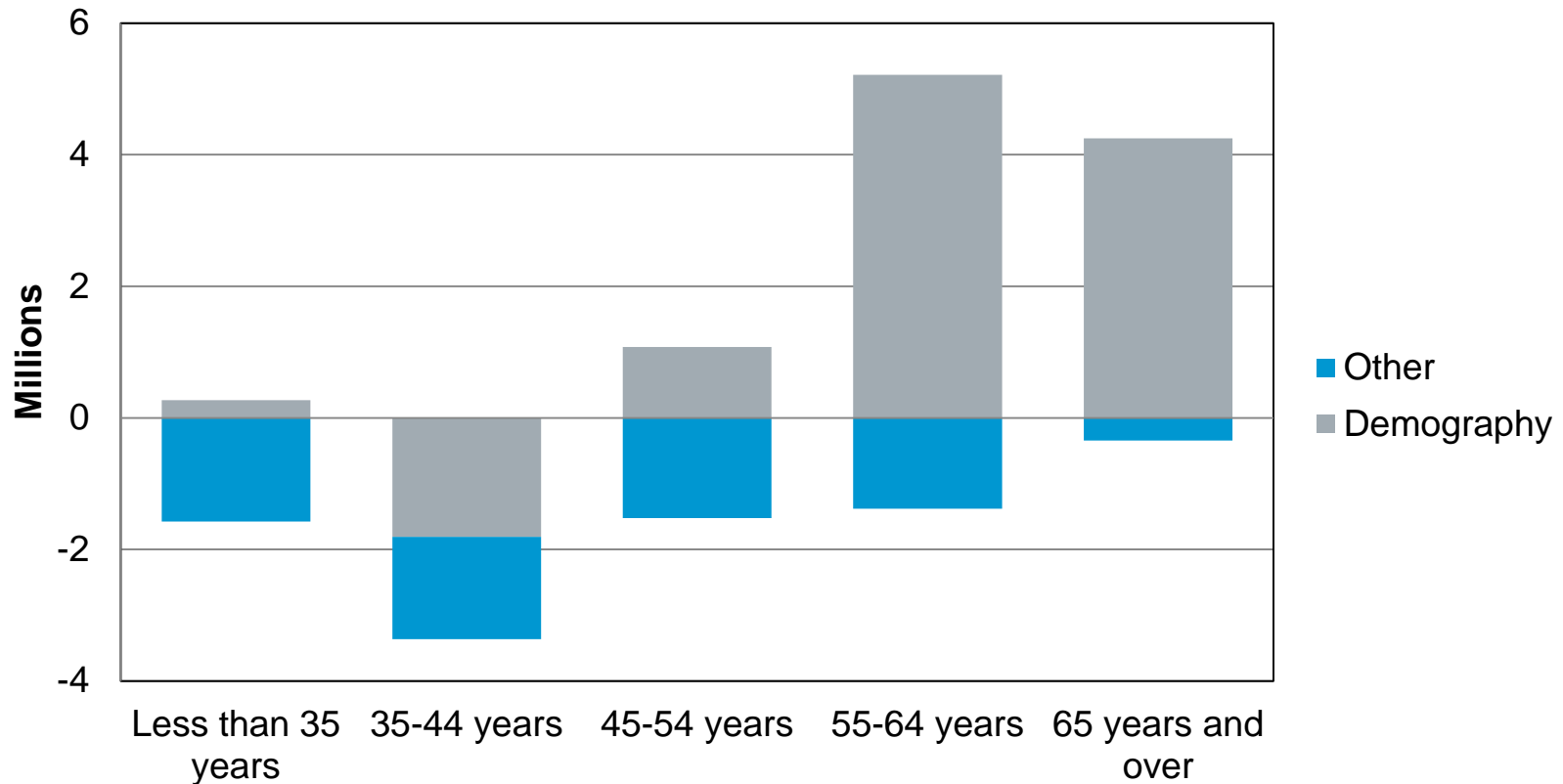


Source: IHS

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How much of the change in homeownership comes from demographics alone?

Change in the number of homeowners, 2003-2013

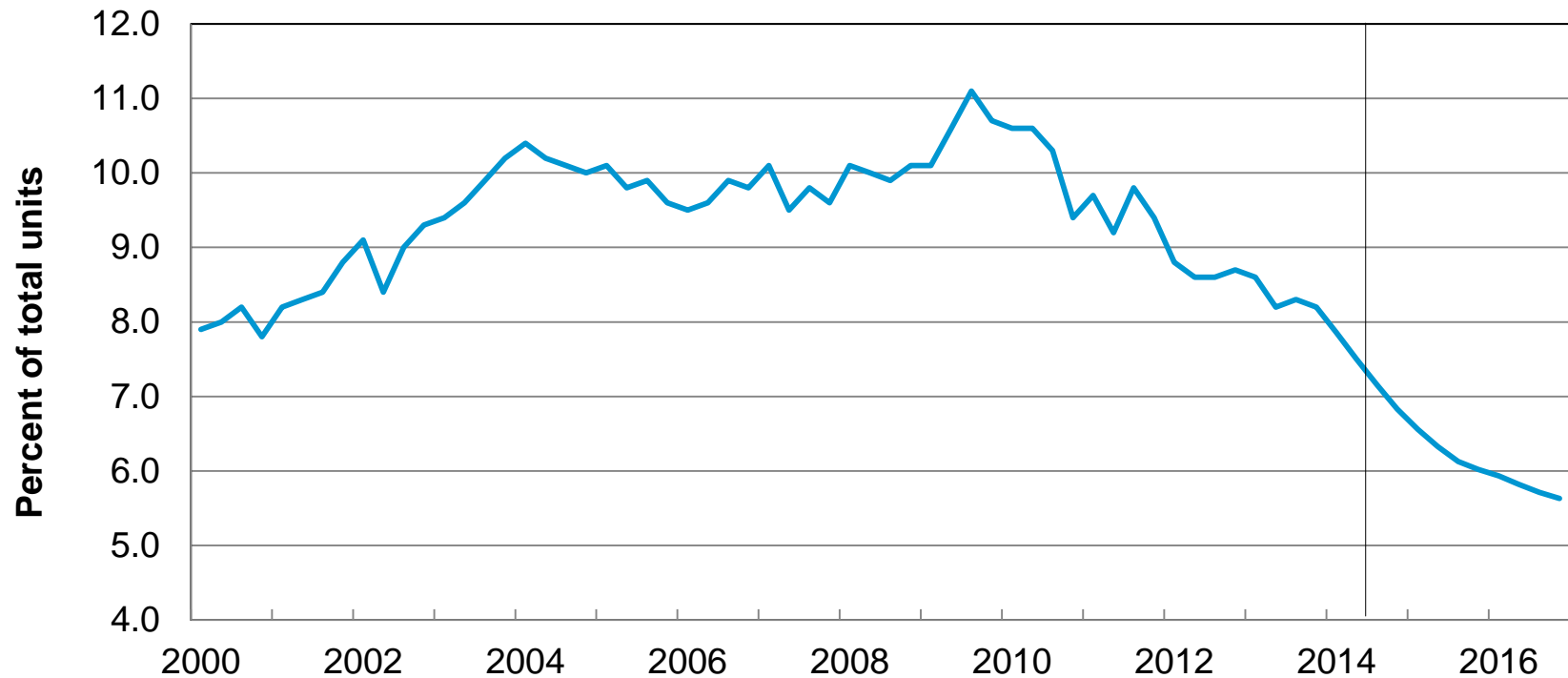


Source: IHS

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We expect the decline in rental vacancy rates to spur building activity

Rental vacancy rates



Source: IHS

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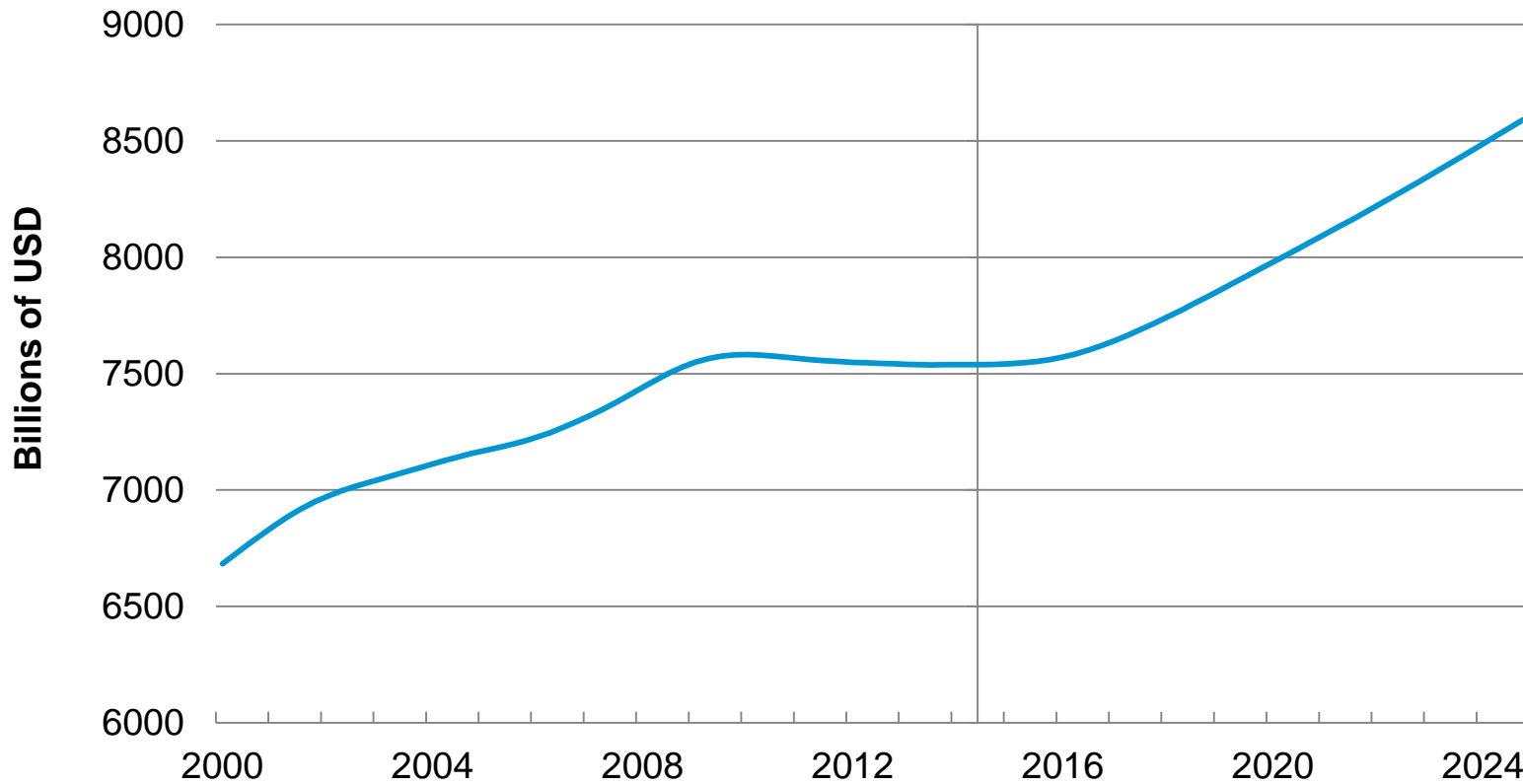
US construction growth by sector

Investment in structures

Percent change, 2009 dollars	2013	2014	2015	2016
Total construction	5.7	4.8	8.6	11.5
Residential	12.0	3.4	15.2	15.3
Commercial	8.0	9.3	11.6	24.9
Manufacturing	-1.3	1.0	4.1	9.1
Mines & wells	0.5	7.8	2.1	-4.6
Healthcare	-9.0	-10.2	9.0	25.1
Public utilities	-7.0	12.3	-14.0	-4.6
Highways & streets	-2.1	2.1	2.9	0.8
Public education	-11.8	-0.5	4.6	2.3

