PANTHEON MACROECONOMICS

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THE **UNITED STATES** IN 2015

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Breakout, at Last; But Growth Gain Comes with Policy Pain

* 2015 will be, finally, **the breakout year for the U.S. economy.** The key headwinds of recent years—tight credit conditions for small businesses and fiscal tightening—are over, and a prolonged period of catch-up in capital spending and new hiring is now likely. The strong dollar and weak overseas growth will make life harder for exporters, but they don't fundamentally change the story; the U.S. is an 87% domestic economy.

* The plunge in oil prices is a clear net boost to the U.S. economy, via the real income effect for consumers. **Oil producers, capital equipment makers and oil servicing businesses will be hit very hard, but their losses will be much smaller than consumers' gains.** Job growth in consumer-facing sectors like retailing, leisure and recreation will accelerate.

* Surveys of small business hiring are consistent with the message of near-record low jobless claims numbers, pointing to **payroll gains trending at 275K or more.** Even with a slower decline in participation, that would be enough to drive unemployment rate down further and, critically, to push up the rate of increase of wages.

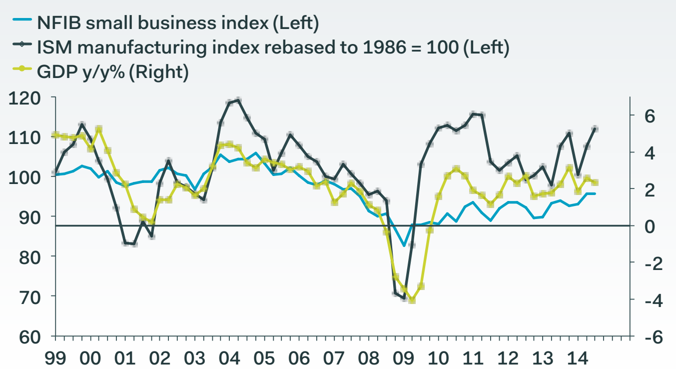
* Businesses can't find the skilled people they need even at the current unemployment rate, and they appear uninterested in hiring people who have not worked for some time or have dropped out of the labor force. That means they will have to **pay more to attract people** currently working for other employers.

* Faster payroll growth, coupled with bigger increases in hourly wages and low headline inflation as a result of depressed oil prices, combine to make a **potent brew for consumers.** Their real spending this year should accelerate towards 3%, significantly stronger than the 2.3% estimated for 2014. And stronger consumption will feed back into faster inventory-building, rising capital spending and further gains in hiring.

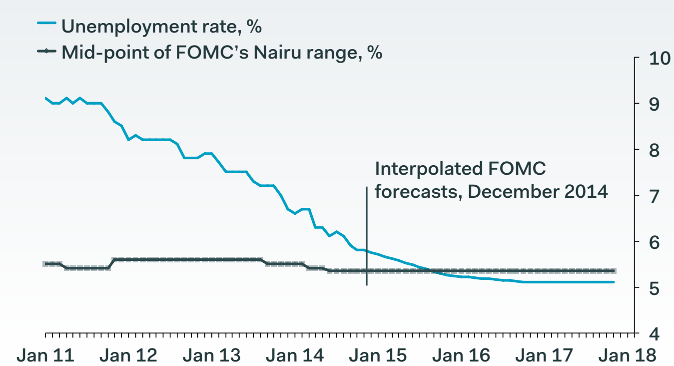
* **The housing market will remain a laggard,** given still-tight lending standards and the likelihood of rising mortgage rates, but the Fed increasingly will come to regard weak housing as a necessary consequence of the normalization of monetary policy. Housing construction now accounts for less than 3% of GDP.

* Fiscal policy is a wild card. The **suspension of the debt ceiling expires March 15,** and it will have to be extended, or the ceiling raised. A legislative solution does not have to be reached by March, because accounting maneuvers and strong April tax revenues will delay the ultimate crunch until the summer, but the issue has to be addressed sooner or later.

