Increasing Sunshine

In our January 2014 commentary, we highlighted "surprising strength in consumer spending and exports, building momentum in business shipments and production" in last year's third quarter and our expectations these trends would continue in the fourth. We raised our estimate of fourth quarter GDP to a range of 2.5 to 3 percent from 2 to 2.5 percent. Actual fourth quarter GDP growth was 2.6 percent despite large reversals in business inventory investment and housing from the third quarter. In addition, fourth quarter GDP was affected by the onset of what became a severe winter. While full year 2013 GDP was 1.9 percent as measured from year-year annual levels, GDP growth in the second half of 2013 increased at an average annual rate over 3 percent.

While the severe winter also negatively impacted this year's first quarter GDP, the economic outlook for 2014 has become more positive with the advent of better weather and the acceleration of positive trends seen in the second half of 2013. After plummeting below 100,000 in December, job growth in the U.S. has increased back to nearly 200,000 jobs per month in February and March with gains spreading from services to construction. Consumer spending continues to be a source of economic strength as retail sales rebounded in February and March. Consumer spending on services has also surged in the first quarter. Manufacturing in the U.S. is running at pre-recession levels, led by durables related to auto and housing sectors. U.S. exports continue to grow led by increasing energy production. The world economy continues to strengthen, led by the industrialized economies in Japan, Europe and the U.S. The recovery in February and March lead us to estimate first quarter GDP of 2.5 percent within a range of 2 to 2.8 percent.

As we leave the first quarter these positive trends continue to build. Data for April shows increasing activity by consumers and business. Consumer and business confidence in the economy has risen as a result of the improved economic landscape. In addition, confidence is buoyed by the continuation of liberal monetary accommodation by the Federal Reserve. With economic growth now improving both nationally and globally, corporate America will have an opportunity to accelerate earnings growth going forward.

In January we asked if the second half 2013 economic strength was the "economic breakout economists and analysts have been looking for since the economic recovery began in 2010." Given the rebound in the first quarter from severe weather and the signs of further acceleration as we enter the second quarter, we believe the answer is "yes." To be sure, there remain fundamental concerns about the shape of the U.S. economic recovery as it pertains to the U.S. labor market in terms of long term unemployed, part-time workers and the pace of wage gains necessary to fuel further consumption gains by consumers. However, two things are apparent since the beginning of this year. More people are working and there are now signs of labor tightness in selected geographic and industry sectors. Along with increasing national and state trends in increasing minimum wages, we believe this will be reflected in an increase in wages above consensus expectations as we go into 2015.

In addition, increased orders, shipments and operating rates and improved confidence in the economic recovery are stimulating businesses to plan for a new round of capital spending. We expect this to include not only machinery and equipment, the mainstay of business investment since the recession, but also a new round of IT upgrades and new "brick and mortar" capacity expansion. This would fuel a heightened level of business investment over the next 12 to18 months.

The risk in our optimistic economic outlook is an unexpected rise in interest rates late this year or in 2015 due to the acceleration of economic growth over the remainder of 2014 and into 2015. We have never subscribed to the deflation fears of the Federal Reserve. We are already seeing early signs of inflation in rising prices for agricultural and industrial commodities and businesses starting to raise prices to compensate for higher costs. If these trends continue into the second and third quarters, it will be challenging for the Fed to keep interest rates at current levels. The long period of low interest rates has fueled a surge in consumer spending for expensive durables such as autos and housing and more recently, furniture and appliances. A rise in interest rates would be a restraint to those purchases as well as heightened capital spending plans by business.

Despite these potential challenges to the 2014 economic outlook, we are more optimistic about the backdrop for improved economic growth this year than in January. We continue to expect U.S. economic growth this year of 2.5 to 3 percent. The key is still the consumer and his income growth. In January, we ended our comment with the term "weather clearing on the horizon." We now see "increasing sunshine" and "favorable winds."