Building construction will pick up

Real net stock of nonresidential buildings

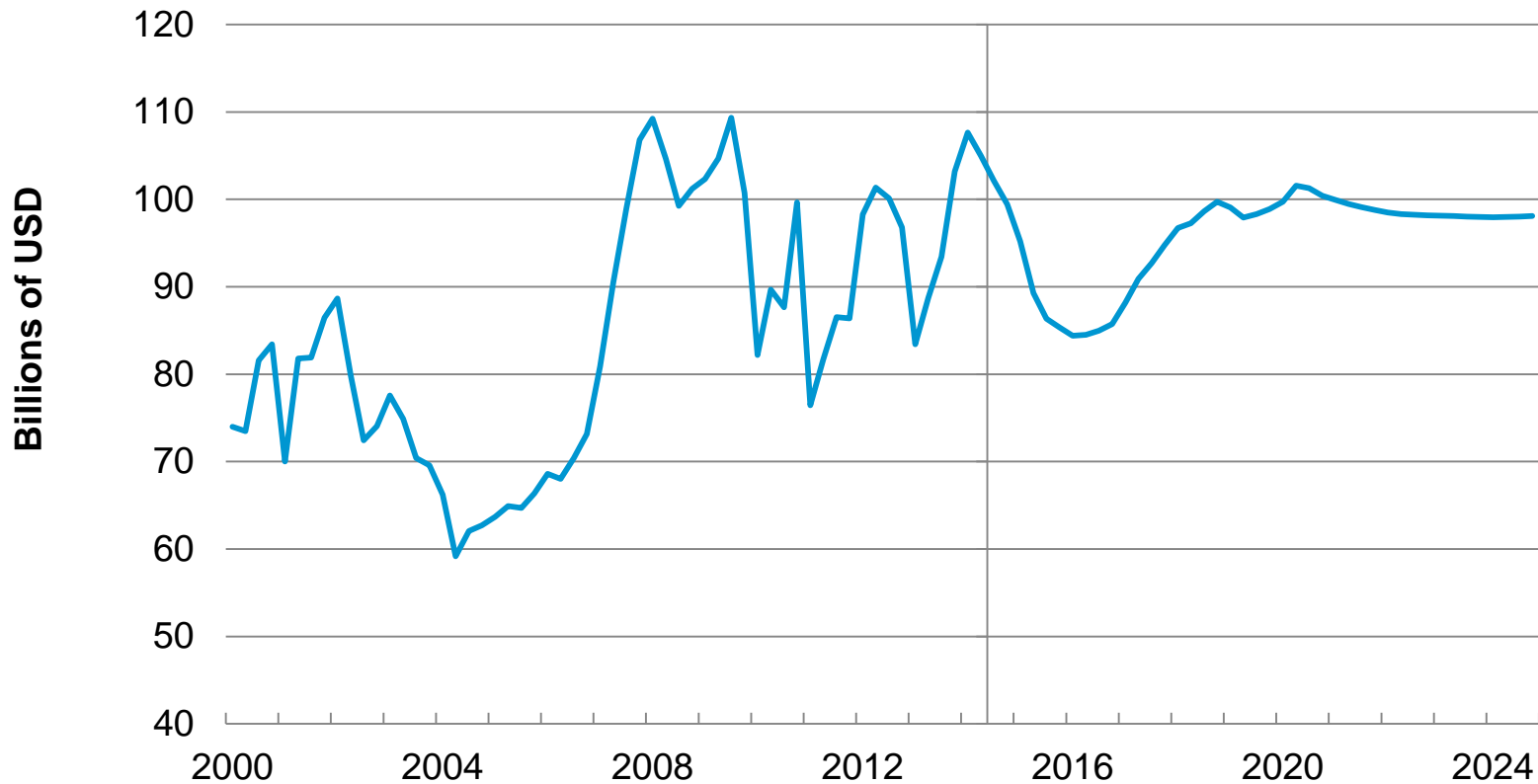


Source: IHS

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A correction in public utilities construction

Real private nonresidential construction - public utilities

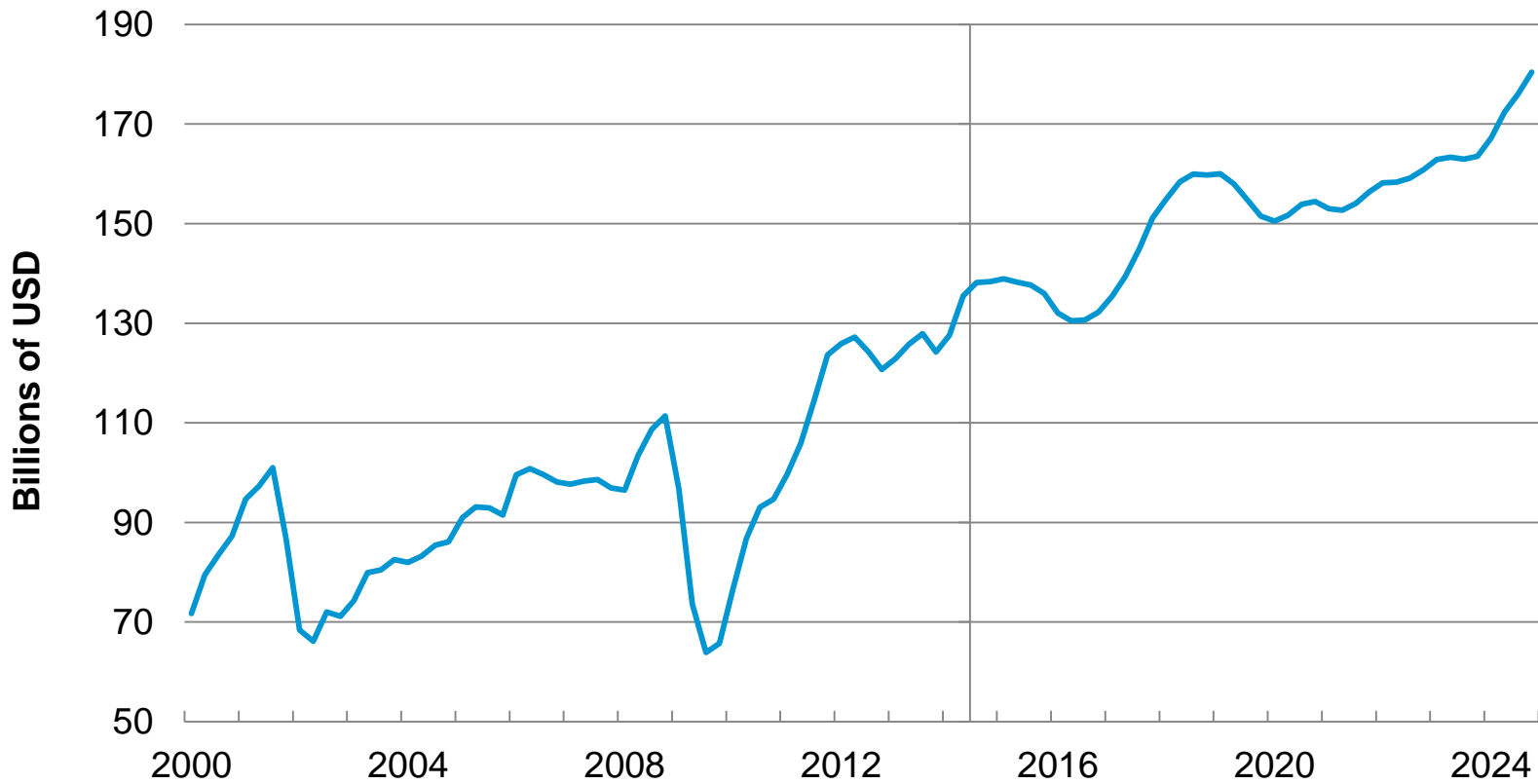


Source: IHS

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Drilling for oil and gas will expand further

Real private nonresidential construction – mines and wells



Source: IHS

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Monetary Policy and Interest Rates

Recent Developments

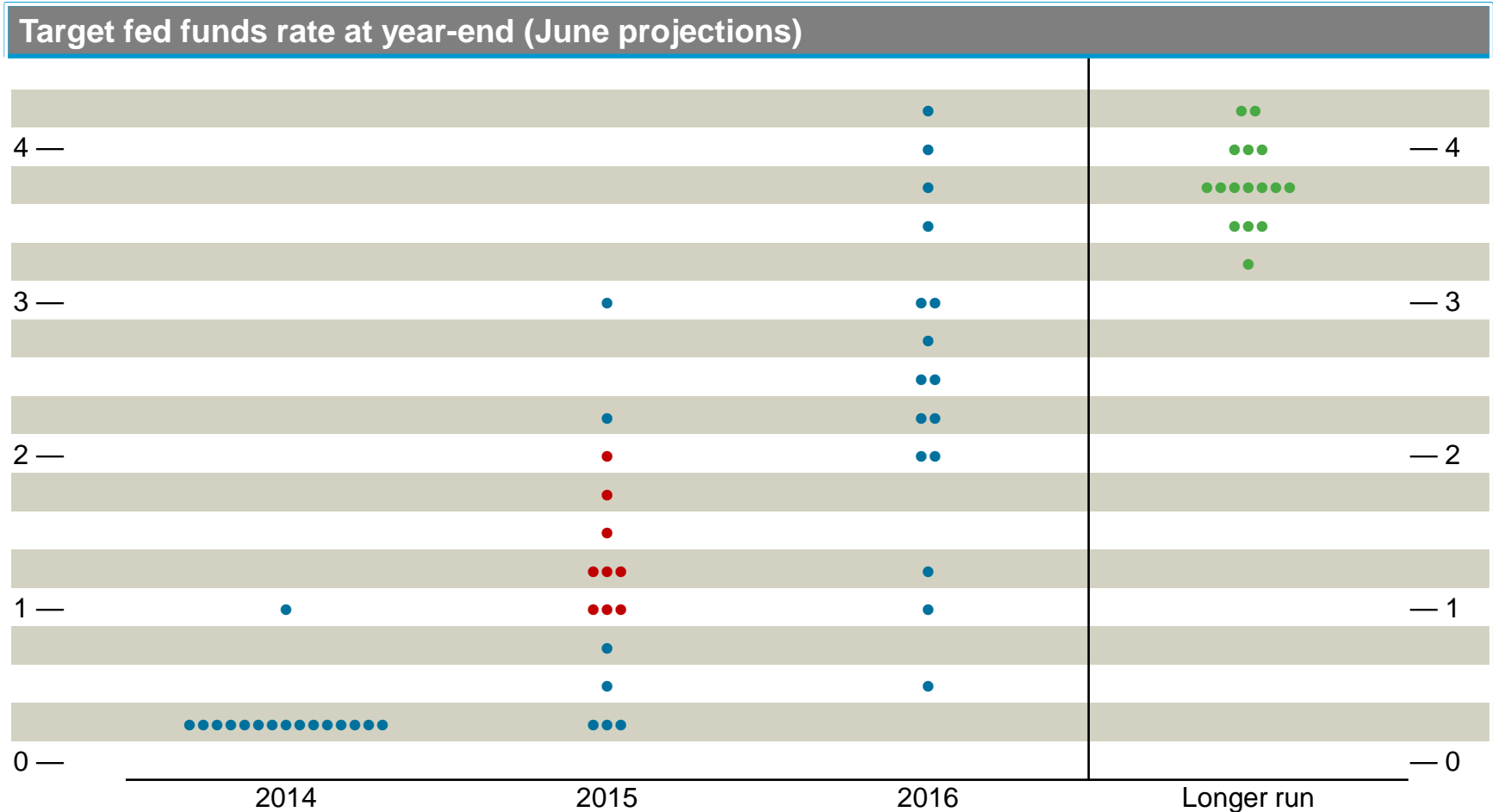
- Interest rate hikes – conversation shifts from the “if” to the “when” and “how.”
- Growing disagreement about labor market slack and inflation risks.
- Are financial stability concerns much of a consideration?
- Monetary policy is data-dependent, but only within limits.
- Labor-market weakness: cyclical vs. structural factors.
 - Implications of secular stagnation for future monetary policy
 - Long-standing issues in labor market
 - “Pent-up wage deflation” as explanation for soft wage growth.
- 2% inflation – target or ceiling?
- Fed’s Jackson Hole conference – Hawkish overtones



Fed will raise interest rate in 2015 come rain or come shine.

Monetary Policy Tightening – The “When”

six-month window – late-2015Q1 to late-2015Q3

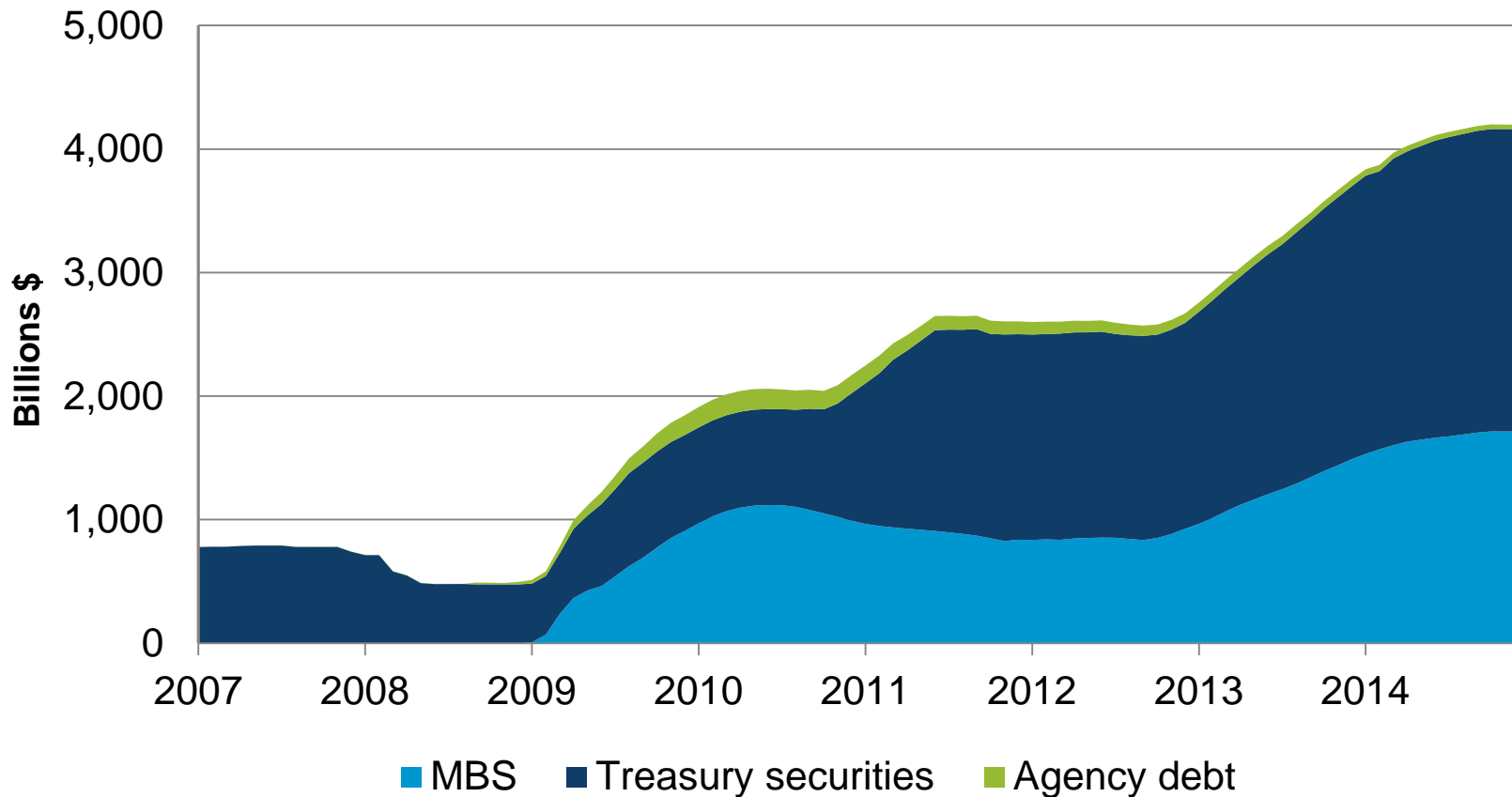


Each shaded circle indicates the value (rounded to nearest ¼ percentage point) of an individual participant’s judgment of the appropriate level of the target federal funds rate at the end of the specified calendar year and over the longer run.

