TIAA-CREF Asset Management

2015 Economic Forecast: U.S. and global economies

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Executive summary

- The U.S. economy should grow more than 3% in 2015, strong enough to justify an end to the Fed's zero interest-rate policy. We expect the Fed to raise short-term rates in June, with additional hikes appropriate for the moderate economic growth we anticipate.
- As job creation continues to pick up, real wages should begin to see some improvement. Lower oil prices will boost consumer and business spending, although the combined net effects of cheaper oil is difficult to measure and forecast.
- Growth in Europe should come in at 1.0% in 2015, avoiding another recession. With continued deflation risk and a lack of demand for credit, the ECB is poised to implement full-blown quantitative easing (QE) to provide more stimulus.
- Japanese Prime Minister Abe's recent electoral win augurs well for much-needed reforms. The yen will weaken further as aggressive monetary easing continues, and GDP should grow 1.6% for the year. China's transition from a commodity-driven to a more domestically focused economy means growth will cool, potentially hurting prospects for other emerging-market countries.

Overview

The global economy ended 2014 at somewhat of a crossroads. While growth in the U.S. appears to be accelerating, several other regions are facing different prospects. Europe continues to stagnate, pushing its central bank closer to full-blown quantitative easing (QE). China and Japan are deep into reform cycles in their respective attempts to restructure and jump-start growth, and much of the emerging world has slowed under the pressures of declining commodity demand, a rising dollar, and elevated inflation.

Despite challenges, expectations for 2015 are not all negative. The U.S. economy is likely to grow more than 3% this year, a rate that historically has been very positive for the global economy. The strengthening dollar and rising wages will lift import demand domestically, providing needed support for overseas markets. Europe may experience modest economic growth in 2015, as a resurgence in some peripheral countries, such as Spain, continues to support demand for German exports, while healthy German consumers are still spending on goods and services from the periphery. Meanwhile, China's economy will continue to slow modestly, but it is unlikely to slip into recession (see Exhibit 1).

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Exhibit 1: Real GDP

	Real GDP %		Forecasted Real GDP %, SAAR				
	2014	2015	Q4 14	Q1 15	Q2 15	Q3 15	Q4 15
U.S.	2.4	3.1	3.0	2.4	3.5	3.1	3.3
China	7.3	7.0	6.1	5.3	7.4	7.0	6.7
Eurozone	0.8	1.0	0.8	1.0	1.0	1.1	1.1
Japan	0.4	1.6	2.8	2.0	3.0	4.0	3.0

Note: Quarterly estimates for China's seasonally adjusted annual rate (SAAR) do not correspond to officially published YTD figures.

Sources: Haver Analytics and TIAA-CREF.

U.S.

The U.S. economy has now grown by more than 3% in four of the past five quarters, and the final quarter of 2014 will likely add to that tally. Indeed, we believe that average growth is now shifting up from about 2.25% per year to something closer to 3%. Economic activity will remain somewhat choppy going forward, and will certainly not converge to normal cyclical growth rates, but it will be enough to justify the end of the Federal Reserve's zero interest-rate policy.

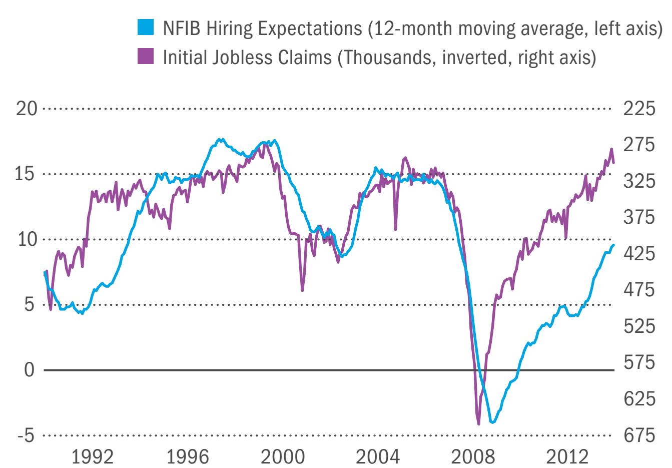
Throughout the course of this slow and fragile recovery, we have looked for a number of specific signs that growth would finally accelerate more convincingly. We needed to see a meaningful rebound in housing, as this spending category is central to consumer behavior. We also needed to see a resumption of capital spending in the private sector to reverse six years of retrenchment by businesses. At the same time, we have needed to see reduced policy uncertainty, a resumption of lending (both mortgages and revolving consumer loans), and further improvement in labor markets and wage growth.

