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The Economic Outlook

May 27, 2016

Emerging Risks in the International Economy

The international economy will likely continue to pose risks to the U.S. economy in 2016. Weaknesses globally are broad-based and include challenges in many emerging market economies in addition to Japan and Europe. Canada has begun a domestic led recovery, but U.S. economic growth has been well below consensus forecasts recently, growing at an annual rate of 1.4% in the fourth quarter 2015 followed by only 0.9% growth in the first quarter 2016. Brazil is mired in a political as well as economic crisis. Russia continues in a deep recession resulting from low energy prices and sanctions, while continued war in Ukraine poses risks to Eastern and Central Europe. Venezuela and other emerging market economies reliant on energy and commodities will likely undergo a highly challenging period until producer prices begin to lift sufficiently to reduce debt risks. The IMF and other organizations maintain a relatively sanguine base forecast of gradual acceleration in economic growth from +3.1% in 2015 to +3.2% in 2016 and +3.5% in 2017, but recent revisions have been downward and their forecast risks also remain weighted to the downside. According to the IMF World Economic Outlook issued in January 2016: "Risks to the global outlook remain tilted to the downside and relate to ongoing adjustments in the global economy: a generalized slowdown in emerging market economies, China's rebalancing, lower commodity prices, and the gradual exit from extraordinarily accommodative monetary conditions in the United States. If these key challenges are not successfully managed, global growth could be derailed." In the context of this weak economic backdrop, unexpected events could trigger risks to the world, domestic and even our regional economies.

Another of these risks is the potential for Brexit. Regardless of one's views on whether the United Kingdom should stay in the European Union (EU) when its citizens go to the polls on June 23rd, there is probably little disagreement that a decision to leave would likely significantly increase near term economic uncertainty, and represent an economic shock to the world economy at a time that it is already incurring unusually slow growth.

The United Kingdom's strong economic recovery from recession brought its unemployment rate down dramatically from 8.4% in the fall of 2011 to 5.1% in March. This dramatic decline was achieved at least in part by the benefits of free trade in the European Union, which allowed both its manufacturers and large services sector to have full preferential access to markets in the entire European Union, now at 28 countries across the continent and representing the largest free trade zone in the world. Exit from the EU would not only end this preferential treatment, but it would also require the United Kingdom to obtain new access to other markets around the globe – a daunting task when protectionism has returned into vogue even in relatively pro free trade countries such as the United States. Those for "Brexit" argue that benefits such as the elimination of excessive EU regulations and greater independence from the EU in general will lead to higher economic growth. However, estimates for long-term GDP losses have been massive. For example, the U.K's Treasury estimates 6% lower real GDP in 2030 if the U.K. leaves the E.U. As more of these reports are released in the coming weeks, the likelihood of a June 23 decision to leave the E.U. should become less.

Yet, let's presume the scenario of the U.K. voting out of the EU. The initial impact would likely be a sharp drop in the pound and probably the euro against the dollar, and increased financial volatility comparable to the turbulence early in the year. A third of U.K. exports go to the European Union, with the rules of trade likely to change almost immediately as the countries preferred status for trade ends. The chief of the London Stock Exchange Xavier Rolet estimates 100,000 jobs in London's financial district would be lost if the U.K. left the EU, with another 185,000 jobs ultimately lost because of indirect demand created by the impacted financial services. (Source: Financial Times)

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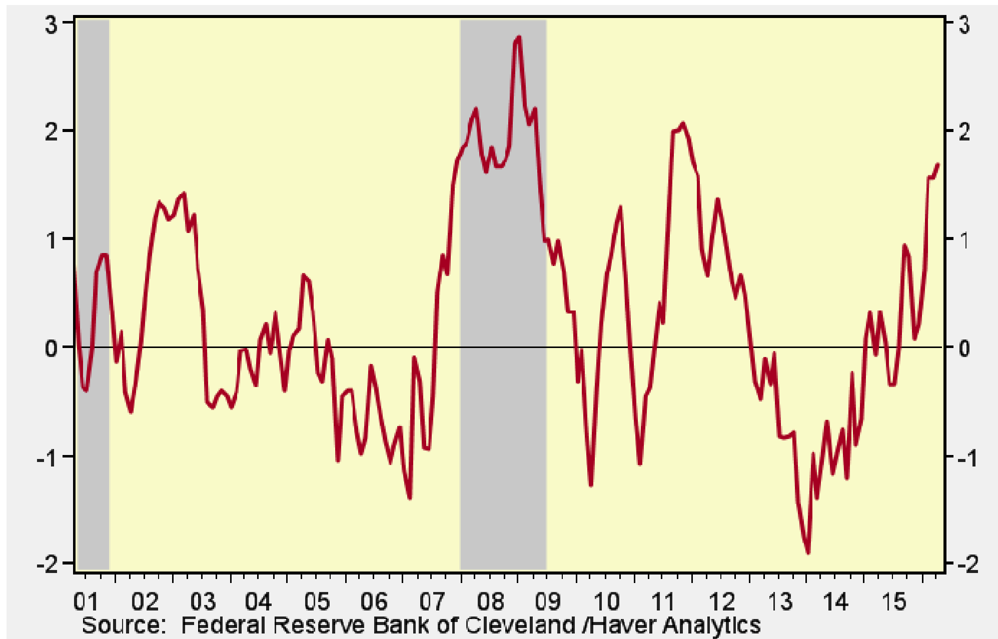
Emerging Risks in the International Economy *(Continued)*

