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With the New Year just around the corner, we identify key themes to watch for the economy and capital markets in 2015.

As 2014 drew to a close, American Institute for Economic Research (AIER) economists and analysts took a step back to put major economic and financial events of the past year in context. They reviewed the milestones achieved by the U.S. economy as the fifth anniversary of the current expansion's beginning dropped into the record books. In this report, our researchers provide a summary of current conditions in relation to history, and most importantly, identify important themes and risks heading into 2015. For the U.S. economy, growth remains a bit below average but relatively steady, while the challenges and outlook for each major sector are very different. The Great Recession wiped out many excesses of the prior expansion. Yet since that expunging process concluded, some parts of the economy still remain weak while others have rebounded admirably.

On the inflation front, the seemingly unending battle of the past four decades against inflation turned into a war against deflation during the recession. New battle plans were drawn and new weapons were conceived. Now with the threat of deflation waning, policymakers and investors are preparing to refocus on inflation concerns.

For investors, much of 2014 was characterized by long periods of calm only to be disturbed by brief bouts of volatility. Fixed income markets coped with the end of quantitative easing (QE) by the Federal Reserve, a mixed outlook for inflation, which trailed the Fed's 2 percent target most of the year, and a relentless demand for the safety of U.S. Treasury securities. American equity markets marched persistently higher, supported by solid growth in earnings, a strengthening dollar, favorable comparisons to foreign capital markets, subdued inflation and lower treasury yields.

The one thing that remains constant in the world of economics, economic policy and capital markets is the emergence of new tensions, chaos and a constant flow of change. From political instability to new technologies, the global economy is in constant motion. In that respect, 2015 is likely to be no different than 2014: full of surprises. However, we offer our perspective on the areas within the economy and capital markets that deserve extra attention as the New Year unfolds.

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Bond markets may be under pressure as the Fed begins raising rates but safe-haven buying may soften the impact. The multi-year bull market in Commodities ended as most commodity prices fell in 2014. The question for 2015 is will the

pick-up in the global economy be enough to reverse the down trend. We expect an improving economy to support sales, earnings growth, and U.S. equity prices in 2015, though rising interest rates could cause some volatility.

ECONOMIC OUTLOOK

AIER's Business Cycle Conditions (BCC) leading indicators point to continued economic expansion in the quarters ahead. We combine our 12 leading indicators into a single index where a reading above 50 percent suggests continued economic expansion. As of our November evaluation, 82 percent of the leading indicators were expanding, or in an upward trend.

For more than 60 years, AIER has used our BCC indicators to warn of potential economic weakness. On average, our leading indicators have signaled impending recession approximately 3 months before an official downturn began. As of November, our index of leading indicators has exceeded 50 percent since September 2009, a run of 63 consecutive months. Consistent readings well above that midpoint suggest a low probability of recession over the next six to 12 months.

In addition to our index of leading indicators, we also calculate three other AIER measures: a cyclical score for our 12 leading indicators, an index of coincident indicators, and an index of lagging indicators. All of our indexes suggest continued economic growth in the quarters ahead (Chart 1). Overall, we remain optimistic about the U.S. economic outlook.

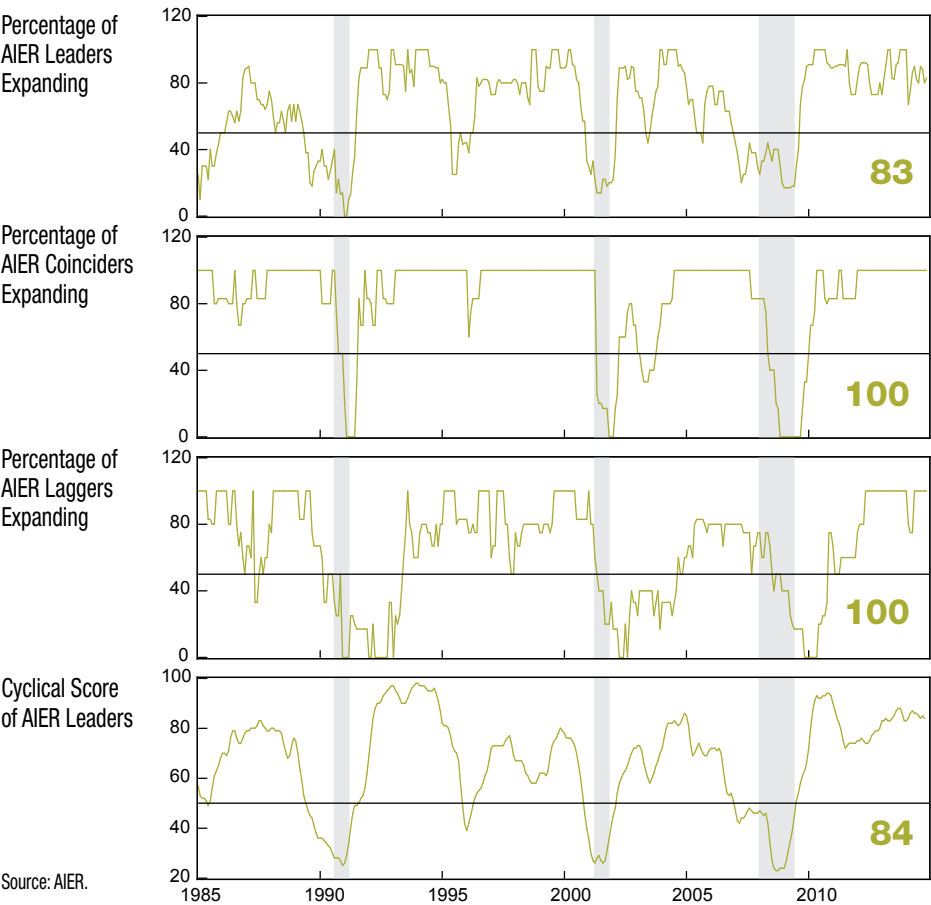
THEMES FOR 2015

Last June marked the fifth anniversary of the Great Recession's end and the start of the current expansion. Several milestones were reached this year: Employment finally exceeded its prerecession peak and the jobless rate fell below 6 percent; the Fed ended its QE asset-purchase program; yields on 10-year U.S. Treasury notes remained above 2 percent for the entire year, and the dollar hit its highest level since 2009.

These milestones are all positive signs. But the strength of the recovery is still considered subpar by historical standards. Growth in real Gross Domestic Product (GDP), the broadest measure of the economy, has been, on average, slower during this recovery compared with previous ones. Unemployment has come down substantially, but the labor market remains soft by other measures. Taken together, slow but steady

Chart 1. INDICATORS AT A GLANCE

Shaded bars represent official recessions. A score above 50 indicates expansion.



improvement and a lack of severe imbalances suggests that the expansion, while somewhat subpar, is likely to continue for quite some time.

A closer examination reveals a number of important qualities that support a favorable outlook for next year. First, consumers have paid off a significant amount of debt that accumulated during the previous expansion. Combined with recovering home values and record high equity prices, consumer balance sheets are the healthiest in decades.