By the end of 2013, we had seen only partial recovery in many of these categories. For example, while employment gains have continued since 2009, they have been lackluster at best, and the headline unemployment rate has at times masked an underlying preponderance of lower-quality and temporary jobs. Housing also began to recover, starting in 2012, but home-price appreciation and investor interest have not fully translated into normalized housing activity. Similarly, loan growth bottomed in 2013 but has been elusive since, neither improving nor worsening. Lastly, political gridlock and policy uncertainty have remained obstacles.

In 2014, some of these growth categories started to show signs of life for the first time in five years. For example, the past year brought a shift in business and consumer sentiment not seen since the beginning of the recovery. By November, the Small Business Optimism Index published by the National Federation of Independent Businesses (NFIB) had reached prerecession levels, and the hiring expectations index within that survey (shown in Exhibit 2) has correlated well with lower unemployment claims.

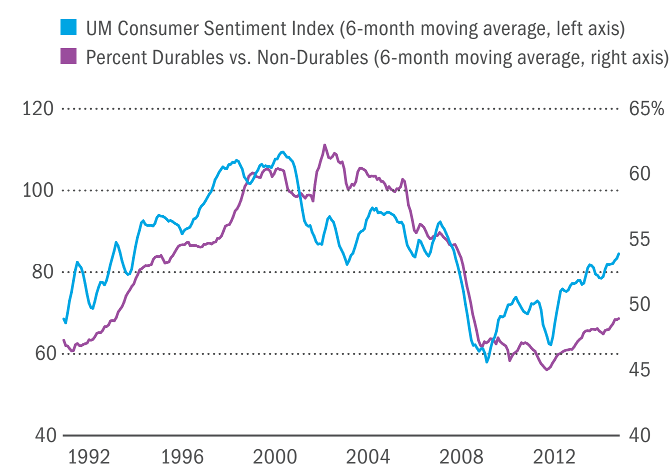
Likewise, as concerns over jobs and incomes subside, both the University of Michigan/Thomson Reuters Consumer Sentiment Index and The Conference Board's Consumer Confidence measure have fully recovered. Improvements in consumer sentiment are strongly correlated with increased spending. Rising confidence generally also leads to greater spending on big-ticket items, reflected in a rising percentage of durable goods purchases (see Exhibit 3).

Exhibit 2: Hiring intentions and unemployment claims



Source: Haver Analytics.

Exhibit 3: Sentiment and durables purchases



Source: Haver Analytics.

The translation of improved business sentiment into healthier employment growth is evident in rising average monthly job creation (see Exhibit 4). Prior to 2014, the economy had difficulty creating jobs at a rate much faster than about 150,000 per month, barely enough to keep up with population growth and new entrants to the workforce. In 2014, that story changed, and through November the economy added jobs at a pace of 240,000 per month, or 2.9 million per year.

Furthermore, job growth is being distributed widely throughout the economy. For example, 250,000 new construction jobs were added in the first 11 months of 2014. Even at the peak of the housing cycle in 2006, the economy averaged only 275,000 new construction jobs per year. Manufacturing is another area in which labor-market dynamics are changing. This perennial job-losing category created 150,000 net new jobs in 2014 (through November). At the same time, retail and professional and business services, two of the economy's largest employment generators, were both running far ahead of average cyclical job creation, at 240,000 and 730,000, respectively. We fully anticipate the economy will create over three million net new jobs in 2015, bringing the unemployment rate down to 5.4%.

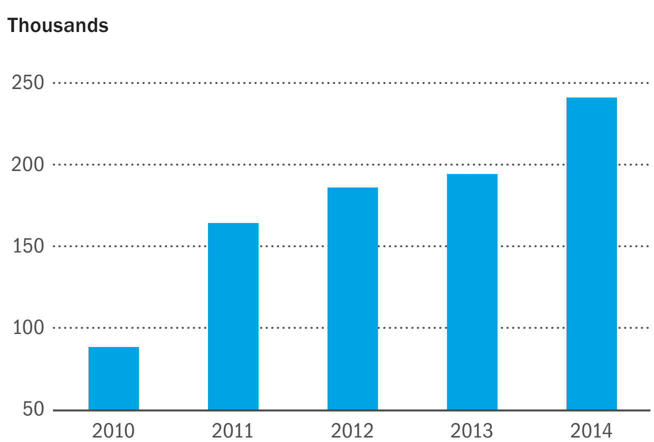
Strengthening labor markets will improve real wages across the economy. Slack in most labor categories has led to flat real wage growth for a number of years. That should change as employment continues to pick up. We expect to see close to 2% real wage growth toward the end of 2015, with a further rise to about 3% in 2016, which would be consistent with most cycles.

