Fixed Income Insight
First Quarter 2015

February 11, 2015

➔ The Economic Expansion Continues in the United States:

- According to the first estimate, Real GDP expanded at a 2.6% seasonally adjusted annual rate in the fourth quarter. While this pace was considerably slower than the 5.0% rate of the third quarter, the composition of the gain suggests that the expansion remains on firm footing.
- Personal Consumption Expenditures contributed 2.9% to the total growth in headline GDP, with stronger contributions coming from both goods and services spending than those sectors had made to third quarter growth.
- Fixed Investment continued to rise, but at a slower pace than that of the third quarter. However, inventory accumulation resumed in the fourth quarter, with the result that gross private domestic investment made about the same contribution to overall GDP growth in the fourth quarter as it did in the third.
- Net Exports of Goods and Services swung from making a positive contribution to GDP growth in the third quarter to a negative contribution in the fourth quarter as Exports slowed and Imports accelerated.
- Federal Government spending took almost one half of one percent off of headline GDP growth in the fourth quarter, sharply reversing the large positive contribution it had made to overall GDP growth in the third quarter. Another increase in State and Local government spending was not enough to offset the decline produced by the Federal swing, making the aggregate contribution from the public sector negative.

➔ The Employment Situation Continues to Make Measured Improvement:

- Non-farm payrolls rose by 257,000 in January, following upwardly revised gains of 329,000 in December and 423,000 in November. Payrolls rose an average of 260,000 persons per month in 2014, a significant improvement over the monthly average pace of 199,000 posted in 2013. After the annual benchmark revisions, Non-Farm payrolls are now 2,499,000 above the pre-recession peak, and 11,200,000 above their recession-related low.
- The official rate of unemployment, U3, rose slightly to 5.7% in January following an increase in the labor force that exceeded the gain in employment. The broadest measure of labor underemployment, U6, remains high at 11.3%.
- As a result, the debate over the degree of slack in the labor market, both within and outside the Federal Reserve, continues.

➔ Inflation Remains Moderate:

- Headline inflation has moved sharply lower led by falling energy prices. Food prices have been on the rise, reflecting the drought in key parts of the country. Owners' equivalent rent, which constitutes almost a quarter of the CPI, has continued to rise and is at its highest level since 2008. Medical costs have started to reverse their prolonged decline, partly due to the Affordable Care Act. However, when viewed in the aggregate, inflation still remains relatively tame, whether one uses the headline CPI, the Core CPI or, the Fed's preferred measure, the Personal Consumption Expenditures Index (PCE).

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Please refer to Notes and Disclosures on page 2.

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- The CPI fell to 0.8% last year as energy prices plunged during the second half of 2014. Other key measures of inflation are below the Fed's target as well. No doubt the Fed is monitoring the recent creep higher in some price measures, but still is equally wary of the potential danger from latent deflationary pressures. Accordingly, the FOMC has continued to indicate that monetary policy will remain highly accommodative.
- On balance, it is difficult to envision demand-pull or cost-push inflation without stronger economic and employment growth as well as a pick-up in wage growth. The capacity utilization rate has been on the rise the past year and continues to spark a debate regarding how much slack there is in the manufacturing economy.
- The European Central Bank (ECB) announced an expanded asset purchase program to help counter deflationary pressures and economic weakness across the Eurozone. The program is designed to purchase €1.1T in public and private sector bonds and last at least until September 2016. Importantly, the statement noted that the program would continue 'until we see a see a sustained adjustment in the path of inflation.'*

➔ **Public Finances, Both Here and Abroad, Remain under Intense Scrutiny:**

- Congress was reshaped by the recent mid-term elections. We await the legislative direction of the new leadership so as to be able to assess the prospects of any significant changes in the course of fiscal policy.
- Events in Ukraine remain unsettled and continue to pose a threat to the Eurozone. The EU joined the US in ratcheting up economic sanctions designed to pressure Russia over its continuing support of rebels in Eastern Ukraine. The impact of economic sanctions and the decline in crude oil prices have contributed to a sharp selloff in the Russian Ruble. It is uncertain whether these factors will further destabilize the region or result in a climb-down from the recent aggressive posture.
- Municipal market conditions continue to feature moderate supply as issuers respond to political pressures favoring fiscal austerity. Concerns over mounting pension and other post employment obligations have acted as a restraint on borrowing despite the low rate surroundings.

** Source: www.ecb.europa.eu : "ECB Announces Expanded Asset Purchase Programme"*

Notes and Disclosures

Sources: Bloomberg; Bureau of Economic Analysis; Bureau of Labor Statistics; Federal Reserve; Census Bureau.