As we enter 2014, the current economic expansion is 4.5 years in duration, roughly the average life of U.S. economic expansions. There is every reason to believe it will continue, as it began at a very depressed level and the economy faces no material capacity constraints. Political noise around fiscal policy will likely increase as the continuing resolution expires. But officials will likely maintain current levels until after mid-term elections. Fiscal policy should not pose a meaningful risk to the economic cycle in 2014.

Consensus Forecasts May be Overly Optimistic

The Federal Reserve (Fed) will likely begin slowing the pace of quantitative easing in 2014 and conclude the program sometime during the year. However, it will seek to compensate for reducing asset purchases by giving guidance that short-term policy rates will remain low for longer than previously stated. While the shifting mix of monetary policy instruments may cause some market volatility next year, the overall stance of monetary policy will remain highly accommodative and should not be a threat to the economic cycle, as overall inflation pressures remain muted. Thus, it is unlikely that the economy will fall backwards absent an unanticipated geopolitical shock that would threaten global activity.

Consensus forecasts anticipate a material strengthening in economic growth next year. Most forecasts anticipate some strengthening in private sector activity – consumer spending, housing investment and business investment – coupled with less fiscal drag due to smaller sequester spending reductions and no repeat of the 2013 payroll tax increases.

### 2014 Economic Data Forecasts

<table>
<thead>
<tr>
<th>Economic Indicator</th>
<th>Forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Domestic Product Growth</td>
<td>2.0%</td>
</tr>
<tr>
<td>CPI Inflation</td>
<td>1.8%</td>
</tr>
<tr>
<td>Unemployment Rate</td>
<td>6.8%</td>
</tr>
<tr>
<td>Fed Funds Rate</td>
<td>0% - 0.25%</td>
</tr>
<tr>
<td>10-Year Treasury Yield</td>
<td>3.00%</td>
</tr>
<tr>
<td>S&amp;P 500 Operating Earnings per Share</td>
<td>$110</td>
</tr>
<tr>
<td>U.S. Dollar Index</td>
<td>88.0</td>
</tr>
</tbody>
</table>

Forecasts for end of period levels as of 11/12/13.

Indeed, the fiscal impulse to economic growth will be positive in 2014 relative to 2013. But the case for strengthening private sector activity next year seems to anticipate a reversion to longer-term trends. We believe near-term indicators and underlying income growth trends suggest such acceleration is unlikely.

### Housing and Durable Goods Consumption Contribute Less to GDP

The major contributors to economic growth during the past several quarters have been residential investment and consumer durables, particularly autos. During the past four quarters, residential investment has grown at an average annual rate of better than 15% and consumer durables have grown close to 8%. But housing affordability has fallen sharply in recent months, following rising home prices over the past year and the sharp increase in mortgage rates over the summer.
This significantly slowed the leading indicators of housing activity, including building permits and pending home sales. Mortgage applications data show a sharp decline in mortgage demand for both purchases and refinancing, suggesting that recent growth rates in residential investment are unlikely to be maintained. While demographic trends provide underlying support for building activity, these shorter-term measures suggest slower growth and a smaller contribution to economic growth from the housing sector in the coming quarters.

Leading Housing Indicators Show Impact of Higher Rates

![Graph showing leading housing indicators](image)

Sources: U.S. Census Bureau & National Assoc. of Realtors. Data from 1/1/02 to 7/31/13.

Regarding consumer durables, the outlook for auto sales remains positive. Auto sales have largely recovered from the recession and reached an annual selling pace of 16 million units in August before slipping modestly the past few months. Industry sources suggest that sales could reach 17 million units by 2015, which is near the peak sales pace of the past expansion. This would represent a materially slower pace of growth – and contribution to gross domestic product (GDP) – compared to the past several quarters. The plunge in mortgage refinancing activity since the summer, often a funding source for durable goods purchases, is also inconsistent with a near-term strengthening in durable goods demand.

Aside from these highly cyclical components of consumer spending, the moderate growth trends in nondurable goods and services should continue. However, the nearly 75% of GDP directly represented by consumer spending and housing investment is likely to grow at a steady to perhaps somewhat slower pace in 2014.

Business Investment Spending Expected to Steady

Consensus views also suggest accelerating business investment spending in 2014. Improvement of foreign developed economies, particularly the nascent economic recoveries in Europe and Japan, should support exports and the activity of foreign subsidiaries. Capital goods orders have improved slightly in recent months from earlier this year and investment in structures has been strong. But business sales growth has remained subdued in recent quarters. In general, companies have held a tight line on expenses, including the depreciation charges associated with capital expenditures, to maintain earnings growth in this slow sales growth environment. Without stronger sales growth, a material acceleration in capital expenditures seems unlikely, as the increase in spending would reduce profit margins. A steady trend in business investment, net of inventories, seems most likely in the coming year.
Continued Slow Labor Market Improvement

Private sector payroll growth also seems unlikely to accelerate without stronger growth in business sales. Historically, the year-over-year growth trend in corporate earnings has had a leading relationship to nonfarm payrolls, although the relationship is less than perfect. The positive, albeit modest, trend in corporate earnings growth should sustain the positive trend in employment in 2014.

Earnings Growth Leads Payroll Growth

Sources: Standard & Poor’s and Bureau of Labor Statistics. Data from 1/1/90 to 9/30/13.

