CAPITAL MARKETS ECONOMICS

Derek Holt (416) 863-7707
derek.holt@scotiabank.com

Dov Zigler (416) 862-3080
dov.zigler@scotiabank.com

Special Report: US Economic Outlook — Enter The Bear Flattener

We view this recovery as having only just begun in earnest and believe in a fairly bullish outlook with upside risks to our growth and interest rate forecasts. In contrast to the tail risk offered up within the range of consensus opinions that the expansion is already growing old and threatens to turn south, we think the bigger tail risk to consensus forecast opinions over 2014-15 lies in the direction of a stronger-than-expected US recovery with Bloomberg's consensus at 2.6% in 2014 and 3% growth in 2015.

As a consequence, whereas the past couple of years have been all about Treasury curve steepening to among the wider 10s minus 2s spreads on record, **we view the next two years as being about a shift toward a bear flattener environment (chart 1)**. Because we think the Fed's forward rate guidance will be more directly challenged by markets going forward, we see the flatteners shown in chart 1 as facing the risk of greater than forecast curve flattening.

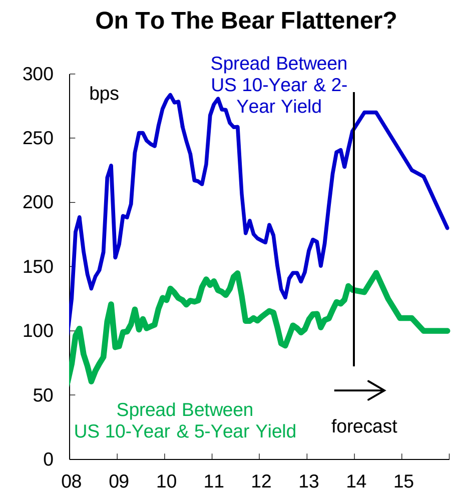
Still A Young Expansion...

We start by rejecting the argument that this is becoming a lengthy expansion that risks running out of gas. True, at 55 months, the current US economic expansion is already longer than any pre-WWII economic expansion and lies just a few months away from the average post-WWII expansion, but averages can be misleading.

There is no hard science on defining the lengths of business cycles such that citing the length of the current one as necessarily begetting weakness ahead is far too simplistic. Recall the famous quip from former Fed Chairman Alan Greenspan and pending Fed Chair Janet Yellen in the 1990s that "expansions don't die of old age" as the expansion then continued until March 2001. The theory on business cycles will probably never be advanced enough to give us any hard and fast rules of thumb on factors driving the length of economic expansions.

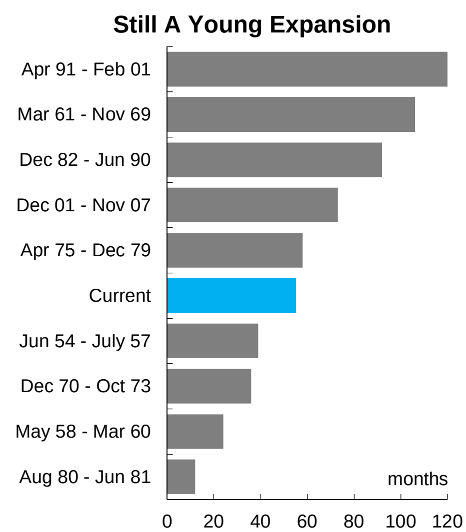
It is also important to note that some of the expansions over the post-war period were uninspiring and skewed the sample lower. Take, for example, the brief expansion from August 1980 ending in June 1981 as the US experienced back-to-back recessions in the early 1980s. Or take the recession of April 1960 until February 1961 that followed the recession that ended in 1958. As chart 2 demonstrates, however, **no fewer than five expansion periods were longer than the current one to date.** The granddaddy of them all was the one that ended in February 2001 and which lasted for 120 months — or more than twice as

Chart 1



Source: Bloomberg, Scotiabank Economics.

Chart 2



Source: NBER, Scotiabank Economics.

