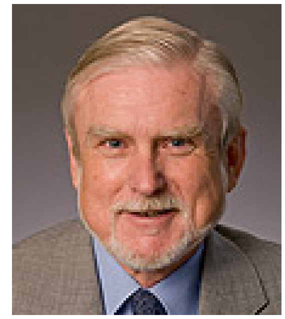
ECONOMIC UPDATE:

Outlook 2015



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Our outlook is for a long global and U.S. economic expansion. The global economy has been expanding over the last half-decade. For the past few years, however, it has only grown at roughly a trend growth rate. As a result, consumer price inflation has been moderate in most developed countries and too low in others. This has allowed many central banks to remain easy. Economic expansion since the Great Recession has been relatively moderate in each of the major regions, which has permitted yields to remain depressed. Global economic growth in 2014 was restrained by several special factors: the severe weather in the U.S. in early 2014, the extremely large Japanese fiscal tightening which generated two quarters of economic decline and the confidence drag in Europe from the crisis in the Ukraine. Following three years of global growth near 3% on the IMF measure, we expect a somewhat faster pace of global growth in 2015, given the lagged benefit of low interest rates and the effect of low energy prices. The likely pickup in global growth should represent a normalization of cyclical expansion in most developed countries following a sluggish pace of expansion in 2014 due to a variety of special factors. This somewhat stronger global growth rate should be due more to a fading of drags on growth than to new sources of strength. Given the downward shift in trend growth in China, we expect the developing economies to expand at about the same pace in 2015 as in 2014.

While we are optimistic about the cyclical outlook for the world economy, we believe this will occur in a longer-term context of a lower path for potential GDP, reflecting both a one-time downshift due to the effect of the Great Recession plus a slowing potential GDP growth rate in the future due to: (1) deteriorating demographics and (2) suboptimal economic policy. The growth rate of the working-age population is decelerating in many parts of the world, with absolute declines in some countries. That is not a significant cyclical problem due to high current unemployment rates in many countries. However, it should contribute to a downshift in trend economic growth in the long run. Improved incentives for work could somewhat mitigate the effect of these demographic trends on future labor supply growth, but that has not yet occurred. There is a drag on potential GDP growth from suboptimal economic policies. For each country, suboptimal economic policy is a choice, not a destiny. A key swing factor in the economic outlook for each country is the medium-term trend of improvement or deterioration in the credibility of economic policy.

Given the slow pace of global growth, there has been concern about deflation, disinflation and lowflation. Deflation is a pattern of declining prices, disinflation is a downward shift in the pace of positive inflation and lowflation is positive inflation persisting at a pace only slightly above zero. One concern is that deflation can make excessive debt more burdensome. Another concern is that when nominal interest rates are near zero, deflation or lowflation can make it hard for central banks to generate negative real interest rates (nominal rates minus actual or expected inflation) in order to stimulate borrowing.

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We make a distinction between "bad deflation" due to a collapse in demand, "capacity hangover deflation" due to past overexpansion of capacity and "good deflation" attributable to successful technological innovation. When deflation (or disinflation or lowflation) is attributable to a decline in demand, the resulting damage tends to come less from a rise in the real burden of debt than from weakness in the income and cash flow available to service the debt. In contrast, the mining sector today illustrates a "capacity hangover deflation," as productive capacity was overbuilt in the past due to excess enthusiasm about the so-called "commodity supercycle" of demand from a Chinese boom. The losers are the countries with excess productive capacity, but the winners are countries which import these commodities. From a historical perspective of centuries of past experience in commodities, this boom/bust cycle can be viewed as the "old normal." We believe that the oil and gas sector is an instance of "good deflation," as technological innovation has sharply reduced the cost of producing oil and gas in the U.S. The U.S. energy service companies are global leaders of technological innovation in the energy sector. We regard the recent weakness in energy prices as a symptom of successful technological innovation rather than as a signal of a weakening global economy.

Given the great concern among central banks about deflation, disinflation and low inflation, central bank policy is broadly anti-deflationary. We believe anti-deflationary central bank policy will lead to a gradual normalization of the rate of inflation back to the central bank targets. There has been a lag in the impact of easy monetary policy because it has been accompanied by fiscal tightening and round after round of incremental regulatory tightening of the financial system. In the end, however, we expect that easy monetary policy will eventually foster a rise in the underlying inflation rate to central bank targets, faster in the U.S. and the UK, much slower in the Eurozone and Japan.

In the near term, weak energy prices should contribute to a slowing of reported inflation in many countries, motivating some central banks to ease further or temporarily postpone tightening. But since low energy prices tend to support global economic growth and the demand for labor and other goods, we expect this inflation slowdown to prove temporary under current conditions of stimulative monetary policy in the developed world.

