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The Economic Outlook

April 2016

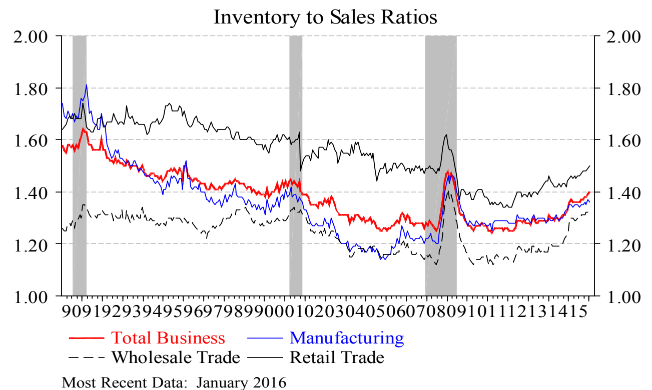
Slow but Steady on the Backs of Consumers

Estimated at 0.9%, real GDP growth in the first quarter is not expected to improve from the slow 1.4% real GDP growth rate in the fourth quarter. High inventories, a generally weak world economy and extreme drops in energy and non-energy commodity prices have slowed overall economic growth in the last half year. However, the American economic expansion has been sustained through this challenging period by modest but gradually rising consumer spending. Despite areas of weakness in manufacturing and mining employment, total nonfarm payroll growth continued at a solid 209,000 average pace in the second quarter, the labor force participation rate showed steady gains, and average wage growth reflected nascent signs of acceleration. Spring also brought some signs of thaw in a manufacturing sector suppressed in 2015 by weaknesses in exports and energy related investment. However, exports still dropped to their lowest levels in January since June 2011, and will detract from economic growth in 2016 as long as the world economy continues to grow at a subpar pace. Capital spending is expected to remain subdued as business investment will not receive the boost it has in recent years from energy related investment. A drop in economy wide corporate profits in the fourth quarter to the lowest level since the third quarter of 2011 will likely also put downward pressure on overall capital investment.

Despite significant impacts on the energy producing sector of the economy, energy price declines have had positive effects on energy users as many consumers have been benefiting from low prices at the gas pumps. As discussed on the upcoming section on inflation, net gains in real per capita disposable incomes in the last 2 years have been primarily the result of declining energy prices. Low gasoline prices have also been generally supportive of auto sales and production. Vehicle sales should continue at a strong pace above 17 million in 2016, matching last-year's brisk pace for the year overall.

The likely continuation of low mortgage rates should also keep the housing recovery on track, with a corresponding increase in housing-related durable goods consumption. Government spending will likely continue to grow as government revenues rise with economic expansion. On the other hand, inventory levels have been generally rising, and probably reflect disappointing sales overall. The Wholesale, Retail and Manufacturing components of Business inventories have continued to climb, and are at their highest since the recession. (Please see the chart below.) Hence, real GDP growth in the first half of the year will likely be restrained until these inventory-to-sales ratios begin to recede. The expected pick-up of GDP growth in the second quarter to 2% should help clear shelves, at least for goods destined for domestic purchasers.

High Inventories create headwinds to economic growth in goods producing sectors



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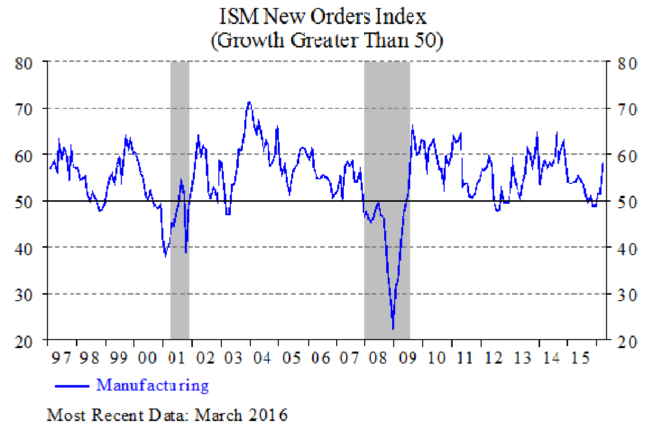
Slow but Steady on the Backs of Consumers *(Continued)*

Overall, real GDP is expected to grow 1.7% in 2016, slower than the 2.4% average annual pace of the last 2 years, but still sufficient to continue to add jobs to the economy, albeit at a slower pace than during the last 2 years. However, these anticipated job increases may not be sufficient to absorb all the new labor force entrants. General declines in the U.S. unemployment rate during recent years are expected to slow significantly in 2016, and the unemployment rate is forecasted at 5.0% in the fourth quarter, equal to its rate in March. Goods intensive areas of the economy are likely to underperform service areas of the economy until overall goods markets return to greater balance. Hence, interior portions of the country, which tend to have relatively high industry concentrations in manufacturing, energy and agriculture, will likely grow more slowly than coastal states in 2016.

