

MOODY'S  
ANALYTICS

**DISMAL SCIENTIST**

# U.S. Macro Outlook 2015: Spirits Unleashed

BY MARK ZANDI — DECEMBER 12, 2014

# U.S. Macro Outlook 2015: Spirits Unleashed

By Mark Zandi

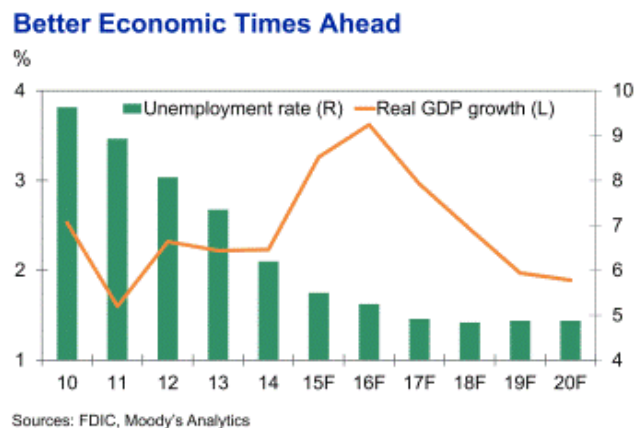
DECEMBER 12, 2014

View the [Moody's Analytics U.S. Macro Forecast](#).

- » Growth should accelerate in 2015 as higher wages spur more spending, construction and investment.
- » The sharp fall in oil prices will slow energy production but still be a net gain for the economy.
- » How fast the Federal Reserve raises interest rates, and how markets respond when they do, will be key to the coming year's economic story.
- » As more millennials begin forming households, housing demand and construction will take off.
- » The aging population and a slower pace of technological change could weigh on the economy's long-term potential.
- » Problems in Europe and China have the potential to hinder the U.S. expansion in 2015.

In general, 2014 was a good year for the U.S. economy, and 2015 should be even better.

The most encouraging development of the past year was the rapid decline in joblessness. At the current pace of job growth, the economy is fast approaching full employment. The next critical step in the economy's return to full health is a meaningful acceleration in wage growth, which appears imminent.



Most surprising has been the recent slide in oil prices, which, if sustained, will provide a significant boost to growth. The U.S. produces a lot more oil than it used to because of the shale revolution, and falling prices will take a toll on future energy development, but the country is still a significant net consumer of oil. As consumers put less of what they earn into their gasoline tanks, therefore, the holiday shopping will receive a lift.

Arguably the biggest disappointment in 2014 was the sideways housing market. The surge in mortgage rates in late 2013 and tight mortgage credit hurt home sales and construction. But mortgage rates have receded and the credit spigot has begun to open. Many millennials who have delayed forming households will begin to do so soon as the job market improves, moreover, making housing a more significant source of growth.

## The Fed factor

This highlights a key threat to the economy in the coming year; namely, the chance that the Federal Reserve will begin to raise interest rates. The Fed needs to engineer short- and long-term rates higher, consistent with the improving job market, in a way that keeps the housing recovery on track. Policymakers have all the tools they need and have gained valuable experience in communicating with financial markets.

Yet the process of normalizing monetary policy may not be as graceful as we hope.

The U.S. is also vulnerable to a softer global economy. With the euro zone and Japan flirting with recession, and China's growth steadily throttling back, the U.S. trade situation will erode. This will be made worse by the recent surge in the value of the dollar, which is sure to continue. If conditions don't get any worse overseas, the U.S. recovery should hold firm. This is a big if.

### Weaker potential

The other developing concern is the U.S. economy's weak potential growth rate. Underlying labor-force and productivity growth remains disappointing. Their weakness will help return the economy to full employment more quickly, but if they do not improve growth will be weaker over the longer term. A persistently low rate of new business formation, which is the fodder for innovation and productivity gains, adds to worries.