Over the past decades, global labor arbitrage between high-wage developed countries and low-wage developing countries (an arbitrage facilitated by currency mercantilism in some emerging countries) has contributed to the global spread of modern economic practices and a major drop in global poverty. However, global labor arbitrage also contributed to median wage stagnation in developed countries. Despite sluggish median income growth, developed country spending was sustained for many years as low interest rates supported a rapid rise in developed country debt. That channel of demand reversed during the global financial crisis. More recently, reduced opportunities for global labor arbitrage and a somewhat slower trend of demand growth in China and the developed countries has contributed to a slower pace of growth among some of the emerging countries. This is especially true for those countries with suboptimal policies or excess productive capacity for commodity exports. Among the developed countries, the speed of financial stabilization and deleveraging after the global financial crisis differed sharply. The U.S. strengthened its core banks quickly and completed its short-term fiscal tightening, while household debt-service-to-income ratios improved substantially. With the fiscal drag fading, the cyclical pace of U.S. economic expansion is now shifting higher. A somewhat similar pattern has emerged in the UK, although more fiscal tightening lies ahead. It is notable that the labor markets of these two countries are among the most flexible in the developed world, which appears to have fostered a combination of strong job growth and postponed wage inflation.

Japan was caught in a stagnant equilibrium for two decades. Japanese deflation in recent decades had multiple causes: (1) long delays in the recovery of its financial system after the Nikkei and real estate bubbles burst, (2) a strong yen in the past, due in part to preferences among risk-averse Japanese investors for domestic investments, (3) competitive challenges from lower-wage countries, and (4) a liquidity trap, as deflation at the zero bound for nominal interest rates prevented a sufficient decline in real interest rates (nominal interest rates minus inflation). A key issue is that the past outsourcing of production by Japanese companies when the yen was strong is unlikely to be followed by a repatriation of those production activities back to Japan now that the yen is weakening.

Japan has adopted a policy of currency depreciation, which is improving its competitiveness and corporate profits, but has also weakened the real income of consumers. Trend economic growth is likely to be low in demographically-challenged Japan. However, following a two-quarter economic decline from the VAT hike, Japanese policy should stimulate a moderate cyclical expansion through low real interest rates. It has engineered low real interest rates by holding nominal interest rates down with central bank actions while fostering a gradual upward drift in underlying inflation. We expect that Japanese expansion will prove sustainable, although sluggish.

The outlook for the Chinese economy is one of the crucial uncertainties for 2015. We suspect that there has been a lag in the recognition of how much the Chinese economy actually slowed in 2014. We would expect a similar or slightly slower growth rate in 2015. We believe that the deceleration in Chinese economic growth is not cyclical but rather is structural, due to the combination of a slowdown in the growth in its labor force and the need to correct past credit and property excesses. We believe that China is beginning a transition from a double-digit trend growth rate in the past to a sustainable growth rate near 6% in future years due to eroding demographics and the need for greater discipline in its investment in infrastructure, property, plant and equipment. We disagree with those who anticipate a financial meltdown in China, since we believe that the government has the financial resources to amortize financial losses over a period of years.

We believe that the long-term outlook for Europe is for sluggish economic growth due to (1) adverse demographics in most European countries, (2) adverse energy prices which have eroded competitiveness, (3) a badly designed euro currency system, (4) a social welfare system which is becoming harder to afford, and (5) slow and bureaucratic decision-making. Reform of "bureaucratic capitalism" in Europe has been quite slow. Cyclically, however, we are more positive about the prospects in Europe for the next several years and expect moderate but sustained European economic expansion in 2015, 2016 and 2017.

We believe that weak data in recent months in Europe is more consistent with a temporary period of European stagnation, rather than presaging a major triple-dip recession, assuming that natural gas supply issues in Europe do not worsen substantially. We believe that concern about a potential cut-off of natural gas supply from Russia this coming winter has depressed confidence in Europe. It is our assumption that there will be minor disruptions to pressure European decision-makers, but that a large-scale disruption is unlikely. If we are correct, these fears should fade early in 2015. The cyclical sectors in Europe never had much of a recovery, so there are hardly any recent boom-time excesses in need of correction. Many years of sluggish auto sales have aged the auto fleet, housing has been depressed and capital spending has been restrained.

The badly timed monetary tightenings by the ECB in 2008 and 2011 contributed to the double-dip recession in Europe, but we believe that a gradual recuperation of the financial system will support a moderate economic expansion in Europe for the next several years. The ECB is no longer the legacy bank of the Bundesbank, but it has moved closer to becoming a normal central bank, similar to the Federal Reserve or the Bank of England. We are not convinced that it will necessarily need to adopt sovereign quantitative easing to support a moderate pace of European economic expansion over the next several years.

We believe that a key theme in the global economy will be monetary policy divergence, with some central banks remaining easy and others gradually normalizing interest rates by future monetary policy tightenings. The recent pattern of currency changes has been supportive of a rebalancing of global growth and inflation, with weakness in the currencies of countries with weak underlying growth and strength in the currencies of countries with stronger growth. Currency wars via competitive monetary easing are a poor substitute for substantial reform of growth-hostile fundamental policies. However, global rebalancing of growth and inflation via currency declines in countries with weak economies and currency rises in countries with strong economies should lower "tail risk" and help sustain global growth.