Manufacturing New Orders Rise in March

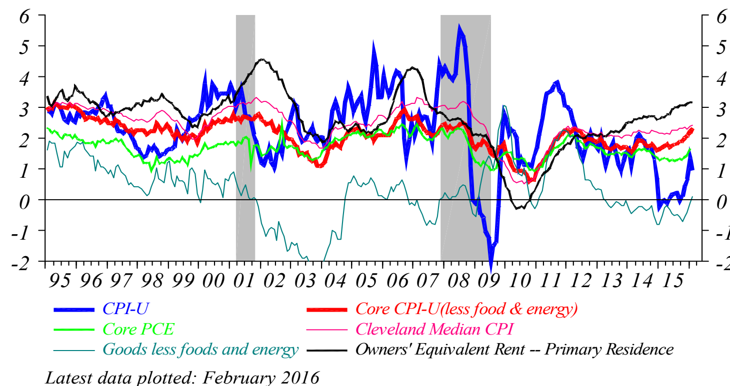


Inflation Quietly Accelerating in Services

The overall Consumer Price Index for Urban Consumers (CPI-U) showed little change for most of 2015, but began to spike in December as energy price declines were no longer sufficient to offset rising prices in the services sector. As evidenced in the chart below, inflation in services has been stealthily accelerating. Rents have risen the fastest, but gains in services have been broad-based. Energy prices are more likely to rise than to fall in the next year if the forecast for continued economic growth is correct. Hence, the reprieve in inflation from energy will likely fade. Goods outside of energy and food are the only major areas experiencing downward price pressures given the current "excess supply of goods." As noted in the discussion regarding high inventories, these forces on goods prices are downward in 2016. However, the accelerating inflation trend in non-goods areas of the economy will probably receive the attention of policy makers and markets in the coming year.

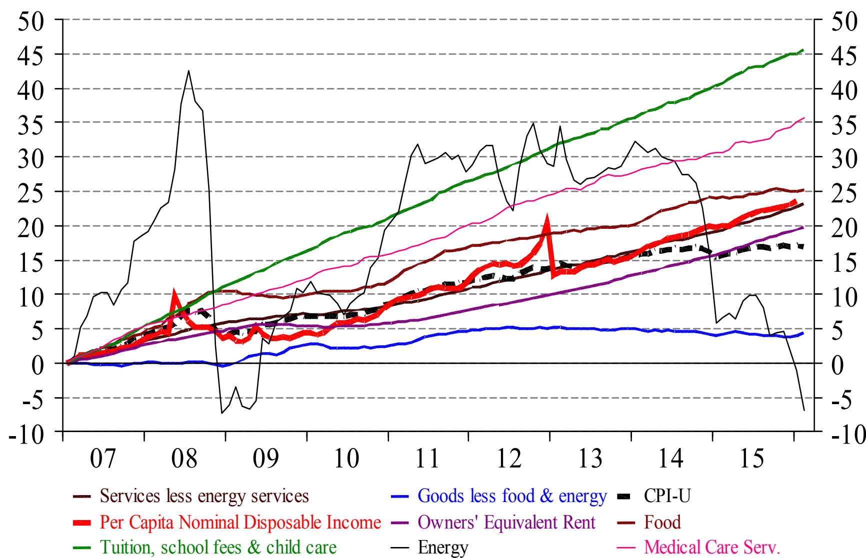
Consumer Price Inflation

12 Month Percent Change



Inflation Quietly Accelerating in Services (Continued)