Monetary Policy Tightening – The “How”

Fed will tighten with a “big” balance sheet

Fed assets



Monetary Policy Tightening – The “How” (cont.)

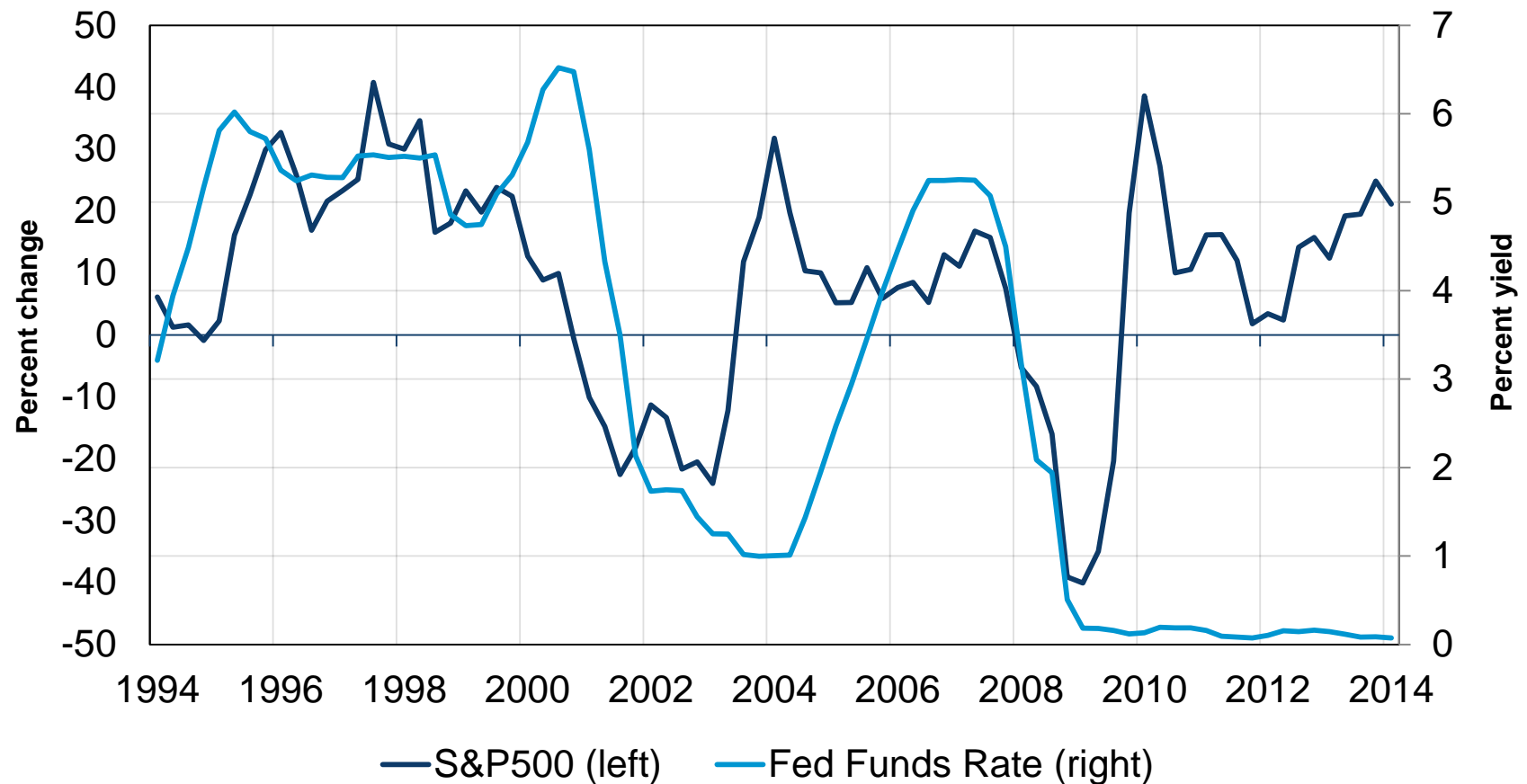
- Fed has never managed short-term interest rates with such abundant liquidity in the financial system.
- Fed loses control over fed funds rate (FFR) with abundant bank reserves.
- But draining reserves quickly introduces financial market risks.
- Solution: raise interest rate on bank reserves (IOR) - currently 0.25 bps
 - FFR trades close to IOR.
 - No bank will lend at rate below what it can earn risk-free from Fed.
- IOR has been “porous” floor for FFR thanks to GSEs.
 - Solution: interest rate on overnight reverse repurchase (repo) agreements to serve supporting role.

Bottom Line:

- Fed has the tools to tighten monetary policy without shrinking its balance sheet.
- FFR will remain operational target, but IOR will be the tool.

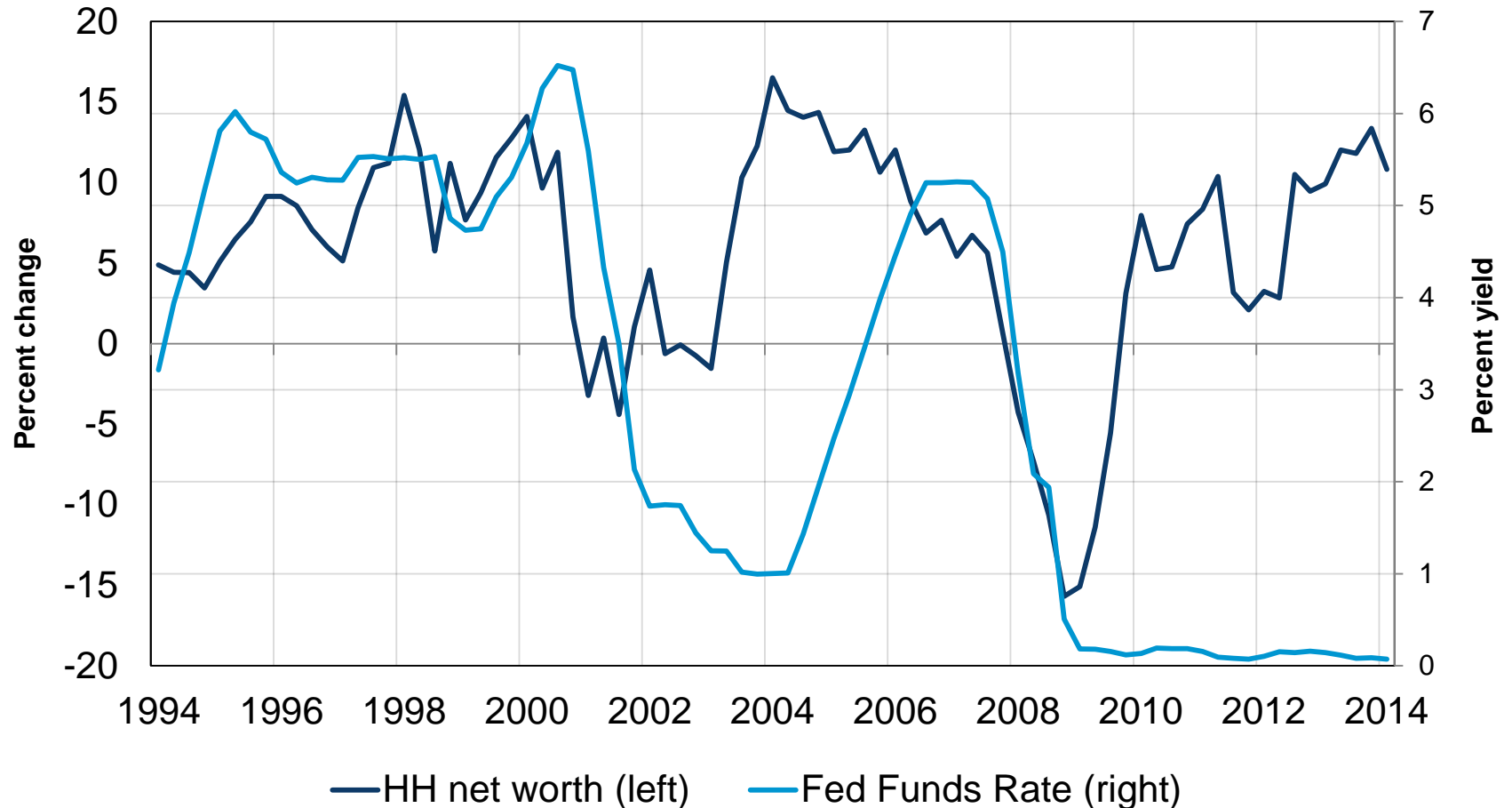
Increases in interest rates have often presaged declines in equity markets.

Relationship between S&P 500 and Fed policy



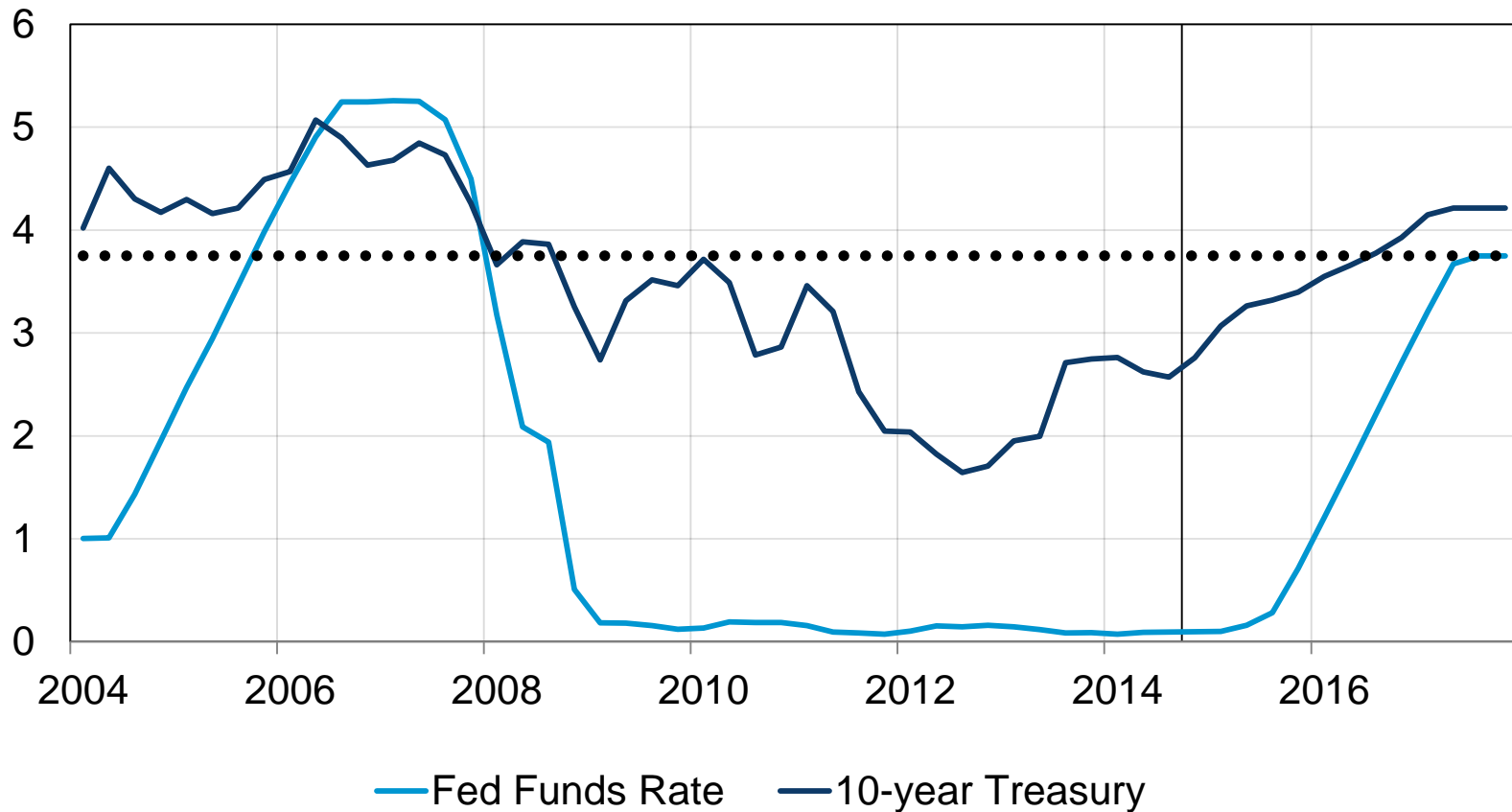
Fed tightening means turning points in financial markets (cont.)