But the untold story comes from nominal wages (see Exhibit 5). Wage and income payments across the economy have already surpassed those of the last business cycle, and this gradual growth and stability in incomes are largely responsible for the current level of consumer spending. While real wage rates are what make the average consumer feel better or worse off, nominal income matters, too. Many two-income families before the recession have once again regained that status amid growing demand for labor. That second salary, which doesn't show up in real-wage calculations, nevertheless contributes to higher income at the household level and does lead to increased consumer spending.

These trends are also indicative of stronger output at the factory level. Businesses invested on the factory floor at about a 7% growth rate in 2014, while spending on inventories hit nearly $70 billion, just $5 billion shy of its long-term average. Moreover, monthly factory output statistics and surveys of purchasing managers suggest that output will continue to grow at an increased pace.

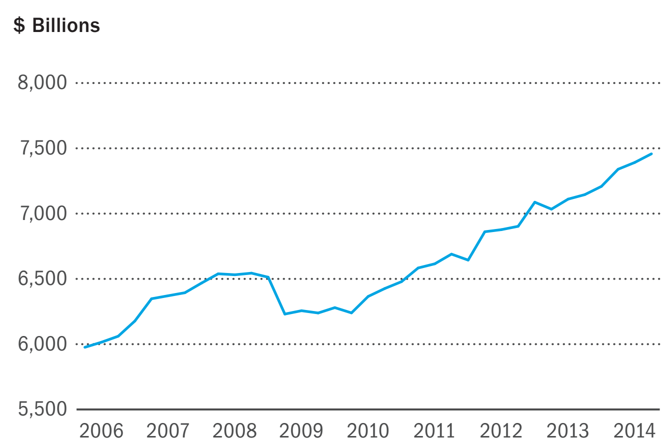
We expect these gains in business spending and labor markets to stimulate consumer demand as well, evidenced by the beginning of an uptick in monthly loan growth. Automotive lending in particular has grown substantially, with light vehicle sales rising to an annualized level above 17 million units in 2014. Mortgage lending is accelerating modestly, and borrower-friendly changes to Fannie Mae and Freddie Mac underwriting rules suggest this category will pick up even more. On the purchasing side, we have not yet seen dramatic growth in either monthly retail sales or personal consumption expenditures. However, retail sales

Exhibit 4: Average monthly job creation



Source: Haver Analytics.

Exhibit 5: Wages and salaries



Source: Haver Analytics.

strengthened during the second half of 2014, and we are expecting a solid Christmas selling season. This portends an upward shift in consumer spending that should add measurably to overall growth in 2015.

Finally, the stimulus provided by sharply lower oil prices will boost economic growth (see Exhibit 6). Oil was selling at less than $54 per barrel at the end of December, 50% below its peak at the beginning of last summer. This price level means we can expect a roughly $1.5 trillion drop in revenues for the world's oil-producing nations annually, all of which ends up in consumers' pockets in one form or another. In the U.S., this translates to roughly $300 billion in retail gasoline savings per year, and more than $1 trillion when factoring in lower production costs across the economy — savings that are shared by businesses and consumers alike.

Exhibit 6: Oil prices

West Texas Intermediate, dollars per barrel

Source: Haver Analytics.

Savings from lower oil prices will boost consumer and business spending, as well as hiring, adding to the growth from fundamental strength in the economy. Demand for goods and services that use more gasoline, such as SUVs and airline travel, will also increase. However, the combined net effect of lower oil prices is difficult to measure and forecast, because oil prices would have to stay low for a long period of time in order for all of the benefits to be realized and for consumers to permanently change their behavior. It is certainly possible that low oil prices could add between 0.3% and 0.5% to overall growth in 2015, as long as prices stabilize near current levels. However, without being able to forecast OPEC production decisions or the fallout from current price movements on countries such as Russia or Iran, we cannot predict oil's path over the coming year with a high degree of conviction. Consequently, we have not included this dynamic in our GDP forecast, accepting instead that this positive shock could well lead to stronger growth than that driven purely by fundamental factors in the economy.