Given the volatile economic and price environment of recent years, it is worthwhile to examine inflation trends over longer periods of time. The chart below shows inflation for various major categories of consumer expenditures since early 2007 – the last year of the last economic expansion. Inflation measured from 2007 shows widely diverging trends between services, energy, food and goods excluding food & energy as evidenced by widely diverse paths in the cumulative percent change in the respective price indexes since January 2007. Nominal disposable personal income per capita rose by about the same amount as the CPI for urban consumers between January 2007 and February 2014, after which personal incomes continued upwards while the overall Consumer Price index flattened, as the sharp drop in energy prices was sufficient to keep the overall CPI almost constant for about 2 years. Per capita disposable personal incomes rose 6.2% between February 2014 and January 2016, while the CPI-U rose only 1.1% during the same period, for a net increase in real disposable income of 5.1%. How much a given consumer was able to take advantage of this gain depended on the specific consumption patterns of the consumer. If energy and goods excluding foods represented a high proportion of his or her budget, then real purchasing power increased significantly. However, as evidenced in the charts, inflation in services less energy services continued to keep pace with rises in disposable personal incomes per capita in the last 2 years. Furthermore, budgets with large expenditures for items such as tuition, school fees & childcare, medical care services and food probably experienced higher inflation than average nominal disposable personal income growth. In summary, in contrast to the sharp declines in energy prices and very low inflation overall for goods excluding food and energy, inflation in services has continued at a steady pace. Consumers with relatively high expenditures in services were the most likely to have incomes that did not keep up with the rising "cost of living" in recent years.

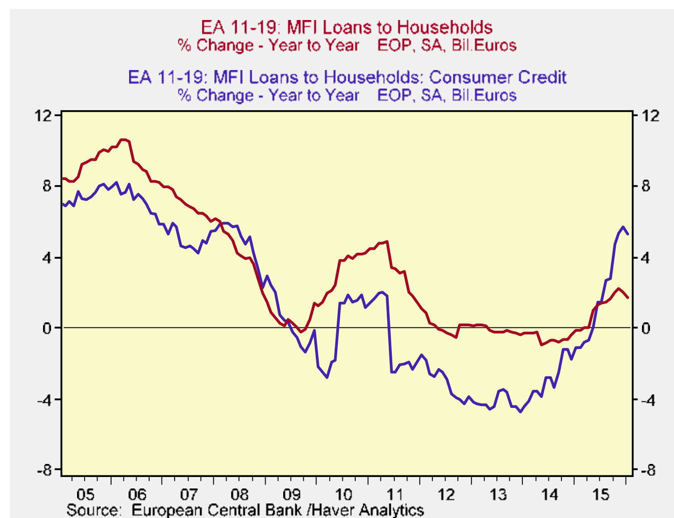


The Federal Reserve is likely to raise rates, but cautiously

With considerable deflationary forces emanating from the world economy, the Federal Reserve will likely move cautiously in raising its Fed Funds rate target in 2016. The Federal Reserve is not forecasted to raise the Fed Funds rate target again until its June 2016 FOMC meeting, and the new forecast calls for only one more increase at year-end for a total of 2 increases this year. This forecast coincides with the recent median forecast of Federal Reserve policy makers during the March 16 FOMC meeting, which brought the number of increases in 2016 down from 4 in the December 2015 FOMC meeting to 2. However, the Federal Reserve will likely remain highly "data dependent" in the decision to raise rates further, and may take advantage of relatively calm periods in financial markets and respectable indicators on labor markets and inflation to raise short-term interest rates. The Federal Reserve's policy tilt has probably turned to increasing rates over keeping them steady. Therefore, 3 quarter point increases in 2016 remains a possibility if economic growth and inflation rise above 2% in the second half of the year. The greater the degree of interest rate normalization, the greater is the Federal Reserve's future flexibility to cut rates if needed. However, contagion effects from the international economy, energy sectors and other commodity sectors will likely remain high, especially in emerging market economies whose fiscal situations are highly dependent on petroleum and other commodity production. Hence, the balancing act of raising rates will likely be a challenging one this year.