Likewise, corporate America looks to be in generally good financial health. Balance sheets for publicly traded businesses are flush with cash, sales have been rising at a moderate pace, profit margins are high by historical measures, interest rates are low, and more recently, energy prices have dropped. Even the federal government's fiscal position has improved markedly over the past few years, though longer-term deficit and debt trends remain concerns.

So with a slowly improving economy, positive readings from our BCC indexes and few imbalances, what will be the key macroeconomic themes to watch in 2015? We will be paying particular attention to three areas: consumer purchasing power, i.e. jobs, wages and debt growth; global expansion; and energy prices.

American consumers account for about 70 percent of U.S. GDP, so as the consumer goes, so goes the economy. Crucial to projections of consumer spending is the outlook for growth in purchasing power, or spending ability. This can come from income, like wages or dividends, from capital gains when assets like stocks and bonds appreciate, or from an increased capacity to borrow. The key elements to watch for next year will be continued employment gains, accelerating wage growth and consumer borrowing, especially using revolving or credit card accounts.

Global economic growth is expected to accelerate slightly in 2015, according to the International Monetary Fund (IMF) as well as many private forecasters. While faster expansion is positive, the aggregate growth rate is still expected to be weak and uneven. Much of the weakness is in Europe and Japan, which together account for about 21% of non-US global output. Other developed economies on average appear to be fairing a bit better.

Among emerging economies, the story is also mixed but on balance, a bit stronger compared with more mature economies. Not surprisingly, the key player is China. Though still considered an emerging economy, its size is only eclipsed by the U.S. With well over 1 billion people and annual growth often ranging above 10 percent in past decades, policies to manage China's domestic expansion can have an outsized impact on the global economy. Over the past 15 years, China's real GDP has expanded at an average annual rate of 9.6 percent. It slowed to 7.3 percent through this year's third quarter and is expected to fall to just 7.1 percent in 2015.

Energy is the third area deserving extra attention next year. Because these resources are so critical to the functioning of all modern economies, developments in commodity markets for natural gas, coal and crude oil are particularly important. Recently, crude prices fell sharply amid rising supplies and sagging global demand. U.S. domestic prices dropped almost 40 percent from a 2014 high of about \$108 to about \$66 a barrel at the end of last month, levels last seen in 2009.

While lower energy costs are good for consumers and many businesses, oil producers suffer. Energy production from shale rock has been a rapidly growing source of U.S. jobs and economic gains in recent years, particularly in places that have been bypassed for decades, such as North Dakota, west Texas and western Pennsylvania. While the net benefit to the U.S. economy from lower energy prices is positive, there are several areas related to energy production, transportation, and capital investment that may suffer. AIER will be monitoring the developments in domestic and global energy markets carefully and analyzing the impact across the economy's major sectors.

AIER WATCHING

3

KEY THEMES FOR 2015

U.S. Consumer Purchasing
Power Gains

Global Economic Growth

Energy

SCORECARD

AIER has created an inflationary pressures scorecard to help monitor those trends that we believe contribute to the development of inflation. Our scorecard tracks 23 indicators and evaluates the performance of each over the past three months in comparison with activity in the prior three months. That is, we compute a moving average of the monthly changes for two consecutive, non-overlapping three-month periods, and calculate the difference between the two. A positive difference shows an upward trend and a negative difference means a downward trend. We then interpret the impact with respect to price pressures.

In our latest review of the scorecard, 15 of the 23 indicators show falling inflationary pressures, two are stable and six show increases (Table 1). Overall, our scorecard suggests generally moderating inflationary pressures and supports our view that price changes are likely to remain tame in the months ahead.

Even with an expectation for just modest price gains in 2015, we are focused on three key areas for possible increases in inflationary pressures: wage costs from a tightening labor market, the potential for accelerating productivity to offset those influences, and the impact of weak global growth on the dollar and commodity prices.

More specifically on wages and productivity: Wages, as measured by average hourly earnings, have been rising at about a 2 percent annual rate over the past four years, below the average 3 percent rate over the past thirty years. Productivity has averaged about 2 percent per year over the past 60 years, while over the past four years, productivity growth has averaged less than 1 percent per year.

Table 1. INFLATIONARY PRESSURES ARE MODERATING

	3-MTH. AVERAGE CHANGE		INFLATION PRESSURE
	Previous	Latest	
DEMAND & SUPPLY			
Demand			
Average hourly earnings (Oct)	2.2%	1.8%	Falling
Nonfarm payrolls-chg., 000s (Oct)	138.8	139.5	Rising
Personal Income (Oct)	4.2%	3.0%	Falling
Retail sales (Oct)	4.4%	2.7%	Falling
Supply			
Ind. Prod. - consumer goods (Oct)	0.4%	-3.2%	Falling
Manufacturing Utilization (Oct)	77.4%	77.3%	Falling
Retail Inventory/sales ratio (Sep)	1.413	1.420	Falling
MONEY, BANKING & CREDIT			
Fed Funds rate (Nov)	0.125%	0.125%	Stable
Interest on excess reserves (Nov)	0.25%	0.25%	Stable
Money Supply (M2) (Oct)	6.8%	3.4%	Falling
Money Velocity (Sep)	1.8%	-3.6%	Falling
Revolving Consumer Credit (Sep)	6.5%	0.2%	Falling
COSTS & PRODUCTIVITY			
Producer Price Index (Oct-2014)			
Final demand	2.2%	0.4%	Falling
Foods	-1.3%	-1.0%	Rising
Energy	4.8%	-19.1%	Falling
Goods less food & energy	1.5%	0.4%	Falling
Services	2.2%	2.6%	Rising
Import Price Index (Oct-2014)			
Autos	-2.4%	-0.4%	Rising
Consumer goods ex. Autos	0.0%	-0.7%	Falling
Commodity Prices (Oct-2014)			
S&P GSCI Commodity Index	-21.8%	-61.2%	Falling
Wages & Productivity (Q3-2014)			
Private Compensation	3.4%	2.7%	Falling
Nonfarm Business Productivity	2.9%	2.0%	Rising
Nonfarm Business: Unit Labor Costs	-0.5%	0.3%	Rising

Sources: BLS, BEA, U.S. Census Bureau, Autodata, Federal Reserve Board, Haver Analytics.

CONSUMER PRICES

Price increases as measured by the Consumer Price Index (CPI) remain slight by historical measures. Total CPI was unchanged in October as a sharp decline in energy costs offset small increases in other goods and services. Over the past 12 months, the CPI has risen 1.7 percent, below a 2.4 percent 20-year average (Table 2).

Because food and energy prices tend to be more volatile and subject to influences beyond typical economic forces such as severe weather patterns or geopolitical forces, we believe it's important to exclude those components by focusing on core CPI. This gauge accounts for almost 77 percent of total CPI. The core CPI rose 0.2 percent in October and 1.8 percent for the past year. That's 0.3 percentage point below a 2.1 percent average annual increase over the past 20 years.

A further disaggregation of the measure into core goods and core services provides a deeper understanding of price increases in the U.S. Core goods have risen at an average annualized rate of just 0.3 percent over the past 20 years and are actually down 0.2 percent in the last 12 months. Core services have risen 2.5 percent over the past year and averaged 2.8 percent annual gains over the last two decades.