Scotiabank Economics

Scotia Plaza 40 King Street West, 63rd Floor
Toronto, Ontario Canada M5H 1H1
Tel: (416) 866-6253 Fax: (416) 866-2829
Email: scotia.economics@scotiabank.com

Continued —

long as the current expansion — and before excessive leverage really distorted the next cycle. By comparison to these periods, we could easily have a long way to go yet.

Indeed, by the end of this year, the current expansion will still be exceeded by four others in the post-war era. Even by the end of next year, if the expansion continues uninterrupted as we think it will, then there will still be three longer post-war expansions and one of comparable length to what by then would be a 78 month long current expansion.

…And It Remains The Weakest On Record

As chart 3 demonstrates, **the current expansion has also been the weakest of any post-war recovery**. Indexed to the start of each cycle's respective expansion period following recessions, every other post-WWII expansion had registered faster cumulative growth in inflation-adjusted GDP than the current expansion. That too would counsel against viewing this as an expansion that risks fizzling out. A still-large output gap and no evidence of inflationary pressures or excessive inventory cycles argue against an exhausted cycle facing overheating risks.

Upside Risks To Drive The Growth Outlook

Returning to our rationale for arguing that risks to our forecast lie to the upside entails addressing a few core arguments.

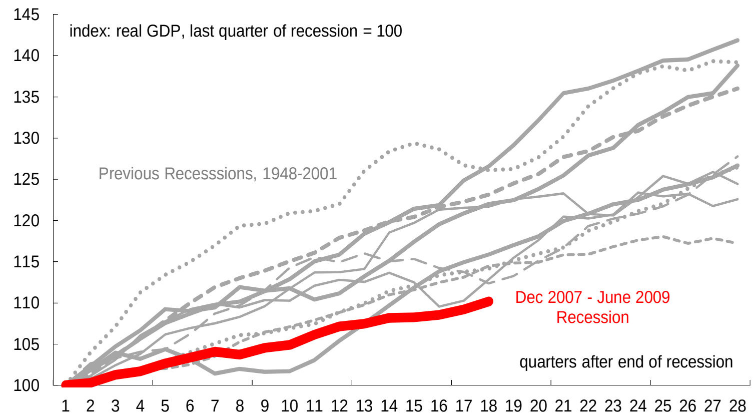
First, the inventory cycle has often caused problems in the past but it is showing few warning signs now. Inventory to sales levels may be getting high again in autos, but not excessively so, and they remain fairly well behaved at the economy-wide level (chart 4). Inventory investment might not drive as much near-term growth as previously, but that's likely a tactical correction in our view. **This suggests that production cuts and employment losses to pare bloated inventories are not a material risk at this juncture.**

Second, we remain concerned about rate risks to housing resales and prices, but **we don't think that the housing risks will flow through to lower construction volumes.** It's the latter that matters most to GDP forecasts as opposed to paper swaps in resale markets. The construction drivers to broader growth should remain positive in our view for several reasons:

- We expect greater carry because of a steeper yield curve to incentivize lenders to **ease up on mortgage availability** as at least a partial offset to rising 30 year fixed mortgage rates. Cheap mortgages are great if borrowers can qualify; going forward we expect moderately more expensive mortgages but with more people having a chance at obtaining one.

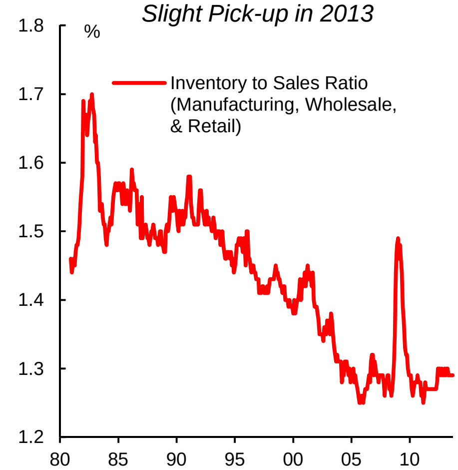
- A rate shock is being imposed in the context of **exceptionally lean new home inventories** that even without adjusting for growth in the number of households over time currently stand at their leanest on record (chart 5).