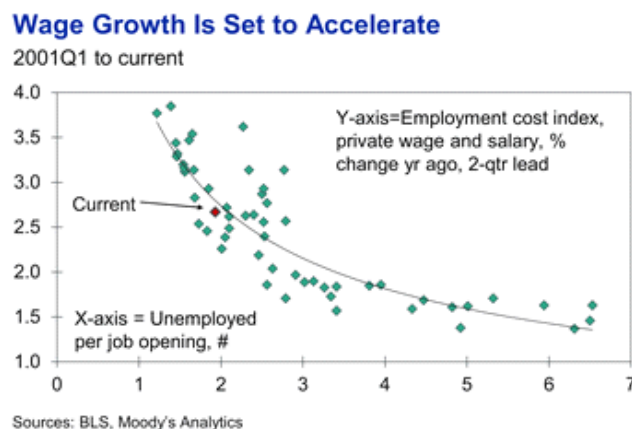
However, it is premature to conclude that the economy's supply side won't come back to life as full employment approaches. The U.S. has a surfeit of potential workers who stepped out of the job market during the tough times; some of them will step back in as wage growth and job opportunities return. Business formation and investment should also recover as the psychological shadow of the Great Recession fades and risk-taking revives.

### Wage resurrection

A key missing ingredient to a stronger economy has been real wage growth. Despite the increasingly robust job creation, the economy is still climbing out of the deep hole created by the Great Recession. Unemployment and underemployment are now falling fast, but there is still slack in the labor market equal to approximately 1.25% of the labor force.

At the current underlying pace of job growth—about 225,000 per month—this slack will be absorbed by mid-2016, assuming stable labor force participation. If participation picks up as disenfranchised workers come back into the labor force, the economy will return to full employment by the end of 2016.

Although full employment is still some distance away, wage growth should soon pick up. Data indicate it already has begun to do so. For much of the recovery, wages have grown only about 2% per year, the rate of inflation. This means workers have not been rewarded for increases in productivity, and is why the profit share of national income has risen to a record high.



As the economy reaches full employment, pay should grow fast enough to cover both inflation and productivity gains. Assuming underlying productivity growth is near 1.5% per year, nominal annual wage growth should steadily accelerate to 3.5% over the next two years.

### Spend versus save

Evidence is mounting that this anticipated acceleration has begun. Wage growth as measured by the employment cost index, the most comprehensive and consistent measure of compensation, hit bottom at 1.5% three years ago. Growth is now definitively above 2%, and the

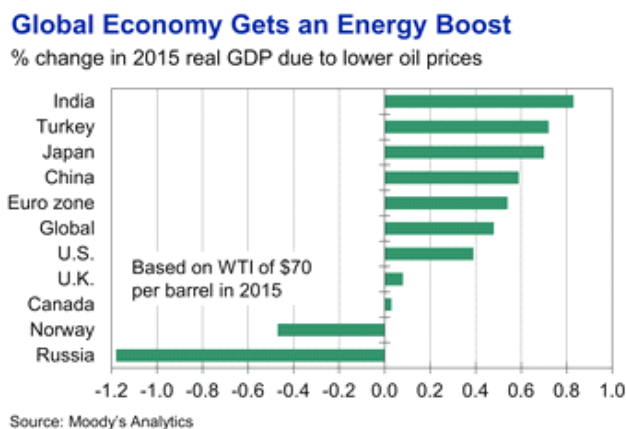
trend lines look good. Wages as measured by data from human-resource company ADP tell an even more positive story.

Stronger wage growth will support stronger consumer spending as long as consumers don't save it all. Given the wealth effects powered by record stock prices and better housing values, saving rates should, if anything, decline. Easier credit and more relaxed consumer attitudes toward borrowing also point to lower saving and greater spending.

Higher wages should also boost consumer sentiment. Perceptions about the economy have been lackluster despite the better job market. Americans judge the economy based on whether their pay is rising faster than inflation, and whether this year's average pay increase was bigger than last year's. This has not been the case until now. Improved moods among consumers could mean more purchases of big-ticket items such as vehicles, whose sales are already back to prerecession levels because of lower gas prices and easy credit. Next could be houses, sales of which have been flat since mortgage rates jumped more than a year ago.

### Energy surprise

Further boosting both consumer spirits and the economy's prospects is the surprising slide in oil prices. At near \$60 per barrel, crude prices have fallen about 40% since summer. If sustained, lower prices will lift global real GDP growth rates in 2015 by more than half a percentage point, and just under that in the U.S.



