Economic Forecast for 2nd Half of 2014: Increasing Momentum, Reduced Headwinds

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Despite GDP growth stalling in Q1 due to the Polar Vortex, slower inventory accumulation and mildly lower exports, the economic recovery remains intact. The anemic performance of the US economy from January through March was aberrant, and the incoming employment, manufacturing and consumer spending data all point to an economic pickup. GDP growth the rest of the year should average 3%, with growth in Q2 closer to 3.25% as the economy rebounds from the harsh winter. In addition, reduced fiscal drag from DC, increased hiring and spending by state and local governments, and increased corporate spending on plant and equipment suggest we are finally entering a period of faster growth.

That said, economically all is not well. Wage growth remains anemic and while the unemployment rate is 6.3%, down from 10%, the fall is largely due to a decline in the labor force participation rate. The ranks of the long-term unemployed remain elevated, along with the number of those working part-time because they can't find full time work. Add to that average overtime hours that are remarkably high and termination rates that are very low and what you have are employers very reluctant to hire. This situation cannot persist, and of late job creation numbers have been on the upswing. Therefore, net job creation will rise from 200,000/month, where it has been for the past year, to 220,000 or 225,000 by year end and unemployment will probably fall to 6.1%. I expect wage growth to start picking up steam in 2015.

The biggest drag on the economy is housing. After a promising first half of 2013, the housing market is, at best, flat. While rising interest rates and home prices, a lack of inventory and lots, shortages of materials and labor, and a lack of credit and first-time buyers play a part, weak household formation is the main culprit. After averaging over 1.2 million in the years prior to the Great Recession, household formations have been averaging 500,000 since the end of the recession. The good news - household formation will rise now that all eight million jobs lost during the recession have been finally made up. We are no longer making up lost ground. Because of this, new single-family construction activity in 2014 will reach 700,000, with multifamily adding 350,000, while existing home sales should be down slightly from last year.

As for inflation, it's benign. No matter how measured, there is no inflation to speak of in the US. Commodity prices will remain well-behaved given weak demand due to economic slowing in China and weak growth in Europe and the developing nations. Absent some sort of geopolitical crisis, energy prices will remain where they are thanks to record US oil production. As a result, expect tapering to end in November and for the Federal Reserve to begin raising short-term interest rates by mid-2015. However, long-term rates have bottomed and 10-yr Treasuries will end the year at about 3% as the economy steadily strengthens.

In short, the economy is improving and Q1 was a speed bump. Long term rates will rise, short-term rates will remain unchanged, and housing will limp into 2015, with prices rising slightly. Most critically, household formation will strengthen and corporate, state and local government spending will rise. Lastly, the likelihood of a recession during the next six months is virtually zero.

Have a wonderful summer and see you in August! (Remember, I will not be writing an article in July).

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