Relationship between household net worth and Fed policy



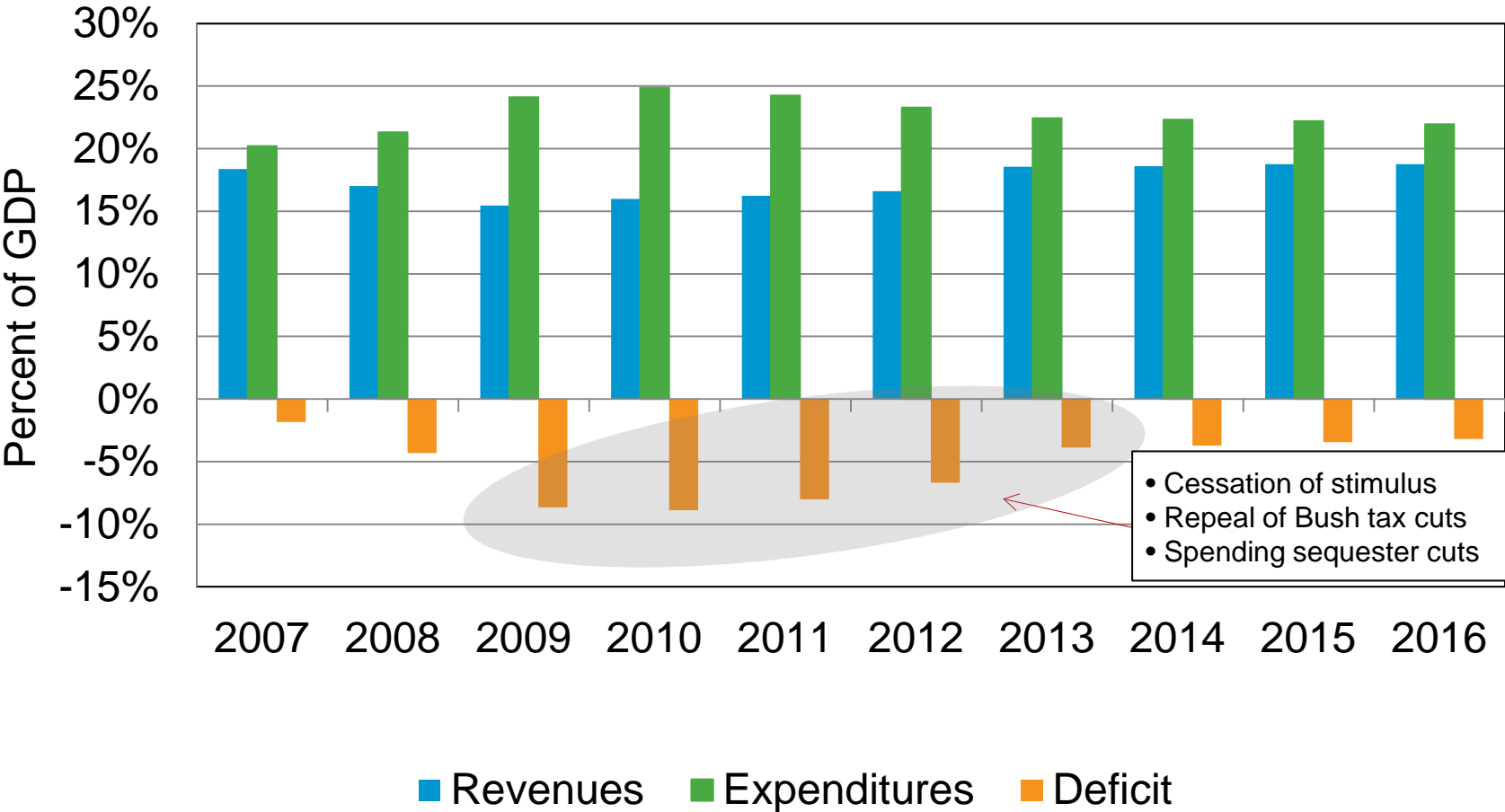
Long-run fed funds rate will be unprecedentedly low, with implications for longer-term rates.

Interest rates



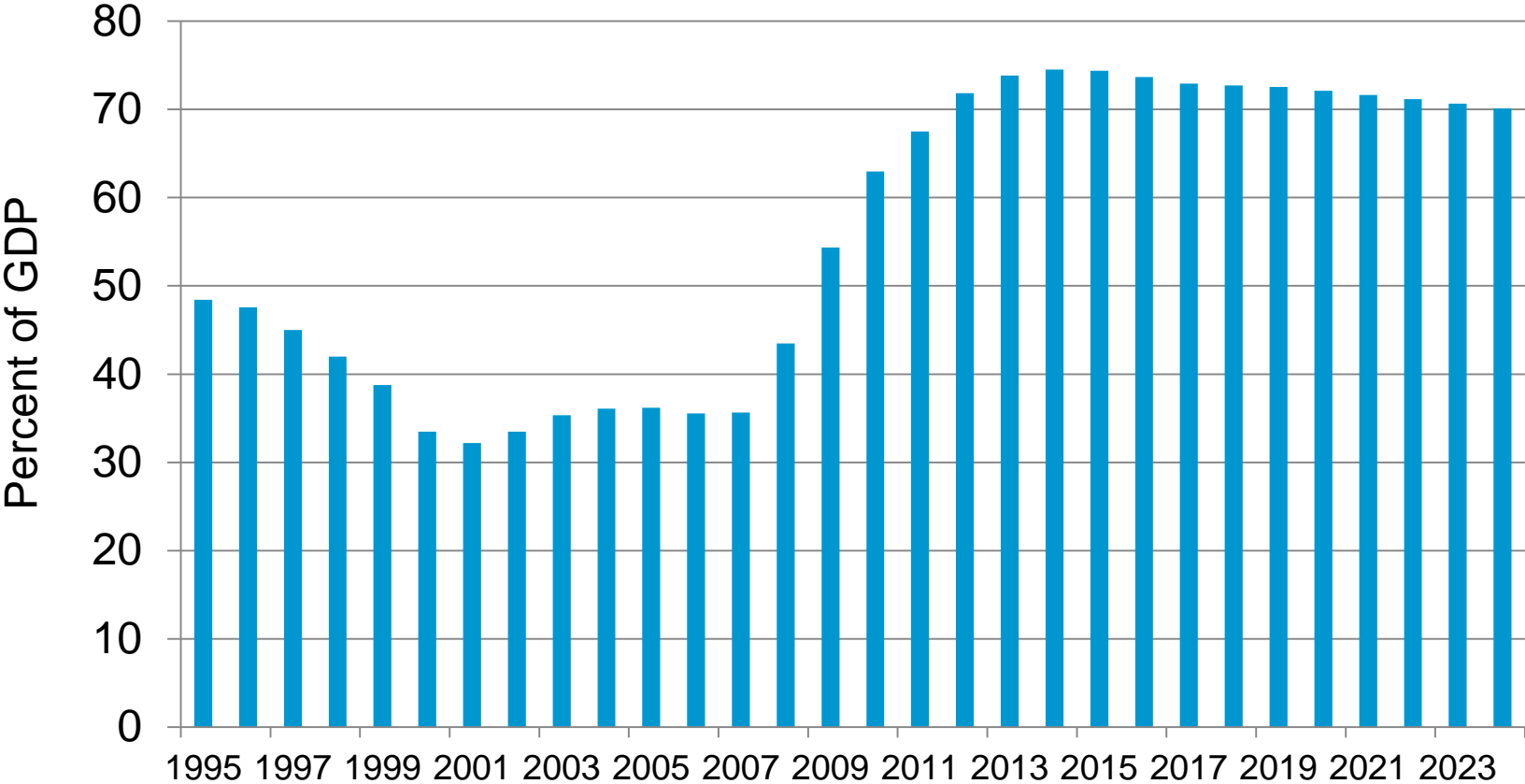
The secret isn't out yet in Washington: The federal budget deficit is unproblematic

Federal budget balance sheet



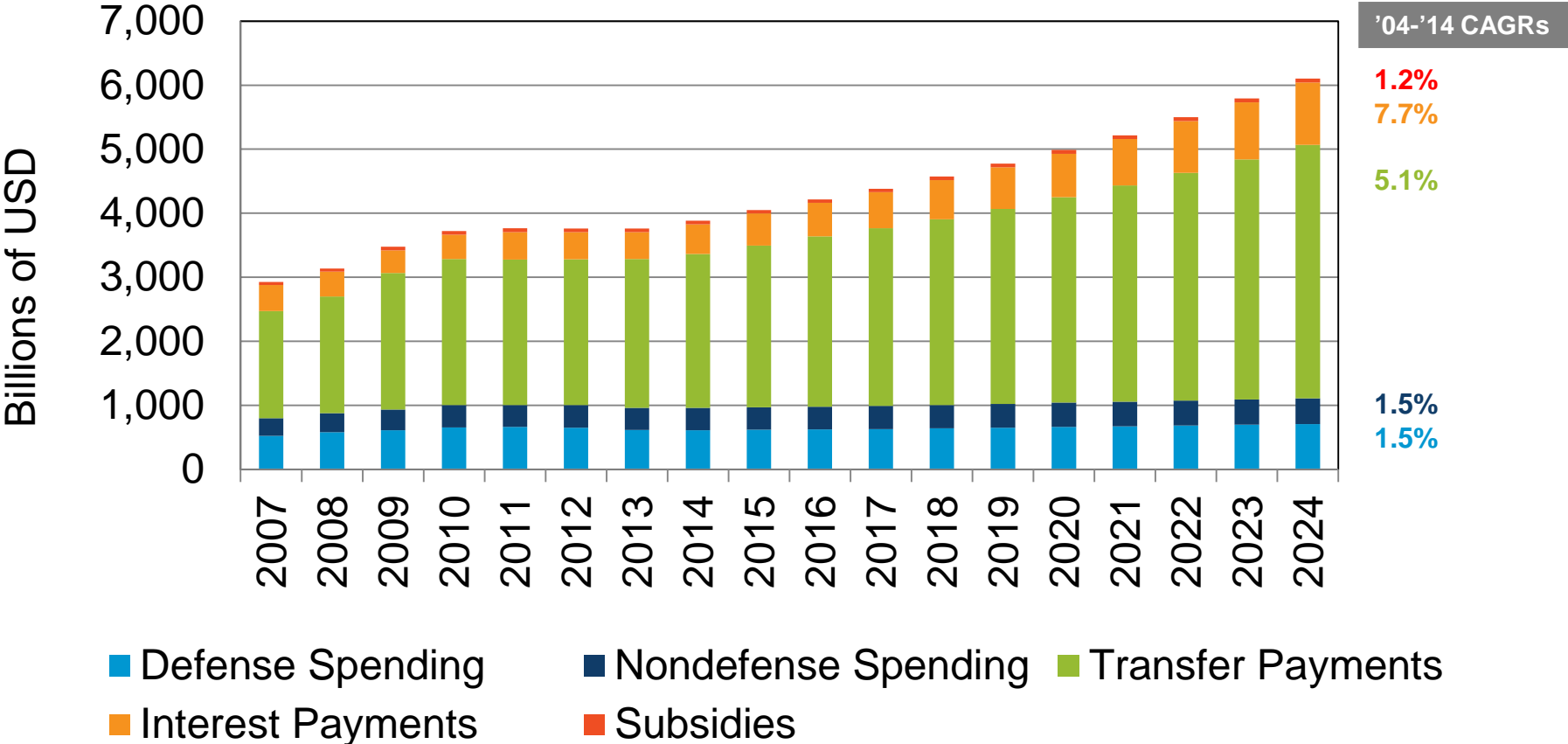
Federal debt to stabilize at around 70% of GDP.