Chart 3 7 Years of Post Recession Growth



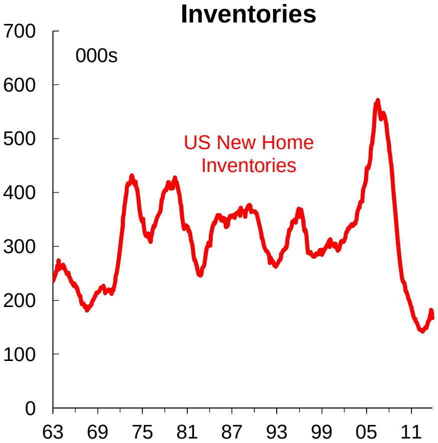
Source: NBER, Bloomberg, Scotiabank Economics.

Chart 4 **Inventory to Sales Ratio** *Slight Pick-up in 2013*



Source: Census Bureau, Scotiabank Economics

Chart 5 **Record Low For New Home Inventories**



Source: Bloomberg, U.S. Census Bureau, Scotiabank Economics.

Continued —

- The new home market had been depressed as a glut of shadow inventory from the resale market created a broad degree of excess housing stock. This shadow inventory is being rapidly reduced, partly as short sales and foreclosure sales are falling as a result of a more positive environment for house prices and while inventory goes into rentals (chart 6). As such, the record low share of total home sales represented by new homes (chart 7) is likely to revert higher and gradually more toward the pre-crisis norm of around 15%-20%. The new home buyers' problem is that they simply cannot find product to buy. **Builders will have no choice but to put shovels in the ground to meet improving new home sales demand.**

- The **pent-up demand** factor is in evidence via the number of people checking out model home inventory (chart 8).

Third, **broader US household sector drivers are arguably among the most constructive in many years.** The household debt service burden lies at its lowest on record partly because of write-offs and low rates, but also notably because households have abstained from borrowing (chart 9). We anticipate only a modest deterioration in the debt service burden over 2014-15. Household net worth is also at its highest on record (chart 10). We see a **constructive degree of trickle down economics** evidenced by the strongest uninterrupted string of house price gains since before the crisis, improving job markets, abstention from borrowing, and still-low borrowing costs. The net worth gains are therefore not just in the hands of the proverbial "millionaires and billionaires" as mainstreet households perhaps gain room to add leverage.

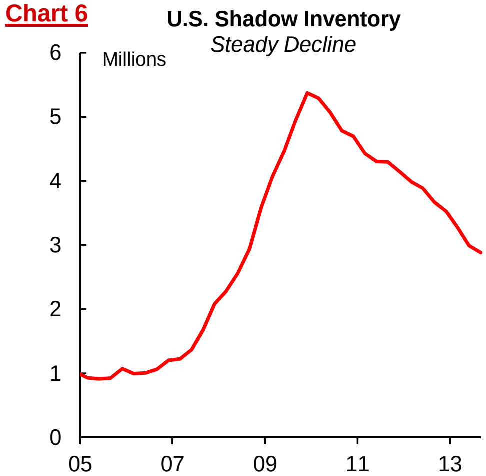
Fourth, **the energy sector will continue to post substantial gains in our view**. The annual pace of increase in crude oil production continues to grow and this is feeding three positive effects:

- Higher exploration and appraisal activity.

- Higher infrastructure spending on roads, refineries and pipelines.

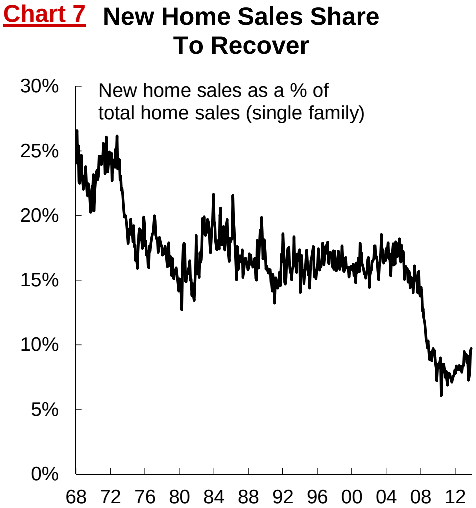
- The impressive improvement in the US petroleum products trade balance (chart 11) which now lies at its narrowest in decades.

