Economic and Financial Markets
Monthly Review & Outlook
Detailed Report

June 2014
Overview of the Economy

In the U.S., the Federal Reserve’s Beige Book report on the economy through late May indicated that the economy continued to expand at a modest to moderate pace across the various districts. Activity in the auto sector was reported to be robust while non-auto activity was generally described as mixed. The anecdotes are largely consistent with data received over the past month. Data across the major economic sectors suggest that second quarter growth has probably snapped back to a 3% pace following a surprise first quarter slump. Auto sales rose sharply in May after a softer April, and should help lift overall consumer spending to near 3% growth for the quarter. Business spending on structures, equipment and intellectual property is showing moderate growth and apartment construction is working to offset weakness in the single family segment of the market. Export growth has been lackluster, and a wider trade deficit will likely detract from second quarter.
Consumer spending was reported to have grown at 3.1% during the first quarter, the gain driven by the strongest pace of service spending since first quarter 2000. Much of this spending increase fell in the health care category, and subsequent data released for the first quarter points to a sizable downward revision to the first quarter consumer spending growth rate. April real consumer spending data slipped after the strong March gains and point toward second quarter consumer spending probably advancing at about a 3%, largely due to strong May auto sales. The auto sector sales cycle looks mature at roughly a 17 million unit rate in May, income trends are modest and confidence remains range bound, therefore spending growth through the balance of the year seems likely to remain in line with more recent, moderate trends. Oil prices will bear watching with renewed instability in Iraq.
Housing construction activity has been a source of softness for the broader economy over the past few quarters. The sharp upward movement in mortgage rates last summer put significant downward pressure on mortgage activity and housing affordability. Housing starts rose sharply in April, but the increase was largely confined to multi-family construction as the rental markets remain relatively robust with declining homeownership rates. Mortgage applications for home purchases have risen during the past few weeks as mortgage rates have declined, but the overall mortgage activity for home purchases remains a fraction of the level prior to the recent downturn. Home price gains will likely slow noticeably in the coming months.
Manufacturing activity indices have bounced back sharply from the weakness recorded during the winter. Overall, the indices remain at levels consistent with moderate growth in the manufacturing sector over the summer months. Business inventories relative to sales have come down from their recent highs and small business sentiment has improved. The indicators are consistent with a snap back in broader economic activity during second quarter following the first quarter slump. The auto and aerospace sectors have been areas of notable strength. One source of mentionable weakness has been the export sector for manufactured goods, where the overall global growth picture remains subdued. Manufactured construction goods have also been noted as an area of relative weakness.
A widening trade deficit detracted from growth during the first quarter and is poised to weigh more heavily on second quarter growth. This largely reflects weakness in export markets. In Europe, the overall pace of economic growth has been quite subdued since emerging from recession in the second quarter of last year. Japan saw growth measures lose momentum throughout much of 2013. Although activity surged during the first quarter, the increase appears to have been a temporary move in anticipation of the consumption tax hike in April. We will likely see a substantial fall-off in Japanese activity during the second quarter. China is continuing what is likely to be a long process of rebalancing its economy. While officials help manage the transition with periodic stimulus measures, the structurally slower trend in China’s growth will likely continue. These conditions are consistent with the subdued pace of U.S. exports experienced over the past year, and suggest that a significant acceleration in export growth remains a ways off.
Labor Market Conditions

Labor market data show a trend of steady growth in labor demand and continued improvement in overall labor market conditions through May. Nonfarm payrolls rose by just over 200,000 in May, roughly in line with average job gains over the past year. The unemployment rate held steady at 6.3% following the large decline in April while labor force participation was unchanged. The pace of labor demand is sufficient to continue lowering unemployment rate over time. Overall wage gains remain subdued and anecdotal information from the Beige Book is consistent with this broad trend. However, reports of shortages of highly skilled workers have been increasing. The labor market data is consistent with the Federal Reserve (Fed) continuing to taper quantitative easing at the June 18 Federal Open Market Committee (FOMC) meeting and concluding the program this fall.
Inflation and Monetary Policy