Our current forecast calls for U.S. GDP growth in the neighborhood of 3.0% for the final quarter of 2014, followed by slightly slower growth in the first quarter of 2015, and then a gradual improvement as the year progresses. Growth should average about 3.1% by the end of 2015, perhaps with an upside surprise based on oil price dynamics (see Exhibit 1).

The risks to this forecast are weighted heavily to the upside, thanks to current oil prices. However, there are a few known risks that may have the potential to slow the forecast. Escalating tensions between Russia and Ukraine could spill over into a broader European or NATO conflict, and the current ruble devaluation could trigger such a scenario. However, such an event would have a greater impact on Europe than on the U.S. The other concern that is sure to continue is the actions of ISIS militants in the Middle East, although we believe this conflict will be contained in the region and unlikely to impact growth at home.

Monetary policy and interest rates

The fundamental improvement in the U.S. economy no longer warrants a zero interest-rate policy. The Fed has already ended its QE program, and its next step will be to raise the target federal funds interest rate above zero. We fully expect that will happen at the June 2015 meeting of the Federal Open Market Committee. This move will be followed by further rate increases appropriate for the level of economic growth evident at the time. However, since we expect economic growth to increase only moderately over the next three to four quarters, we also anticipate rate increases to be slow and measured. The Fed has communicated clearly that it is easier to fight inflation than deflation — in other words, that the downside risks of raising interest rates too slowly are better than the risk of raising them too quickly if the economy is not unequivocally out of the danger zone of another recession. Our expectation for the path of the federal funds rate is shown in Exhibit 7.

Exhibit 7: Fed funds target (%)

	2015	2016	2017
First Quarter	0.00	1.00	2.25
Second Quarter	0.25	1.25	2.50
Third Quarter	0.50	1.75	2.75
Fourth Quarter	0.50	2.00	3.00

Source: TIAA-CREF Asset Management.

Long-term interest rate movements have been significantly more difficult to forecast than Fed actions. During the height of the Fed's QE program, in May 2013, the 10-year U.S. Treasury yield fell below 1.7%, then climbed to nearly 3% seven short months later, when the Fed began to taper its monthly bond purchases. Since that point, rather than rising as would be expected in an accelerating economy, the 10-year yield has fallen to about 2.1%.

We attribute this drop to perceived weakness abroad and the expected decoupling of monetary policy between the largest economies around the world. As Europe and China have continued to weaken, demand for dollar-denominated investments has picked up. Some of that investment flow has ended up in U.S. Treasuries, driving their prices higher and yields lower. Going forward, we expect the strengthening economy to push Treasury yields higher, although the divergence in global growth will continue to drive fund flows into U.S.-based assets, keeping a relative lid on the rise in yields. Our forecast is for the 10-year Treasury to reach 2.75% by year-end 2015.

Europe

The Eurozone has been in and out of recession since 2008, having never attained any measure of "escape velocity." At last count, the region exited its second recession during the latter half of 2013 and has managed to skirt entering a new recession since then. However, many financial market participants have been expecting a recession since last summer because of mounting weakness across the continent. Financial metrics would also suggest that a new recession is a real possibility: Long-term interest rates have reached all-time lows, and medium-term inflation expectations have dipped well below 2%, the European Central Bank's (ECB's) Maginot Line. Finally, demand is stagnant across the continent. Credit growth has stopped falling but cannot be described as rising. Thus, any ECB monetary stimulus may not be adequate to combat the problems facing the Eurozone.

However, we believe growth can accelerate modestly in 2015, thereby avoiding another dip into recession territory. This is primarily because, in our view, the German and French economies are fundamentally more stable than most market participants give them credit for. In the case of Germany, the consumer is relatively healthy. Employment growth and wages have been strong, and consumer spending has not shown any signs of slowing. Meanwhile, the production side has moderated somewhat, especially in construction activity. There was a swoon of sorts in German automotive production and other industrial sectors during the late summer months, but much of this was likely caused by changes in the national holiday and school calendars, a factor not widely reported in the media.

France has also performed better than expected. The French federal government has moved forward with structural spending reforms, but many of the more drastic cuts have been put off for a few years. This has allowed government spending to remain a net positive for French growth in 2014. The government has also pushed several dozen structural reforms through its legislature, which will help alleviate "stickiness," or inflexibility, in labor markets. Finally, France has lowered its marginal business tax rate as a temporary stimulus measure.