However, the sharp drop in labor force participation that contributed meaningfully to the decline in the unemployment rate in 2013 seems unlikely to be repeated. That means the rate of decline in unemployment should slow without stronger job growth. Demographic trends and other factors will likely continue to suppress labor force participation for the foreseeable future, but we don’t anticipate a further significant decline from the current depressed level.

The unemployment rate now stands less than one percentage point away from the Fed’s 6.5% threshold for beginning interest rate normalization, yet the Fed has not yet begun scaling back quantitative easing. Tapering seems very likely to commence in the coming months as labor market conditions improve further and the Fed becomes more concerned about the longer-term costs and risks associated with the program. But the Fed will also remain highly sensitive to the potential effect of tapering on interest rates and broader financial conditions. To counter the potential negative effects of such a shift, the Fed will likely lower the unemployment threshold established for beginning interest rate normalization when they scale back long-term asset purchases. Recent research papers by Fed staff indicate such a shift in policy instruments is likely in the coming months.

Inflation Expected to Remain Muted

The expectation of ongoing monetary policy support in 2014 rests on a view that inflation will remain muted. Persistent labor market slack is likely to result in continued subdued wage gains and labor costs. Labor accounts for approximately 60% of total production costs on an economy-wide basis, so there will be little pressure for price increases to maintain profit margins.

Credit growth remains anemic despite five years of a zero percent interest rate policy and better than $3 trillion in quantitative easing. The lack of a bank credit demand in response to the stimuli of lower rates likely reflects the continued overhang of debt outstanding in the broader economy.
No Deleveraging Yet – Debt Outstanding Growing

Non-financial debt outstanding has grown to $41 trillion through the second quarter of 2013, mainly due to greater Treasury debt. The ratio of nonfinancial debt outstanding to GDP is 243% today, higher than the 230% during the third quarter of 2008 when Lehman Brothers failed. The high level of leverage in today’s economy will likely keep credit demand subdued. Without acceleration in credit demand, overall demand growth seems unlikely to materially outpace supply and price pressures should remain subdued. In addition, a slower sustainable growth rate in China and supply side developments have alleviated commodity and resource price pressures. On balance, measured inflation rates for goods and services should remain subdued in the coming year.

Near-Term Inflation Drivers Muted – Slow Bank Credit Growth

Therefore, the nominal GDP growth environment is likely to be slightly better than the 3.1% year-over-year pace so far in 2013, but it will likely remain subdued vs. historical averages. Nominal GDP growth is a rough approximation of the expected growth rate in corporate revenues. The continued growth, albeit moderate, in corporate revenues and subdued input cost pressure should also allow the corporate sector to maintain high profit margins. However, the prospects of further margin expansion look to be limited with productivity gains flattening as the cycle has matured, the benefit of falling interest costs largely exhausted and regulatory and tax burdens likely to rise in the coming years. Profit growth is likely to be limited to the mid-single digits in 2014.
Market Outlook: Less Dramatic Domestic Market Returns

Assuming the fundamental environment evolves along the lines we have outlined, we should anticipate less dramatic domestic market returns in the coming year. The market will likely experience greater volatility in 2014 as the steady source of support from quantitative easing diminishes and more attention is focused on the ebb and flow of fundamental developments vs. policy support. Equity returns, which mainly reflected price to earnings multiple expansions in 2013, are likely to more closely reflect earnings growth in 2014 given current valuations and the move toward less monetary policy easing. With an expectation of diminishing liquidity support and relative valuation differentials, large cap equities should assert leadership after significantly lagging small caps in 2013.

Most segments of the bond market should perform better from a total return perspective in 2014 given higher interest rates. Some gradual upward movement in Treasury yields across the yield curve is likely, but the dramatic moves of 2013 are unlikely to be repeated in 2014. We find the high yield municipal market particularly attractive from an asset allocation perspective – particularly on a tax equivalent basis – while the low inflation environment and exceptionally low real yields offered in the inflation protected space make this segment of the market a funding source.

The dollar should benefit from both the relative performance of the U.S. economy and initial steps toward monetary policy normalization while other major central banks continue to ease monetary policy further. Weaker foreign currencies should aid foreign central banks in their easing efforts and support recovery efforts. These easing efforts and generally lower level of yields in the G-7 relative to Treasuries (except the U.K.) should support equity multiples in those markets. Emerging markets, in aggregate, have been very sensitive to the prospects of diminishing global liquidity and increasing interest rates across equity and bond markets and currencies. This will likely continue in 2014, but we should see differentiation amongst the emerging market countries that are more or less susceptible to changing flows. In a global environment with less liquidity, countries with significant current accounts gaps, such as India and Turkey, will likely experience greater pressure than countries with more stable balances, such as Korea or Mexico.

Source: These views were prepared by Keith Hembre, Chief Economist for U.S. Bank. 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 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 not available for investment.

The S&P 500 Index is an unmanaged, capitalization weighted index of 500 widely traded stocks that are considered to represent the performance of the U.S. stock market in general. Equity securities are subject to stock market fluctuations that occur in response to economic and business developments. International investing involves special risks, including foreign taxation, currency risks, risks associated with possible differences in financial standards, and other risks associated with future political and economic developments. 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. Investing in fixed income securities are subject to various risks, including changes in interest rates, credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications, and other factors. Investment in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer term debt securities. Investments in lower rated and non-rated securities present a greater risk of loss to principal and interest than higher rated securities. 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.