Inflation readings look to have generally stabilized and moved incrementally higher during the first months of the year. Overall inflation will likely move higher still in the coming months as oil prices have increased due to instability in key producing regions. Aside from energy, the upward pressure coming from agricultural commodities earlier this year looks to have diminished and low inflation in major economies abroad will likely limit the broader import price movement. Labor market conditions have firmed somewhat and are unlikely to act as a source of disinflation. Overall, lower unemployment and an inflection point in the disinflationary pressure of the past few years suggests the Fed will continue to steadily conclude quantitative easing over the next few months. Shorter-term interest rates should remain under upward pressure as rate normalization draws closer.
Equity markets saw positive performance in May, which lifted some broad equity indices like the S&P 500 to new highs. Anticipation of further European Central Bank (ECB) easing lifted equities on a global basis during the second half of May and early June. The implied level of market volatility has declined to multi-year lows, likely in large part reflecting easing by the world’s major central banks. As the Fed continues to taper and ultimately conclude quantitative easing this fall, we think market volatility will meaningfully increase. We anticipate further outperformance of large cap stocks relative to small cap stocks and other market segments more sensitive to changes in liquidity.
International Markets

International equity markets have generally performed similar to domestic markets this year. Europe has been the top performing region, benefitting from further central bank action and improved credit conditions in the periphery countries. In contrast, Japan has been a weaker performer as it digests the large advance from last year and its economy copes with a large tax increase implemented in early April. Emerging market equities have trended higher from the recent low in early February, benefitting from ECB actions and recently from relaxed credit restraint in China. Economic conditions outside the U.S. show relatively broad based but subdued growth. We have maintained a modest overweight to EAFE stocks in our asset allocation strategy in anticipation of additional monetary support from the ECB and Bank of Japan while the Fed steadily tapers and concludes quantitative easing.

Source: MSCI Barra

Source: MSCI Barra

Source: MSCI Barra

Source: MSCI Barra
Fixed Income Market

Fixed income market performance has exceeded consensus expectations as yields have moved lower and spreads tighter as the year progressed. Domestic economic growth has failed to meet expectations so far this year, but there is no reason to expect that yields will move lower on the basis of U.S. economic growth or inflation. The yield decline so far this year has been a global phenomenon. The moves have been particularly pronounced in Europe, where yields have moved back toward or exceed historical lows. This has resulted in Treasury yields approaching historically high levels on a comparative basis and has worked to anchor yields at lower levels. The very low level of global yields should act as a restraint on Treasury yields, although we should still anticipate that 10-year yields will gravitate toward 3% through the balance of the year.

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>Metric</th>
<th>2012 (A)</th>
<th>2013 (A)</th>
<th>2014 (F)</th>
<th>2014 Bloomberg Consensus*</th>
<th>2015 Bloomberg Consensus*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP (Q4/Q4)</td>
<td>2.0%</td>
<td>2.6%</td>
<td>1.5% - 2.5%</td>
<td>2.5%</td>
<td>3.1%</td>
</tr>
<tr>
<td><strong>Personal Consumption Expenditures</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Personal Consumption Expenditures</td>
<td>2.0%</td>
<td>2.3%</td>
<td>1.5% - 2.5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment</td>
<td>3.1%</td>
<td>8.3%</td>
<td>4.0% - 6.0%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Exports ($)</td>
<td>-$412B</td>
<td>-$383B</td>
<td>-$420B</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Government Spending</td>
<td>-1.1%</td>
<td>-2.4%</td>
<td>0.0% - 1.0%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unemployment Rate***</td>
<td>7.9%</td>
<td>6.7%</td>
<td>6.0%</td>
<td>6.4%</td>
<td>5.9%</td>
</tr>
<tr>
<td>CPI***</td>
<td>1.7%</td>
<td>1.5%</td>
<td>1.5% - 2.5%</td>
<td>1.7%</td>
<td>2.1%</td>
</tr>
<tr>
<td>CPI Excluding Food and Energy</td>
<td>1.9%</td>
<td>1.7%</td>
<td>1.5% - 2.5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fed Funds***</td>
<td>0.25%</td>
<td>0.25%</td>
<td>0.0% - 0.25%</td>
<td>0.25%</td>
<td>0.38%****</td>
</tr>
<tr>
<td>10 Year Treasury***</td>
<td>1.76%</td>
<td>3.03%</td>
<td>2.5% - 3.5%</td>
<td>3.14%</td>
<td>3.43%****</td>
</tr>
<tr>
<td>Corporate Earnings (S&amp;P Operating)</td>
<td>$96.82</td>
<td>$107.30</td>
<td>$113.50</td>
<td>119.81**</td>
<td>$137.39**</td>
</tr>
<tr>
<td>Trade Weighted Dollar***</td>
<td>$79.80</td>
<td>$80</td>
<td>$80-$90</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Bloomberg - June 4, 2014

**Standard and Poors - June 4, 2014

***End of Period Level

****Q2 2015 Bloomberg Consensus
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 1000 Growth 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-indices 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. An inflation protected security 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.

NOT A DEPOSIT | NOT FDIC INSURED | MAY LOSE VALUE | NOT GUARANTEED BY THE BANK
NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY