Outlook and Market Review – Third Quarter 2014

Third quarter GDP growth was revised upward to 3.9% by the Bureau of Economic Analysis following a very strong 4.6% growth rate in the second quarter. Strong preliminary sales data, lower gas prices, and an uptick in personal income in the early stages of the fourth quarter suggest good (but not great) growth of about 3%. Growth of about 3% in the fourth quarter, following strong second and third quarter growth, and a dismal contraction in the first quarter should result in annual growth of about 2.25% for the year.

Inflation pressures are nonexistent in either near term or long term forecasts. Lower energy prices have helped keep inflation low. Even the core inflation rate without food and energy continues to fall below Fed targets. Global growth was revised downward by the IMF, supporting a view that low inflation is a global phenomenon that will not be reversed soon. Inflation forecasts by professional forecasters have been revised downward, and very long run inflation forecasts are barely above the Fed's 2% target. There is improvement in the labor market, but it remains slow and steady. The highly publicized U-3 unemployment rate has fallen to 5.8% while the U-6 rate, based on a broad measure of unemployment and underemployment, remains at 11.5%.

Interest rates are low by historic standards with fed funds barely above zero and the 10-year Treasury rate at about 2.3%. But, on a relative basis, U.S. rates are very attractive to foreign investors. Given global geopolitical risks, the U.S. Treasury bond offers a safe haven investment with few alternatives. The strong value of the dollar, weak global economies, foreign trade surpluses, and prospects for low inflation all work in favor of high Treasury bond prices and low yields. While the total national debt remains at a staggering 17 trillion plus dollars, government deficits are now lower resulting in slower growth of the national debt. The supply of new Treasury bond issues to finance the debt is subsequently lower helping to keep Treasury bond prices up and yields down. This pattern suggests low long term interest rates for the near term.

Fed policy is expected to tighten short term rates in 2015 but that scenario is not a foregone conclusion. With low inflation expectations and annual growth lagging long term trend growth of 3.2% it would be a risky move for the Fed to move too quickly to raise rates. Even if the Fed did begin a gradual series of moves to raise the fed fund rate it would be very difficult to overcome global market pressures weighing down on long term Treasury yields. While it is difficult to believe that interest rates could remain artificially low for as long as they have, there are good reasons to believe that this condition can continue through 2015.

FOMC Minutes – The "Data Dependence" Signal

The September minutes of the Federal Reserve's Open Market Committee (FOMC) offered no surprises. Commitments to end the bond buying program at the end of this month were reaffirmed. The only controversy revolved around the wording of the Fed's view on when short term rates might be increased. The Fed stated its plans to keep the fed funds rate near its current level for a considerable time. The only question seems to be what the Fed means by a "considerable time." Back in March, Fed Chair Nancy Yellen suggested that a considerable amount of time would be no sooner than May, 2015. The September minutes reveal concern among FOMC members that the phrase "for a considerable time" might limit the flexibility of the Fed to act sooner if necessary while other members wanted to clearly signal that an increase is not eminent. The resolution seems to be a "data dependence" signal where the Fed pledges to keep short term rates near zero until inflation and jobs data warrant a change.

Movement to a "Neutral" Fed and "Normal" Interest Rates is Probably Premature

The Fed has a dual mandate of promoting full employment while also keeping inflation in check. So far, the Fed has made more progress on low inflation than full employment. Economic performance has picked up recently, growing at annual rates of 4.6% in the second quarter and 3.9% (revised) in the third quarter, while average monthly job growth has topped 200,000 for nine straight months. Nevertheless, the FOMC minutes recognized a lag between GDP growth and improvement of the unemployment rate and wages. The ample supply of workers continues to work against higher labor earnings and the U-3 unemployment rate of 5.8% masks underlying problems in worker participation rates and quality of employment. The U-6 unemployment rate, which adjusts for part time work and other measures of job search, is currently at 11.5%. The labor participation rate is currently at an historic low of 62.8%.

A number of factors beyond the weak labor market are currently working to hold back Fed moves to more normal interest rates. There are still doubts about the ability of the economy to reach and sustain full employment growth without easy credit. Industrial capacity utilization is almost 2% below the long run average and approximately 6% below full capacity where inflation pressures mount The housing recovery remained slow in all but a few areas of the country, despite extremely low mortgage rates. Slow growth in Europe and a strong value of the dollar is making U.S. exports more expensive and imports cheaper. Less government spending, designed to slow the growth of the national debt, is reducing stimulation from deficit spending. At the same time inflation remains dormant. The recent Survey of Professional Forecasters provided downward revisions of inflation estimates and forecasts of longer term inflation remain in line with Fed targets. The implied expectations of future inflation from the pricing of Treasury Inflation-Protected Securities (TIPS) are approximately 25 basis points below the Fed's 2% inflation target. Based on the interpretation of the Fed's "data dependent" approach to higher interest rates, the likelihood of an interest rate hike in the next few quarters seems small.

The Contrarian Case for Low Long Term Interest Rates

Most analysts seem to think interest rates will go up in 2015. Part of that logic is based on a long awaited move of the 10-year Treasury yield back to a normal spread of 200 to 300 basis points above inflation, which would put the long term rate at about 4% to 5%. For example, in a recent quarterly Bloomberg Global Poll, given a chance to speculate on only one asset class, 45 percent of respondents (investors, traders and analysts) picked debt securities as the most likely to fall in value (yields to rise). Over three times as many respondents in the survey chose bonds over gold. Government debt and junk bonds were the favorites for declining prices (higher yields) beating out other asset classes that included stocks, commodities, currencies and real estate. The market seems to think a strengthening U.S. economy and a more hawkish Fed will ultimately lead to higher yields. While higher long term rates in 2015 represents a consensus view, there are good reasons to believe that such a move is not yet in the cards.

Can the Fed Really Increase Long Term Rates?

While analysts are pondering whether or not the Fed *will* target higher long term interest rates in 2015, a more relevant question may be whether the Fed *can* effectively control long term rates in the current environment. Normally, the Fed first raises the short term fed fund rate making it more expensive for banks to borrow short term reserves. As expectations for higher short term rates builds, investors prefer short term debt that can be rolled over at higher rates in the future, rather than lock in existing long term rates. The dynamics in the bond market leads to a shift in demand from long term bonds to short term bonds. Long term bond prices fall and long term yields rise while short term bond prices rise and yields fall. The ultimate outcome is a steeper yield curve with higher long term rates. This is the same strategy Alan Greenspan followed from 2004 to 2006, but long-term bonds failed to take the expected path to higher rates. That failure of the Fed to achieve higher long term interest rates is partly responsible for the housing boom and subsequent financial crisis.

Complex Global Capital Flows

The lesson from the Greenspan era is that the dynamics of the bond market are complex and current global market capital flows will work against a Fed policy to push long term rates higher. Global capital flows are driven by differences in risk premiums, inflation rates, exchange rates, and trade balances that can frustrate domestic monetary policies. Movements of Treasury yields this year offer a case in point. The yield on the 10-year U.S. Treasury note fell 71 basis points in 2014 even as the Fed wound down its bond-buying program. Low global interest rates, a strong dollar, and geopolitical unrest around the globe resulted in a strong demand for U.S. long term bonds that more than offset the Fed's reduced demand.

The potential disconnect of Fed policy with long term interest rate movements poses a potential problem for Fed policy in 2015. Raising short-term rates in the face of stable or falling long-term rates could lead to a situation where the yield curve becomes very flat or even inverted. This unintended consequence could easily take place given the low and relatively flat shape of the existing yield curve. A flat or inverted yield curve discourages banks from extending credit because they finance long-term loans with short-term debt. The only fallback left for the Fed in this situation would be to sell from their portfolio of long term bonds in an attempt to counteract market flows and support higher long term yields.

Is the Fed's War Chest of Long Term Bonds Going to Offset Global Demand?

If the Fed resorts to selling long term bonds the challenge will be to offset a "global savings glut" that is putting downward pressure on U.S. long term rates. Large trade deficits in the U.S. have provided ample dollars in the global market seeking dollar denominated returns. Europe alone is generating a current account dollar surplus of about $400 billion per year. It is almost a foregone conclusion that most of the accumulated surpluses around the world will be used to buy dollar denominated assets, especially long term bonds. Figure 1 illustrates the relationship between the 10-year U.S. Treasury and the 10-year German Bund over time. The Treasury bond –German bund spread is an indicator used to predict investor fund flows to the competing U.S. and German "safe haven" bond investments. Currently, the spread has jumped to 160 basis points from a more normal 60 to 80 basis points. An investor would find a 2.4% yield on a 10-year Treasury today to be very attractive compared to the 0.8% yield on the 10-year German bund or 0.5% on the Japanese bond.

Figure 1. Yield Spread between the U.S. 10-Year Treasury and the 10-Year German Bund

(U.S. 10-Year Bond Yield – German 10-Year Bund Yield)

Note....the spread has now jumped to 160 basis points!

Source: Bloomberg, Guggenheim Investments

In the near term, economic troubles in the euro area (reducing the appeal of the euro as a safe haven investment) and appreciation of the dollar also promote the view of strong prices and relatively low yields of the 10-year U.S. Treasury. Figure 2 illustrates the strength of the U.S. dollar relative to the euro. Add expectations for a very low inflation rate in the U.S. and it is clear that the Fed's long term bond sales will need to overcome strong global demand, making it unlikely that long term interest rates will have strong upward pressures anytime soon.

Figure 2. Euro per Dollar Exchange Rate (June 2013 to November 2014)

Source: eXchangeRate.com

Survey of Professional Forecasters – Low Inflation with Modest Growth

The panel of 42 economists in the Survey of Professional Forecasters cut their estimates of inflation. The survey released on November 17 of this year, reveals a consensus view that inflation will stay at or below the Fed's 2% target at least through 2016. Inflation below 2% runs counter to expectations of higher interest rates in 2015. Inflation above 2% to 2.5% is considered by the Fed to be a sign of economic recovery allowing a return to a more neutral monetary policy and a higher fed fund rate.

Low Near-Term Inflation

Table 1 shows survey estimates on a quarter-to-quarter basis for both the consumer price index (CPI) and the personal consumption expenditure index (PCE). The green numbers indicate downward revisions by forecasters since the last release of the Survey of Professional Forecasters three months ago. For all inflation measures in each of the next four quarters the forecasters lowered inflation estimates. Forecasters expect current-quarter headline CPI inflation to average 1.0%, lower than the last survey's estimate of 2.0%. The forecasters predict current-quarter headline PCE inflation of 1.2 %, lower than the prior prediction of 1.9%.

Table 1. Quarterly Forecasts of Average Annual Inflation

Forecast	IVQ 2014	IQ 2015	IIQ 2015	IIIQ 2015	IV Q 2015
Headline CPI - Previous	2.0	2.1	2.2	2.1	NA
Headline CPI- Recent	**1.0**	**1.8**	**1.9**	**2.0**	**2.0**
Core CPI-Previous	2.1	2.2	2.1	2.1	NA
Core CPI - Recent	**1.7**	**1.9**	**1.9**	**1.9**	2.0
Headline PCE-Previous	1.9	2.0	2.0	2.0	NA
Headline PCE-Recent	**1.2**	**1.7**	**1.8**	**1.8**	1.9
Core PCE-Previous	1.9	1.9	2.0	1.9	NA
Core PCE-Recent	**1.6**	**1.7**	**1.7**	**1.8**	1.8

Source: Survey of Professional Forecasters, Federal Reserve Bank of Philadelphia, November 17, 2014 release date. Consensus is defined as the median forecast of the 42 forecasters.

