Overview of the Economy

The surprisingly steep slump in first quarter Gross Domestic product (GDP) will cause 2014 economic growth to fall well short of the expectations in place at the beginning of the year. However, most indicators point to better second quarter performance and growth should continue throughout the balance of the year. But despite the growth shortfall during the first half of the year, labor market conditions continue to improve. Payrolls have recently grown at an accelerating pace and the June unemployment rate fell to a new cyclical low of 6.1%. In addition, recent inflation readings have moved higher. Both unemployment and inflation levels are nearing levels consistent with the objectives identified by Federal Reserve (Fed) officials. Given these circumstances, quantitative easing should be steadily tapered to completion and expectations for the beginning of rate normalization should be brought forward to the first half of 2015.
Consumer Expenditures

Consumer spending during the first quarter for services, particularly health care, was revised sharply lower and reduced the overall growth rate for consumer spending to just 1%. Data available through June suggests that consumer spending growth has improved to around a 2.5% rate during the second quarter and is consistent with a bounce back in broader economic growth. Overall, the trend in income growth remains modest and consistent with moderate gains in consumer spending. Household net worth has been buoyed by the performance of financial markets and recovery in home prices, but the savings rate remains relatively low and households have shown limited appetite for increasing credit balances.

Source: Conference Board

Source: Department of Commerce

Source: Department of Commerce, Federal Reserve
The housing sector remains an area of relative economic softness following the increase in mortgage rates during the second half of 2013. Most recent indicators for sales and building activity have shown some improvement, but the pace remains gradual. Housing sector activity should continue to improve gradually if longer-term interest rates remain within recent ranges and broader economic activity and employment growth continue along their projected paths, as building activity remains below longer-term trends in population growth and household formation. Building activity in the multifamily market segment has shown relative strength compared to the single family segment as homeownership rates have continued to trend lower.
Manufacturing sector surveys and other activity indicators have accelerated through the second quarter as broader economic activity has rebounded from the first quarter slump. Inventory-to-sales ratios have dropped from recent highs and point toward a better balance as we conclude the first half of the year. We look for continued moderate growth trends in production during the second half of the year, reflecting the likely moderate trend in final sales over this period. Auto production has been leader within the industrial sector as sales have been robust. Moderation in auto production is likely on a forward-looking basis with sales reaching a 17 million unit rate through mid-year. Business equipment, and potentially exports, should help offset more moderate gains in auto production.
International Trade

The trade deficit has widened fairly dramatically in recent months as export gains have remained tepid and import growth has increased. The overall level of international trade growth remains sluggish relative to past cycles and reflects the more restrained pace of growth in global economic activity over the past several months. Net exports look as though they will detract from economic growth again during the second quarter, but the contribution to economic growth from trade should stabilize during the second half of the year. We continue to expect the dollar to strengthen based on stronger domestic economic performance and the narrowing proximity to the beginning of monetary policy normalization.
Despite fairly flat economic growth in volume terms for the first half of the year, job gains have continued and accelerated in recent months along with the rebound in second quarter economic growth measures. The improvement in job growth dropped the unemployment rate to a new cyclical low of 6.1% in June. The downward trend in unemployment should moderate in the coming months as the labor markets have outpaced the broader economy and participation rates look to be stabilizing at lower levels. Nevertheless, the unemployment rate has trended downward by about 1 percentage point per year over the past few years. If the current rate of decline continues, the unemployment rate would stand near 5% next summer, below the roughly 5.5% level the Fed considers to be consistent with full employment. Wage growth should continue to show modest upward pressure, which will likely reinforce views that inflation will continue trending toward the Fed’s objective.
Inflation and Monetary Policy

Since the latter part of 2013, the inflection point in inflation measures has been partially due to higher energy and food prices, but the increase in price levels is much more broad-based than these more volatile components. Looking at various components of the Consumer Price Index (CPI), we see service price inflation has been sustained over the past few years, a trend that has recently accelerated. Housing costs are the biggest component of this index, but medical and hospital services, transportation services, insurance and other service prices have all contributed to this trend. Service sector inflation trends have historically exhibited more inertia than the more volatile commodity and goods prices categories. Goods prices more broadly are trending well below services prices, particularly in the more discretionary categories. However, overall price level trends will make it increasingly difficult for the Fed to characterize inflation as below its objective, which will weaken the basis for extraordinary monetary policy accommodation.

Source: Bureau of Labor Statistics

Source: Federal Reserve Board

Source: Bureau of Labor Statistics

Source: Reuters
The rebound in economic activity should provide a favorable environment for corporations during the second quarter. Pre-announcements of second quarter results have been more favorable, and bottom-up analyst expectations look for 7% growth versus the second quarter 2013. Sustained economic growth in the second half and into 2015 should be consistent with continued earnings growth. Equity valuations have continued to increase this year and may exhibit some sensitivity to changing interest rate expectations as we move into the second half. Implied volatility measures moved to new cyclical lows in early July, but they should revert toward longer-term averages as quantitative easing ends and policy rate normalization comes into focus. Overall, equities should move directionally with earnings, but with higher volatility in the quarters ahead.
International Markets

International equity markets have generally continued to trade in line with or modestly lag the performance of the domestic markets year to date. European equity markets have failed to gain much traction from the most recent easing actions by the European Central Bank and broader economic performance measures remain mixed. Most recently, the periphery markets have experienced some downward pressure due to reemerging banking sector concerns. Emerging market performance has modestly exceeded that of developed markets in recent months. Overall, valuations in the foreign markets are more attractive than the domestic markets, but catalysts have yet to emerge to lead to foreign equity outperformance.
Will interest rate markets react as harshly to a change in policy expectations as they did in 2013? Shorter-term interest rates do not appear to expect meaningful changes in policy rates over the next few years. Two-year Treasury notes currently yield about 50 basis points, which suggests an expected policy rate of about 25 basis points over the next two years (when considering the normal term premium over the expected policy rate). While policy rates are likely to remain low relative to long-term averages, we believe these expectations and current yields should be adjusted upward. However, markets for longer-term interest rates appear better prepared for policy rate changes for several reasons. The yield curve remains very steep and long-term rates remain much higher than last year, yields abroad are lower making Treasuries comparatively attractive and long-term growth expectations continue to be scaled lower.

Source: Bloomberg

Source: Barclays Capital. Based on the Barclays U.S. Aggregate Bond Index.

Source: Barclays Capital. Based on the Barclays U.S. Aggregate Bond Index.
# Economic, Rates and Earnings Forecast

<table>
<thead>
<tr>
<th></th>
<th>2012 (A)</th>
<th>2013 (A)</th>
<th>2014 (F)</th>
<th>2014 Bloomberg Consensus**</th>
<th>2015 Bloomberg Consensus**</th>
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</thead>
<tbody>
<tr>
<td>Real GDP (Q4/Q4)</td>
<td>2.0%</td>
<td>2.6%</td>
<td>1.0% - 2.0%</td>
<td>1.7%</td>
<td>3.0%</td>
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<tr>
<td>Personal Consumption Expenditures</td>
<td>2.0%</td>
<td>2.3%</td>
<td>1.0% - 2.0%</td>
<td>1.7%</td>
<td>3.0%</td>
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<tr>
<td>Investment</td>
<td>3.1%</td>
<td>8.3%</td>
<td>2.0% - 4.0%</td>
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<td>3.0%</td>
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<tr>
<td>Net Exports ($)</td>
<td>-$431</td>
<td>-$412</td>
<td>-$440B</td>
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<td>3.0%</td>
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<tr>
<td>Government Spending</td>
<td>-1.1%</td>
<td>-2.4%</td>
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<tr>
<td>Unemployment Rate****</td>
<td>7.8%</td>
<td>6.7%</td>
<td>6.0%</td>
<td>6.2%</td>
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<tr>
<td>CPI****</td>
<td>1.7%</td>
<td>1.5%</td>
<td>1.5% - 2.5%</td>
<td>2.00%</td>
<td>2.2%</td>
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<tr>
<td>CPI Excluding Food &amp; Energy</td>
<td>1.9%</td>
<td>1.7%</td>
<td>1.5% - 2.5%</td>
<td>2.00%</td>
<td>2.2%</td>
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<tr>
<td>Fed Funds****</td>
<td>0.25%</td>
<td>0.25%</td>
<td>0.00% - 0.25%</td>
<td>0.25%</td>
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<tr>
<td>10 Year Treasury****</td>
<td>1.75%</td>
<td>3.00%</td>
<td>2.5% - 3.5%</td>
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<td>Corporate Earnings (S&amp;P Operating)</td>
<td>$96.82</td>
<td>$107.30</td>
<td>$113.50</td>
<td>$118.19***</td>
<td>$136.50***</td>
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<tr>
<td>Trade Weighted Dollar****</td>
<td>79.80</td>
<td>80.04</td>
<td>80-90</td>
<td>80-90</td>
<td>80-90</td>
</tr>
</tbody>
</table>

*Actual level - December 31, 2013
**Bloomberg - July 16, 2014
***Standard & Poors - July 10, 2014
****End of Period Level
Index Definitions

The **Barclays U.S. Aggregate Bond Index** represents securities that are SEC-registered, taxable and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities.

The **MSCI EAFE Index** is an equity index which captures large and mid cap representation across Developed Markets countries around the world, excluding the US and Canada.

The **MSCI Emerging Markets Index** captures large and mid cap representation across 21 Emerging Markets (EM) countries.

The **MSCI ACWI (All Country World Index) Index** is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets.

The **MSCI ACWI (All Country World Index) Index ex U.S.** is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets, excluding the United States.

The **MSCI World Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets.

The **MSCI EM (Emerging Markets) Asia Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of emerging markets in Asia.