This significant long-term divergence between core goods prices (+0.3 percent) and core services (+2.8 percent) is an important element in the outlook for 2015. Critical questions are: Will core goods prices continue to fall? Will prices for core services accelerate, hold steady or decelerate? Monitoring these areas and the forces behind price increases are major focal points for next year.

Table 2. CONSUMER PRICE INCREASES REMAIN TAME

Data for October 2014	Share	m/m %	3-mth.*	12-mth.*	5-yr.*	20-yr.*
Consumer Price Index	100.0	0.0	-0.4	1.7	1.9	2.4
Food	14.0	0.1	2.8	3.1	2.4	2.6
Energy	9.3	-1.9	-18.8	-1.6	3.8	4.3
CPI excl. Food and Energy	76.7	0.2	1.4	1.8	1.7	2.1
Goods excl. Food & Energy	19.4	0.0	-0.2	-0.2	0.6	0.3
Apparel	3.5	-0.2	-1.6	0.6	1.2	-0.2
New Vehicles	3.5	0.2	1.6	0.6	1.6	0.3
Medical Care Commodities	1.7	0.0	1.5	2.6	2.4	2.7
Services excl. Energy	57.3	0.3	2.0	2.5	2.0	2.8
Shelter 32.1	0.2	3.0	3.1	1.8	2.6	
Medical Care Services	5.8	0.2	1.3	1.9	3.1	3.9
Transportation Services	3.7	0.8	1.0	1.8	2.4	2.6
Education	3.1	0.5	1.7	3.3	3.8	5.2

*=annualized rate

Everyday Price Index

AIER's Everyday Price Index (EPI) decreased 1.0 percent in October because a drop in energy prices offset gains in food costs. Yet the CPI did not change on a month-to-month basis in October. The difference between the two indexes stemmed from increases in housing and education costs, which are not reflected in the EPI gauge. The EPI measures the prices of frequently purchased goods and services, therefore infrequent expenditures on things like housing and education are not included. Over the past year through November, the average retail price of gasoline slid 15 percent, taking pressure off household budgets. However, food prices continued to rise. Meats, fish, poultry and eggs climbed 8.3 percent this year while dairy products gained 5.6 percent.

**MONETARY POLICY ENTERING
NEW PHASE**

Following seven years of extraordinary events and unconventional policy initiatives, 2015 may show the start of a shift back to more normal policy decisions. We will be watching for three key developments, including a mid-2015 interest rate rise, the pace of Fed tightening and the fate of the central bank's policy of balance sheet reinvestment.

In December 2008, the Fed set its benchmark short-term interest rate to a "zero lower bound," its lowest level ever. Now, amid a continuing expansion, the Fed has suggested a rate rise may come as early as the middle of 2015. It would be the first hike in the federal funds rate since mid-2006.

The effects of ending such an unprecedented period of low rates may depend on how quickly increases take place, given the uncertainty surrounding the strength of economic growth. The pacing of interest rate hikes will likely be a critical element in determining financial market reactions as well.

In the last rate-hike cycle (2004-2006), the fed funds target rate rose by 0.25 percentage points with each Federal Open Market Committee (FOMC) meeting over a two-year period until it reached 5.25 percent in June 2006. We cannot be sure of the pace this time, given the influences affecting the current economic environment. In addition to starting from a record low rate, there is the disparate performance in the world's major economies and a still soft U.S. labor market. It is not out of the realm of possibility that rate increases this time around will occur more gradually, say at every other or every third FOMC meeting. And, should the U.S. expansion lose momentum, further hikes could be postponed.

As the American economy struggled to recover from the financial crisis and recession, the Fed stepped in to support growth through its quantitative easing policy of large-scale asset purchases. This form of monetary easing produced a sizable increase in holdings on the central bank's balance sheet. In October, the Fed ended the policy. Now with a probable rate rise drawing closer, we look to whether the Fed will also cease its policy of rolling over the securities it holds – known as balance sheet reinvestment – or if it will begin shrinking its holdings by not reinvesting those assets when they mature.

**NEW CONGRESS, NEW FISCAL
PRIORITIES**

November's mid-term elections changed the balance of power in the U.S. Congress. When the new legislative session convenes in January, Republicans will run the Senate as well as the House of Representatives. However, Republicans, who will hold 54 seats in the upper chamber, would need at least a few others to reach the 60 votes needed to end a filibuster or override a presidential veto. Nonetheless, Republicans are likely to reshape the nation's fiscal priorities.

Curbing the budget deficit has been an important priority for Republicans for years. Their emphasis on cutting spending while reducing taxes has fueled repeated battles, created the "fiscal cliff" in 2011, and led to a government shutdown in 2013.

Yet amid economic expansion in recent years, the deficit has shrunk considerably (Chart 2). At the depth of the Great Recession in 2009, it reached 9.8 percent of GDP. By last year, the deficit had narrowed to 4 percent of GDP. The Congressional Budget Office projects further shrinkage into next year, ultimately reaching the long-term average of 2.8 percent of GDP. In this environment, the sense of urgency over deficit reduction has subsided.

Still, Republicans' control of Congress can be expected to alter government's spending priorities. One likely area of change is defense spending. The Pentagon's outlays have fallen in the past two years by a total of about 10 percent mainly because of the automatic spending cuts known as sequestration that began in early 2013. Most Republicans opposed these cuts. A bipartisan National Defense Panel, in a report issued in July, argued that inadequate funding threatens U.S. military capabilities. In a world of rising geopolitical tensions and instability, an argument for greater defense spending may win broad support in Congress.

A significant increase in military spending would have a noticeable effect on the wider economy. Any hike in government spending, if it is not accompanied by a corresponding increase in tax revenue, stimulates aggregate demand and thus promotes growth. If military spending were restored to a pre-sequestration level, it would rise to 4 percent of GDP, from about 3.5 percent currently. Such a bump in federal spending would likely provide a boost to economic growth though it would also widen the budget deficit.

Republicans have campaigned against the Patient Protection and Affordable Care Act (ACA) of 2010, the president's signature legislative achievement. The Republican-led House has voted, in the past, to repeal the measure. The repeal never went into effect because the Senate, controlled by Democrats, never took up the issue. Next year Republicans will hold the majority in the Senate, as well as the House. Nevertheless, since most of the law has been implemented, to the benefit of many constituent groups, an outright repeal by the new Congress seems unlikely. But changes to various provisions of the law are possible.

For example, a 2.3 percent excise tax on medical devices that took effect in January 2013 has drawn substantial criticism. It is opposed by Republican leaders in both the House and Senate as well as medical device makers. Bills have been introduced in both chambers to repeal the tax. By itself, a rollback is unlikely to significantly affect the broader economy, given that tax is fairly small. Yet giving relief to one group could spur lobbying efforts to repeal other measures introduced in the law. Affected organizations such as hospitals, home-health agencies, labs, insurers and drug companies may press lawmakers harder for similar treatment should the burden be eased for device makers. And they may find more sympathetic ears with Republicans in charge. A trend of piecemeal rollbacks would threaten to unravel the ACA, which seeks to balance added costs with expanded sources of revenue.