Saudi Arabia is crucial to where oil prices are headed next. The Saudis' decision not to scale back production to offset supply growth in the U.S. and elsewhere was the proximate cause for the plunge in prices. Softer global demand growth and a robust dollar also contributed, but if Saudi Arabia had reined in production as it has in times past, prices would have held firm.

The Saudis appear to believe that the global surfeit of oil is here to stay and the burden of balancing supply and demand must be shared more broadly. They can financially absorb the fall in revenue, at least for a while, given the savings they built when prices were high. A lower global oil price also likely fits their geopolitical strategy. Saudi Arabia's adversaries—Iran, Russia, and the insurgency calling itself the Islamic State—are all suffering badly from the lower prices.

### Bottom of the barrel?

We believe oil is close to a bottom, and will slowly climb back to \$100 per barrel over the next three years. Lower prices will eventually force cuts in production, mostly where costs are high, such as the North Sea and the Arctic, but even investment in low-cost U.S. shale production will weaken. Lower prices will also prop up oil demand—possibly faster than expected, judging from a recent surge in sales of gas-guzzling SUVs.

The principal economic beneficiaries of this will be consumers, who will enjoy what amounts to a meaningful tax cut. In the U.S., this is expected to equal close to \$100 billion in 2015, or 0.6% of income. Global oil-related investment and production will be hurt, but U.S. shale producers, whose average break-even cost is closer to \$60 per barrel, should do relatively well. On net, the oil price decline is expected to lift U.S. GDP growth next year by 0.4 percentage point.

## Hopes for housing

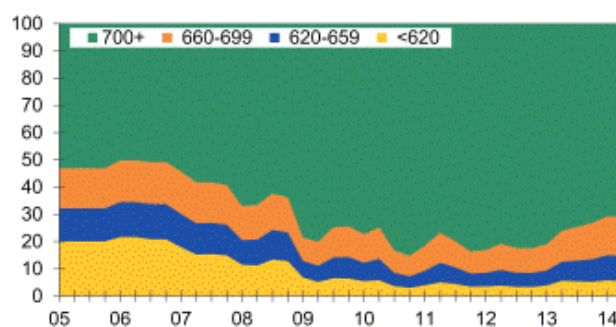
Housing's recovery has been disappointing, but that is expected to change in 2015. While home sales, construction, prices and rents have come a long way since the housing bust ended three years ago, the market is far from normal, at least in terms of sales and construction. House prices and rents are now roughly consistent with household incomes, but sales are still almost 15% below what would be considered typical, and housing starts are off by one-third.

Housing has been held back by a combination of factors. The heretofore tough job market has been hard on millennials, who have been slow to form households. There are more than 3 million more 18- to 34-year-olds living with their parents today than there were prior to the recession. Many of these twenty- and early-thirty-somethings will form households and move into apartments as the job market tightens. Apartment construction is already the bright spot in the housing market, and it is sure to get brighter.

Tight mortgage credit combined with a previous jump in mortgage rates significantly crimped first-time homebuyers. The lack of first-timers makes it difficult for trade-up buyers to sell their homes, ultimately hurting sales of new homes and single-family construction.

### Mortgage Lending Standards Remain Tight

% of originations by vintage by credit score



Sources: Equifax, Moody's Analytics

This too should change soon. Mortgage finance giants Fannie Mae and Freddie Mac recently signaled a greater willingness to lend by lowering their minimum down payment requirement from 5% to 3%. They have also relaxed the representations and warranties they require on the loans they buy. This should ease lenders' concerns about being forced to buy back loans that eventually get into trouble, thus encouraging more new lending.

Housing starts are expected to ramp up from just over 1 million units this year to nearly 2 million units in 2017. This is much more than the estimated 1.7 million units required to meet demand in a typical year, and reflects the unleashing of pent-up demand by those millennial households.

The increased construction also represents a lot more jobs. All the current slack in the labor market will be absorbed by stronger housing construction.