While the Federal Reserve's policy propensity is towards higher interest rates, other central banks around the world have taken an entirely different track on monetary policy, directly addressing a deflationary backdrop worldwide. Citing the weakness in China and nonexistent inflation, the European Central Bank (ECB) launched its most stimulative monetary policy to date featuring a 0.0% policy refinance rate (previously 0.25%), and an interest rate of -0.4% (previously -0.3%) on the central bank's deposit facility for banks. The negative interest rate means banks have to pay 0.4% for their deposits at the European Central Bank. (In contrast, banks with excess reserves in the U.S., money center banks primarily, are paid by the Federal Reserve for the deposits they maintain at the Federal Reserve.) Hence, the euro-area banks have increased incentives to lend out their money, which they increasingly have done as evidenced in the following chart. Although imposition of negative interest rates beginning in January 2014 accompany other historic monetary policy actions such as large asset purchases, ECB policy makers recently noted the potentially stimulative effects of negative rates on Major Financial Institution (MFI) lending to the private sector, although this assertion will be tested in the coming months. In addition to negative interest rates on bank reserves, the ECB is increasing its large asset purchases from 60 billion euros per month to 80 billion euros. In perhaps the biggest surprise to financial markets, the European central bank is also liberalizing the assets that it can purchase to include non-bank corporate bonds. Hence, the asset purchases not only increase liquidity in the financial system, but they also reduce the cost of businesses to borrow in capital markets. The monetary policy actions are controversial as they utilize highly unconventional tools. However, the ECB has showed its intent to increase financial market liquidity and ultimately raise the level of inflation to levels consistent with the central bank's mandated rate of 2%. In this highly activist regard, it has not been alone. The central banks of Japan, Switzerland, Denmark and Sweden have also started or kept negative policy rates in the first quarter.

European banks have boosted lending to consumers in the last year



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Long-term Interest rates likely to edge higher

Long-term Treasury interest rates are not expected to make dramatic moves upward in the next year, as long-term yields have become increasingly suppressed by high world demand for bonds in a sluggish world economy. However, the 10-year U.S. Treasury interest rate is forecasted to reach 2.23% as inflation normalizes and economic growth accelerates somewhat. Given the recent state of the international economy and financial markets, this upward movement in U.S. Treasury interest rates has large forecast risks. However, the upward potential for long-term rates began to emerge with the ECB policy actions, and it could gain further traction with even modest increase in real GDP and inflation. In all likelihood, unless a recession develops, long-term interest rates will continue a modest rise in 2016.

The main baseline forecasts by quarter and annual average are in Table 1 for the GDP accounts and in Table 2 for the other major indicators forecasted.

Forecast Risks

As with all forecasts, the economic forecast for 2016 is subject to unknowable events and surprises.

Downside risks to the economy are significant, especially in the first half of 2016. If worldwide economic growth weakens as a result of some combination of China, Europe and Japan deterioration, it would likely suppress already weak worldwide demand for commodities and energy, bring additional countries into recession, and intensify downward pressures on already stressed financial markets in the materials and energy sectors. In such an event, U.S. economic growth, headline inflation, the Fed Funds rate target and long-term Treasury yields would likely be below the benchmark forecasts in Tables 1 and 2. Additionally, if consumer and business confidence falls sufficiently to reduce consumer spending and other discretionary spending significantly, then transmission to the U.S. economy of recent shocks would make a recession likely. Two consecutive quarters of real GDP declines, the classic textbook definition of a recession, is not necessary for an official recession to occur. According to the National Bureau of Economic Research (NBER), a sustained period of overall weakness in the economy may be sufficient for the “recession” label. This is dependent on expert agreement on what sufficient weakness represents in terms of employment, incomes, spending and other factors.

Policy uncertainty was reduced by the U.S. federal budget that was signed for fiscal year 2016. A permanent R&D tax credit, multi-year expansion of accelerated depreciation credits and several industry specific tax saving advantages should ultimately provide a positive boost to business capital investment, although the precise impact on 2016 is still difficult to estimate. Stronger economic growth than in the forecast would likely support higher interest rates and possibly higher headline inflation than in the benchmark forecasts in Tables 1 and 2. Upside forecast risks to the economy are most significant in the second half of the year, but the downside risks to the economy in 2016 are dominant at this time. The elections to the Presidency and to Congress are also important this year, and create policy uncertainty as economic consequences in the long-term are unknown at this time.

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Table 1
Real GDP
Forecast as of April 2, 2016

