Outlook 2014: A spring in the economy's step

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The winter of our discontent

Coldest January in 17 years of data on energy usage for heating

2nd coldest February

Coldest March

Lots of snow/ice along the way

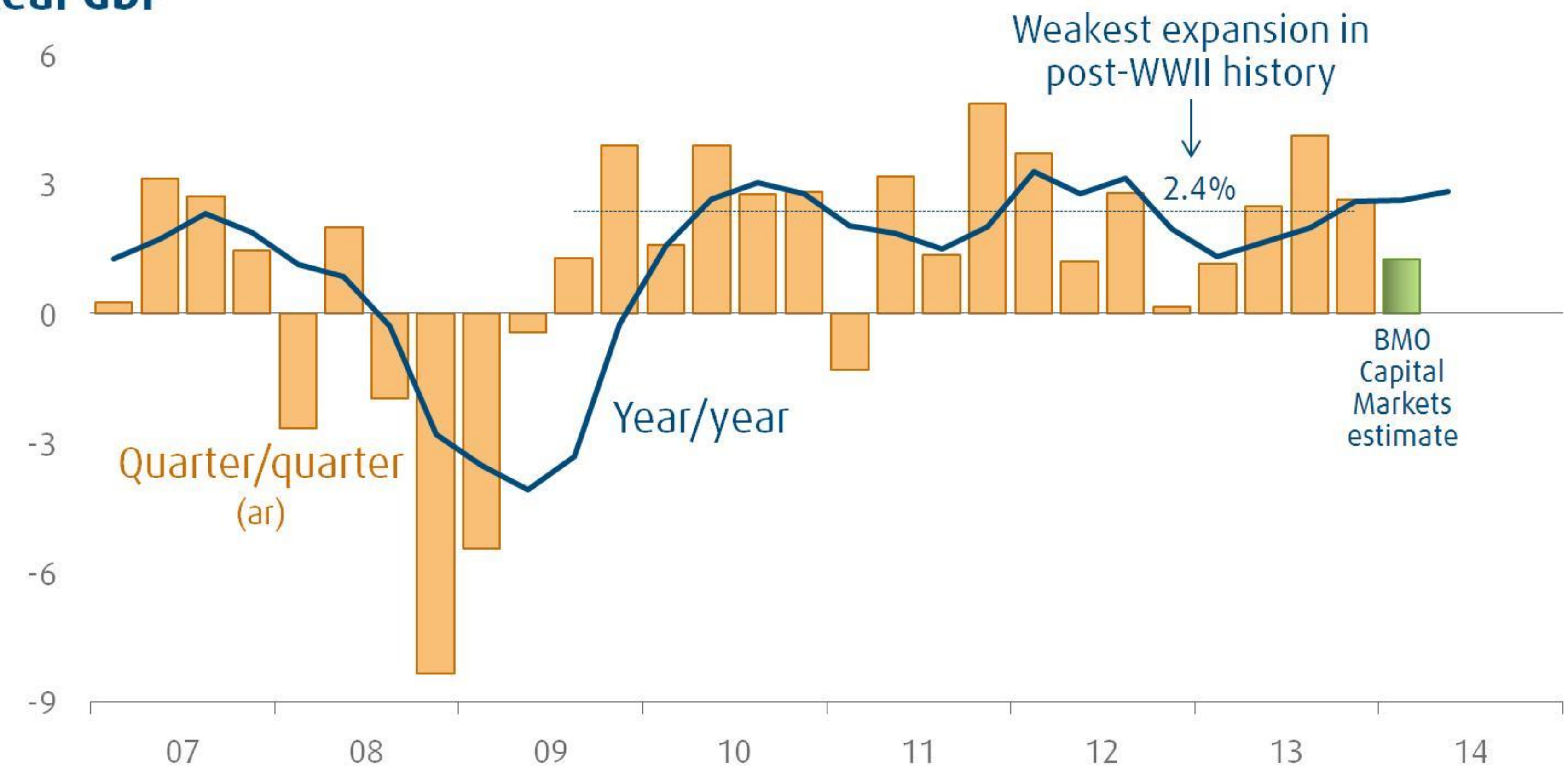
An economic burden

Source: National Oceanic and Atmospheric Administration (NOAA)

More than weather weighed down economy ...still stuck in slow-growth rut?