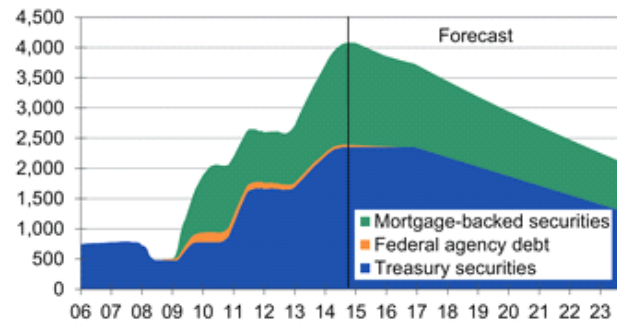
## Interest rate risk

Forecasting interest rates is generally foolhardy, but a quickly improving economy makes it prudent to prepare for higher rates over the next several years. If everything sticks roughly to script, the Federal Reserve will normalize short- and long-term rates as the job market tightens. More jobs and stronger wage growth will trump the ill effects of higher rates on the housing market and broader economy.

When the economy is healthy, the federal funds rate should be approximately 4% and the 10-year Treasury yield closer to 5%. While much improved from recent years, the U.S. economy is far from healthy. Full employment is still in the distance, inflation remains stubbornly below the Federal Reserve's target, and the financial system is adjusting to stiffer regulatory requirements and increasingly tough capital and liquidity standards. The Fed's balance sheet is also bloated with Treasury and mortgage securities following several rounds of quantitative easing. This will put downward pressure on long-term rates until these securities mature, which could take until the 2020s.

## Slow Exit by the Fed

Assets held outright on Fed's balance sheet, \$ bil



Source: Moody's Analytics

All this suggests that the Fed's normalization of interest rates should occur slowly. Policymakers will begin raising short-term rates in mid-2015, but rates won't approach 4% until early 2018. The 10-year Treasury yield, currently near 2.25%, won't make it back to 5% on a consistent basis for the foreseeable future.

But bond traders are notoriously fickle, and they may not follow the Fed's script. This could be seen in the summer of 2013, when then-Fed Chairman Ben Bernanke began talking about ending QE. Traders thought Bernanke was signaling an imminent rise in short-term rates, and they sold bonds. Long-term rates jumped.

### Investor nerves

Fed officials moved quickly to calm traders' nerves, and bond yields have since receded, but the housing market was hurt badly. Emerging economies that rely on foreign bond investors to fund large current account deficits, such as Brazil, India, South Africa and Turkey, are still struggling with the aftermath of that spike in rates.

Another similarly debilitating surge in long-term rates seems less likely given their decline this year, but it can't be dismissed. As the economy approaches full employment, wage growth picks up and the first Fed rate hike approaches, bond investors may panic again. They may fear that the Fed will be forced to raise short-term rates more aggressively to contain inflation. Housing and the global economy would be hurt, posing a threat to our sanguine outlook.

Given the surprising decline in long-term rates this year, it is also worth considering that they may remain lower longer than anticipated. With the Bank of Japan aggressively buying bonds and the European Central Bank likely to step up its own bond purchases, U.S. long-term rates could also be held down. Stiffer bank liquidity requirements, which require large multinational banks to hold larger and more liquid bond portfolios, may also contribute. Lower than expected long-term rates would be a plus for housing and economic growth.

### Overseas trouble

The U.S. economy is less sensitive than most to changes in global conditions, but it isn't immune. And there is plenty of trouble overseas. With the value of the dollar surging, the U.S. trade balance is sure to deteriorate. Global trade, which to date hasn't been a factor in the U.S. recovery, will soon become a meaningful drag.

Most worrisome are the euro zone's travails. The single-currency region is flirting with another recession, and its unemployment is already painfully high. Political fissures are widening in nearly all the euro zone's member countries. Euro-skeptic political parties with mixed commitments to meeting their nations' debt obligations are gaining strength. If one of these parties appears set to gain control of a government, global investors could again question the European resolve to keep the euro zone together. Another round of financial turmoil would ensue.