Stimulative monetary policy has generated only sluggish growth so far in this long global expansion due to a partially offsetting combination of drags from (1) fiscal tightening, (2) private sector deleveraging, and (3) restrictive financial regulation. A substantial degree of fiscal tightening has already occurred in most developed countries. Fiscal tightening is likely to prove less of a drag over the next several years. There are major differences among countries in their progress in deleveraging. A substantial improvement in private sector debt service burdens has already occurred in the U.S. household sector, but debt burdens remain high in Europe and China.

The logical consequence of the prolonged economic expansion that we expect is that excess capacity should be gradually reduced over time. Bond yields should gradually drift higher over the next several years, especially in those countries with "normalizing central banks." We expect that interest rate normalization should prove to be a multiyear process in most developed countries, gradual enough that it will not disrupt sustained economic expansion.

The global economy should enter 2015 with underlying inflation below the inflation targets (at or near 2%) of all four of the G4 central banks (the Federal Reserve, the Bank of England, the European Central Bank and the Bank of Japan). Our expectation is that underlying inflation will gradually rise to or above target over the coming years in both the U.S. and the UK. While the usual acceleration of wage inflation has been delayed so far in this cycle, we do now expect an upward drift in wage inflation in both the U.S. and the UK. In both Europe and Japan, the underlying inflation rate should drift gradually higher but remain below target for the next several years.

In the U.S., compensation surveys by the National Federation of Independent Business have been trending higher, the ratio of job openings to the unemployed has strengthened and the Employment Cost Index has started to rise at a more rapid pace. Slack is being reduced in the U.S. labor market, as growth in labor market demand exceeds the growth in labor supply every month. We believe that the U.S. economy is at the inflection point to somewhat faster wage growth.

The monetary policy divergence between the "normalizing central banks" (the Federal Reserve and the Bank of England) and the "ZIRP central banks" is likely to contribute to a basic dollar uptrend over the next several years. ZIRP stands for "zero interest rate policy." Divergent monetary policy between the "normalizing central banks" and the "ZIRP central banks" should be characterized by both (1) a widening of interest rate spreads as U.S. and UK rates rise and (2) a shift in the relative growth of central bank balance sheets. The U.S. dollar should also benefit from the continued rise in domestic energy production, which is causing a sustainable reduction in the U.S. current account deficit. These factors help explain the substantial rise in the dollar in 2014 and should contribute to some further dollar rise over the next several years.

We believe that the U.S. economy has just made an upward shift from a half-decade of expansion at a real GDP growth rate slightly above 2% to three years of 3% real GDP growth. This new "three-for-three" growth acceleration should be due largely to a fading of the persistent drag from the government sector over the last half-decade. Overall real GDP has been growing nearly 1% slower than private sector real GDP in the U.S. over the last half-decade due to weakness in the government sector, a pattern which should now end as the fiscal drag fades. Over the next three years, we expect U.S. real GDP growth to accelerate to about 3% and nominal GDP growth (real GDP growth plus inflation) to accelerate to about 5%. We expect this acceleration of real and nominal economic growth to contribute to a multiyear uptrend in U.S. interest rates.

The U.S. expansion has lasted about as long as the average Postwar expansion, but is younger in age if viewed from the perspective of the inflation cycle, the credit cycle and the monetary policy cycle. The Fed has been worried about inflation, but in a different way than it usually does when the expansion has lasted five years. It has been worried that inflation was below target, not above target. We divide monetary policy into five stages (aggressively stimulative, stimulative, neutral, restrictive and aggressively restrictive). After five years of expansion, monetary policy would normally be restrictive or aggressively restrictive, threatening to generate a financial crisis and a recession. Today, however, the Fed is trying to raise the inflation rate and monetary policy remains quite stimulative, fully supportive of our longstanding thesis of a long economic expansion. The core of the Federal Reserve appears to have a dovish perspective on a variety of issues: (1) the state of the labor market, (2) the risk of future inflation, (3) potential tolerance of a period of core inflation above 2%, (4) the risk of asset bubbles and the Fed's role in preventing them, and (5) the prospect of a terminal Fed funds rate below historic norms.

We believe that U.S. monetary policy will be very supportive of economic expansion for the next several years. With inflation below the Fed's target and some slack remaining in the labor market, both parts of the Fed's dual mandate support stimulative monetary policy.

We currently expect the first hike in the Federal funds rate near mid-2015, but the pace of subsequent increases is likely to be gradual given the Fed's dovish bias and uncertainties about the functioning of the money markets as the Fed raises interest rates in the context of a multi-trillion dollar balance sheet and a shrunken Federal funds market. Since we believe that the U.S. economy is not currently very inflation-prone, we would expect a monetary policy fully supportive of economic expansion in 2015 and 2016, with the need to shift to a truly restrictive policy postponed until 2017 or 2018, after the Presidential election of 2016.