Democrats as well as Republicans recognize the need for wider tax reform, encompassing both corporate and personal income taxes. A good economic case can be made that simplifying U.S. tax law would improve efficiency and bring other benefits to the economy. But expecting a wide-reaching overhaul next year is optimistic at best when it comes to such a contentious issue, particularly in a year when prospective presidential candidates will be shaping their 2016 political plans. Yet that political maneuvering will almost certainly affect the way Republican leaders of the new Congress shape fiscal policy.

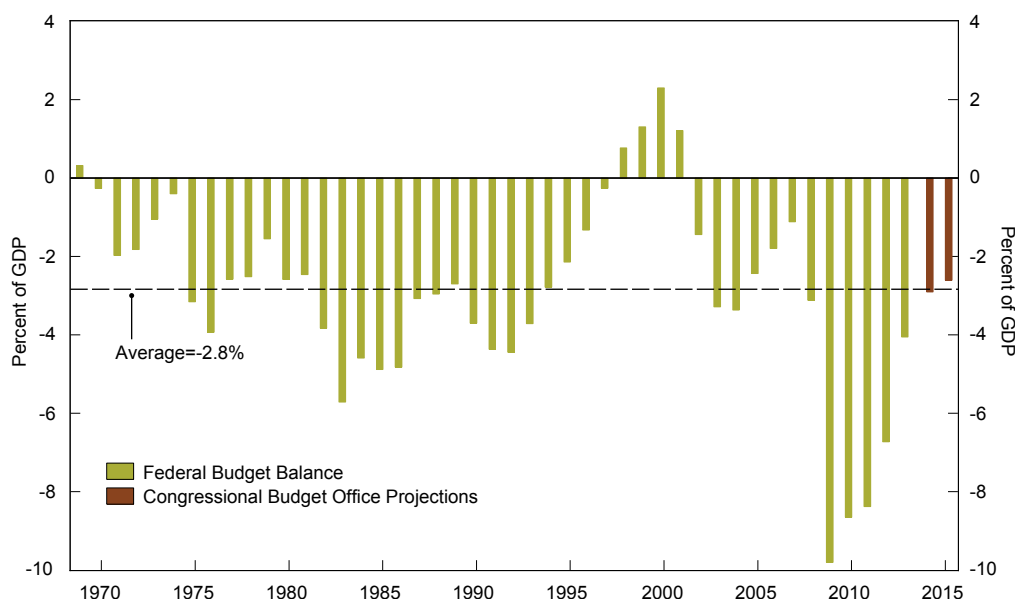
CBO PROJECTING:

2.6%

BUDGET DEFICIT IN 2015

The projected Federal budget deficit for 2015, is down from a deficit of 9.8% in 2009.

Chart 2. SHRINKING OF FEDERAL BUDGET DEFICIT EXPECTED TO CONTINUE



Source: U.S. Office of Management and Budget, Congressional Budget Office, Haver Analytics

Note: Dashed line is the 1969 to 2013 average.

CONSUMER BORROWING

Consumer borrowing trends may play an important role in the growth of purchasing power for consumers in 2015. Over the past several years, slow and steady improvements in the labor market have helped Americans reduce their overall debt burdens and increase their savings. Over the past year, the economy has created an average of 228,000 new jobs each month resulting in a decline in the overall unemployment rate to 5.8 percent. These improvements in the labor market are contributing to slow but steady gains in wages and the highest level of consumer confidence since before the recession. If job creation and wage gains continue in 2015, Americans may feel more confident about taking on new debt which will increase purchasing power and boost spending.

Consumer debt is typically broken down into three major categories: real estate (mortgages and home equity), non-revolving (mostly autos and education), and revolving (typically credit cards). In 2014, the share of young people who own homes continued to decline to a multi-decade low. But this trend may turn around in 2015 as the labor market improves, banks ease lending standards,

and interest rates start to drift up from their very low levels, thus drawing some homebuyers from the rental market. In fact, real estate brokers are already seeing more traffic and banks are experiencing stronger mortgage demand. In general, banks appear more willing to meet demand, and are approving more people with a down payment of less than 20 percent.

Home owners' equity has recovered about 80 percent of its pre-recession high. However, demand for home equity loans has been flat even though lending standards have eased. With home prices gradually appreciating in many markets and the labor market improving, more people may take on home equity loans in 2015, possibly leading to a pick-up in home improvement projects.

Auto sales have been one of the bright spots in the current business cycle including a 17.2 million unit annual rate in November, the second strongest pace since 2006. Consequently, auto loans have been one of the few areas where consumers have been taking on new debt.

Banks have eased auto loan approval standards but interest rates on auto loans have crept higher. The lower standards may have contributed to a rise in 30-

day delinquencies. On the other hand, aggressive collection by lenders has likely limited 90-day delinquencies and reposessions. While more people are getting auto loans, recent warnings of a sub-prime auto loan bubble seem overblown.

In the revolving credit world, more Americans are opening new credit cards but don't appear to be living off them. Credit cards lines are far from being maxed out. About 25 percent of outstanding balances are paid each month and people are well below their credit limit.

FIXED INCOME INVESTING

The yield on 10-year U.S. Treasury notes has been in a decades-long downward trend since peaking in 1981. Yields touched a low of 1.43 percent in 2012 before rebounding to 3.04 percent at the end of last year. This year, notes averaged 2.6 percent through November 24, making it the first year since 2010 that the yield did not dip below 2 percent (Chart 3).

As the current economic expansion gains momentum, yields across the maturity and quality spectrum – from the safest treasury security to the riskiest high-yield corporate bond – are likely to move higher, driven by expectations for a Fed Funds rate increase, slightly higher infla-

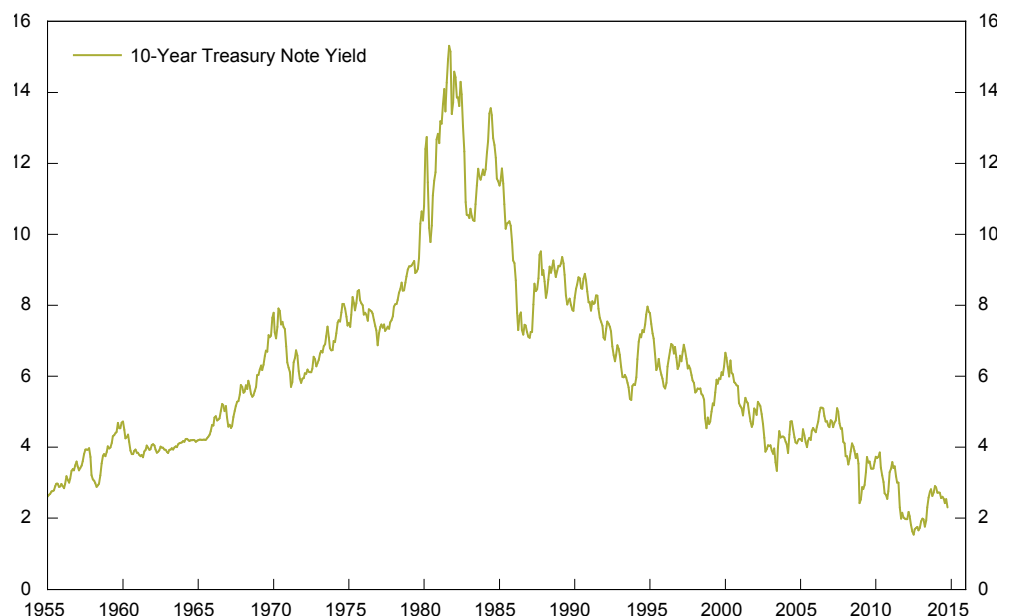
AVERAGE YIELD

2.56%

ON 10 YEAR TREASURY NOTE

Average Yield on the 10 year Treasury Note in 2014, was the third lowest annual average over the past 60 years.