Chart 6



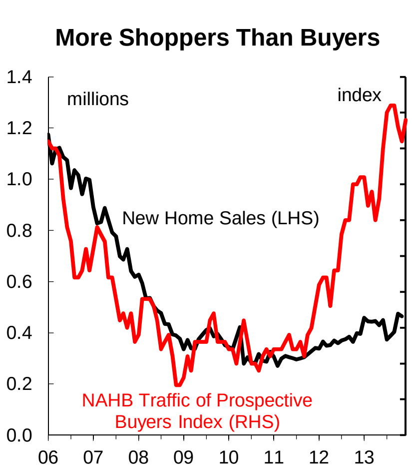
Source: Bloomberg, Scotiabank Economics

Chart 7



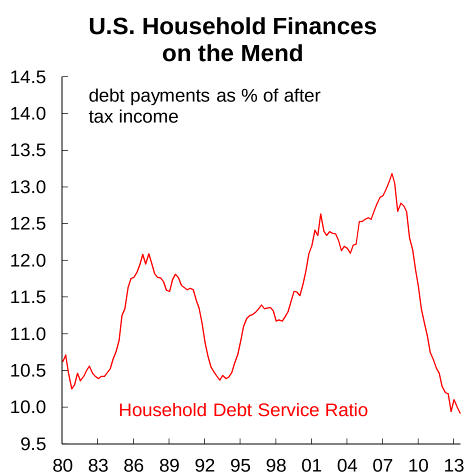
Source: US Bureau of the Census, NAR, Scotiabank Economics.

Chart 8



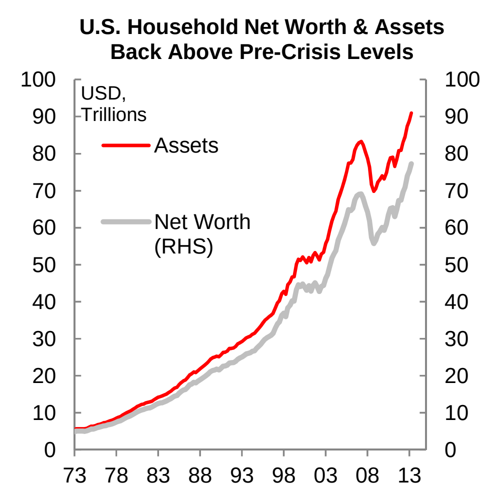
Source: U.S. Bureau of the Census, NAHB, Scotiabank Economics.

Chart 9



Source: Federal Reserve, Scotiabank Economics.

Chart 10



Source: Federal Reserve, Scotiabank Economics

Continued —

Fifth, **less fiscal drag** should easily mean half to three-quarters of a percentage point less downside risk to growth this year versus last.

On To The Bear Flattener

As monetary policy exits draw progressively nearer throughout our forecast horizon, we think the front-end of the Treasury curve will cheapen considerably more than the belly. What is in our forecast (chart 1 again) is actually a fairly modest flattening in measures like the spread between 10 year and 2 year Treasuries, or the spread between 10 year and 5 year Treasuries compared to other recovery periods as we think the pace of fed fund hikes will be gradual. Approaching record levels of steepness, however, makes it difficult to envision a further steepening of the curve from here. Also, as time passes, the markets will likely demand a higher uncertainty premium on the fed funds outlook. Indeed, because we have always been deeply skeptical toward central bank forward rate guidance, the risk to our print forecast is toward a greater bear flattener in our view.

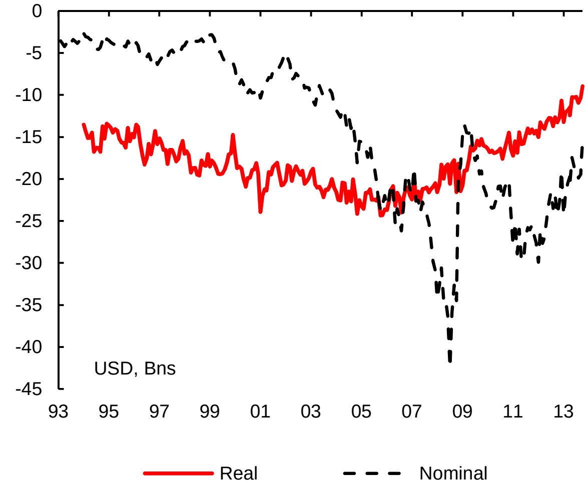
Our 10s forecast calls for about a 3½ % yield by the end of 2014 and about 4¼% by the end of next year. This should become more in line with where we think combined inflation and economic growth rates trend in the absence of continued Fed purchases. To shoot past such a yield range would likely make the curve more attractive to major foreign buyers like Japanese accounts, especially if Japan's economy retrenches in Q2 upon raising the sales tax and expanding stimulus from the BoJ. This would further encourage flows out of JGBs on a strong carry into the Treasury curve. Pension money would probably also find such yields to be attractive.