Many of these jobs are high paying by world standards, and their loss would reduce average household incomes significantly. The Bank of England predicts a technical recession would result in the United Kingdom, with stagflation a possibility as inflation rises with productivity growth declines and currency declines. However, even as large as these potential shocks are to the United Kingdom economy, the political and economic damage to the European Union would likely be even greater, hitting at the core of the EU's ability to manage the sovereign debt loads in its weakest economies. The U.K. exit, should it occur, would likely trigger the exits of other relatively strong economies in the EU that have serious disagreements regarding sovereign debt relief, fiscal policy, immigration, security, defense and regulations viewed as dictated from Brussels. Germany and other countries recently supported a plan to assist Greece's sovereign debt repayment this year, but the beginnings of a possible downsizing of the EU would likely harden positions and possibly raise future default risks in Greece or other EU countries with high debt levels. This potential cascade of economic shocks could ultimately contribute to a wider world economic slowdown with outright recessions in both advanced and developing economies. Europe would likely enter a continental recession initially. The rising international debt of developing countries would facilitate the weakness in Europe to spread to financial markets and economies virtually worldwide.

The discussion above is a 'worst case scenario' and certainly not our forecast. However, one cannot underestimate the complexity of international connectivity and the potential for shocks to be transmitted via financial markets. To assist in the monitoring of these potential global financial stresses on the U.S., the Federal Reserve Bank of Cleveland produces an index to measure the general state of financial markets. The chart of the index is below. The Cleveland Fed Financial Stress Index (CFSI) is a comprehensive index that has equity, credit market, commercial and residential real estate, securitization, and interbank market subcomponents, many of which have been on a rising trend. There are 4 Risk categories for the CFSI: Grade 1 Low Stress Period, Grade 2 Normal Stress Period, Grade 3 Moderate Stress Period, and Grade 4 Significant Stress Period. The indicator is currently in the upper zone of the Grade 3 Moderate risk period category. We will be monitoring this and other high quality indicators of financial and economic functioning in the coming weeks and months, especially if world economic events enter the realm of the "unexpected."

Cleveland Fed Financial Stress Index

Above 0 = Above Average Financial Stress



The Federal Reserve is likely to raise rates, but cautiously

The considerable negative forces emanating from the world economy and the recent slowdown in U.S. economic growth will likely keep the Federal Reserve cautious in raising its Fed Funds rate target in 2016. Hence, the Federal Reserve is not forecasted to raise the Fed Funds rate target again until the September 2016 FOMC meeting. At that point, real GDP growth and inflation are both expected to solidly reach 2%. Overall, the Federal Reserve will likely remain highly “data dependent” in the decisions to raise rates further, taking advantage of relatively strong economic quarters to raise rates and staying on hold when economic conditions are less robust. The trend in the Fed Funds rate target is probably upwards as Federal Reserve policy makers have generally been forecasting rising rates. The greater the degree of interest rate level 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 commodities. The balancing act of raising rates will likely be a challenging one this year.

While the Federal Reserve’s policy propensity is probably upwards, other central banks around the world have taken an entirely different track on monetary policy, as they directly address 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 have gradually done. 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 has increased 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 also liberalized 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.

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 rise gradually as inflation and economic growth accelerate somewhat. Given the recent volatile state of the international economy and financial markets, this upward movement in U.S. Treasury interest rates has large forecast risks. 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 could result in a mild recession at best. Weak business investment spending, should it continue, poses an especially large risk to overall GDP growth. If it fails to accelerate in mid-2016, then recession risks would rise significantly. 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 May 27, 2016