Chart 3. TREASURY YIELDS ARE NEAR 60 YEAR LOW



Source: Federal Reserve Board, Haver Analytics

tion and a somewhat greater willingness by some investors to move away from ultra-safe Treasuries and into slightly more risky investments.

The outlook for fixed income markets in 2015 is not as much about whether rates will rise but when and by how much. The key things to watch will be the timing and pacing of Fed moves (see monetary policy), as well as economic growth and inflation rates. These three factors are important because they could alter the path of monetary policy. The net effect of all these elements is likely to be somewhat higher market rates next year. There are potential wildcards that could alter this outlook, however, such as further weakening in the global economy or the emergence of significant new threats to political stability. Either development could cause a rush to the safety of Treasuries and the dollar.

COMMODITIES

Most commodity futures experienced a major run-up in prices between 2001 and 2011 (Chart 4). Since then, prices for many raw materials have been roughly flat or have fallen. While every type of commodity, whether energy, agriculture, industrial or precious metals, has its own unique fundamentals, each is influenced

to some degree by global economic conditions. The key theme for raw materials next year will be the extent to which global economic growth recovers, particularly in China, thereby pushing up demand.

Despite ongoing weakness in some parts of the world, in aggregate, overall global growth is expected to accelerate slightly in 2015. Broadly, marginal improvements in global GDP are expected to come from the U.S., Europe (though growth there is still expected to be quite slow) and several key emerging economies, such as India, Brazil and Mexico. China and the United Kingdom are the notable exceptions: Real GDP is expected to slow in both countries next year compared with 2014.

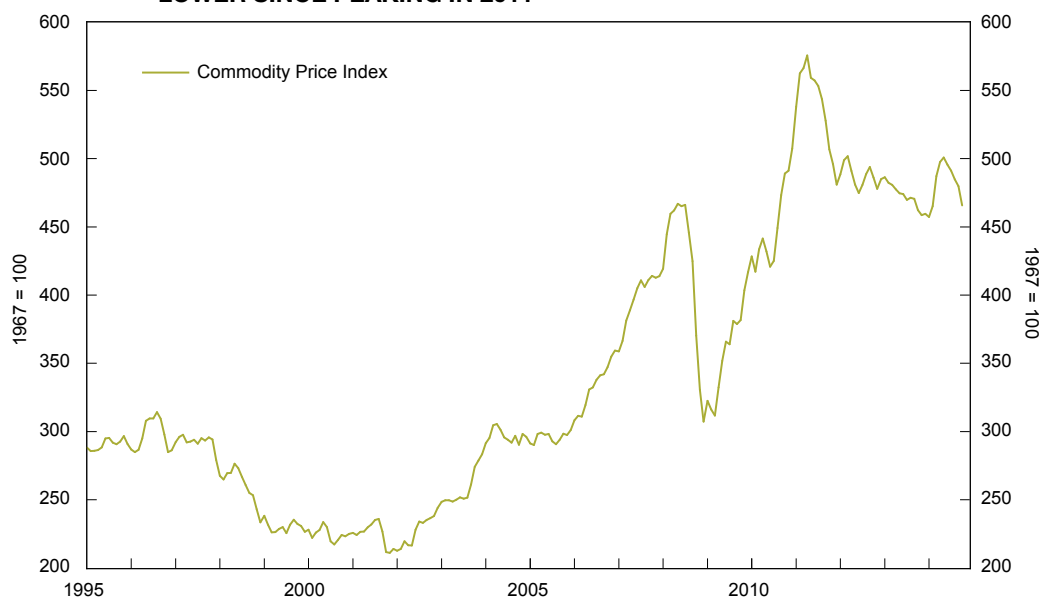
AIER researchers will be paying particular attention to global energy markets in 2015. Among the many forces that shape these markets is the feedback loop between world economic growth and energy prices and the resulting impact on individual countries. Stronger growth boosts demand, exerting upward pressure on prices. Weaker growth crimps the need for more energy, and that, coupled with rising production, puts negative pressure prices. Crude oil displayed the effects of those influences this year, dropping about 40 percent in U.S. markets as Japan, an energy importer, fell into recession and

growth cooled in China while global production continued to rise.

Developments such as horizontal drilling and hydraulic fracturing techniques have been a critical element in energy exploration and extraction. New technologies to produce oil and gas from shale rock or tar sands have led to some major shifts in global output. However, these new techniques and devices tend to be expensive, and may quickly shift from being economically feasible to unprofitable should prices continue to fall.

Politics plays an important role in energy markets, from the internal dynamics of OPEC to the approval of the Keystone XL pipeline in the U.S.; from uncertainties in Russia and Ukraine to shifting Middle Eastern alliances. The recent decision by OPEC, led by Saudi Arabia, to accept lower prices to protect market share is likely a direct result of the ability of nations such as the U.S. to extract crude using new technologies. For example, if oil prices were stable at \$100 per barrel, U.S. dependence on foreign supplies is lower as domestic suppliers can profitably produce substantial quantities. Should prices fall to \$60 a barrel, the U.S. may become more reliant on foreign sources as economics lead producers to shutdown some domestic wells.

Chart 4. COMMODITY PRICES HAVE BEEN TRENDING LOWER SINCE PEAKING IN 2011



Source: Commodity Research Bureau, Haver Analytics

CRB COMMODITY PRICE INDEX:

20.8%
DECLINE

The CRB Commodity Price Index fell from the peak in 2011 through November 2014.