Table 2 shows the survey inflation estimates for 2014, 2015, and 2016. The downward revisions of inflation are not just for the near term. Forecasters also see lower headline and core measures of CPI and PCE inflation into 2015 and 2016. Headline CPI inflation is expected to average 1.9% in 2015, down from 2.2% in the last survey, and 2.1% in 2016, down 0.2% from the previous estimate. Forecasters expect headline PCE inflation to average 1.8% in 2015 (down from 2.0% in the last survey) and 1.9% in 2016 (down 0.1% from the previous estimate).

Table 2. Average Annual Inflation Forecasts

Forecast	2014	2015	2016
Headline CPI- Previous	2.3	2.2	2.3
Headline CPI - Recent	**1.8**	**1.9**	**2.1**
Core CPI - Previous	2.1	2.1	2.2
Core CPI - Recent	**1.8**	**2.0**	**2.0**
Headline PCE - Previous	1.8	2.0	2.0
Headline PCE - Recent	**1.5**	**1.8**	**1.9**
Core PCE - Previous	1.7	1.9	1.9
Core PCE - Recent	**1.5**	**1.8**	**1.8**

Source: Survey of Professional Forecasters, Federal Reserve Bank of Philadelphia. Consensus is defined as the median forecast of the 42 forecasters.

Table 3 shows long run inflation estimates from the Survey of Professional Forecasters. Even for the very long run, forecasters see the ten-year annual-average CPI and PCE inflation to be 2.2% and 2%, respectively.

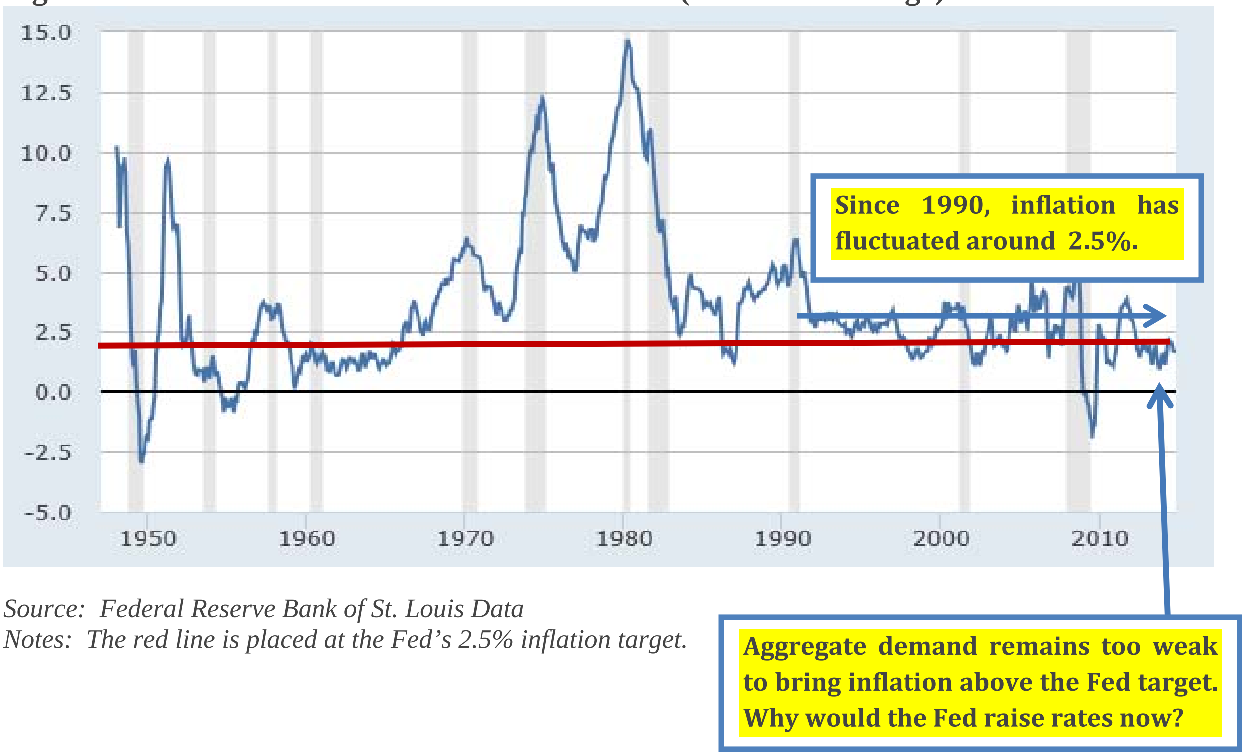
Table 3. Long Run Average Annual Inflation Forecasts

Forecast	2014-2018	2014-2023
Headline PCI-Previous	2.2	2.2
Headline PCI - Recent	**2.09**	2.2
Headline PCE- Previous	2.0	2.0
Headline :PCE - Recent	**1.9**	2.0

Source: Survey of Professional Forecasters, Federal Reserve Bank of Philadelphia.

Forecasters see low inflation going forward and recent downward revisions in inflation estimates suggest that the last two quarters of higher than expected growth have not altered their views. Figure 3 presents past inflation history and illustrates that inflation rates have fluctuated around 2.5% since 1990 and below 2.5% since the 2009 recession. Signs of an improved recovery in the second half of 2014 are not changing that scenario from the perspective of forecasters. Even with GDP growth averaging about 4.3% in the second and third quarter of this year, the current annualized inflation rate for 2014 is only 1.4%. The Fed may discount the lower than expected price pressures based on the view that falling oil prices and lags in labor market strength are temporary drivers of price moderation. Even so, it may be difficult for the Fed to make moves to higher interest rates until stronger inflation pressures materialize. Fed officials would like to see confirmation of their inflation expectations before they move to fully reverse the long held expansionary policy. Two quarters of growth that are back on the trend line growth path is not likely to be enough validation of a return to a strong private sector recovery.