Publicly held federal debt



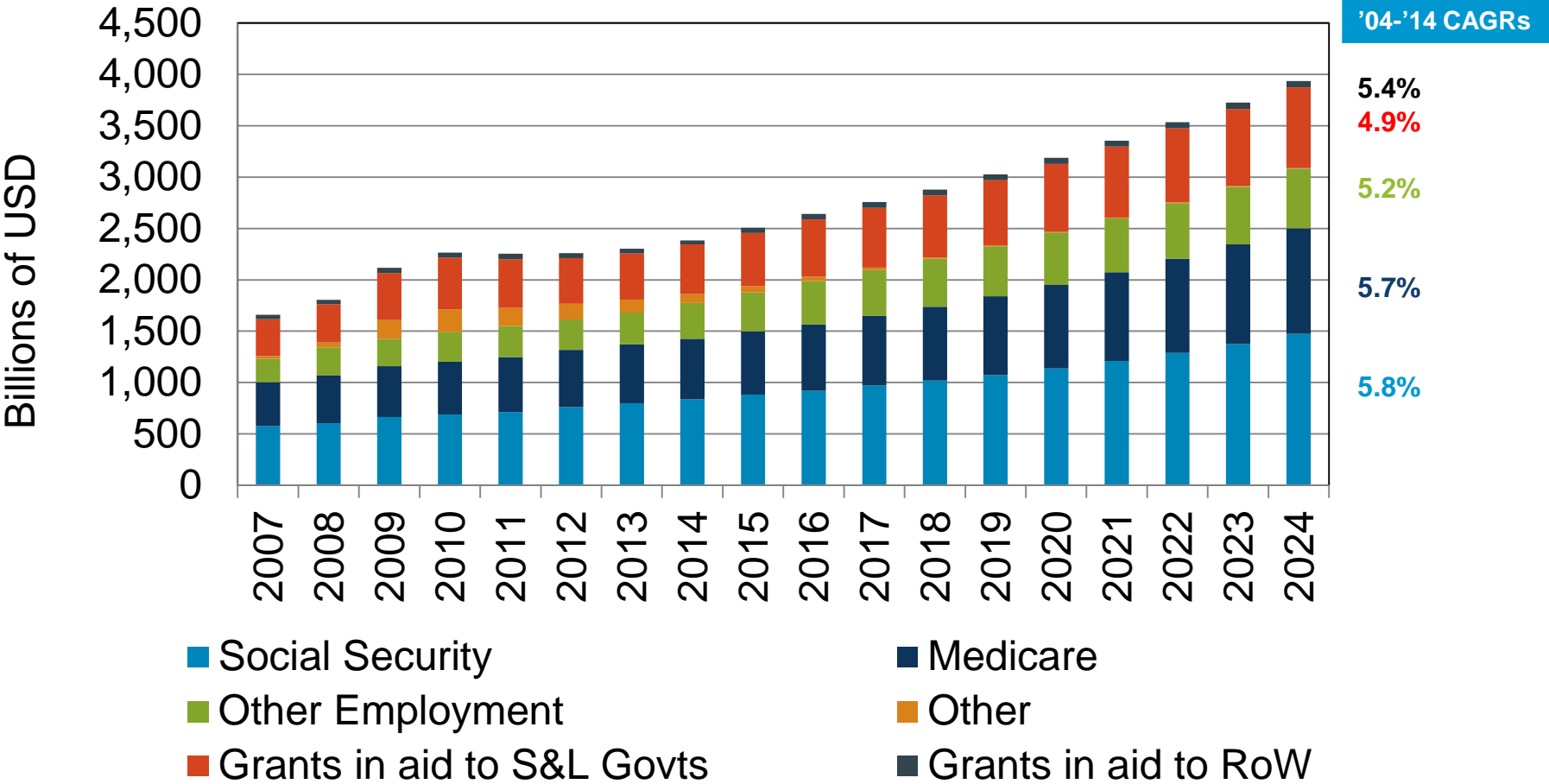
Most federal spending growth that will occur over the next decade will involve transfer payments

Federal budget expenditures



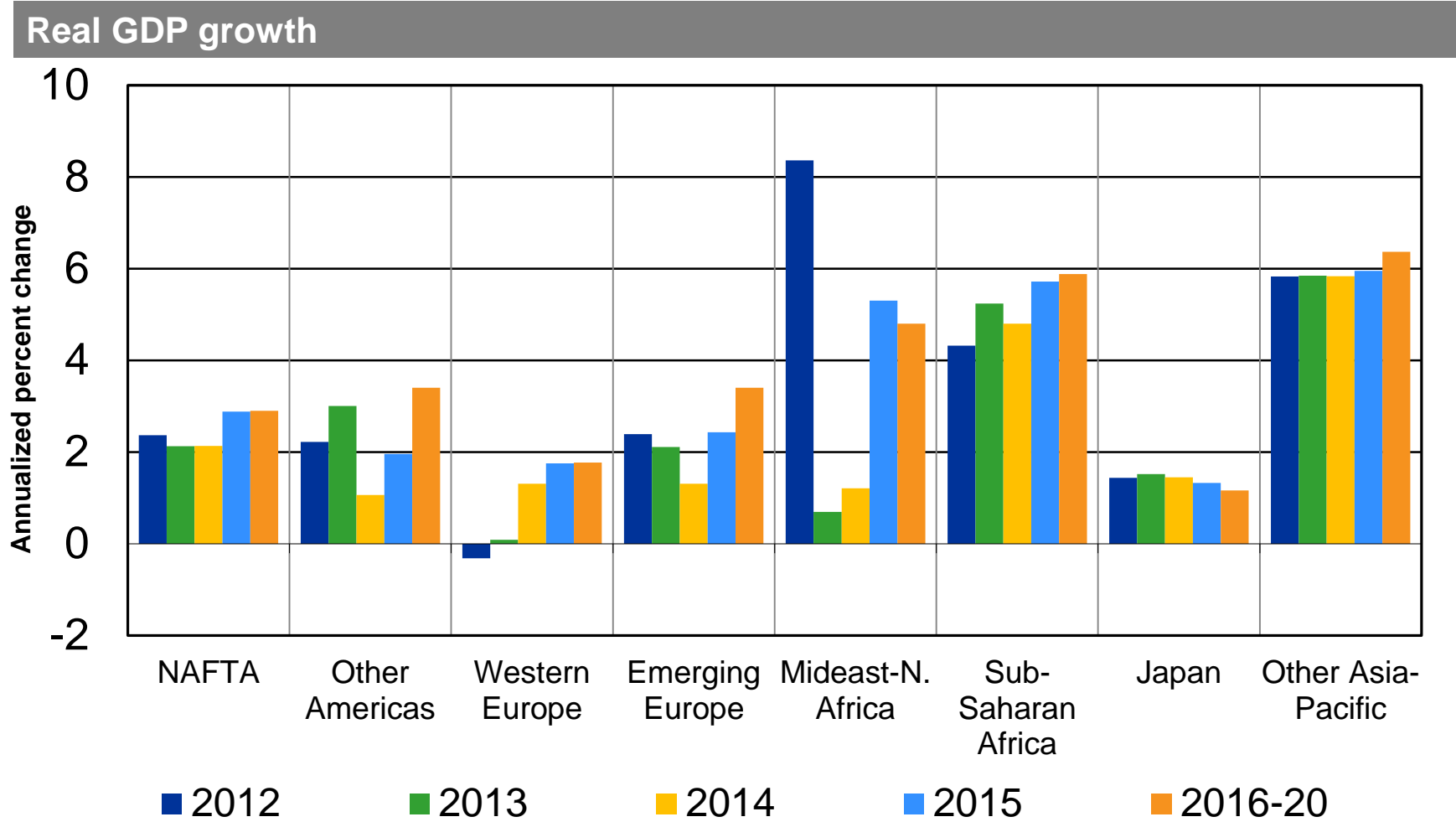
Most types of transfer payments will be growing at a 5-6% annual rate for the next decade

Federal budget expenditures – breakdown of transfer payments



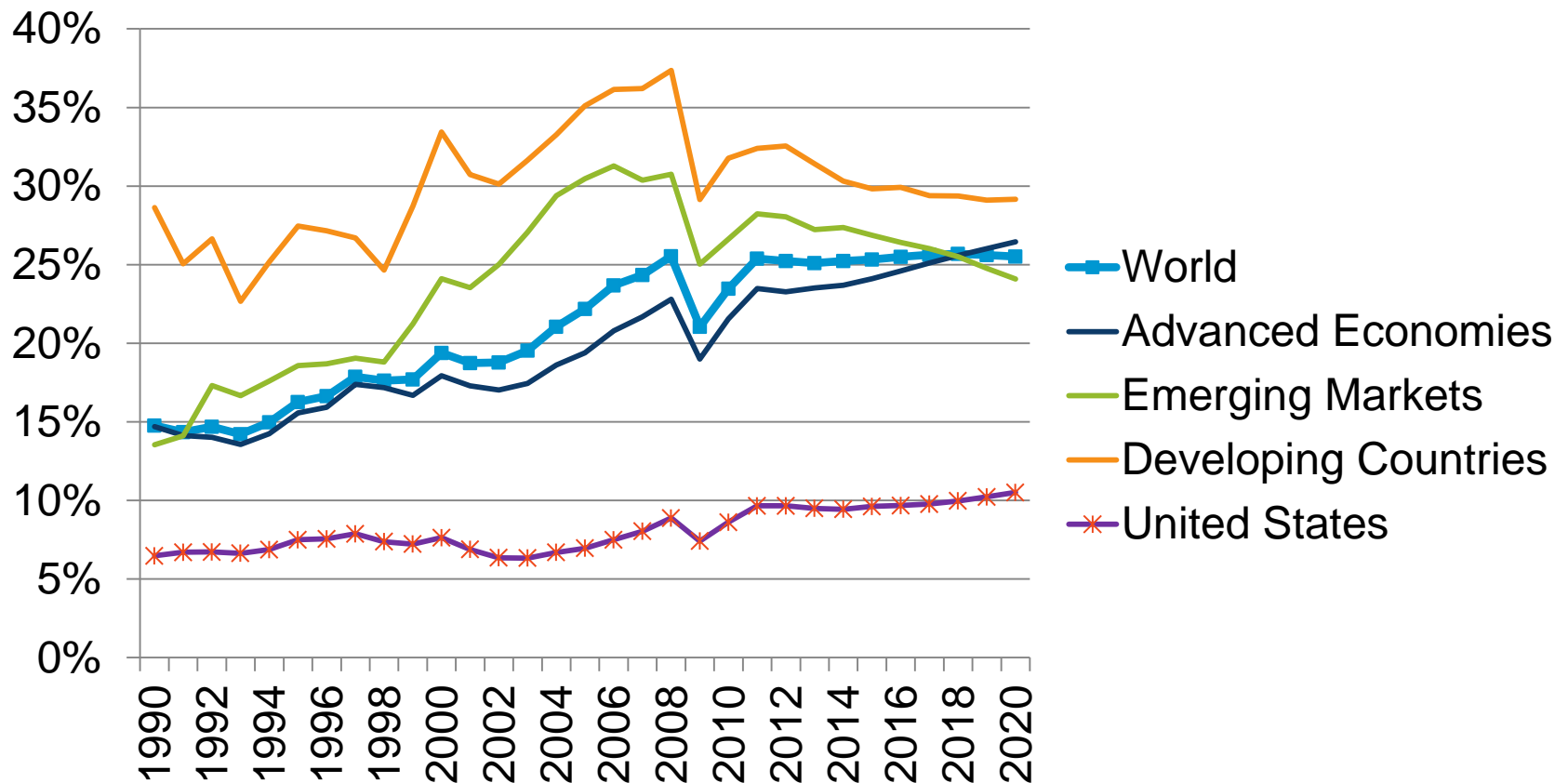
International Economic Growth and US Trade

Asia-Pacific leads regions in real GDP growth



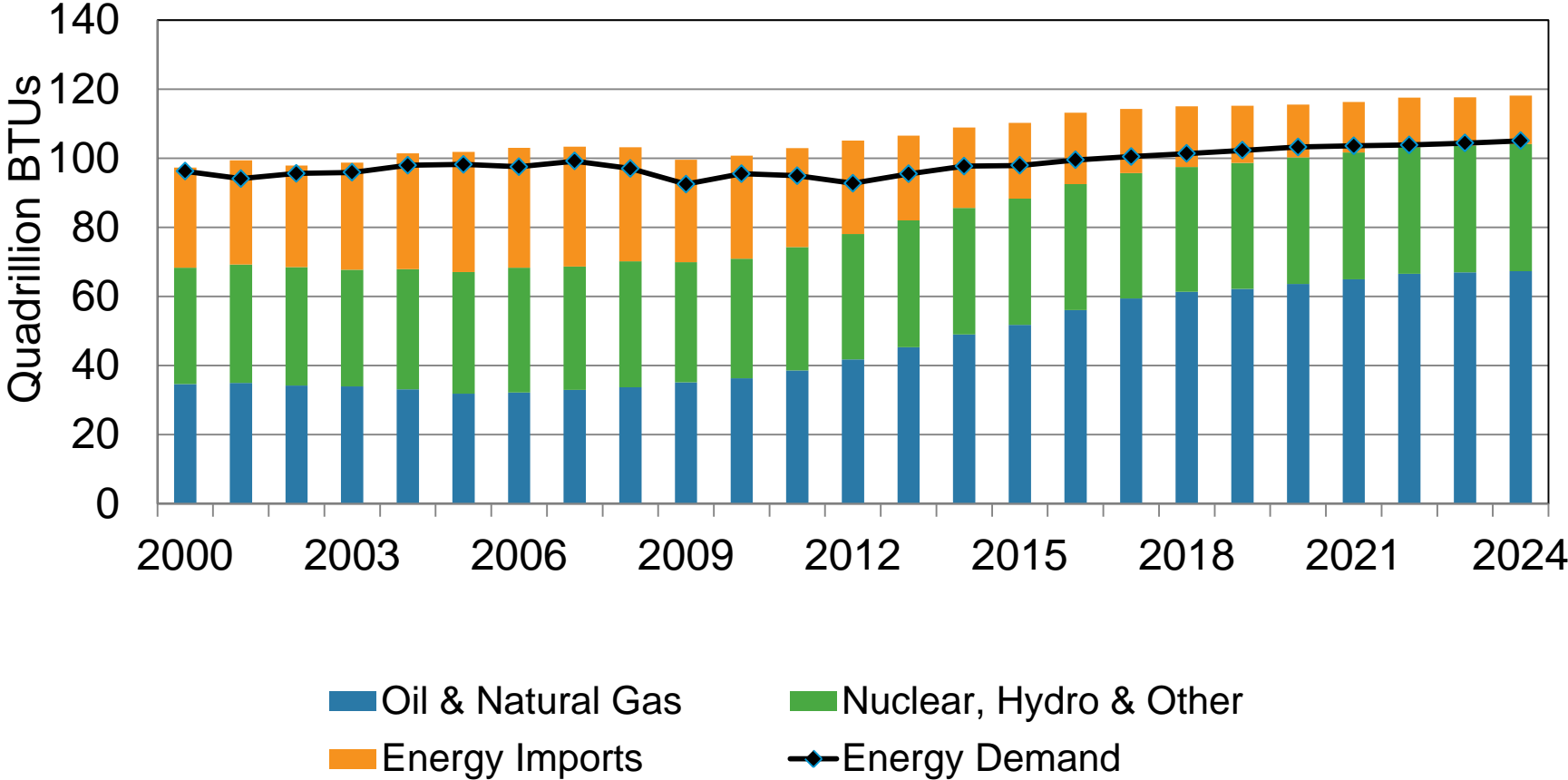
Foreign trade growth has not grown as a share of GDP since the end of the recession