U.S. EQUITIES

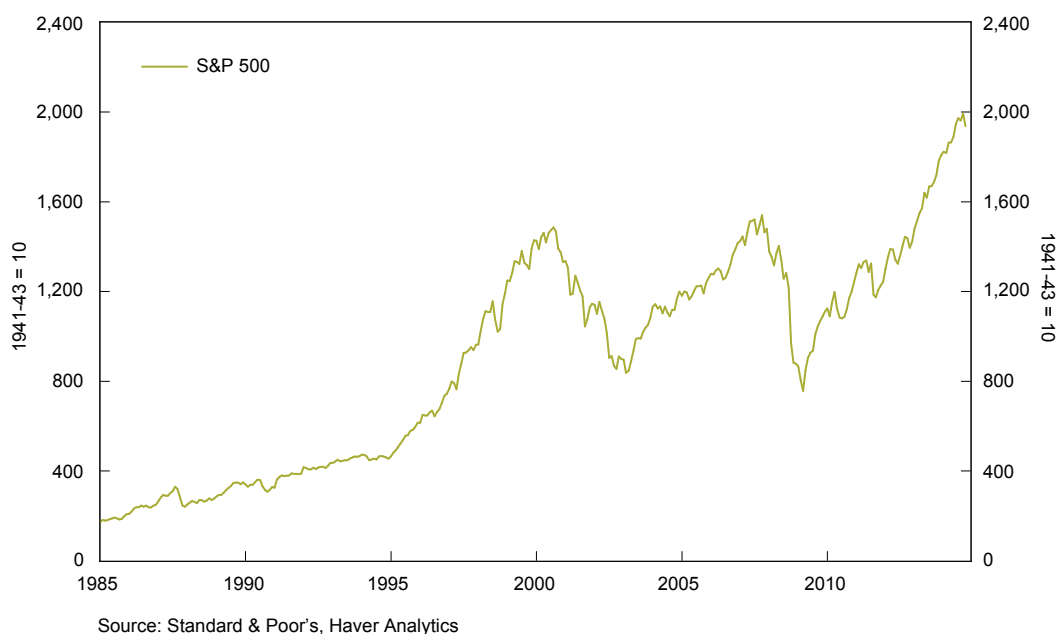
The extraordinary rise in equity prices since 2009 has been well supported by improvements in fundamentals, primarily sales, earnings, and valuations. The Great Recession saw the Standard & Poor's 500 Index fall 57 percent from the peak in October 2007 to the financial crisis low in March 2009. Since then, the benchmark index has tripled to 2,072.83 at the end of November (Chart 5). That's 32 percent higher than the pre-crisis peak of 1,565.15. Over the same period, sales per share have risen 33 percent, and earnings per share are up 167 percent. As a result, valuations on a price-to-earnings (P/E) basis are still roughly equal to the long-run average of about 17.

For 2015, we continue to focus on the fundamentals of the U.S. stock market and expect continued improvement in the nation's economy to support sales and earnings growth, as well as valuations and equity prices. However, there are other factors that may influence prices and bear watching. Corporate balance sheets are in generally good health, with strong cash positions and a moderate level of low-cost debt. Strong balance sheets can help reduce the risk associated with investing in shares and provide support for valuations. Furthermore, cash flows remain strong, allowing for substantial stock buybacks by some companies and stable dividend payouts by others.

In addition, while the U.S. expansion is still weaker than previous recoveries, it's growth is strong compared with other developed markets. That makes U.S. assets more attractive to foreign investors, suggesting further support for share prices.

The main risks that we see on the horizon for U.S. equity markets come from the likely upward move in interest rates noted previously, the potential for extended global economic weakness hurting international sales for some U.S. companies, and a flare-up in geopolitical tensions in places like the Middle East or Ukraine.

Chart 5. THE S&P 500 HAS MORE THAN TRIPLED SINCE THE LOW IN 2009



GLOBAL EQUITIES

An interesting debate among economists and investors in recent years has focused on coupling or de-coupling, or the extent to which global economies are synchronized or their financial markets are correlated. In our view, the prospects for growth among the world's economies are about as varied today as they have been in many years. Those widely divergent growth prospects are apparent in the widely divergent performance of developed equity markets (Chart 7).

Developed economies are mixed. The U.S. has posted relatively steady growth and appears to be gaining momentum. Canada's expansion is expected to be modest but stable next year, and Eurozone growth is forecast to accelerate a bit but remain very weak. Conversely, Japan contracted for two straight quarters as of September 30 while growth in the U.K. is expected to cool.

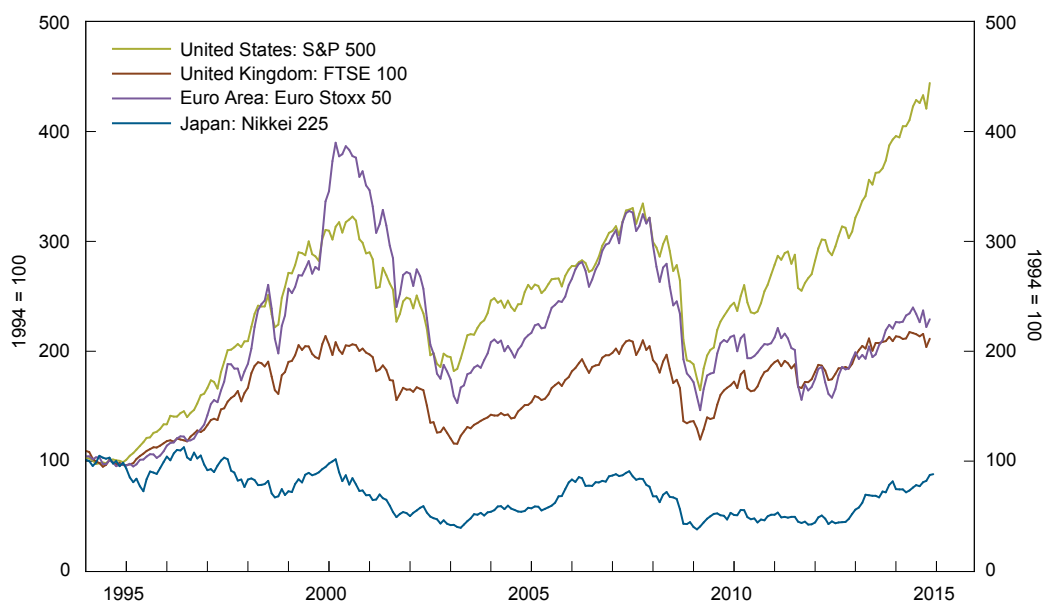
Among emerging markets, the outlook is also quite mixed. In China, the world's second-largest economy, growth has been decelerating for years and next year is expected to slide to the lowest rate since the early 1990s. Russia looks to be another weak spot with real GDP growth of just 0.5 percent and a rising risk of recession. However, prospects outside of those two look generally favorable among larger emerging economies.

Aside from the growth prospects of each individual equity market, we will mainly be watching two things next year: currency values and commodity prices. The performance of a nation's currency can have a major impact on the total return of an investment in that country. For example, if an investor buys shares on the local market in a foreign country and the stock rises 10 percent while the currency drops 15 percent, the investor will have a net loss.

The performance of a country's currency can also have a big impact on economic growth prospects. A weakening currency makes exports cheaper but imports become more expensive. If a country depends on exports for growth or imports of commodities for manufacturing, currency moves become critical to the economic outlook.

Finally, commodity prices may play an important role in global equity markets, especially in emerging economies, as many of these rely on commodity exports. As a result, they are heavily dependent on the prices raw materials command. If weak commodity values persist, many emerging economies may have a tough time meeting growth expectations, while producers such as mining firms may struggle to meet earnings forecasts.

Chart 6. U.S. EQUITIES HAVE LED DEVELOPED MARKETS SINCE THE LOW IN 2009



Source: Standard & Poor's, Financial Times, European Central Bank, Nihon Keizai Shinbun (Nikkei), Haver Analytics

THE ECONOMY...

The U.S. is leading the way among developed economies. The U.S. jobs market is gaining momentum and the tightening labor market should put upward pressure on wages. Better wage growth should in turn support continued growth in consumer spending. This positive dynamic or virtuous cycle is likely to become stronger in 2015 and is consistent with the positive results from our BCC leading indicators. The key themes to watch will be the strength of the gains in consumer purchasing power, energy prices and global growth.