Figure 3. CPI Inflation Timeline 1948 to Present (Annual % change)



Source: Federal Reserve Bank of St. Louis Data
Notes: The red line is placed at the Fed's 2.5% inflation target.

Survey of Professional Forecasters – GDP and the Labor Market

The Survey of Professional Forecasters consensus outlook for growth in the U.S. economy is slightly lower than in the survey three months ago. While growth in the last two quarters was higher than expected, forecasters continue to call for below-trend line growth. The consensus forecast calls for real GDP grow at an annual rate of 2.7% this quarter and 2.8% next quarter. A summary of quarterly GDP forecasts from both the prior and revised surveys of professional forecasters appears in Table 4. Downward revisions in GDP appear in red.

Table 4. Quarterly Consensus Real GDP Growth Estimates (median estimates)

Forecast	IVQ 2014	IQ 2015	IIQ 2015	IIIQ 2015	IV Q 2015
Previous Estimate	3.1	3.1	3.1	3.0	N.A.
Recent Estimate	**2.7**	**2.8**	3.1	**2.8**	3.0

Source: Survey of Professional Forecasters, Federal Reserve Bank of Philadelphia.

Table 5 provides consensus forecasts of annual-average over annual-average real GDP for 2014 through 2017. The estimate for 2014 is slightly higher (noted in green) due to higher than expected growth in the second and third quarters. Even so, the 2.2% growth rate for the year is well below what might be expected in a recovery. Real GDP is expected to grow at 3% in 2015, 2.9% in 2016, and 2.7% in 2017. These modest growth rate estimates are in line with the low inflation estimates noted earlier.

Table 5. Average Annual Real GDP Growth Estimates

Forecast	2014	2015	2016	2017
Prior Estimate	2.1	3.1	2.9	2.8
Recent Estimate	**2.2**	**3.0**	2.9	**2.7**

Source: Survey of Professional Forecasters, Federal Reserve Bank of Philadelphia.

The labor market continues to show modest improvement but a low labor force participation rate makes it difficult to translate a given unemployment rate into a threshold for full employment. Continued reductions in the unemployment rate could easily take place without price pressures as long as there is an ample labor supply "reserve" that might enter the workforce at some point. While the unemployment rate has moderated to 5.8%, the lack of inflation pressure suggests that there remains a lot of room before full employment is reached. Table 6 shows the quarterly consensus forecast for the unemployment rate and monthly payroll increases

Table 6. Quarterly Unemployment Rate and Payroll Estimates

Forecast	IVQ 2014	IQ 2015	IIQ 2015	IIIQ 2015	IV Q 2015
Unemployment % (U-3)					
Prior Estimate	6.0	5.8	5.8	5.6	N.A.
Recent Estimate	**5.9**	5.8	**5.7**	5.6	5.5
Payrolls (Thousands per Month)					
Prior Estimate	211.1	208.3	209.2	200.7	N.A.
Recent Estimate	211.6	**211.2**	**195.4**	**208**	201.3

Source: Survey of Professional Forecasters, Federal Reserve Bank of Philadelphia.

While payroll expansion of about 200,000 per month may seem healthy it does not make much progress toward lowering the unemployment rate. Forecasters expect the unemployment rate to fall to 5.5% by the end of next year. What is not clear is whether the labor force participation rate will keep up with the pace of employment. Table 7 presents the longer run employment estimates from the Survey of Professional Forecasters. While gradual, forecasters see continued reductions in the unemployment rate to 5.2% in 2017.

Table 7. Annual Unemployment and Payroll Estimates

Forecast	2014	2015	2016	2017
Unemployment % (U-3)				
Prior Estimate	6.3	5.7	5.4	5.3
Recent Estimate	**6.2**	**5.6**	5.4	**5.2**
Payrolls (Thousands per Month)				
Prior Estimate	204.8	214	N.A.	N.A.
Recent Estimate	**206.4**	**212.3**	N.A.	N.A.

Source: Survey of Professional Forecasters, Federal Reserve Bank of Philadelphia.

International Monetary Fund – World Economic Outlook and Revision

Table 8 provides the October 7th IMF growth estimates and revisions from the April report. Global GDP growth is estimated to be 3.3% for 2014 and 3.8% in 2015. Downside risks to global growth increased since the mid-year forecasts, illustrated by the number of downward growth revision marked in red. Overall, the global economic recovery continues to be uneven and modest. The IMF report generally downgraded "potential growth" rates, defined as the growth rate at which annual output can expand without stimulating inflation. Weak investment in real assets is the key culprit in the lower potential growth rates.

Table 8. IMF Global Growth Projections and Recent Revisions (percentage change)