United States (% chng)

Real GDP



Payback for 2013:Q4 capex surge and 2013 inventory buildup

Economy has faced significant headwinds

Household deleveraging

Fiscal consolidation

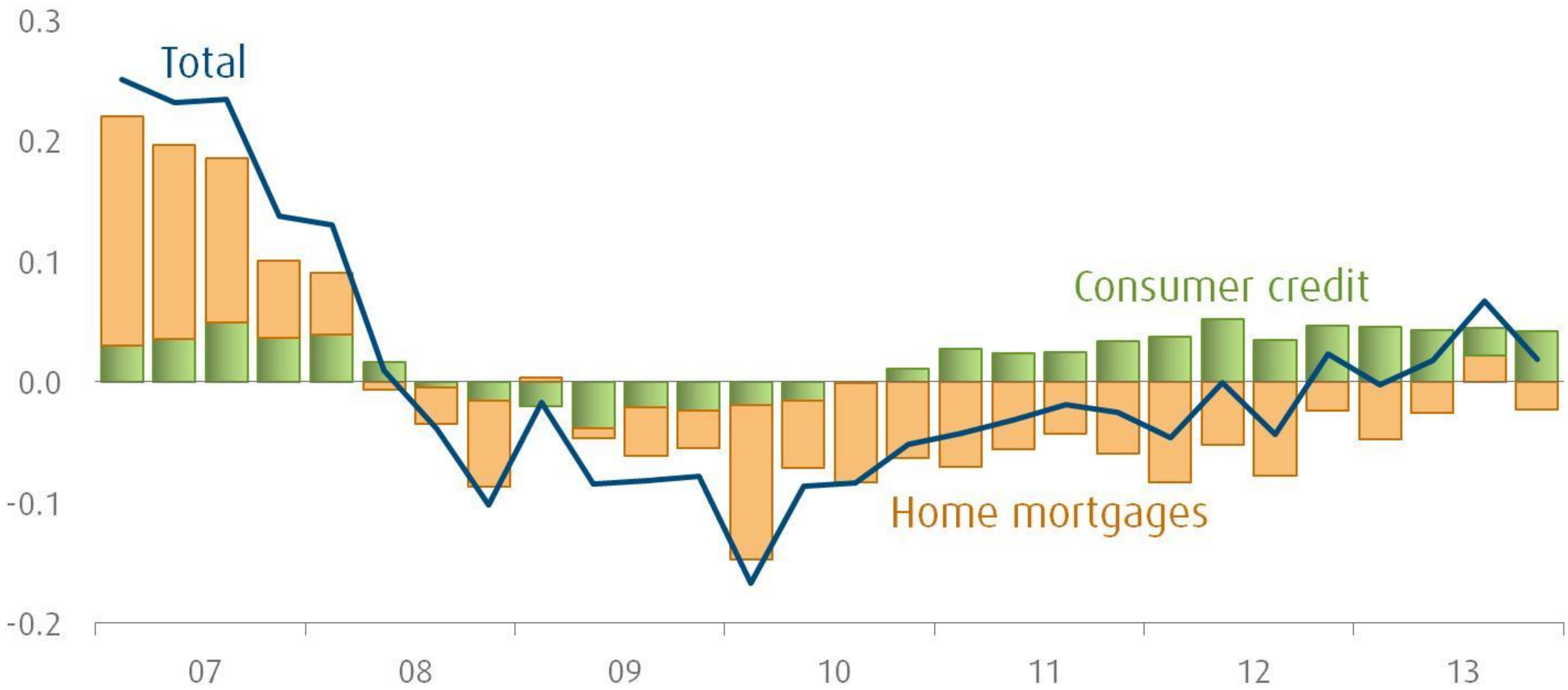
Elevated uncertainty

Not necessarily "secular stagnation"