Annualized Real Growth Rates (bln Chained 2009 Dollars)	15-III	15-IV	16-I	16-II	16-III	16-IV	17-I	17-II	17-III	17-IV	2015	2016	2017
REAL GROSS DOMESTIC PRODUCT	16414.0	16470.6	16505.1	16596.1	16681.3	16761.6	16845.4	16935.3	17023.8	17111.9	16348.9	16636.0	16979.1
Real GDP Annualized Growth Rate	2.0	1.4	0.8	2.2	2.1	1.9	2.0	2.2	2.1	2.1	2.4	1.8	2.1
4-quarter % change	2.1	2.0	2.0	1.6	1.6	1.8	2.1	2.0	2.1	2.1			
CONSUMPTION	11262.4	11330.7	11384.2	11461.7	11533.6	11601.1	11672.4	11735.0	11787.6	11838.8	11213.3	11495.2	11758.4
% change	3.0	2.4	1.9	2.8	2.5	2.4	2.5	2.2	1.8	1.7	3.1	2.5	2.3
DURABLE GOODS	1481.7	1495.5	1489.4	1514.8	1532.6	1547.3	1564.6	1571.7	1578.8	1585.2	1466.5	1521.0	1575.1
% change	6.6	3.8	-1.6	7.0	4.8	3.9	4.6	1.8	1.8	1.6	6.0	3.7	3.6
NON-DURABLE GOODS	2447.9	2451.5	2457.6	2473.2	2485.7	2499.5	2514.2	2529.9	2539.6	2549.0	2430.1	2479.0	2533.2
% change	4.2	0.6	1.0	2.6	2.0	2.2	2.4	2.5	1.5	1.5	2.6	2.0	2.2
SERVICES	7363.4	7415.0	7464.5	7502.5	7543.3	7582.6	7622.0	7662.0	7697.9	7733.4	7345.3	7523.2	7678.8
% change	2.1	2.8	2.7	2.1	2.2	2.1	2.1	2.1	1.9	1.9	2.8	2.4	2.1
GROSS PRIV. DOM. INVESTMENT	2859.7	2852.7	2833.6	2855.7	2882.3	2914.7	2949.1	2985.2	3021.5	3057.5	2851.9	2871.6	3003.3
% change	-0.7	-1.0	-2.7	3.2	3.8	4.6	4.8	5.0	4.9	4.9	4.9	0.7	4.6
FIXED INVESTMENT	2760.7	2763.2	2752.8	2787.8	2814.0	2852.0	2885.3	2923.4	2960.1	2997.2	2740.2	2801.6	2941.5
% change	3.7	0.4	-1.5	5.2	3.8	5.5	4.8	5.4	5.1	5.1	4.0	2.2	5.0
NON-RESIDENTIAL	2224.9	2213.0	2177.8	2184.2	2192.1	2208.2	2224.5	2246.7	2268.8	2290.9	2209.3	2190.6	2257.7
% change	2.6	-2.1	-6.2	1.2	1.5	3.0	3.0	4.1	4.0	3.9	2.8	-0.8	3.1
NON-RESIDENTIAL STRUCTURE	456.6	450.7	440.3	440.5	442.3	444.5	447.7	451.9	455.6	459.4	457.7	441.9	453.7
% change	-7.2	-5.1	-8.9	0.2	1.6	2.1	2.8	3.9	3.3	3.4	-1.7	-3.4	2.7
EQUIPMENT	1072.0	1066.4	1041.6	1040.2	1041.1	1049.7	1057.5	1070.1	1084.0	1096.9	1057.8	1043.2	1077.1
% change	9.9	-2.1	-9.0	-0.5	0.3	3.3	3.0	4.8	5.3	4.8	3.1	-1.4	3.3
INTELLECTUAL PROPERTY	699.6	699.4	699.2	703.5	708.7	714.0	719.3	724.6	729.1	734.5	696.8	706.4	726.9
% change	-0.8	-0.1	-0.1	2.5	3.0	3.0	3.0	3.0	2.5	3.0	5.7	1.4	2.9
RESIDENTIAL	534.4	547.4	569.5	586.0	604.2	626.2	643.3	659.2	673.7	688.7	529.6	596.5	666.2
% change	8.2	10.1	17.2	12.1	13.1	15.3	11.4	10.2	9.1	9.2	8.9	12.6	11.7
CHANGE IN INVENTORIES	85.5	78.3	69.6	55.3	55.5	50.3	51.6	49.4	48.8	47.7	97.5	57.7	49.4
NET EXPORTS	-546.1	-551.9	-561.2	-581.7	-609.3	-643.3	-679.5	-702.8	-717.7	-731.4	-543.5	-598.9	-707.8
EXPORTS	2121.1	2110.3	2099.5	2078.3	2067.1	2061.1	2060.3	2059.9	2065.1	2070.4	2110.1	2076.5	2063.9
% change	0.7	-2.0	-2.0	-4.0	-2.1	-1.2	-0.2	-0.1	1.0	1.0	1.1	-1.6	-0.6
IMPORTS	2667.2	2662.2	2660.6	2660.0	2676.4	2704.4	2739.8	2762.7	2782.7	2801.8	2653.5	2675.4	2771.8
% change	2.3	-0.7	-0.2	-0.1	2.5	4.2	5.3	3.4	2.9	2.8	4.9	0.8	3.6
GOVERNMENT PURCHASES	2869.7	2870.6	2878.9	2890.1	2903.9	2917.7	2931.6	2945.6	2959.7	2973.8	2858.9	2897.7	2952.7
% change	1.8	0.1	1.2	1.6	1.9	1.9	1.9	1.9	1.9	1.9	0.7	1.4	1.9
FEDERAL	1112.0	1118.3	1113.8	1116.6	1119.4	1122.1	1124.9	1127.7	1130.5	1133.4	1113.2	1118.0	1129.1
% change	0.3	2.3	-1.6	1.0	1.0	1.0	1.0	1.0	1.0	1.0	-0.3	0.4	1.0
STATE & LOCAL	1756.2	1750.9	1763.5	1773.6	1784.5	1795.6	1806.7	1817.9	1829.1	1840.5	1744.3	1779.3	1823.6
% change	2.8	-1.2	2.9	2.3	2.5	2.5	2.5	2.5	2.5	2.5	1.4	2.0	2.5