Country/Area	2012	2013	2014	2015	Revisions+ 2014	Revisions+ 2015
World Output	3.4	3.3	3.3	3.8	**-0.1**	**-0.2**
Advanced Economies	**1.2**	**1.4**	**1.8**	**2.3**	**0.0**	**-0.1**
United States	2.3	2.2	2.2	3.1	0.5	0.0
Euro Zone	-0.7	-0.4	0.8	1.3	**-0.3**	**-0.2**
Germany	0.9	0.5	1.4	1.5	**-0.5**	**-0.2**
*France	0.3	0.3	0.4	1.0	**-0.4**	**-0.5**
Italy	-2.4	-1.9	-0.2	0.8	**-0.5**	**-0.3**
Spain	-1.6	-1.2	1.3	1.7	0.1	0.1
Japan	1.5	1.5	0.9	0.8	**-0.7**	**-0.2**
United Kingdom	0.3	1.7	3.2	2.7	0.0	0.0
Canada	1.7	2.0	2.3	2.4	0.1	0.1
Non-G7 Countries	2.0	2.3	2.9	3.1	0.0	**-0.1**
Emerging and Developing Economies	**5.1**	**4.7**	**4.4**	**5.0**	**-0.1**	**-0.2**
Commonwealth of Independent States	3.4	2.2	0.8	1.6	**-0.1**	**-0.5**
Russia	3.4	1.3	0.2	0.5	0.0	**-0.5**
Excluding Russia	3.6	4.2	2.0	4.0	**-0.4**	**-0.4**
Emerging and Developed Asia	6.7	6.6	6.5	6.6	0.1	0.0
China	7.7	7.7	7.4	7.1	0.0	0.0
India	4.7	5.0	5.6	6.4	0.2	0.0
ASEAN-5++	6.2	5.2	4.7	5.4	0.1	**-0.2**
Latin America and Caribbean	2.9	2.7	1.3	2.2	**-0.7**	**-0.4**
Brazil	1.0	2.5	0.3	1.4	**-1.0**	**-0.6**
Mexico	4.0	1.1	2.4	3.5	0.0	0.1
Mid. East, North Africa, Afghanistan, Pakistan	4.8	2.5	2.7	3.9	**-0.4**	**-0.9**
Sub-Saharan Africa	4.4	5.1	5.1	5.8	**-0.4**	0.0
South Africa	2.5	1.9	1.4	2.3	**-0.3**	**-0.4**

Source: IMF, World Economic Outlook, October 2014
Notes: + Revisions measured from July 2014 to October 2014 forecasts.
++ ASEAN-5 represents Indonesia, Malaysia, Philippines, Thailand, and Vietnam

Advanced economies as a whole are expected to grow 1.8% in 2014 and 2.3% in 2015. The IMF forecast for U.S. growth is slightly higher than the forecast from the Survey of Professional Forecasters. Annual growth is expected to reach 3.1% in 2015. Growth for the euro zone countries has been revised downward and remains fragile. Growth is expected to be slow and gradual with a compression in interest rate spreads between sound and stressed countries. Long term interest rates in the core euro area countries are in record-low territory and monetary stimulus continues. France and Italy continue to be the weakest members in the euro area. Japan is the weakest of the advanced economies.

The best growth prospects are expected to be in emerging market and developing economies. The growth forecast of 4.4% for 2014 is lower than expected earlier in the year, largely due to tensions linked to Russia and neighboring countries. China's growth is likely to ease down to a more sustainable level of 7.4% in 2014-15.

Growth prospects in Latin America are expected to fall significantly to around 1.3%. Declining exports and links to slower global growth should ease allowing growth to rebound to about 2.2% in 2015, according to the IMF.

The IMF revised growth estimates downward for the Middle East and North Africa. Improvements in domestic security and external demand are expected, but fragile. Conditions for Russia and other parts of the Commonwealth of Independent States are also fragile as geopolitical events pose high risk.

Summary of Recent Economic Data

GDP and Output *– Economic growth exceeded long run trend growth for two consecutive quarters based on broad based improvements. Only private investment remains as a stumbling block to improved performance. It is unlikely that the economy can sustain the last two quarters of growth over 3.5%.*

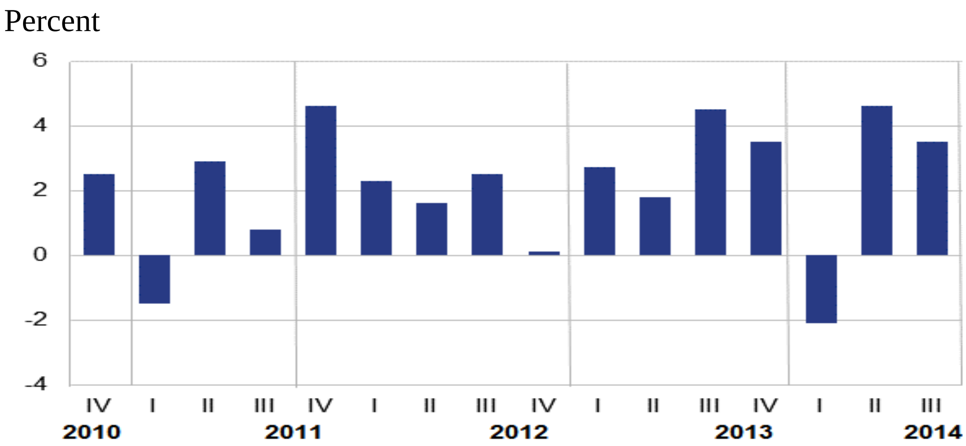
- Based on the first revision of Real GDP growth by the Bureau of Economic Analysis, the U.S. grew at an annual rate of 3.9% in the third quarter of 2014. Second quarter GDP growth was 4.6%.

- Positive contributions to third quarter GDP came from personal consumption expenditures, exports, nonresidential fixed investment, federal government spending, and state and local government spending. Negative contributions came from private inventory investment and imports.

- Consumer spending decelerated in the third quarter, increasing 1.8% after increasing 2.5% in the second quarter. Spending on nondurable and durable goods both slowed, while spending on services picked up. Business investment rose but not as much as in the second quarter. Investment in structures, equipment, and intellectual property products slowed. Exports of goods and services decelerated.

- Real final sales of domestic product, GDP less the change in private inventories, increased 4.2% in the third quarter, compared with an increase of 3.2% in the second.

Figure 4. Real GDP by Quarter (Seasonally Adjusted Annual Data)



Source: U.S. Bureau of Economic Analysis

***Personal Income and Personal Saving** – Personal income rebounded in the second and third quarters of 2014. Consumer use of credit also increased, helping to fuel higher than normal GDP growth.*

- Real disposable personal income, which adjusts for taxes and inflation, rose 2.7% in the third quarter after increasing 4.4% in the second quarter. Current-dollar disposable personal income rose 0.1% in September after rising 0.3% in August.