Real exports as a share of real GDP



Imports will supply only 12% of US energy requirements by 2024, down from 21% in 2014

US Energy Trade Balance



Trade positions of the top 15 US international trade partners (2013, goods only)

International trade position

Rank	Country	Exports	Imports	Total Trade	Net Trade Position
---	Total, All Countries	\$1,579	\$2,268	\$3,846	\$(689)
---	Total, Top 15 Countries	\$1,079	\$1,711	\$2,790	\$(632)
1	Canada	\$300	\$332	\$632	\$(32)
2	China	\$122	\$440	\$562	\$(318)
3	Mexico	\$226	\$281	\$507	\$(55)
4	Japan	\$65	\$139	\$204	\$(74)
5	Germany	\$47	\$115	\$162	\$(68)
6	South Korea	\$42	\$62	\$104	\$(20)
7	U.K.	\$47	\$53	\$100	\$(6)
8	France	\$32	\$45	\$77	\$(13)
9	Brazil	\$44	\$28	\$72	\$16
10	Saudi Arabia	\$19	\$52	\$71	\$(33)
11	India	\$21	\$42	\$64	\$(22)
12	Taiwan	\$26	\$38	\$64	\$(12)
13	Netherlands	\$43	\$19	\$62	\$24
14	Switzerland	\$27	\$28	\$55	\$(1)
15	Italy	\$17	\$39	\$55	\$(22)

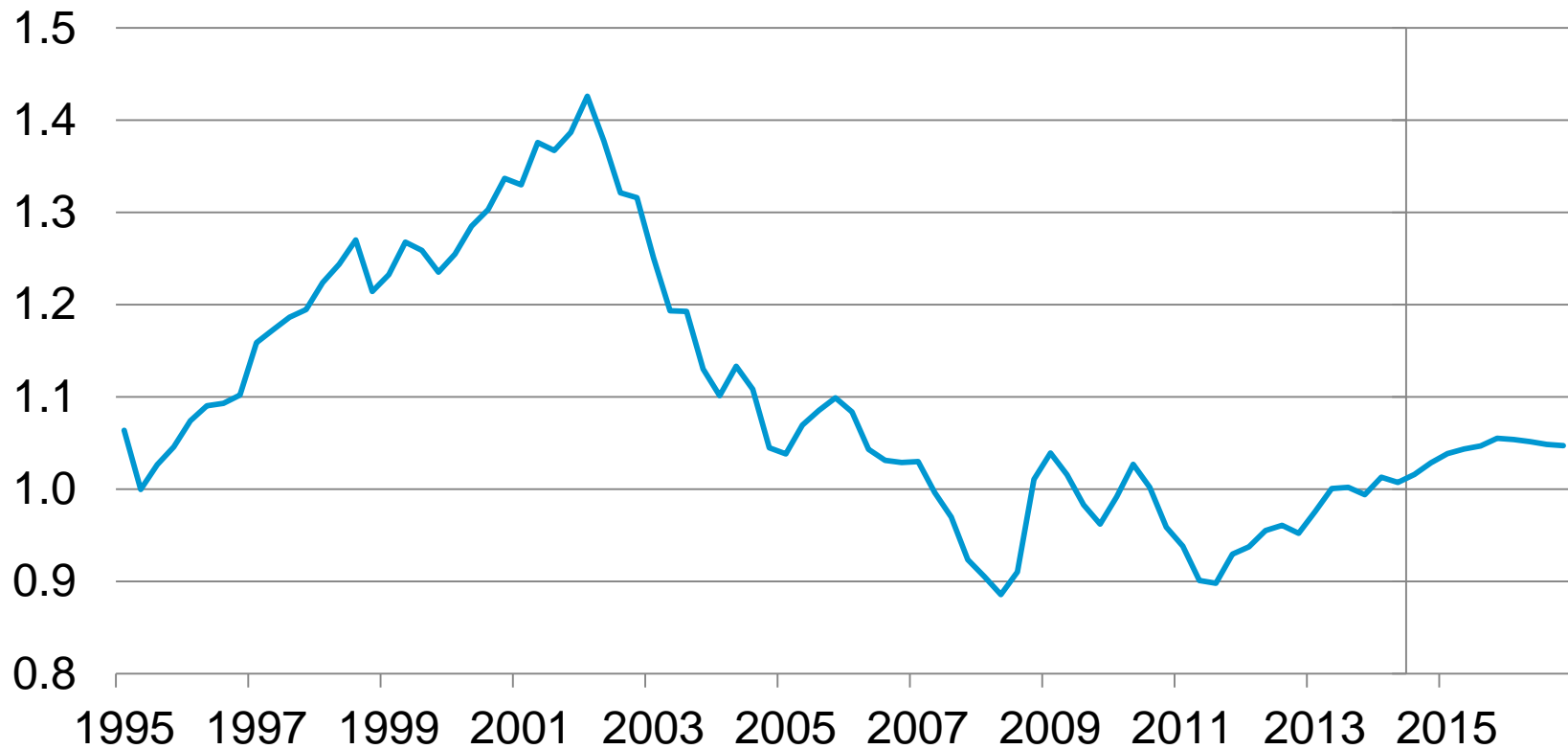
All numbers in \$billions

Several key US industries will be impacted if a steep economic downturn occurs in Europe.

Key merchandise exports to Europe (\$bn)	2010	2013	% change
Aircraft and parts (civilian)	24.9	32.8	31.7%
Pharmaceutical preparations	23.0	22.9	-0.5%
Medicinal equipment	10.0	10.0	0.8%
Passenger cars	6.6	9.9	50.4%
Fuel oil	2.4	9.4	290.6%
Chemicals - organic	8.5	7.8	-8.3%
Industrial machines	5.8	6.4	11.5%
Chemicals - other	5.7	6.0	5.8%
Apparel, household goods – non-textile	5.1	5.9	15.2%

Stronger interest rates and relative economic growth point to an increase in the dollar.

Major trading partner exchange rate (inflation adjusted, 2009=1.0)



Thank you!

Questions?

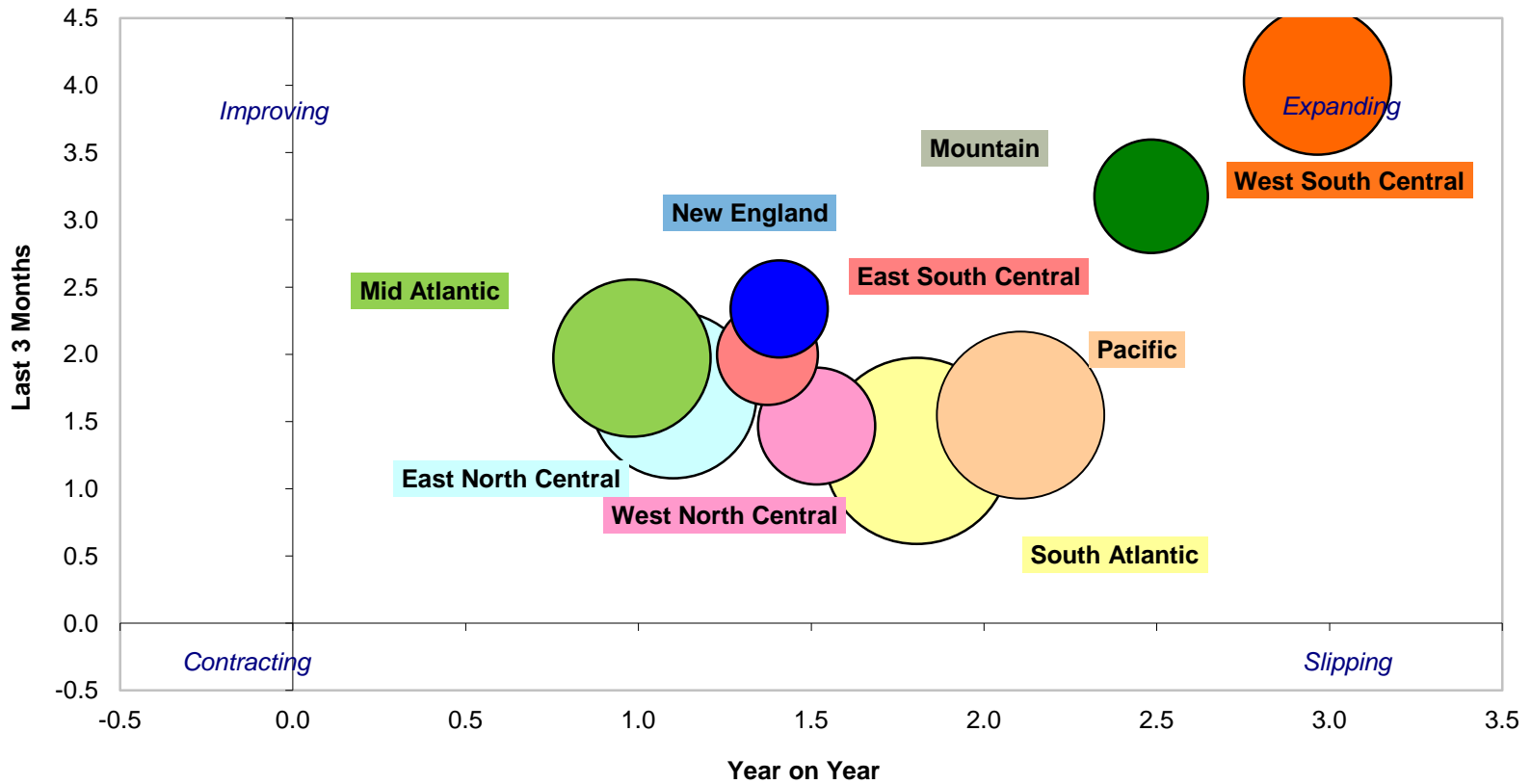


Slow but Steady Growth in 2014-16: The Montana Outlook

Steven Frable, Economist, +1 215 789 7427, steven.frable@ihs.com

Mountain region leads the country behind West South Central

Region Employment Momentum in July
(Percent change, annual rate)

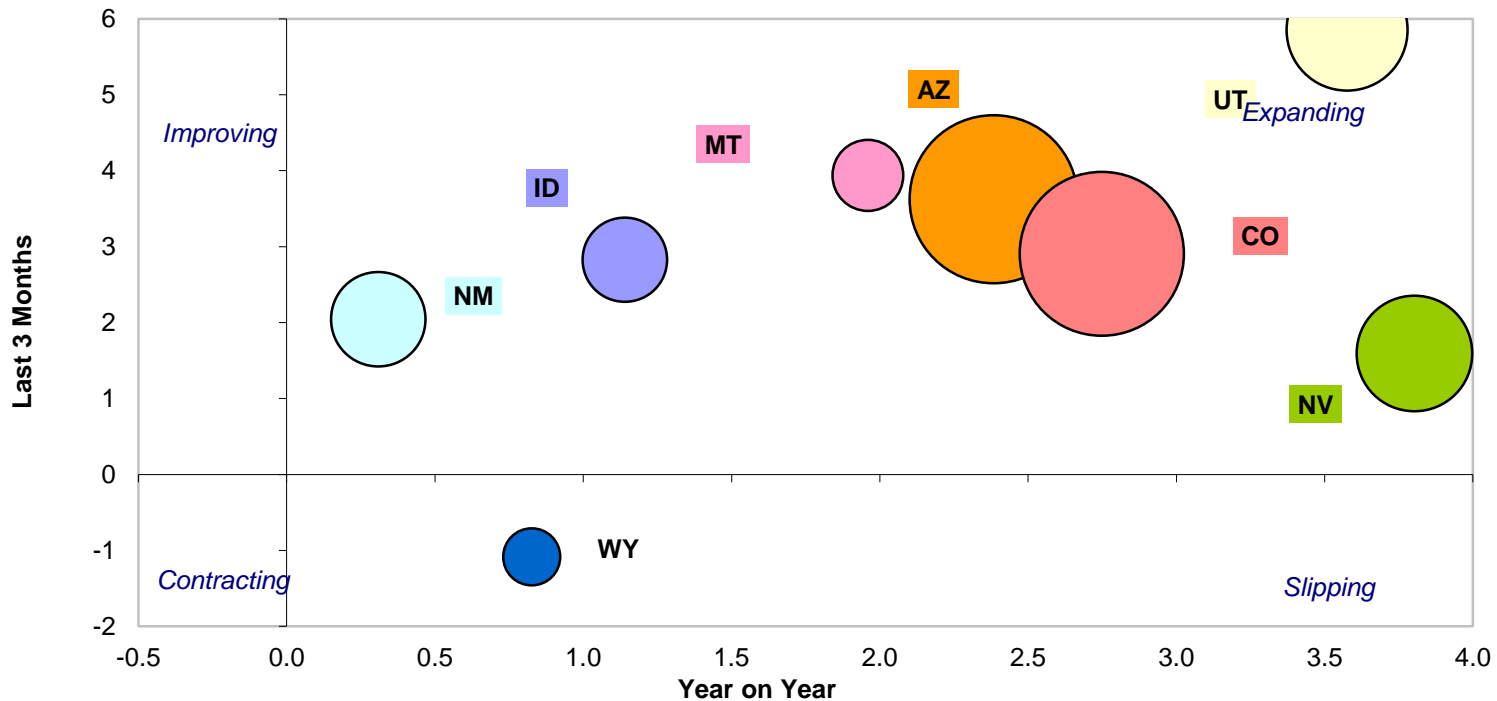


Source: Bureau of Labor Statistics

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Montana expands in the middle of the pack, improved considerably in the last three months

