1ST QUARTER IN REVIEW

OUTLOOK FOR THE ECONOMY: A LONGER, IF NOT STRONGER, RECOVERY

Although the U.S. economy remains relatively strong, it's not ready for a rocket ship-like performance, either.

Growth in most U.S. metrics has been slow for three months or longer. Some of that stagnation is weather-related, but not all. Up-and-down bounces related to the government shutdown and budget settlement, major inventory buildups, and higher interest rates have all been negatives for recent economic activity.

Despite the current soft spell, there are several major positives that could make this recovery one of the longest on record.

What this recovery has lacked in robustness may be trumped by longevity. This recovery has already lasted longer than half of all post-World War II recoveries. The housing market still has a huge runway in front of it, oil and gas production continues to accelerate, government austerity measures should continue to soften, and the world economy is again showing signs of life, potentially boosting U.S. exports.

There are factors that will potentially hold the economy back in 2014.

In the short run, good but slowing growth rates in autos, housing, and jetliners mean that other sectors will need to pick up the slack. Higher interest rates and new geopolitical uncertainties won't be helping matters, either.

In the longer term, demographics and socioeconomic trends may permanently keep the U.S. GDP growth rate at 2.0%–2.5%, or perhaps even less.

This is thanks to an aging population that spends less; a move to e-commerce from employment-heavy and construction-needy brick-and-mortar retailers; and the declining need for office space as more workers do their jobs with less space or work from home. Technology, generally a very good thing, also seems to be putting a real dent in employment opportunities.

The U.S. economic data has shown signs of weakening for the past three months running, despite some real optimism that developed in the fourth quarter of 2013. That optimism was based on the end to the fiscal stalemate in Washington in October, a 4.1% GDP growth rate in the third quarter, and a 3.2% growth rate in the fourth quarter (later revised down to just 2.4% growth). Sky-high retail sales data that was subsequently revised sharply downward also contributed to economists' bright mood at the end of 2013.

Poor weather seems to have interrupted the upward trajectory. The effects of abnormally cold and snowy weather seem real, but the weather is not the only cause for the recent weakness, in my opinion. Parts of the economy, including the housing sector, were already showing some slowing even before the cold weather arrived.

The Economy: A Rocket Ship Ready for Blast-Off, or an Ocean Liner Stuck in Its Wake?

Putting the weather aside (poor weather will likely make the first quarter weaker than it otherwise would have been, but could make the second quarter stronger), there is an ongoing debate about the underlying strength of the economy.

Prior to the weather news, many economists believed the economy was set to grow 3.0%–3.5% or even more in 2014. They believed that the economy had finally reached its so-called escape velocity. There was a second group of economists who believed that while some sectors of the economy were indeed improving, other sectors were beginning to stall out. I generally subscribe to this second point of view. I also believe that over the past three years, the economy has been on a fairly steady, but slow, 2% growth trajectory. Like a slow-moving ocean liner, it has been nearly impossible for the economy to speed up, slow down, or change direction.

Economic Forecast for 2014

	2011	2012	2013	2014E
GDP	2.0%	2.0%	2.5%	2%-2.5%
Inflation	3.0%	1.8%	1.2%	1.5%-1.8%
Employment Growth (monthly avg)	202,000	189,000	193,000	190,000
Unemployment Rate	8.5%	7.8%	6.7	5.9-6.2%
10-Year Treasury	1.9%	1.8%	2.9%	3.5%-4.0%
Auto Sales (millions)	12.8	14.5	15.5	16-16.5
Housing Starts (thousands)	624	829	925	1,050-1,100
Existing Home Sales (millions)	4.3	4.7	5.1	5.1

Historical Data Source: St. Louis Federal Reserve

The unemployment rate forecast dropped from a range of 6.2%-6.5% to 5.9%-6.2% as the December unemployment rate came in better than expected. Many had also held out some hope that extended unemployment benefits would be renewed by Congress, which tends to encourage labor force participation, inflating the unemployment rate. That was the sole change made in most forecasts. Meanwhile consensus GDP estimates for the full year 2014 have generally been dropping from 3% or so in December to the still-too-high 2.7% average now.

What Changed Over the Course of the First Quarter?

Geopolitical Events Reduced Investor Confidence. While my annual forecast is unchanged, there were a lot of unexpected events and short-term changes during the first quarter. Certainly the situation in Ukraine was a surprise that could upset consumer and business confidence. And if sanctions are implemented, European growth and energy markets could be upset.

Interest Rates Make a Surprise Move Down. Second, the first quarter saw falling interest rates instead of the rising rates that almost everyone had been anticipating as a result of the Fed's decision to taper bond purchases. The interest rate on the 10-year U.S. Treasury bond fell from 2.9% at the end of 2013 to 2.6% as of mid-March. This surprised us. Slower-than-expected growth, both in the United States and in China as well as a flight to safety may have helped interest rates fall instead of the anticipated rise. Low corporate revenue growth rates (less borrowing need for working capital and expansion) and sluggish housing and auto markets (both big users of credit) may have also kept a lid on rates.

China's Slow Growth Spooks World Markets.

The news out of China has not been particularly robust lately, either. Although analysts had generally expected China's growth to slow from 7.7% in 2013 to 7.5% in 2014, there was a lot of hope that they could do better.

China seems to have been successful at cutting some export- and investment-oriented spending as they had planned. However, Chinese consumers have not yet picked up the slack as much as hoped. Though the Lunar New Year complicates any data analysis, both January (which should have been soft because of the holiday) and February (which should have been a big rebound month) combined were soft. Exports in February were particularly bad, with results down 18%. However, retail sales, fixed investment, industrial production, and purchasing manager surveys have also been disappointing. According to a Wall Street Journal survey, economists now believe that China's growth rate will be the biggest threat to the world growth rate. Over the intermediate term, an outright decline in the Chinese working-age population cannot be ignored.