Note: Data and percent changes are expressed at seasonally adjusted annual rates.
*Non-Residential Fixed Investment includes Intellectual Property Investment not shown separately.

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Table 2
Economic Indicators
Forecast as of May 27, 2016

KEY ECONOMIC INDICATORS	15-III	15-IV	16-I	16-II	16-III	16-IV	17-I	17-II	17-III	17-IV	2015	2016	2017
Gross Domestic Product (bln $) *	3.3	2.3	1.4	3.6	3.7	3.9	4.0	4.2	4.1	4.3	3.5	3.0	4.0
Real GDP (2009 chained $)	2.0	1.4	0.8	2.2	2.1	1.9	2.0	2.2	2.1	2.1	2.4	1.8	2.1
Implicit GDP Price Deflator *	1.3	0.9	0.6	1.3	1.6	1.9	2.0	2.0	2.0	2.1	1.0	1.2	1.9
Consumer Price Index -- CPI-U *	1.4	0.8	-0.3	3.0	2.8	2.6	2.5	2.2	2.2	2.2	0.1	1.5	2.5
Producer Price Index *	-0.3	-4.9	-4.8	1.7	4.4	1.5	1.9	1.5	1.6	1.9	-3.3	-1.1	2.0
FEDERAL FUNDS RATE -- average	0.14	0.16	0.36	0.38	0.41	0.67	1.04	1.13	1.13	1.13	0.13	0.46	1.11
-- end of quarter	0.07	0.20	0.38	0.38	0.63	0.88	1.13	1.13	1.13	1.13			
10-YEAR T-NOTE -- average	2.22	2.19	1.92	1.83	1.96	2.10	2.23	2.33	2.29	2.29	2.14	1.95	2.29
U.S. DOLLAR (FRB Index)	91.7	94.1	91.5	91.4	92.3	92.9	92.2	91.7	91.2	90.8	91.3	92.0	91.5
AVERAGE MONTHLY CHANGE (Th	192	282	203	148	184	177	167	162	160	159	229	178	162
UNEMPLOYMENT RATE (%)	5.2	5.0	4.9	5.0	5.0	5.1	5.1	5.2	5.1	5.1	5.3	5.0	5.1
Existing Home Sales (Thous SAAR)	5403.3	5200.0	5300.0	5547.4	5889.9	5946.2	5925.3	5883.8	5826.7	5822.8	5233.3	5670.9	5864.6
Housing Starts (Millions)	1.15	1.14	1.15	1.22	1.34	1.38	1.37	1.36	1.34	1.34	1.11	1.27	1.35
Motor Vehicle Sales (Millions SAAR)	17.8	17.8	17.1	17.2	17.0	17.0	16.9	16.7	16.5	16.5	17.3	17.1	16.7
Industrial Production Growth (SA) *	1.5	-3.4	-1.5	-0.7	1.7	1.9	1.9	1.7	1.7	1.8	0.3	-0.8	1.7
Consumer Credit *	7.4	6.3	4.8	4.8	4.6	3.9	3.9	4.1	4.1	4.2	6.9	5.5	4.1
C & I *	8.3	9.3	10.2	12.8	10.5	9.6	7.1	6.5	6.5	5.8	11.4	10.4	8.0
CORPORATE PROFITS (Bil. of $)	2049.9	1890.3	1896.8	1954.7	2007.7	2049.1	2088.2	2126.5	2161.8	2193.0	2008.9	1977.1	2142.4
% change *	-6.2	-27.7	1.4	12.8	11.3	8.5	7.9	7.5	6.8	5.9	-3.1	-1.6	8.4
(Profits generated through U.S. GDP)													

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

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

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