	15-I	15-II	15-III	15-IV	16-I	16-II	16-III	16-IV	2014	2015	2016
Annualized Real Growth Rates											
(bln Chained 2009 Dollars)											
GROSS DOMESTIC PRODUCT (bln $)	17649.4	17913.1	18060.3	18165.4	18249.1	18402.2	18573.6	18757.6	17348.2	17947.1	18495.6
% change	0.8	6.1	3.3	2.3	1.9	3.4	3.8	4.0	4.1	3.5	3.1
IMPLICIT PRICE DEFLATOR	109.1	109.7	110.0	110.3	110.5	110.9	111.4	112.0	108.7	109.8	111.2
% change	0.1	2.1	1.3	0.9	0.9	1.4	1.9	2.1	1.6	1.0	1.3
REAL GROSS DOMESTIC PRODUCT	16177.3	16333.6	16414.0	16470.6	16509.1	16590.5	16668.1	16747.1	15961.7	16348.9	16628.7
Real GDP Annualized Growth Rate	0.6	3.9	2.0	1.4	**0.9**	**2.0**	**1.9**	**1.9**	**2.4**	**2.4**	**1.7**
4-quarter % change	2.9	2.7	2.1	2.0	2.1	1.6	1.5	**1.7**			
CONSUMPTION	11081.2	11178.9	11262.4	11330.7	11376.9	11460.3	11538.5	11612.7	10875.7	11213.3	11497.1
% change	1.7	3.6	3.0	2.4	1.6	3.0	2.8	2.6	2.7	3.1	2.5
DURABLE GOODS	1430.4	1458.3	1481.7	1495.5	1494.9	1522.8	1541.0	1560.3	1384.1	1466.5	1529.7
% change	2.0	8.0	6.6	3.8	-0.2	7.7	4.9	5.1	5.9	6.0	4.3
NON-DURABLE GOODS	2397.8	2423.0	2447.9	2451.5	2449.3	2465.5	2485.2	2500.2	2367.8	2430.1	2475.0
% change	0.7	4.3	4.2	0.6	-0.4	2.7	3.2	2.4	2.1	2.6	1.9
SERVICES	7277.4	7325.3	7363.4	7415.0	7465.1	7504.4	7544.8	7584.9	7144.6	7345.3	7524.8
% change	2.1	2.7	2.1	2.8	2.7	2.1	2.2	2.1	2.4	2.8	2.4
GROSS PRIV. DOM. INVESTMENT	2830.2	2864.8	2859.7	2852.7	2872.1	2891.3	2919.0	2948.6	2717.7	2851.9	2907.8
% change	8.6	5.0	-0.7	-1.0	2.8	2.7	3.9	4.1	5.4	4.9	2.0
FIXED INVESTMENT	2701.4	2735.5	2760.7	2763.2	2793.4	2818.8	2849.1	2887.6	2633.7	2740.2	2837.2
% change	3.3	5.1	3.7	0.4	4.5	3.7	4.4	5.5	5.3	4.0	3.5
NON-RESIDENTIAL*	2188.6	2210.6	2224.9	2213.0	2209.1	2215.8	2224.3	2242.9	2148.3	2209.3	2223.0
% change	1.6	4.1	2.6	-2.1	-0.7	1.2	1.5	3.4	6.2	2.8	0.6
NON-RESIDENTIAL STRUCTURE	458.2	465.2	456.6	450.7	453.1	456.8	461.7	469.4	465.4	457.7	460.3
% change	-7.4	6.3	-7.2	-5.1	2.2	3.3	4.4	6.8	8.3	-1.7	0.6
EQUIPMENT	1046.0	1046.9	1072.0	1066.4	1060.1	1063.1	1066.7	1077.6	1026.2	1057.8	1066.9
% change	2.3	0.3	9.9	-2.1	-2.4	1.1	1.4	4.2	5.8	3.1	0.9
RESIDENTIAL	512.4	524.0	534.4	547.4	566.8	585.4	607.2	627.1	486.4	529.6	596.6
% change	10.1	9.4	8.2	10.1	14.9	13.8	15.7	13.8	1.8	8.9	12.7
CHANGE IN INVENTORIES	112.8	113.5	85.5	78.3	66.0	58.8	56.2	47.9	68.0	97.5	57.2
NET EXPORTS	-541.2	-534.6	-546.1	-551.9	-593.2	-627.7	-670.3	-709.5	-442.5	-543.5	-650.2
EXPORTS	2091.4	2117.5	2121.1	2110.3	2080.9	2069.4	2060.2	2056.2	2086.4	2110.1	2066.7
% change	-6.0	5.1	0.7	-2.0	-5.5	-2.2	-1.8	-0.8	3.4	1.1	-2.1
IMPORTS	2632.5	2652.1	2667.2	2662.2	2674.1	2697.1	2730.5	2765.7	2528.9	2653.5	2716.8
% change	7.1	3.0	2.3	-0.7	1.8	3.5	5.0	5.3	3.8	4.9	2.4
GOVERNMENT PURCHASES	2838.5	2856.9	2869.7	2870.6	2884.2	2897.1	2910.8	2924.7	2838.3	2858.9	2904.2
% change	-0.1	2.6	1.8	0.1	1.9	1.8	1.9	1.9	-0.6	0.7	1.6
FEDERAL	1111.3	1111.3	1112.0	1118.3	1122.5	1125.3	1128.1	1130.9	1116.3	1113.2	1126.7
% change	1.1	0.0	0.3	2.3	1.5	1.0	1.0	1.0	-2.4	-0.3	1.2
STATE & LOCAL	1725.9	1744.1	1756.2	1750.9	1761.7	1771.8	1782.8	1793.8	1720.8	1744.3	1777.5
% change	-0.8	4.3	2.8	-1.2	2.5	2.3	2.5	2.5	0.6	1.4	1.9