The **MSCI Europe Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the developed markets in Europe.

The **MSCI Europe & Middle East Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the developed markets in Europe and the Middle East.

The **MSCI EM (Emerging Markets) Latin America Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of emerging markets in Latin America.

The **MSCI North America Index** is designed to measure the performance of the large and mid cap segments of the US and Canada markets.

The **MSCI Pacific Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the developed markets in the Pacific region.

The **Russell 1000® Growth Index** is a market-capitalization-weighted index that measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

The **Russell 1000® Value Index** is a large-cap value index measuring the performance of the largest 1,000 U.S. incorporated companies with lower price-to-book ratios and lower forecasted growth values.

The **Russell 2000® Index** is composed of the 2,000 smallest stocks in the Russell 3000® Index and is widely regarded in the industry as the premier measure of small-cap stock performance.

The **Russell Midcap Index** measures the performance of the mid-cap segment of the U.S. equity universe. The Russell Midcap is a subset of the Russell 1000® Index.

The **S&P 500 Index** is a capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy.
Disclosure

Source: These views were prepared by Keith Hembre, Chief Economist for U.S. Bank. These views are subject to change at any time based upon market or other conditions and are current as of the date indicated on these materials. This information is not intended to be a forecast of future events or guarantee of future results. It is not intended to provide specific advice or be construed as an offering of securities or a recommendation to invest.

Not for use as a primary basis of investment decisions. Not to be construed to meet the needs of any particular investor. Not a representation or solicitation or an offer to sell/buy any security. Investors should consult with their investment professional for advice concerning their particular situation. U.S. Bank and its representatives do not provide tax or legal advice. Each tax and financial situation is unique. Consult a tax and/or legal advisor for advice and information concerning a particular situation.

Past performance does not guarantee future results. All performance data, while deemed obtained from reliable sources, are not guaranteed for accuracy. Indexes shown are unmanaged and are not available for investment. The S&P 500 Index is a capitalization weighted index of 500 widely traded stocks that are considered to represent the performance of the U.S. stock market in general. Russell 1000 Value measures the performance of those Russell 1000 Index securities with lower price-to-book ratios and lower forecasted growth values, and is representative of U.S. securities exhibiting value characteristics. Russell Midcap measures the performance of the mid-cap segment of the U.S. equity universe and is a subset of the Russell 1000 Index. Russell 2000 measures the performance of the 2,000 smallest companies in the Russell 3000 Index and is representative of the U.S. small capitalization securities market. The NASDAQ Composite Index is market capitalization weighted average of roughly 5,000 stocks that are electronically traded in the NASDAQ market. MSCI EAFE Index is an unmanaged index that includes approximately 1,000 companies representing the stock markets of 21 countries in Europe, Australasia and the Far East (EAFE). MSCI Emerging Markets EMG Index is designed to measure equity market performance in global emerging markets. This index includes sub-indexes for various countries (such as China and Brazil). MSCI All Country World Index (excluding U.S.) tracks the performance of stocks representing developed and emerging markets around the world that collectively comprise most foreign stock markets. U.S. stocks are excluded from this index. MSCI World Index is an unmanaged index which tracks equity market performance of developed markets through individual country indices. MSCI Country Indices represent the market for a particular country.

Equity securities are subject to stock market fluctuations that occur in response to economic and business developments. Growth stocks are typically more volatile than value stocks; however, value stocks have a lower expected growth rate in earnings and sales. The value of large cap stocks will rise and fall in response to the activities of the company that issued them, general market conditions, and/or economic conditions. Stocks of small- and mid-cap companies pose special risks, including possible illiquidity and greater price volatility than stocks of larger, more established companies.

International investing involves risks not typically associated with domestic investing, including risks of adverse currency fluctuations, potential political and economic instability, different accounting standards, foreign government regulations, currency exchange rates, limited liquidity, and volatile prices. Investing in emerging markets may involve greater risks than investing in more developed countries. In addition, concentration of investments in a single region may result in greater volatility. Investments in fixed income debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in real estate can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates and risks related to renting properties, such as rental defaults. Inflation protected securities is a special type of note or bond designed to offer protection from inflation. Interest payments vary with the rate of inflation. These securities offer a lower return compared to other similar investments. The principal value may increase or decrease with the rate of inflation. Investments in high-yield bonds offer the potential for high current income and attractive total return, but involve certain risks. Changes in economic conditions or other circumstances may adversely affect a bond issuer's ability to make principal and interest payments. There are special risks associated with an investment in commodities, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes, and the impact of adverse political or financial factors. An investment in a hedge fund involves a substantially more complicated set of risk factors than traditional investments in stocks and bonds. Hedge funds are speculative and involve a high degree of risk. Investments in private equity are illiquid by nature and typically represent a long-term binding commitment. The investments made by private equity funds are not readily marketable and the valuation procedures for these positions are often subjective in nature.