...INFLATION...

Our inflationary pressures scorecard suggests that price pressures are moderating and that despite the pick-up in economic activity and tightening in the labor market, consumer price increases are likely to remain tame.

...THE FED...

The Fed is moving closer to policy normalization, likely raising interest rates in mid-2015, the first increase since 2006. Moving the fed funds target off the 0 to 0.25 percent lower bound may cause some volatility in markets initially, but is an important step towards restoring normal functioning in the financial system. The important thing to watch will be the pace and magnitude of future rate increases.

...WASHINGTON...

November's mid-term elections changed the balance of power in the U.S. Congress. With a newly acquired majority, Republicans are likely to reshape the nation's fiscal priorities. Potential areas of focus are overall spending cuts, tax cuts, defense spending plans, and the medical device tax that was established as part of the Affordable Care Act.

...BORROWING...

Consumer borrowing trends may play an important role in the growth of purchasing power for consumers in 2015. Over the past several years, slow and steady improvements in the labor market have helped Americans reduce their overall debt burdens and increase their savings. If job creation and wage gains continue in 2015, Americans may feel more confident about taking on new debt, which will increase purchasing power and boost spending.

...INVESTING

The outlook for fixed income markets in 2015 is not as much about whether rates will rise but when and by how much. The key things to watch will be the timing and pacing of Fed moves, as well as economic growth and inflation rates.

Most commodity prices experienced a major run-up in prices between 2001 and 2011 but have been roughly flat or have fallen since. The key theme for raw materials next year will be the extent to which global economic growth recovers, particularly in China, thereby pushing up demand.

The S&P 500 has tripled to 2,072.83 at the end of November from the low in 2009. Yet, its valuation as measured by the price-to-earnings (P/E) ratio is still roughly equal to the long-run average of about 17. For 2015, we continue to focus on the fundamentals of the U.S. stock market and expect continued improvement in the nation's economy to support sales and earnings growth, as well as valuations and equity prices.

Global economic growth is expected to accelerate slightly in 2015. As is the case with the U.S., better economic growth should support equity fundamentals internationally. Aside from the economic growth prospects underlying each individual equity market, we will also be watching currency values and commodity prices as each can have a significant impact on equity market performance.

CAPITAL MARKET PERFORMANCE

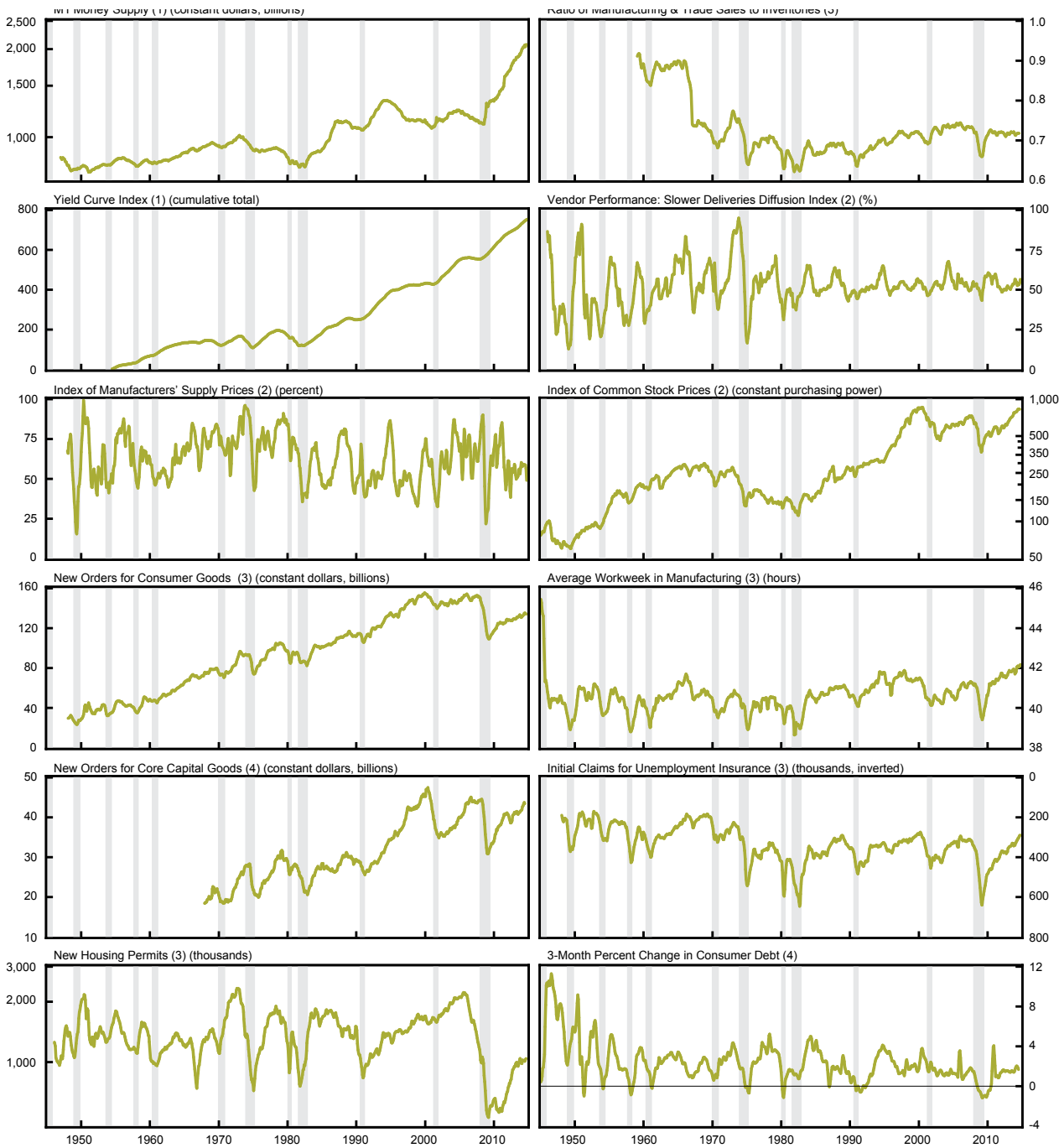
	Nov-14	3M	12M	2013	2012	2011	3 year*	5 year*	10 year*
Equity Markets									
S&P 1500	2.3	2.9	13.8	30.1	13.7	-0.3	18.3	13.9	6.1
S&P 500	2.5	3.2	14.5	29.6	13.4	0.0	18.4	13.5	5.8
S&P 400	1.7	0.3	10.6	31.6	16.1	-3.1	17.7	16.1	8.5
Russell 2000	0.0	-0.1	2.7	37.0	14.6	-5.5	16.7	15.1	6.4
FTSE Global All-Cap	1.3	-1.7	5.6	21.2	13.1	-10.0	15.3	8.0	--
FTSE Developed All-Cap	1.6	-1.2	5.9	24.7	12.9	-8.3	16.5	8.8	--
FTSE Emerging Mkt All cap	-0.8	-6.3	2.0	-6.4	14.9	-22.1	5.3	1.1	--
Bond Markets									
Ryan Labs Treasury Index Total Return	0.9	1.6	7.8	-6.6	2.9	16.2	1.9	4.6	5.1
Dow Jones Corporate Bond Index Total Return	0.9	0.6	7.3	-1.9	11.1	8.5	6.1	6.5	6.4
JP Morgan Emerging Market Bond Index TR	-0.4	-1.2	9.3	-6.6	18.5	8.5	6.7	7.9	8.2
Commodity Markets									
Gold	-4.3	-9.0	-7.8	-15.5	6.4	28.1	-12.2	1.1	10.4
Silver	0.4	-13.4	-16.7	-36.3	1.6	-7.6	-20.3	-1.6	9.6
CRB All Commodities	-2.2	-6.0	-0.6	-3.1	-9.6	19.6	-2.8	2.5	4.3