Mountain States Employment Momentum in July
(Percent change, annual rate)



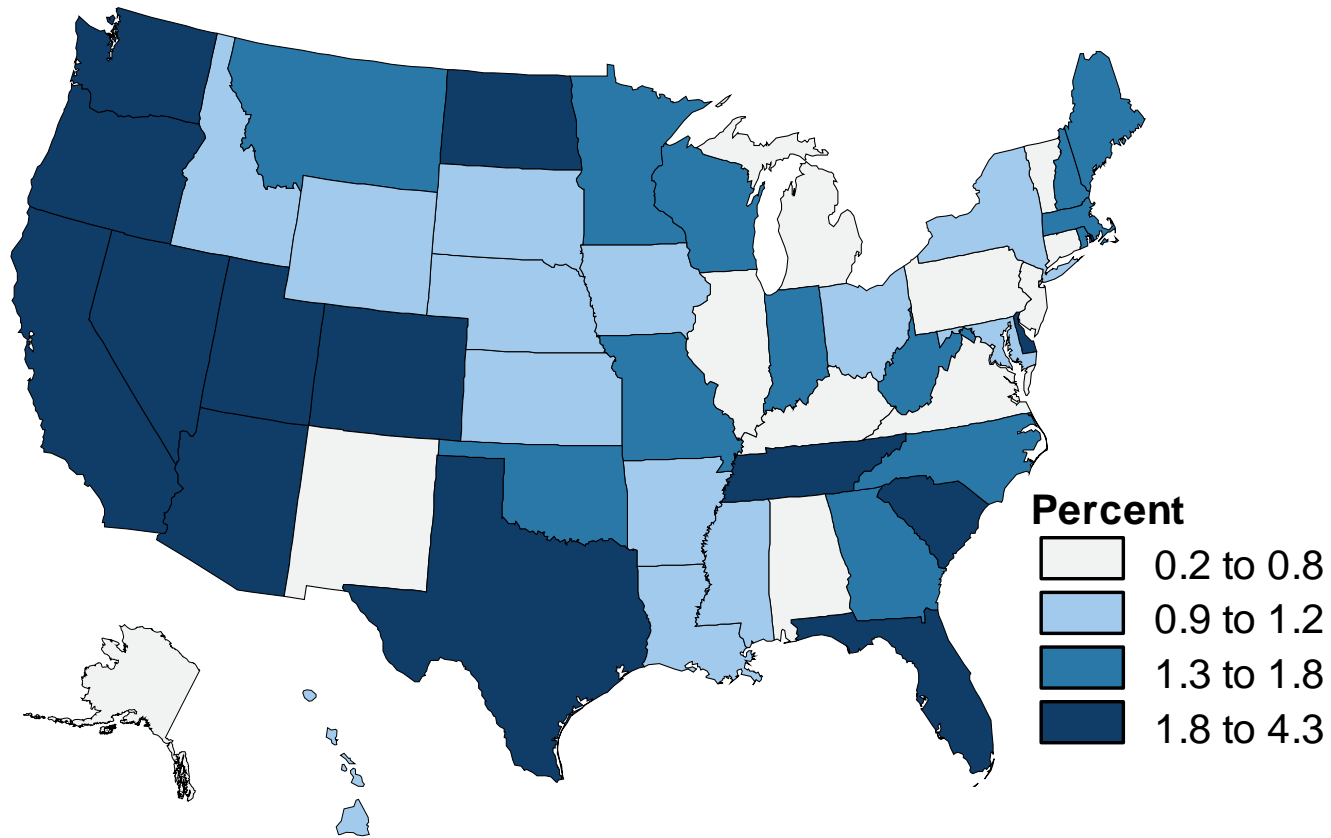
Source: Bureau of Labor Statistics

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Moderate employment growth expected for 2014

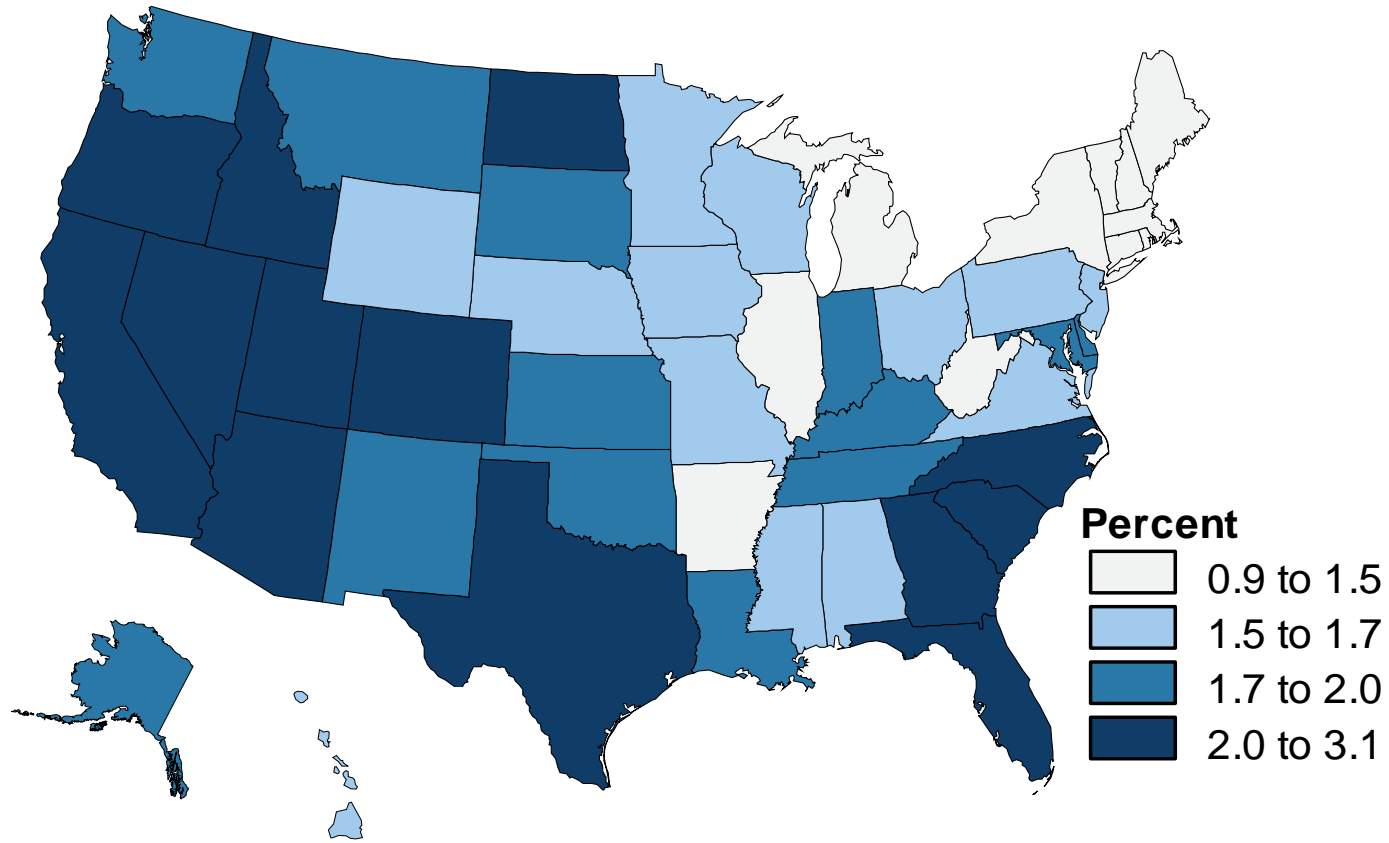
With summer hiring picking up the slack

State Employment Growth 2014 (Percent change a year ago)



A little stronger going forward into 2015: Construction, natural resources and mining will pave the way

State Employment Growth 2015 (Percent change a year ago)

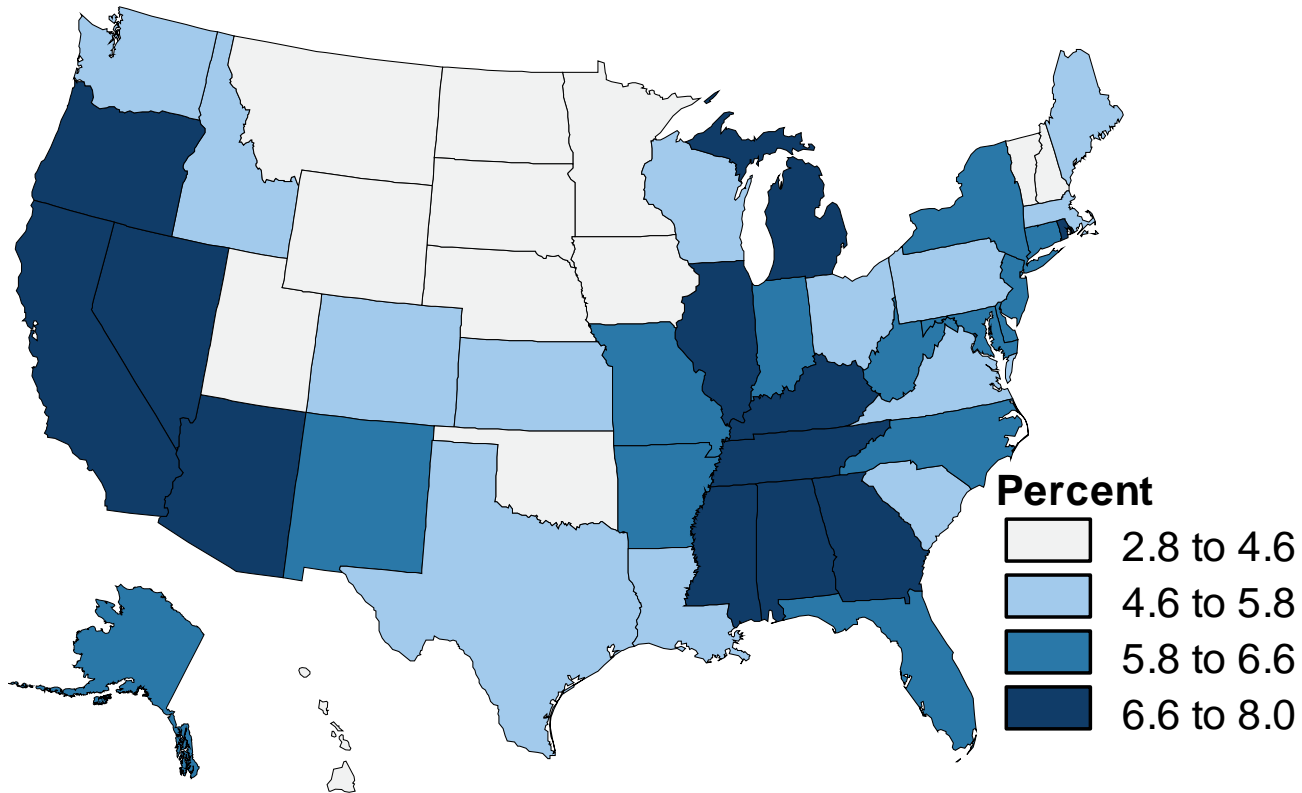


Source: IHS

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Montana's jobless will remain in the group of states with the lowest rates

Unemployment Rate July 2014



Source: Bureau of Labor Statistics

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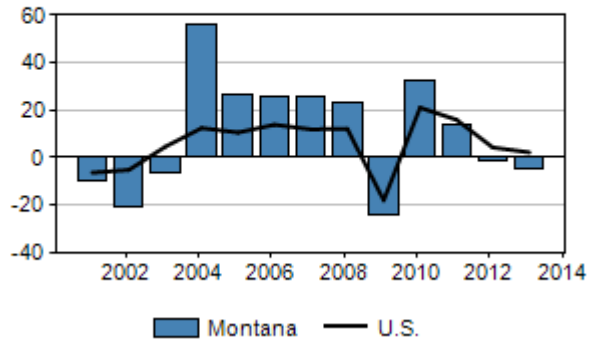
Montana exports are on par with national performance

China retains the top 3rd largest export destination in 2012

Montana Exports

Total Exports

(Percent change, annual rate)



Source: Census Bureau, International Trade Administration, US Department of Commerce, IHS

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Montana's Largest Export Destinations in 2013

	Share of Total (%)	Value (Mil. \$)	Change from 2012 (%)
Canada	39.1	586	-8.2
South Korea	11.2	168	-2.4
China	6.7	101	-4.6