### The ECB steps in

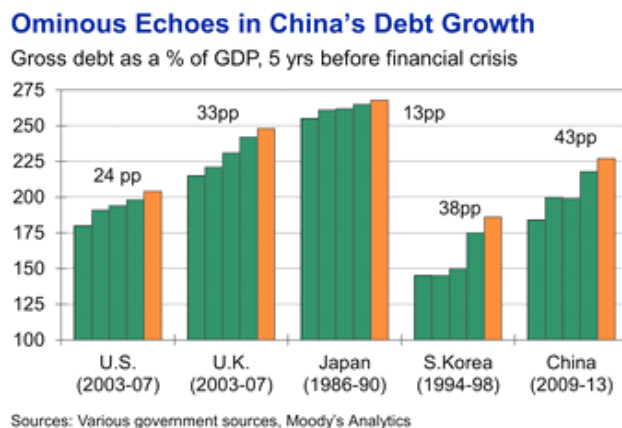
The European Central Bank is expected to forestall such a scenario. The ECB has ramped up its bond-buying program in recent months by purchasing covered bonds and asset-backed securities. This won't be enough, however, and the ECB will next buy supranational European bonds, such as those issued by the European Investment Bank. It will be politically harder for the ECB to buy individual nations' sovereign bonds, but it is increasingly likely to do so. While the economic stimulus won't be as large as those provided by quantitative easing in the U.S. and U.K., it could still help by lowering the euro's value and countering deflation fears.

It is a stretch to think the ECB's actions can jump-start the euro zone economy. That requires broad economic and fiscal reform, particularly in France and Italy. It is also reasonable to worry the ECB won't do enough to head off another European debt crisis. That would be a problem for the U.S.

### Growth and risk in China

China's struggles to hit its own economic growth targets poses another threat. Chinese policymakers recognize they have significant structural problems, and have been willing to give up some growth to address them. Most notably, Chinese real estate markets are overbuilt, and speculation has been rampant. Many state-owned enterprises are unproductive. Corruption is endemic and environmental degradation epic.

Most disconcerting, leverage has soared in China, comparable to other countries that have suffered severe financial crises. Much of this debt is held by local governments and financial institutions that have financed the runaway real estate activity.



Each time reform efforts have hit growth too hard, however, Chinese officials have eased up and provided monetary and fiscal stimuli. Most recently, the Chinese central bank surprised financial markets by cutting rates. China's growth slowdown hasn't been painless, but so far it has been well-managed. That China's financial system is relatively closed and authorities are able to quickly change policy has helped.

### Putin's choices

Still, balancing reform and growth isn't easy, and China's managers may stumble. It wouldn't take much of a misstep to undermine already-reeling global commodity markets, weaken fragile emerging economies, and upset financial markets. The U.S. economy wouldn't survive this storm unscathed.

Russia's economic problems are by themselves not a reason to worry, but the pressure they put on Russian President Vladimir Putin could be. Sharply lower oil prices, Western economic sanctions due to Russia's incursion into Ukraine, and the collapsing ruble and resulting higher inflation and interest rates are suffocating Russia's economy. The government's fiscal situation is also rapidly eroding. How Putin will respond to this is difficult to forecast. It is equally easy to imagine him reining in his adventurism or ramping it up. His choices could have large implications for global and U.S. economic growth.

### What's the U.S. potential?

As the U.S. economy approaches full employment, attention will shift to the economy's weak potential growth rate—the pace at which the

economy can consistently grow without generating inflationary pressures. Since the Great Recession, the economy's estimated potential has been a dismal 1.3% per year. This reflects both lackluster labor productivity growth of 1%, and paltry labor force gains weighed down by falling participation.

A poor potential growth rate has allowed slack in the labor market to be absorbed more quickly. But once full employment is achieved, unless potential picks up, economic growth will slow sharply. This will hurt living standards, particularly for lower-income households, and undermine the government's precarious fiscal situation.

The fall in potential growth rates was in part anticipated. The large baby-boom cohort has begun to retire in recent years, reducing labor force participation. More than half the decline in participation since the recession hit is attributable to retiring boomers. Some of the slowdown is likely temporary, related to the recession and its fallout. Fewer job opportunities have also contributed to lower participation and less foreign immigration, which is important to the growth of the working-age population.

### **Shadows of the recession**

Lagging productivity growth is also probably partly cyclical, reflecting the dark psychological shadow of the recession and uncertainty created by political brinkmanship in Washington. Businesses have been especially nervous, reluctant to use the cash they have built up during the recovery to expand and fund more investment. Entrepreneurs have also been understandably wary about starting businesses.