Many other Eurozone economies have moved along at about a constant rate throughout 2014, and some of the peripheral countries have actually outperformed expectations. Spain in particular grew at a 2.0% pace for half a year. Cranes can once again be seen on the Madrid skyline, residential real estate has picked up, and consumers are spending at a stronger than 3% pace again. Granted, Spain — like many of the countries on the periphery that have struggled in recent years — is growing from a small base, but there is growth nonetheless.

ECB policy is driven solely through an inflation lens. It's this dynamic that has pushed the central bank to become more and more creative in its efforts to stimulate demand and ultimately raise inflation expectations. However, most of the tools that the ECB has tried have proven ineffective. The easiest way to see this is by looking at the ECB's balance sheet (see Exhibit 8). Like the Fed during its QE phases, the ECB has been trying to increase the size of its balance sheet to provide more liquidity to the economy, under the theory that more liquidity will buy time for the economy to heal, as well as give individual governments an opportunity to enact needed structural reforms. Because past measures have not succeeded in expanding the balance sheet, we expect the ECB to initiate U.S.-style QE in 2015. This will be the strongest signal yet of the central bank's intent to solve the currency union's ailments.

Exhibit 8: ECB balance sheet

Source: Haver Analytics.

Under a QE scenario, the euro will weaken, but not by as much as one might expect based on economic performance in the Eurozone. This is primarily because capital markets are much stickier in Europe than in the U.S. For example, on the corporate side, European capital markets are smaller and less developed, providing fewer options for businesses to raise capital outside of the banking system. On the consumer side, relative to the U.S., a larger proportion of household wealth in Europe is locked up in real estate. These factors lead to a certain support level for the euro that does not exist with the dollar. Consequently, we see the euro hovering close to its current levels between $1.20 and $1.25 per euro, but with an expectation that the soon-to-be-announced QE program will push this exchange rate closer to $1.10 by the end of 2015. Exhibit 9 shows our expectations for several important currency pairs.

Japan

Japan has been stuck in an economic malaise for two decades, which has had the effect of slowly deflating its economy over time. The result: falling prices, flat nominal wages, and the gradual deceleration of domestic production in favor of investment overseas. A fundamental problem in the Japanese economy is the perverse incentive structure that falling prices provide. Consumers are incentivized to postpone purchases because waiting always leads to a lower price. Meanwhile, producers are incentivized not to make goods because falling prices mean production margins get squeezed over time. Ironically, falling prices also lead to rising real incomes as long as nominal wages hold steady. This landscape also provides fertile ground for currency speculation. Japan has enjoyed some of the highest real interest rates in the world, thanks to low nominal interest rates and deflation. This has made the yen a major trading currency and led to a very strong yen "carry" trade.*

Prime Minister Shinzo Abe campaigned on the premise that he would initiate policies and programs ("Abenomics") to end his country's vicious deflationary cycle. As part of Abenomics, he championed three broad policy tools, or "arrows." The first arrow was extremely easy monetary policy and QE; the second was massive fiscal stimulus; and the third is a collection of structural reforms designed to open the Japanese economy, increase competition, and improve labor markets.

Among the goals that will set the economy on the right footing is a return to positive inflation. The Bank of Japan (BOJ) has set a target of attaining a stable 2% inflation rate. Beginning in 2012, the BOJ began injecting trillions of yen into the system to purchase Japanese Government Bonds (JGBs). This has been met with only marginal success, but there seems to be a genuine willingness to follow through, so we expect to see more stimulus as long as inflation remains below target. One of the byproducts of this policy has been a weaker yen relative to most other currencies, a trend that we expect will continue. Exhibit 10 shows the correlation between a falling yen and rising Japanese stock prices.

Another of Abe's goals is to stimulate domestic production. This will require the corporate sector to shift its emphasis from overseas to domestic investment. However, to do that, the yen would need to fall much further, perhaps to a range of ¥140–¥160 to the dollar.