Note: Data and percent changes are expressed at seasonally adjusted annual rates.

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*Non-Residential Fixed Investment includes Intellectual Property Investment not shown separately.

Table 2
Economic Indicators
Forecast as of April 2, 2016

KEY ECONOMIC INDICATORS	15-I	15-II	15-III	15-IV	16-I	16-II	16-III	16-IV	2014	2015	2016
Gross Domestic Product (bln $) *	0.8	6.1	3.3	2.3	**1.9**	3.4	3.8	4.0	**4.1**	**3.5**	**3.1**
Real GDP (2009 chained $)	0.6	3.9	2.0	1.4	**0.9**	2.0	1.9	1.9	**2.4**	**2.4**	**1.7**
Implicit GDP Price Deflator *	0.1	2.1	1.3	0.9	0.9	1.4	1.9	2.1	**1.6**	**1.0**	**1.3**
Consumer Price Index -- CPI-U *	-2.9	2.4	1.4	0.8	0.2	3.0	2.1	2.1	**1.6**	**0.1**	**1.5**
Producer Price Index *	-10.9	3.3	-0.3	-4.7	-5.1	1.9	3.4	0.2	**1.9**	**-3.3**	**-1.3**
FEDERAL FUNDS RATE -- average	0.11	0.12	0.14	0.16	0.38	0.42	0.63	0.67	**0.09**	**0.13**	**0.53**
-- end of quarter	0.06	0.08	0.07	0.20	0.38	0.63	0.63	0.88			
10-YEAR T-NOTE -- average	1.97	2.17	2.22	2.19	1.91	2.06	2.20	2.23	**2.54**	**2.14**	**2.10**
U.S. DOLLAR (FRB Index)	89.5	90.0	91.9	92.0	92.0	91.7	91.7	92.0	**78.4**	**90.8**	**91.8**
AVERAGE MONTHLY CHANGE (Th	190	251	192	282	209	151	188	213	**251**	**229**	**190**
UNEMPLOYMENT RATE (%)	5.6	5.4	5.2	5.0	4.9	4.9	4.9	5.0	**6.2**	**5.3**	**4.9**
Existing Home Sales (Thous SAAR)	5050.0	5280.0	5403.3	5200.0	5211.3	5512.7	5706.1	5728.7	**4923.3**	**5233.3**	**5539.7**
Housing Starts (Millions)	0.98	1.16	1.15	1.14	1.15	1.23	1.33	1.37	**1.00**	**1.11**	**1.27**
Motor Vehicle Sales (Millions SAAR)	16.7	17.1	17.8	17.8	17.4	17.2	17.1	17.1	**16.4**	**17.3**	**17.2**
Industrial Production Growth (SA) *	-0.4	-2.1	2.5	-3.3	-0.4	1.3	1.8	2.0	**3.7**	**1.3**	**0.0**
Consumer Credit *	5.5	8.1	7.5	6.1	2.2	4.1	4.3	4.4	**6.7**	**6.8**	**4.7**
C & I *	13.8	12.2	8.3	10.0	10.4	7.6	7.4	6.6	**10.5**	**11.5**	**9.0**
CORPORATE PROFITS (Bil. of $)	2012.5	2083.0	2049.9	1890.3	1897.2	1955.9	2013.1	2063.2	**2072.9**	**2008.9**	**1982.4**
% change *	-21.1	14.8	-6.2	-27.7	1.5	13.0	12.2	10.3	**1.7**	**-3.1**	**-1.3**
(Profits generated through U.S. GDP)											

* Annualized Growth Rates
Red -- First Period Forecasted
Brown -- Annual Averages

Historical Data Source: Haver Analytics, FACTSET, Recessions shown in grey in charts
Forecasts: Huntington Wealth and Investment Management, a division of The Huntington National Bank.

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