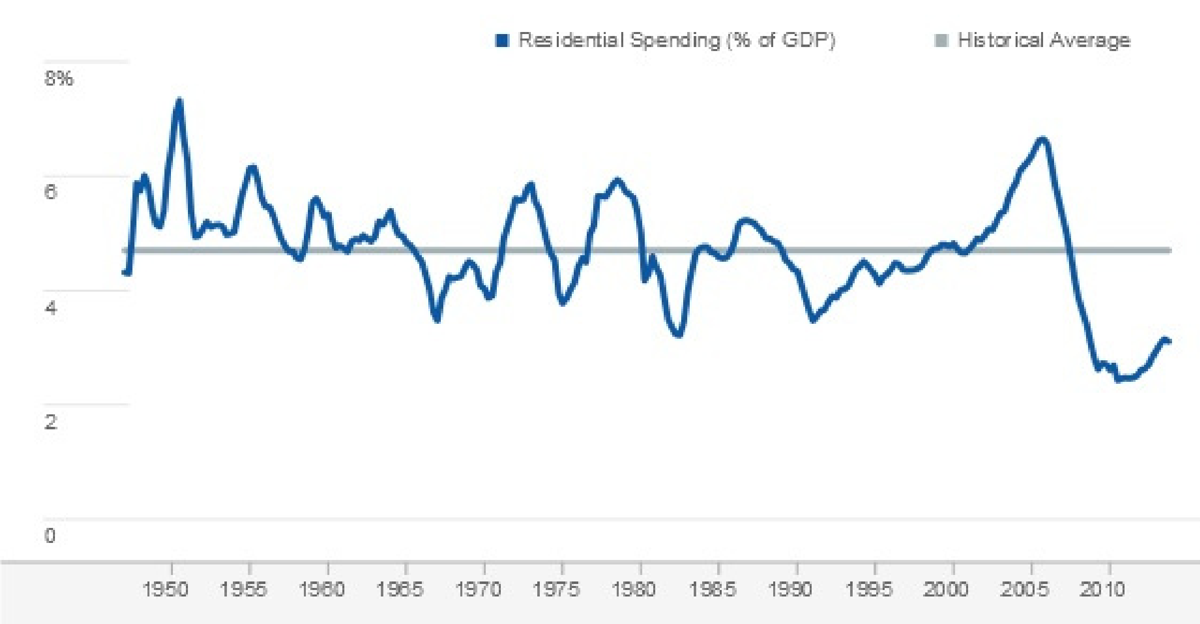
But total Chinese debt (public and private) has soared and now approaches 200% of GDP, making lending a little more difficult. Poor demographics and a shrinking working-age population will only make matters worse. Trading partners are also likely to object to China resuming its growth through some type of engineered export binge. Competitors in Southeast Asia, including Vietnam, mean that China is not the only game in town anymore, either. Ever-worsening pollution issues also make it more difficult to go back to the days of heavy industry as an engine of growth. Don't get me wrong: China isn't falling apart, but the days of huge commodity booms and 10% growth rates are probably gone for good. In fact, today's 7.5% growth could look downright exhilarating just five years from now.

Long-Term Growth Drivers Remain Intact ...

Weather May Be Distorting Short-Term Data. It is nearly impossible to tell if recent economic weakness in the United States is entirely weather-related or if that is merely an excuse for poor results. Housing starts for January and February combined were below year-ago levels, and that is likely to be true again in March. Weather could have kept some builders from physically being able to dig a foundation or buyers from even looking at homes. However, markets with great weather (the West Coast) haven't been doing so well, either. Also, some of the more weather-addled markets have looked better than one might expect (the Northeast). So although the statistics have clearly been hit by weather, the economy still looks to be less than robust.

Housing Continues to Have a Huge Runway in Front of It. Certainly the housing market remains potentially the largest driver of economic activity in the short and intermediate term. Residential spending, which includes new homes of all stripes, remodeling expenses, and brokerage commissions on new and existing homes, have averaged more than 4.7% of GDP in the postwar era. Sometimes that percentage has spiked very close to the 7% level. This recession, spending got as low as 2.4% and still stands at a meager 3.1%.

Residential Spending as a Percentage of GDP



Bureau of Economic Analysis, Morningstar Calculations

Long-Term Growth Drivers Remain Intact ... (cont.)

The runway in front of the industry remains immense. Furthermore, construction is a large employer with high weekly hours and high hourly wages. The industry also has a lot of knock-on effects across other industries, including furniture, mortgage brokerage, transportation, and lumber. For now, the construction industry has recovered less than a quarter of the 2 million jobs lost during the recession, explaining a great deal of the slow economic recovery.

Analysts Have Consistently Underestimated the Current U.S. Energy Boom.

The oil and gas boom in the United States continues to surprise even the experts and remains one of the bedrocks of this recovery. Growth in oil production had been slowing for several decades until new technology enabled drillers to tap new fields and producers to recover more oil from current wells. That production could expand even further for another couple of years. Things could get even better, as experts have consistently underestimated the boom. The current 2020 forecast is now 50% higher than it was in a government forecast that is just a year old, as shown by the gap between the red and blue forecast lines below.

Like the housing industry, the oil boom benefits many sectors beyond the drillers. Low natural gas and oil prices enable the United States to have unusually low electricity prices compared with the rest of the world. In turn, these low electricity prices, combined with direct use of natural gas, benefit large portions of the manufacturing sector including chemicals, steel, and plastics. Low energy prices even benefit offices, which now have lower electricity bills.

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