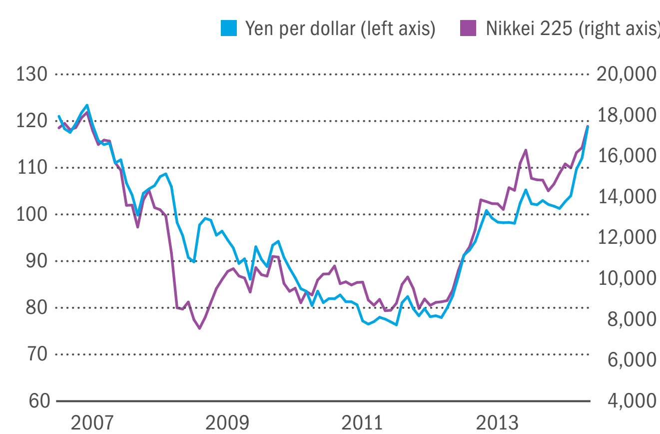
Exhibit 9: Foreign exchange rates

	Period end	
	2014	2015
Euro	1.21	1.10
Yen	120	130
CAD	0.86	0.80
AUD	0.82	0.75
BRL (Brazilian real)	2.66	2.50

Note that the euro, Canadian dollar, and Australian dollar are priced in dollars per currency unit, while the yen and Brazilian real are priced in currency units per dollar.

Sources: U.S. Federal Reserve, TIAA CREF.

Exhibit 10: Yen and the Nikkei



Source: Haver Analytics.

Whether Abe is ultimately successful in this program will take more time to discern. However, given his willingness and determination to carry these policies to fruition, we view their success as a distinct possibility. Thus, we expect the yen to extend its slide as further stimulus measures are enacted. The BOJ recently announced a new, aggressive round of QE, and we fully expect to see additional easing in 2015. Further, we have seen the enactment of two very large fiscal stimulus packages in Japan under Abe. Given December's pro-Abe election results, we expect another package shortly. Our forecast for the yen is 130 to the dollar by the end of 2015.

Emerging markets

Over the past 12–18 months, emerging-market economies have faced the dual headwinds of falling commodity prices and a strengthening dollar. Additionally, as is common in the developing world, several governments have made policy mistakes that are likely to extend the pain for their populations.

The commodity cycle arguably ended with the changeover to the new Chinese administration. President Xi Jinping has shifted focus away from single-minded industrialization and toward softer targets such as anti-corruption efforts, environmental cleanup, employment conditions, and rural development. At the same time, he has initiated reforms at the federal agency level, introducing judicial and bankruptcy reform, among others. He has also begun to accelerate the liberalization of China's currency while simultaneously gaining more control over capital markets.

These initiatives, combined with weaker economic performance in the other major non-U.S. economies, have had the effect of lowering demand for most commodities. China used to be known for stockpiling commodities but for the most part has stopped that practice. This shift has rippled through supply chains worldwide and hurt growth prospects for several emerging-market countries that rely heavily on commodity exports.

The rising dollar has also been a headwind. Historically, rising interest rates in the U.S. have been associated with volatility in emerging economies, and the current path suggests this pattern will recur. However, we believe emerging-market countries are collectively more capable today of managing changing conditions than in the past, for two reasons. First, compared to past cycles, much of their debt is denominated in their respective local currencies, rather than in U.S. dollars. This should at least partially buffer these economies from the impact of a rising dollar. Second, interest rates in the U.S. should rise at a slower pace than in past tightening cycles, allowing more time for these countries to adjust.

Conclusion

The global economy is likely to grow modestly in 2015, hampered on one hand by cooling in China and continued slow growth in Europe, but helped on the other hand by a stronger U.S. economy. This establishes 2015 as a year of slight acceleration, but also sets up 2016 for better performance as long as the various actors play their parts appropriately over the next 12 months.

We expect the dollar to strengthen further in the upcoming year, accompanied by higher U.S. interest rates. The Fed's tightening policy stance will stand in contrast to looser money policy in Europe and Japan, pushing the euro and yen to multiyear lows. China will continue on its path toward reform, and the yuan will strengthen marginally as the government slowly moves toward a less rigidly managed exchange rate. We expect Japan to deliver more fiscal and monetary stimulus in 2015, further weakening the yen, but we also believe that it will take more than one year for the government's reforms to accomplish their objectives. Finally, we think the positive impact of lower oil prices will help the world along its growth path in 2015, providing a tailwind exactly at the right time for this business cycle.

* A carry trade is a short-term strategy in which investors sell a currency from a low interest-rate country and use the proceeds to buy a higher-yielding currency from another country, capitalizing on the rate differential.

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