What could prevent higher 10 year yields than we are forecasting entails reinforcing our longstanding argument that as Fed buying is 'tapered', supply-side issuance will also be reduced (chart 12). The timing is mismatched somewhat as we expect more material reductions in auction sizes toward the front end of the curve to take until into FY2015 to emerge whereas the Fed is tapering purchases now. Also, there may be duration implications in that less Fed buying concentrated on the curve beyond 3s will be mismatched to less issuance on the under 3s portion of the curve. This is one factor that causes us to limit the degree of curve flattening in our forecasts.

We forecast the first hike in the Fed funds target to arrive in 2015Q4 and judge the tail risks to be slightly skewed toward earlier than later. The majority of FOMC members (14 of 17) expect a rate hike next year. We doubt the majority expect that to arrive by Q4 which would lean toward an earlier hike on the strongly conditional view that the Fed's forecasts must come true. If that happens, it would likely only flatten the curve more than we anticipate.

Chart 11

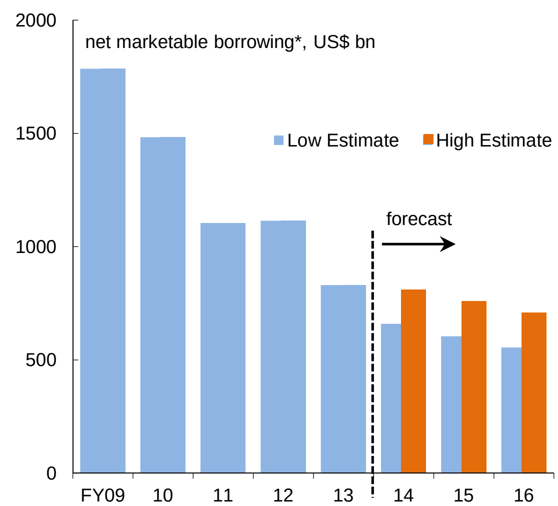
U.S. Petroleum Products Trade Balance
Improving Dramatically



Source: Census Bureau, Scotiabank Economics

Chart 12

Issuance Projected to Decline



* Fiscal yr-end: Sept. 30. Source: Scotiabank Economics.

Stronger Economy = Stronger Equities

We're not equity strategists and so we operate with the privilege of not having to forecast exact index levels. Rather, we offer reasons why we think equities will post further gains over 2014-15.

All about economic growth. If growth does in fact accelerate, it seems likely that US equity markets will be pulled higher with the economy. The Bloomberg consensus forecast is calling for EPS growth of $116.65/share from top-down strategists and something more along the lines of $125/share from the aggregation of bottom-up forecasts. The view is that with nominal GDP likely to post a decent increase in 2014, S&P 500 revenues and earnings should also be able to expand in the 10-15% range.

Continued —

Normally it takes a recession to see a major, sustained equity pull-back, with the vast majority of bear markets over the past 30 years corresponding with economic contractions – something which we do not think is at all likely to happen this year. As chart 13 to the right shows, a sustained bear market typically requires a recession. An exception might appear to be 1987, but even that was not a sustained drop as equities recovered within a one-year period on a buy-on-dip opportunity that went on to higher levels. We don't think that a recession is in the cards (on the contrary, we expect the economy to pick up) and therefore doomsday scenarios based on a sustained correction of the steep climb in stocks in 2013 seem to be over-done. As QE withdrawal continues to be priced in, we foresee the chance of a buy-on-dip opportunity in advance of continued equity gains and in the context of the fairly normal cyclical development of rising bond yields.