*=Annualized

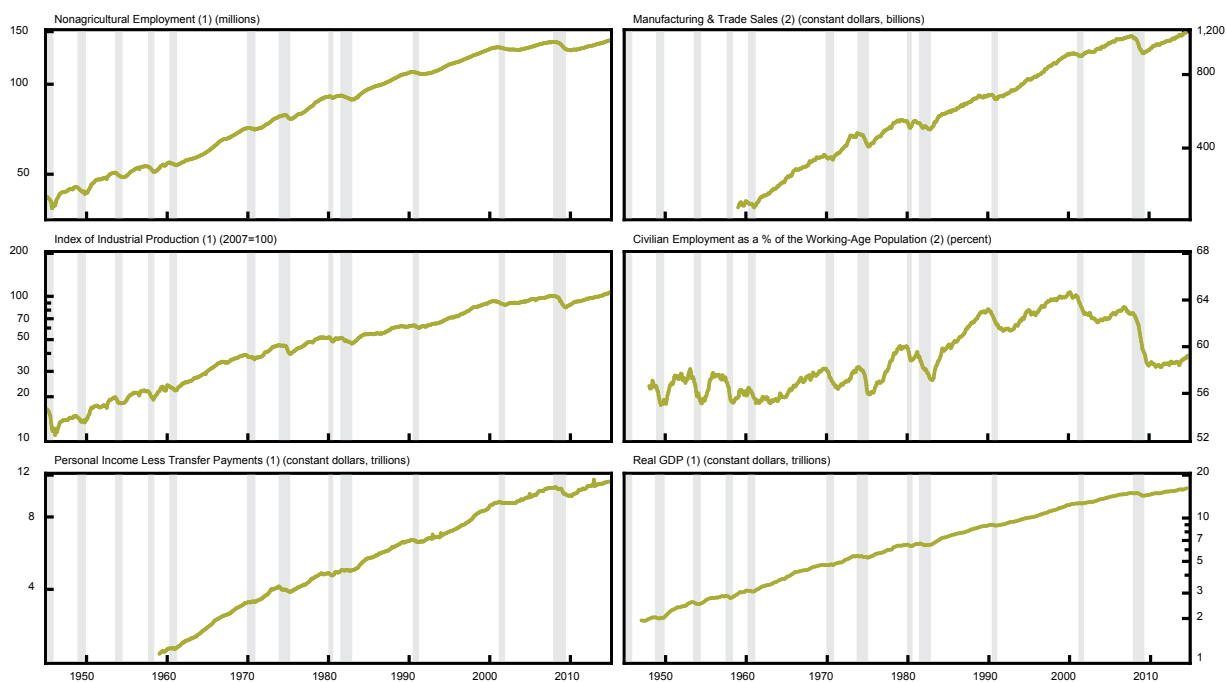
	Average Over Period								
	Nov-14	3M	12M	2013	2012	2011	3 year*	5 year*	10 year*
Consumer Finance Rates									
30-yr Fixed Mortgage	4.1	4.1	4.3	4.2	3.8	4.6	4.1	4.4	5.1
15-yr Fixed Mortgage	3.2	3.3	3.4	3.3	3.2	3.9	3.3	3.6	4.5
5-yr Adjustable Mortgage	3.6	3.6	3.6	3.4	3.0	3.3	3.3	3.5	--
Home Equity Loan	4.4	4.4	4.8	5.1	4.7	4.9	4.8	4.9	--
48-month New Car Loan	3.2	3.2	3.1	2.7	3.3	4.3	3.1	4.0	--

*=Annualized

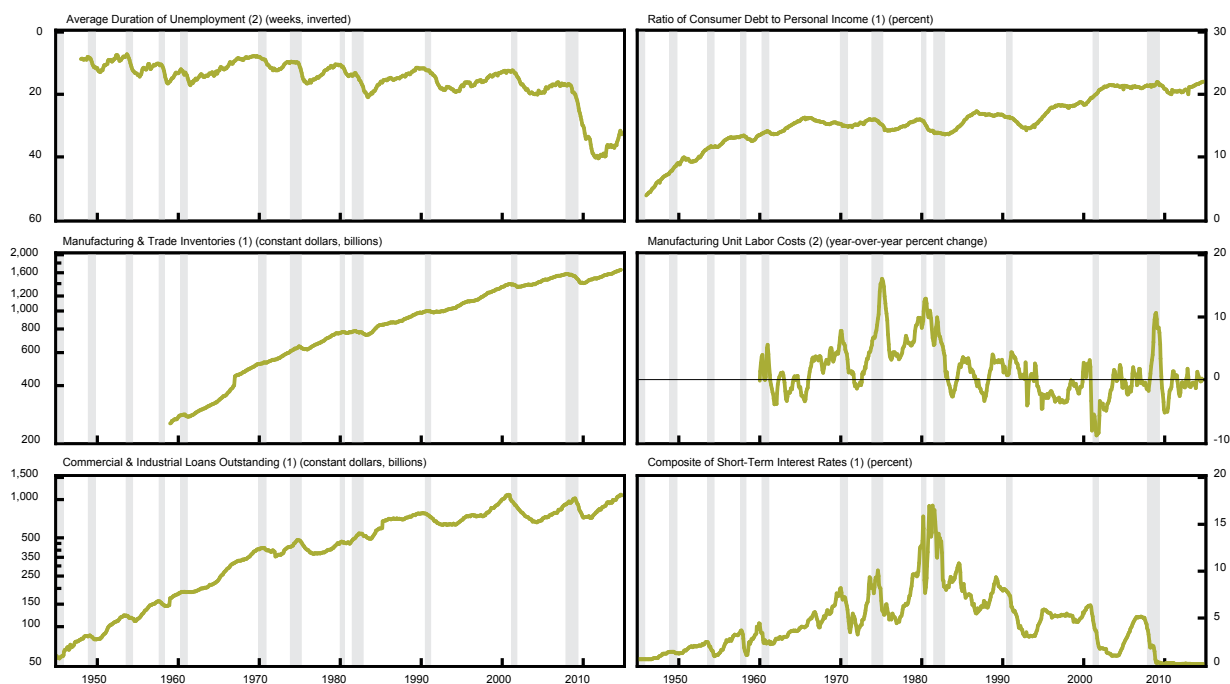
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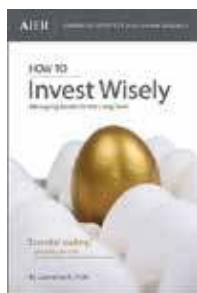
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