- Personal income rose 0.2% in September after rising 0.3% in August. Wages and salaries, the largest component of personal income, rose 0.2% in September after rising 0.5% in August.

- Personal saving as a percentage of Real Disposable Income increased to 5.5% in the third quarter from 5.4% in the second quarter. The increase of savings in the third quarter reverses a general trend of lower savings.

- Consumer credit increased at a seasonally adjusted annual rate of 6.5% during the third quarter. Revolving credit increased at an annual rate of 3%, while non-revolving credit increased at an annual rate of 8%. In September, consumer credit increased at an annual rate of 6%.

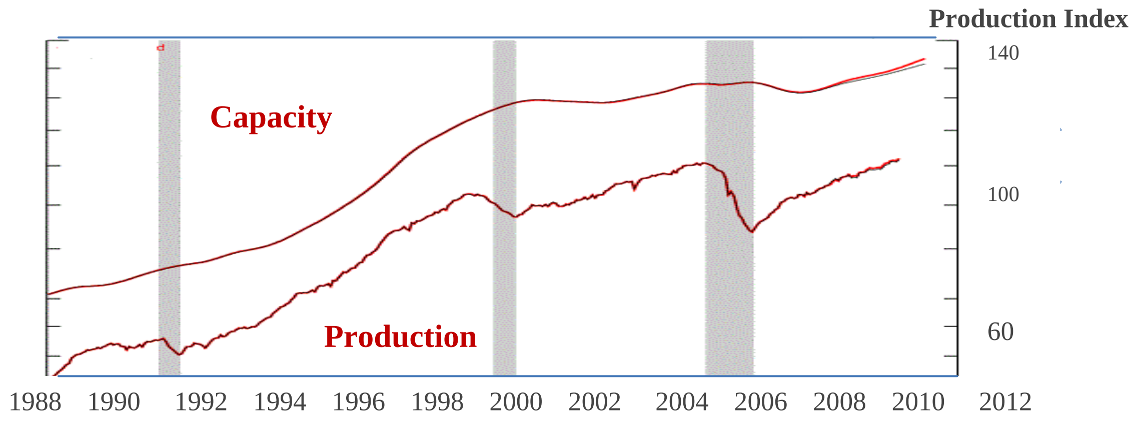
***Production** – Manufacturing posted good growth in the second and third quarters but has slowed in the most recent months. Capacity utilization fell to 78.9%, well below the 85% rate that roughly marks full employment. Capacity utilization in October was about 4% above utilization one year ago but was 1.2% below the long run average, suggesting that there is room for expansion before bottlenecks lead to price pressure.*

- Manufacturing output increased 0.2% in October for the second consecutive month. The index for mining declined 0.9% and the output of utilities fell 0.7%. Motor vehicle production fell 1.9% in September and 1.2% in October. There were also drops in the production of nonmetallic mineral products, as well as electrical equipment, appliances and components. Weaker manufacturing numbers going into the end of the year suggest a slower growth rate for the fourth quarter.

- Factory production rose 0.2% in October. September's increase in factory output was revised down to 0.2% from 0.5%. A growth rate of about 2% in fourth quarter GDP is consistent with the October production numbers. Industrial production fell 0.1% in October after advancing 0.8% in September.

- In October the industrial production index reached 104.9% of its 2007 average. Total industrial production in October was 4.0% above its level of a year earlier. Figure 5 shows the relationship between industrial production (blue) and industrial capacity (red). While industrial production is expanding it continues to lag behind capacity growth.

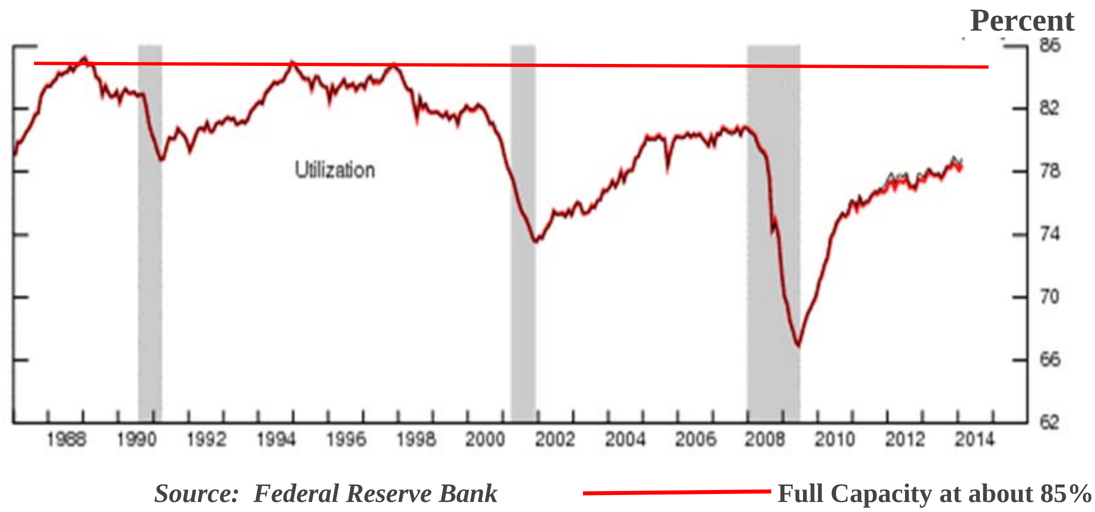
Figure 5. Industrial Production and Capacity



Source: Federal Reserve Bank

- Capacity utilization for the industrial sector, illustrated in Figure 6, fell 0.3% in October to 78.9%, a rate that is 1.2% points below its long-run (1972–2013) average and about 6% below full capacity.