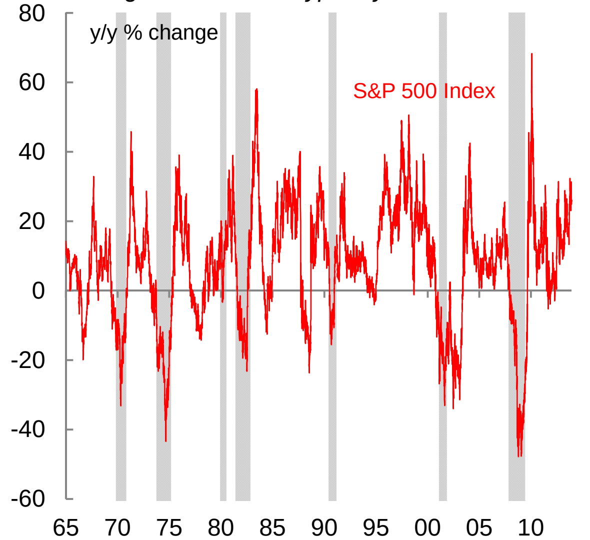
Tail risks seem to be less of a concern. Aside from the decent top-line and bottom-line growth profile that consensus sees for 2014, the more important point is what we *don't* think will happen. The downside tail risks for 2014, ranging from a deepening of the emerging markets sell-off focused on the 'fragile 5' to a bumpy implementation of Europe's new bank capital standards would certainly not be positive for US equities — but they do not represent the type of systemic challenges that markets have been fretting over in the post-financial crisis era.

A more 'normal' investing environment means more 'normal' multiples. The corollary is that the multiple normalization seen in 2013, which saw the forward-looking P/E on the S&P 500 return to its pre-crisis average (chart 14), should sustain itself, with a tail risk that valuations tip into stronger-than-average territory as the equity market overshoots (as it's known to do).

A market without major macro-shocks was quite benign for stock multiples in 2013. To remind readers, the major hiccups in 2013 were: a) a 'fiscal cliff' scenario that was much less bad than advertised, b) a bank panic in Cyprus that failed to spill over to the rest of the world, and c) fears of Fed tapering which turned out to be somewhat of a non-event for equities by the time the taper actually happened. US equity markets were able to weather moderate shocks, including tail risks that had profound implications for particular assets (Greek and Cypriot banks, defense stocks, 10-year bonds, etc.) but not for the market as a whole. We expect more of the same this year.

Chart 13

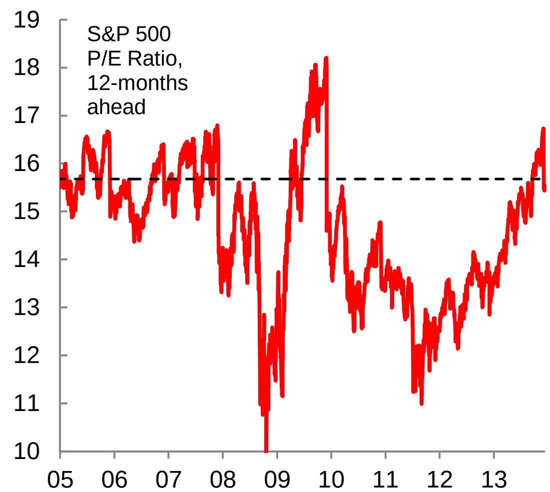
It Takes a Recession...
A Falling Stock Market Typically Needs a Recession



Grey bars represent recession periods.
Source: Bloomberg, Scotiabank Economics.

Chart 14

Mutliple Expansion Drove Gains in 2011-13...
....But Equities Aren't Over-Valued



Source: Bloomberg, Scotiabank Economics

For further forecast details, please see our 2014-15 monthly global forecast available here. Additional market perspectives can be obtained from Camilla Sutton (FX Strategy), Roger Quick (fixed income research), Stephen Dafoe and Francesco Sorbara (corporate credit), Guy Haselmann (US fixed income strategy), Vincent Delisle (equity strategy), Patricia Mohr (commodities) and Na Liu (China and commodities).