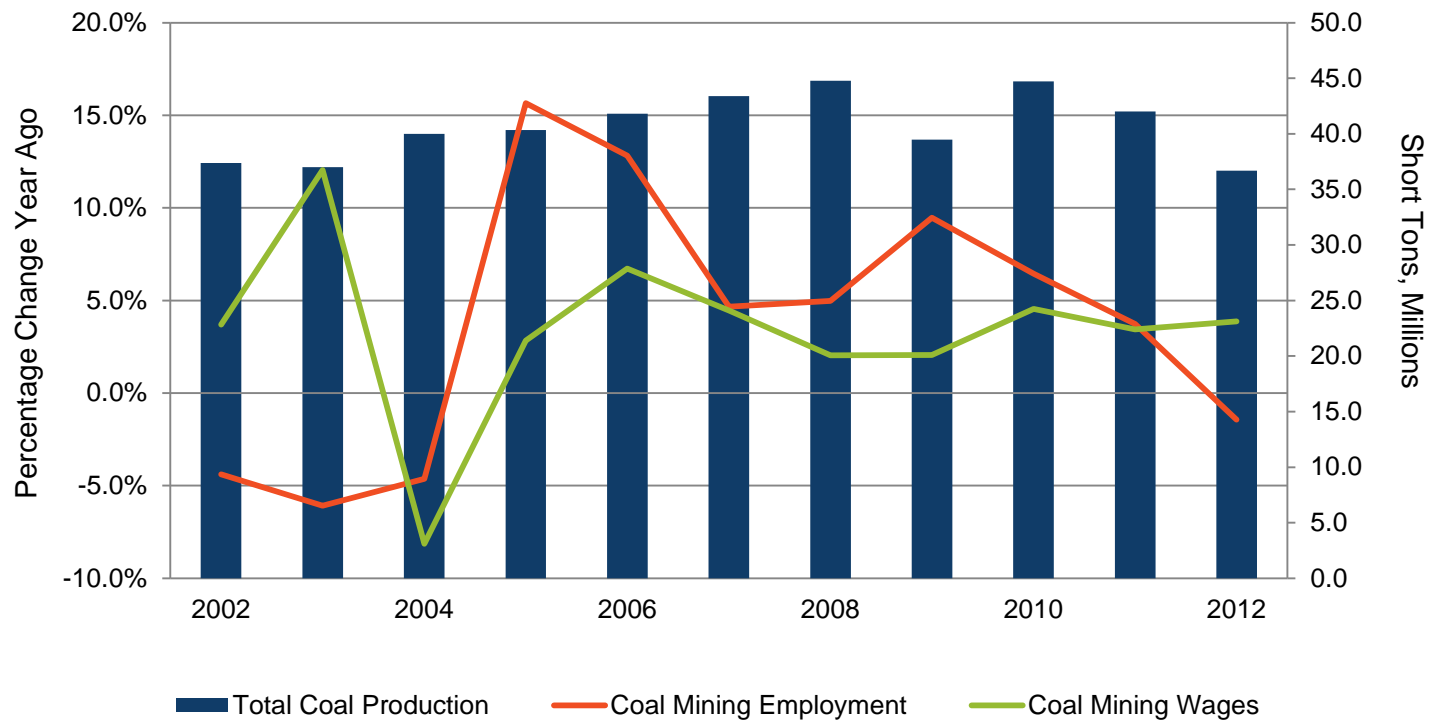
Source: Census Bureau, International Trade Administration, US Department of Commerce

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Montana exports correlate highly with US trends; moving towards Asia

Montana's Coal Production and Employment decline while wage growth remains steady

Coal Production vs. Coal Mining Employment and Wage Growth in Montana



Source: Energy Information Administration, Bureau of Labor Statistics

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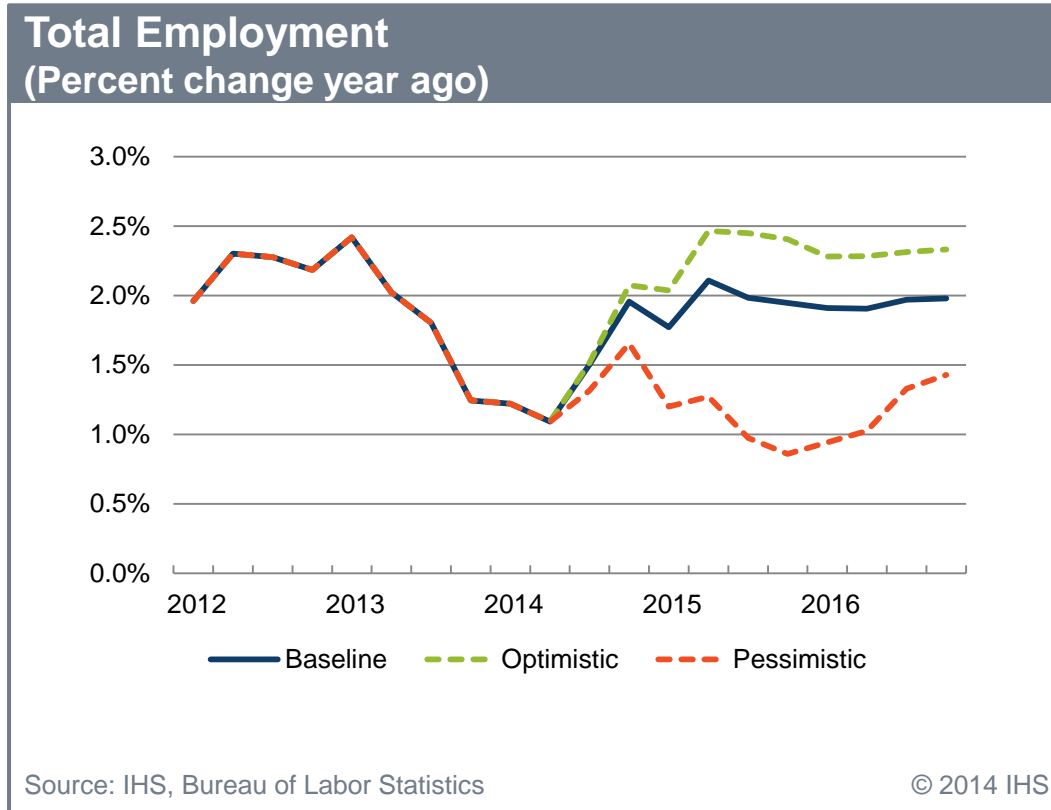
IHS expectations for Montana: A year ahead

Employment a bright spot, while other areas rank relatively low

Montana Outlook over the Next Four Quarters

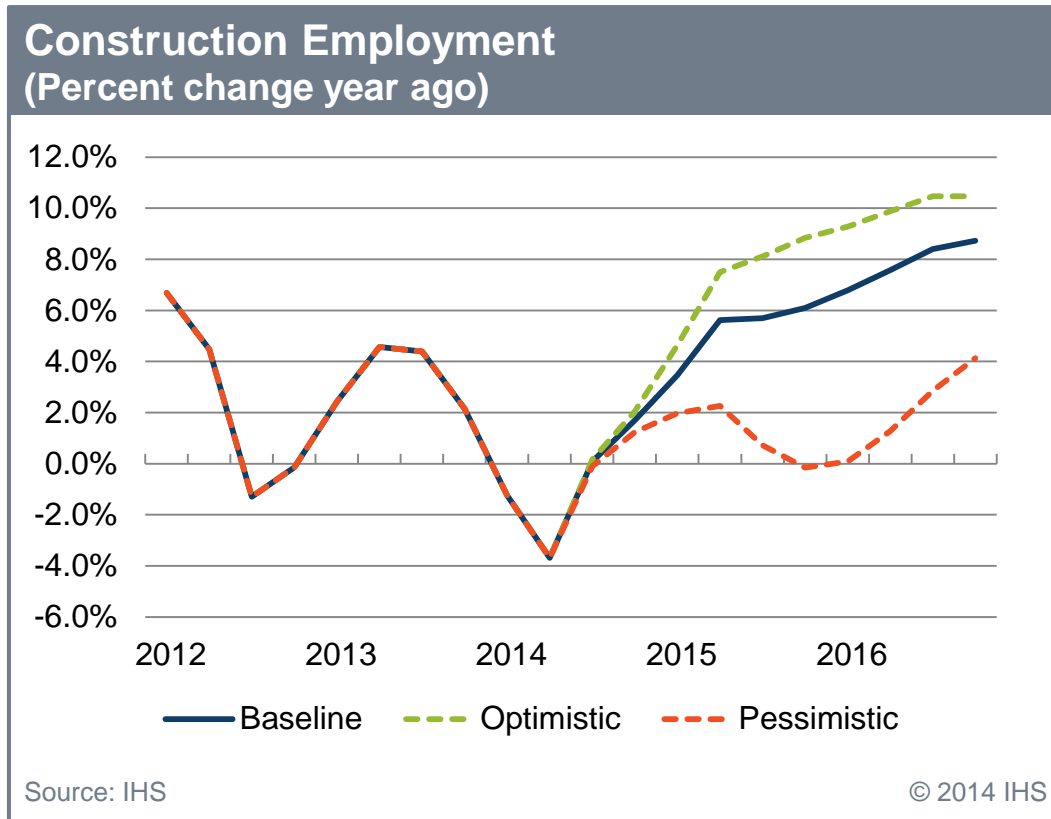
		Baseline Scenario			Pessimistic			Optimistic		
		Level	%	Rank	Level	%	Rank	Level	%	Rank
Year-over-year Change (2015Q3)	Employment	+9,054	+2.0	18	+4,443	+1.0	9	+11,176	+2.4	16
	Personal Income (Mil.\$)	+1,656	+4.0	42	+1,000	+2.4	40	+2306	+5.6	32
	Real Gross State Product (Mil. 2005\$)	+851	+2.1	43	197	0.5	39	+1,364	+3.2	48
Level (2015Q3)	Unemployment Rate (%)	4.4		40	4.7		44	4.3		38
	Housing Starts	4316		43	3,179		42	4,706		43

Forecast Risks for Montana Employment Growth



- Government budget cuts, depressed construction and volatile natural resource and mining sector poses risks going forward

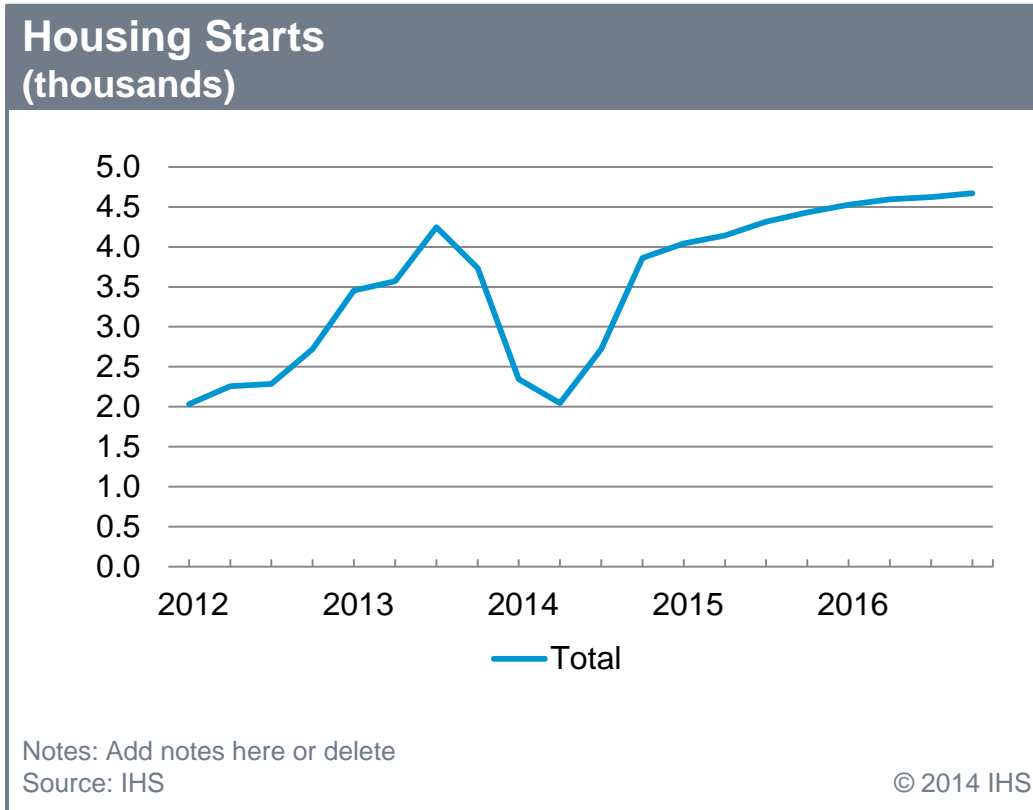
Forecast Risks for Construction Sector Employment: Housing and Federal Highway Trust Fund



Short Term Risks to the Construction Sector:

- A muted housing starts recovery can slow growth
- The Federal Highway Trust funds drying up can have impacts on construction growth in the medium term

After cooling in the beginning of the year, new housing construction is expected to bounce back later in 2014



- Housing starts are expected to rebound thanks to increase in population from in-migration during 2013
- Many new Montana residents came to the state looking to fulfill positions:
 1. In the Bakken oil field
 2. Refill a retiring labor force
- New migrants should help spur demand for new home construction into 2015

Personal income and wages expected to pick up later in 2014



- 2012 to 2013 hit hard due to dampened wage growth in the professional and business services sector
- picking up in the first quarter of 2014, we expect a recovery in income and wage growth thanks to a bounce in professional and business service wage growth as well as construction and natural resources.

Contact us



Thank You!

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