Figure 6. Capacity Utilization

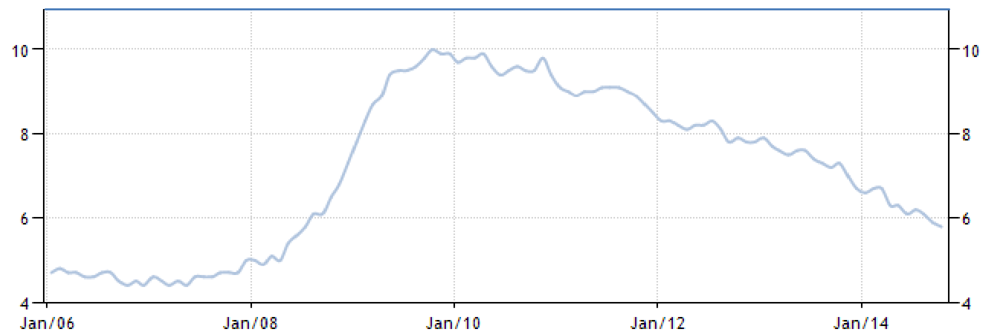


Source: Federal Reserve Bank

***Labor and Unemployment** – The U-3 unemployment rate continues to ease downward, reaching 5.8% in October. The broader U-6 unemployment rate also declined to 11.5% from 11.8%. Weakness behind the numbers continues as the labor force participation rate remains at an historic low of 62.8%.*

- The unemployment rate (U-3) eased down to 5.8% in October as the number of unemployed persons fell to nine million. The U-3 rate fell by .8% with a reduction in unemployed persons of 1.2 million since the start of the year. Figure 7 shows the U-3 unemployment rate since January 2006.
- The number of long-term unemployed, defined as persons who are jobless for 27 weeks or more, remained at 2.9 million. The long-term unemployed represent 32% of the unemployed.

Figure 7. U-3 Unemployment Rate for the U.S. (January 2006 to Present)



Source: Bureau of Labor Statistics

- The civilian labor force participation rate was little changed at 62.8% in October, remaining close to an historic low. Figure 8 shows the declining pattern of the labor force participation rate since the Great Recession. The employment-population ratio increased to 59.2% in October.

Figure 8. Labor Force Participation Rate (January, 2004 to October, 2014)

Source: Bureau of Labor Statistics

- Involuntary part-time workers, representing persons employed part time for economic reasons, was about unchanged in October at 7.0 million. These persons would have preferred full-time employment and have part time jobs because their hours had been cut back or because they were unable to find a full-time job.

- Persons who are marginally attached to the labor force remained unchanged in October at 2.2 million. These persons were counted in the labor force. They want and are available for work and have looked for a job sometime in the prior 12 months. They were not counted in the calculation of the U-3 unemployment rate because they had not searched for work in the 4 weeks prior to the survey. Of the marginally attached persons there were 770,000 discouraged workers who are not looking for work because there are no jobs that match their skill set.

- The U-6 unemployment rate was 11.5% in October, down slightly from 11.8% in September and 12% in August. The U-6 unemployment rate is a broader measure than the more traditional U-3 rate. The base for the U-6 rate includes persons seeking full-time employment (the more familiar U-3 rate) as well as marginally attached workers and part-time workers for economic reasons. Part-time workers counted as employed by U-3 could be working as little as an hour a week and marginally attached workers include those who have gotten discouraged and stopped looking, but still want to work.

- Real average hourly earnings for all employees rose 0.1% from September to October. Real average weekly earnings increased 0.4% over the month due to the increase in real average hourly earnings combined with a 0.3% increase in the average workweek.

- For the year from October 2013 to October 2014 real average hourly earnings increased 0.4%, seasonally adjusted. This increase in real average hourly earnings, combined with a 0.6% increase in the average workweek, resulted in a 0.9% increase in real average weekly earnings over the past year.

- Compensation costs for civilian workers increased 0.7%, seasonally adjusted, for the 3-month period ending September 2014. Wages and salaries (which make up about 70% of compensation costs) increased 0.8%, and benefits (which make up the remaining 30% of compensation) increased 0.6%.

Inflation **-** *All inflation indicators remain in line with or below the Fed's target of 2%. Lower energy prices have helped bring the all items CPI down but even the core CPI, without energy and food components, has remained calm. Overall, both the all items and core CPI inflation numbers have been less volatile. The long run inflation rate implied by pricing of the Treasury Inflation Protected Securities is 2.15% and has fallen about 50 basis points from one year ago.*

- The Consumer Price Index for All Urban Consumers (CPI-U) was unchanged in October on a seasonally adjusted basis. Over the last 12 months, the all items index increased 1.7% before seasonal adjustment.

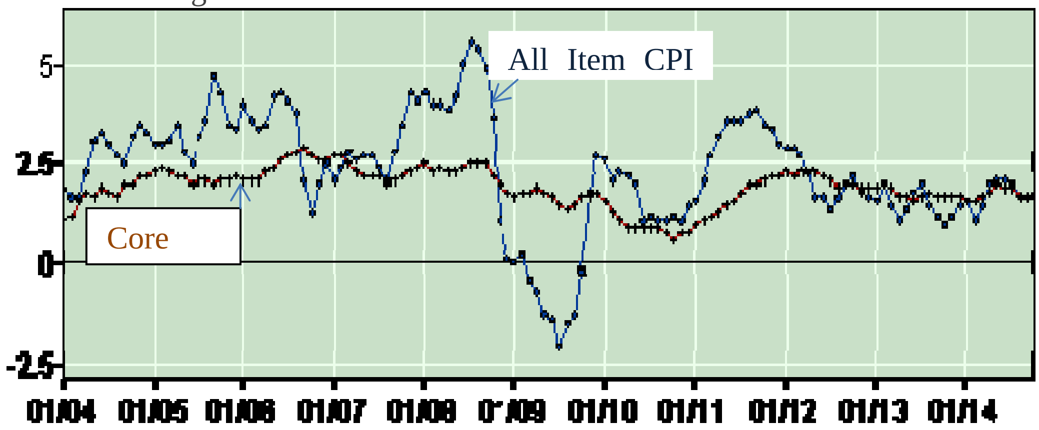
- The gasoline index fell for the fourth month in a row, declining 3%. The indexes for natural gas and fuel oil also declined. The food index rose slightly in October.