GDP GROWTH WILL ACCELERATE AS SMALL FIRMS RECOVER...



...DRIVING DOWN UNEMPLOYMENT BELOW THE NAIRU



* **The U.S. does not face European-deflation risk,** or anything remotely like it. Headline inflation will turn negative, briefly, in the spring, thanks to the plunge in gasoline prices, but the core will not not move much for the foreseeable future. Non-oil prices likely will fall outright in 2015, thanks in part to the rising dollar, but they account for only 25% of the core CPI. The biggest single component, rent, accounts for 41% of the index and is gradually picking up speed, reflecting the very low—and still falling—vacancy rate. If wage gains pick up, it would be reasonable to expect landlords to reach into their tenants' wallets to extract some of the increase, driving rent inflation up.

* The pace of wage gains also is key to the non-housing services ex-rent component of the core CPI—34% of the index—so it is easy to imagine a pick up here over the course of the year. Putting the elements together, the outlook is for **a gradual increase in core inflation** this year.

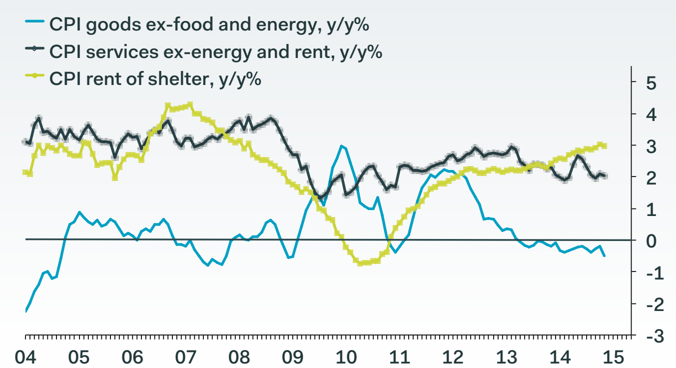
* Rising inflation,however, is not likely to be the trigger for the first Fed rate hike; policy is set to be tightened initially in the spring as the **unemployment rate drops into the Fed's Nairu range,** even if core inflation hasn't budged. The speed with which rates then rise will be determined largely by the pace of wage gains; the Fed's view of the inflation process is primarily cost-push. In this context, the Fed will be closely watching the mix-adjusted employment costs index for signs of wage pressures, not just the raw hourly earnings data.

* We don't know for sure what is the Fed's base case forecast for wage gains, but we suspect policymakers will be surprised by the speed of the upturn, which is due to begin anytime now and then to persist for at least a couple of years. Over the past 30 years, **movements in the fed funds rate have been linked more closely to the rate of growth of wages** than any other variable.

* The big risk for the Fed is that businesses don't wait for wages to accelerate before raising prices. If firms anticipate faster increases in employee compensation—and surveys suggest they do—and demand is strong, it would be rational for them to start probing their markets for opportunities to raise prices before their margins are squeezed. In this scenario, **the Fed runs the risk that both wages and inflation rise more quickly** than they expect, forcing policymakers into a faster pace of tightening. We expect the funds rate to end 2015 at 1.25%, and 2016 at 3.0%, higher than the Fed and the markets expect.

* Accelerating wages and a more aggressive Fed make **an uncomfortable combination for both stocks and bonds, even as economic growth strengthens.** But with the BOJ pursuing aggressive QE and the ECB taking further steps towards it, global liquidity will be flowing fast enough to prevent either a sustained blowout at the long end of the curve or a meltdown in stocks. Still, long-term rates will rise substantially under our scenario, and with the S&P500 now fully valued it is hard to see significant further net gains in stock prices this year; we look for the index to end the year close to its current level.

GOODS PRICES WILL FALL IN 2015 BUT OTHER CORE CPI WILL RISE



THE FED'S KEY CONCERN IS WAGES, WHICH WILL ACCELERATE