Growth potential is thus expected to revive as the recession fades and full employment approaches. Some signs indicate this may be occurring, as labor force participation has stabilized over the past year despite continued boomer retirements. Foreign immigration should rebound with the better job market, and business confidence and investment have recently been much better. Over the next five years, potential growth should rise to 2.25% per year, equal to 0.75% labor force growth plus 1.5% productivity growth.

### **Structural risks**

However, there is a meaningful risk that this is overly optimistic. Structural impediments to labor force and productivity growth may not quickly recede. Workers who stepped out of the job market during the tough times may not return, at least not to the degree hoped for. Their skills and marketability may have eroded so significantly that they are unable to find suitable work.

The animal spirits that drive business formation and investment could also remain bottled up. An aging population may prove more of a brake on risk-taking than thought. Entrepreneurs tend to start companies in their thirties, and there is a dearth of thirty-somethings. An even more disconcerting possibility is a downshift in the pace of technological change. Perhaps technologies such as 3D manufacturing, drones and DNA sequencing don't stack up to the productivity-enhancing power of the internet, which fueled growth in the 1990s and early 2000s.

### **Don't bet against the U.S.**

Despite these reasonable concerns, betting against the American economy remains a bad strategy. The U.S. has clearly had a difficult run over the past 15 years, and has been scarred by terrorism, wars and technology and housing bubbles. Lower- and middle-income households have seen living standards decline. But the bad times are likely ending. Many of the economic wrongs have been righted. Households have deleveraged, the financial system has recapitalized, and U.S. businesses have reduced their cost structures and are highly competitive. Serious problems remain and politics complicate our ability to address them. But if history is any guide, we will.



## About Moody's Analytics Economic & Consumer Credit Analytics

Moody's Analytics helps capital markets and credit risk management professionals worldwide respond to an evolving marketplace with confidence. Through its team of economists, Moody's Analytics is a leading independent provider of data, analysis, modeling and forecasts on national and regional economies, financial markets, and credit risk.

Moody's Analytics tracks and analyzes trends in consumer credit and spending, output and income, mortgage activity, population, central bank behavior, and prices. Our customized models, concise and timely reports, and one of the largest assembled financial, economic and demographic databases support firms and policymakers in strategic planning, product and sales forecasting, credit risk and sensitivity management, and investment research. Our customers include multinational corporations, governments at all levels, central banks and financial regulators, retailers, mutual funds, financial institutions, utilities, residential and commercial real estate firms, insurance companies, and professional investors.

Our web and print periodicals and special publications cover every U.S. state and metropolitan area; countries throughout Europe, Asia and the Americas; and the world's major cities, plus the U.S. housing market and other industries. From our offices in the U.S., the United Kingdom, and Australia, we provide up-to-the-minute reporting and analysis on the world's major economies.

Moody's Analytics added Economy.com to its portfolio in 2005. Its economics and consumer credit analytics arm is based in West Chester PA, a suburb of Philadelphia, with offices in London, Prague, and Sydney. More information is available at [www.economy.com](http://www.economy.com).

---

© 2014, Moody's Analytics, Inc. and/or its licensors and affiliates (together, "Moody's"). All rights reserved. ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY COPYRIGHT LAW AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT. All information contained herein is obtained by Moody's from sources believed by it to be accurate and reliable. Because of the possibility of human and mechanical error as well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. Under no circumstances shall Moody's have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of Moody's or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if Moody's is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The financial reporting, analysis, projections, observations, and other information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell, or hold any securities. NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER. Each opinion must be weighed solely as one

## CONTACT US

For further information contact us at a location below:

U.S./CANADA  
+1.866.275.3266

EMEA  
+44.20.7772.5454

ASIA/PACIFIC  
+852.3551.3077

OTHER LOCATIONS  
+1.610.235.5299

Email us: [help@economy.com](mailto:help@economy.com)  
Or visit us: [www.economy.com](http://www.economy.com)

Copyright© 2014, Moody's Analytics, Inc. All Rights Reserved.

**MOODY'S**  
ANALYTICS