- The core index for all items less food and energy increased 0.2% in October. Higher price indexes occurred for shelter, airline fares, household furnishings and operations, medical care, recreation, personal care, tobacco, and new vehicles. The indexes for used cars and trucks and for apparel declined in October.

- The all items index increased 1.7% over the last 12 months, the same increase as for the 12 months ending September. The index for all items less food and energy increased 1.8% over the span, and the food index rose 3.1%. In contrast, the energy index declined 1.6% over the last 12 months. Figure 9 shows the all-item and core CPI index from January 2004 to present.

Figure 9. Consumer Price Index for All Urban Consumers (All Items and Core Items)

12-Month % Change



Source: Bureau of Labor Statistics

- The price index for gross domestic purchases, which measures prices paid by U.S. residents, increased 1.3% in the third quarter, compared with an increase of 2% in the second quarter. Excluding food and energy prices, the price index for gross domestic purchases increased 1.5%, compared with an increase of 1.7%.

- The personal consumption expenditure index (PCE), the Fed's favorite measure of inflation, increased 0.1% in September after decreasing 0.1% in August. Excluding food and energy, the core PCE index increased 0.1% in September, the same increase as in August.

- A measure of the outlook for annual inflation over the five-year period that begins five years from now, derived from yields on Treasury Inflation-Protected Securities, has fallen to 2.15% from 2.69% on Dec. 31. The decline reflects a drop in the price investors are willing to pay for protection against an unexpected jump in inflation.

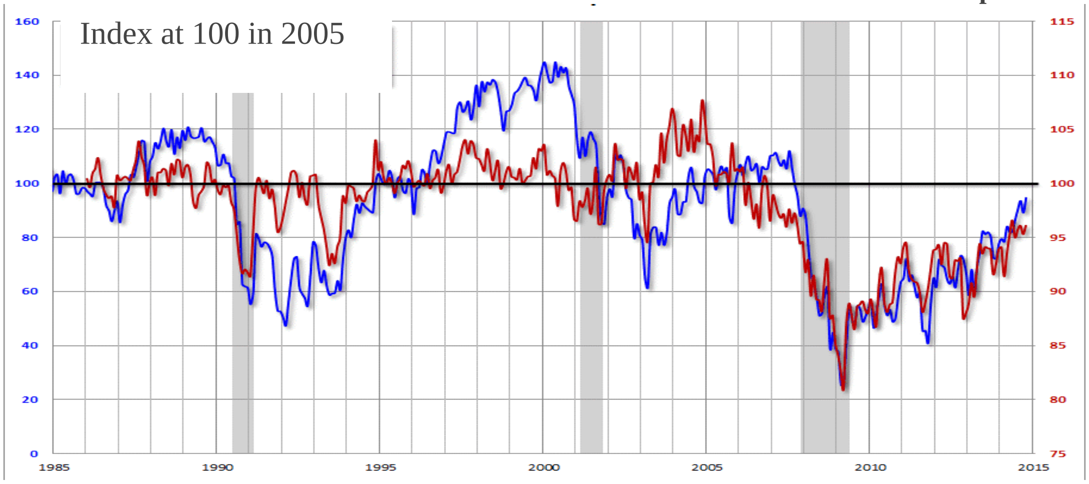
Sentiment and Confidence Index – *The Thomson Reuters/University of Michigan Consumer Confidence Index continues to improve slowly. The index reached 86.9 in October compared to a long run average of about 85. Overall, confidence shows good, but not great, support for consumer demand going into 2015.*

- The Thomson Reuters/University of Michigan's overall index of consumer sentiment reached 89.4 in November from 86.9 in October. Consumer Confidence in the United States averaged 85.06 from 1952 until 2014, reaching a high of 111.40 in January of 2000 and a record low of 51.70 in May of 1980.
-
- **Figure 9. ThomsonReuters/University of Michigan Consumer Sentiment Index**

Index

- The Conference Board Consumer Confidence Index® fell in September but rebounded in October. The Index now stands at 94.5 (1985=100). The Present Situation Index edged up from 93.0 to 93.7, while the Expectations Index increased sharply to 95.0 from 86.4 in September. Figure 10 illustrates movement of the Conference Board Consumer and Business Optimism indexes relative to the base year index of 100 in 2005.

Figure 10. Consumer Confidence Index (Left Axis) and NRB Optimism Index (Right Axis)



- **The Conference Board Leading Economic Index®** (LEI) for the U.S. increased 0.9% in October to 105.2 following a .7% increase in September. There was no change in the index in August. The index was set at 100 in 2005. The upward trend in the LEI points to continued economic growth into early 2015.

International Update – *The IMF outlook for global growth has been revised downward (see section on IMF global growth). The strong dollar is expected to hurt the U.S. balance of trade going forward.*

- Based on the preliminary estimate the U.S. current-account deficit fell to $98.5 billion in the second quarter of 2014 from $102.1 billion in the first quarter. The deficit decreased to 2.3% of current-dollar gross domestic product (GDP) from 2.4% in the first quarter.

- Greece's economy finally pulled out of recession in the third quarter, after six years of declining output brought about due to the 2008 financial crisis and its public debt crisis. The Greek economy grew 1.7% as compared to a year ago, making it one of the fastest growing economies in the Euro-zone. Increases in both tourism and domestic consumption boosted national output.

- Japan's economy slid back into recession as national output fell again in the third quarter, dragged down by companies holding back on capital spending and cutting inventories.