Household deleveraging ending

United States ($ trlns : sa)

Household credit flows



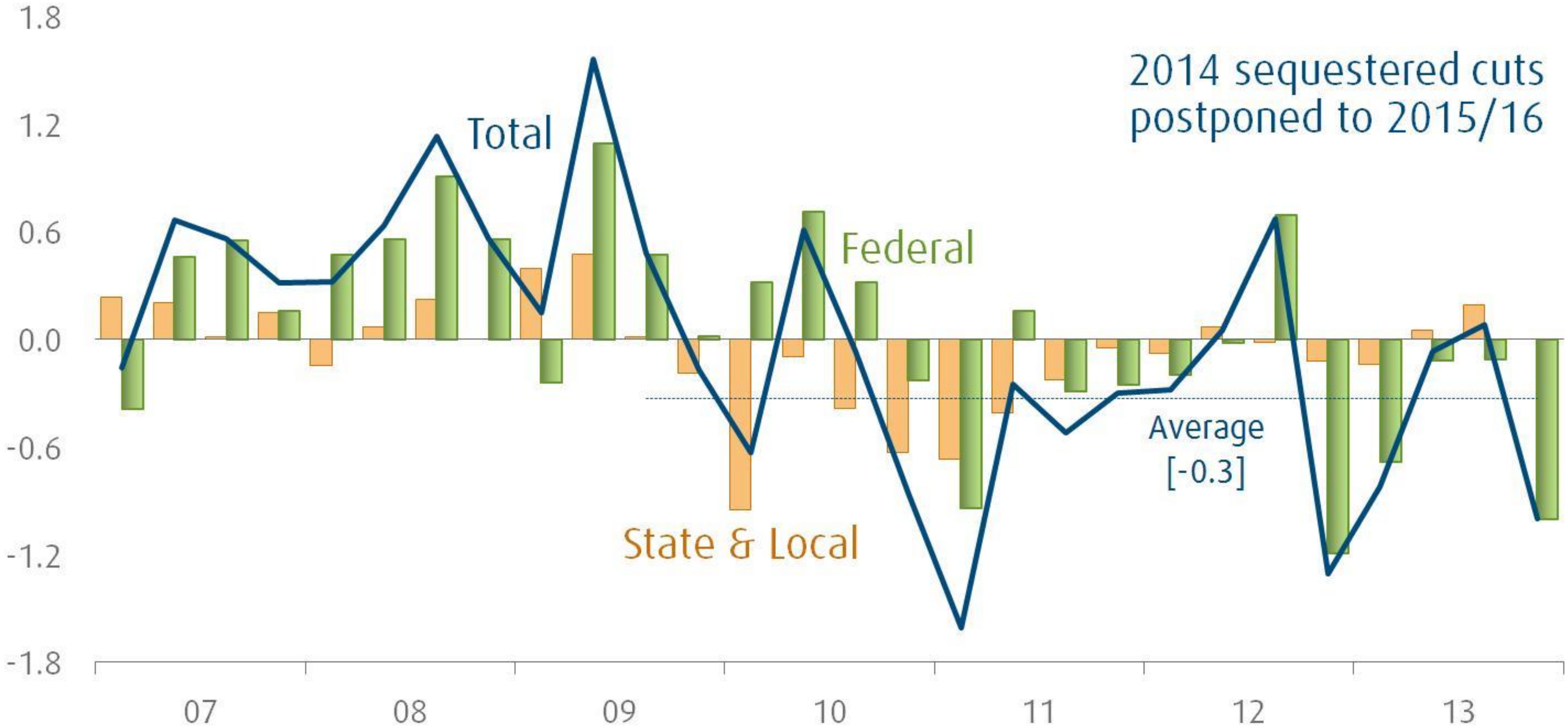
$1.0 trln debt reduction from 2008:Q2-to-2012:Q3 worth 0.4 ppts per quarter

Households include nonprofit organizations

Fiscal consolidation fading

United States (ppts : saar)

Contribution to real GDP growth from government spending



Tax hikes heralded 2013

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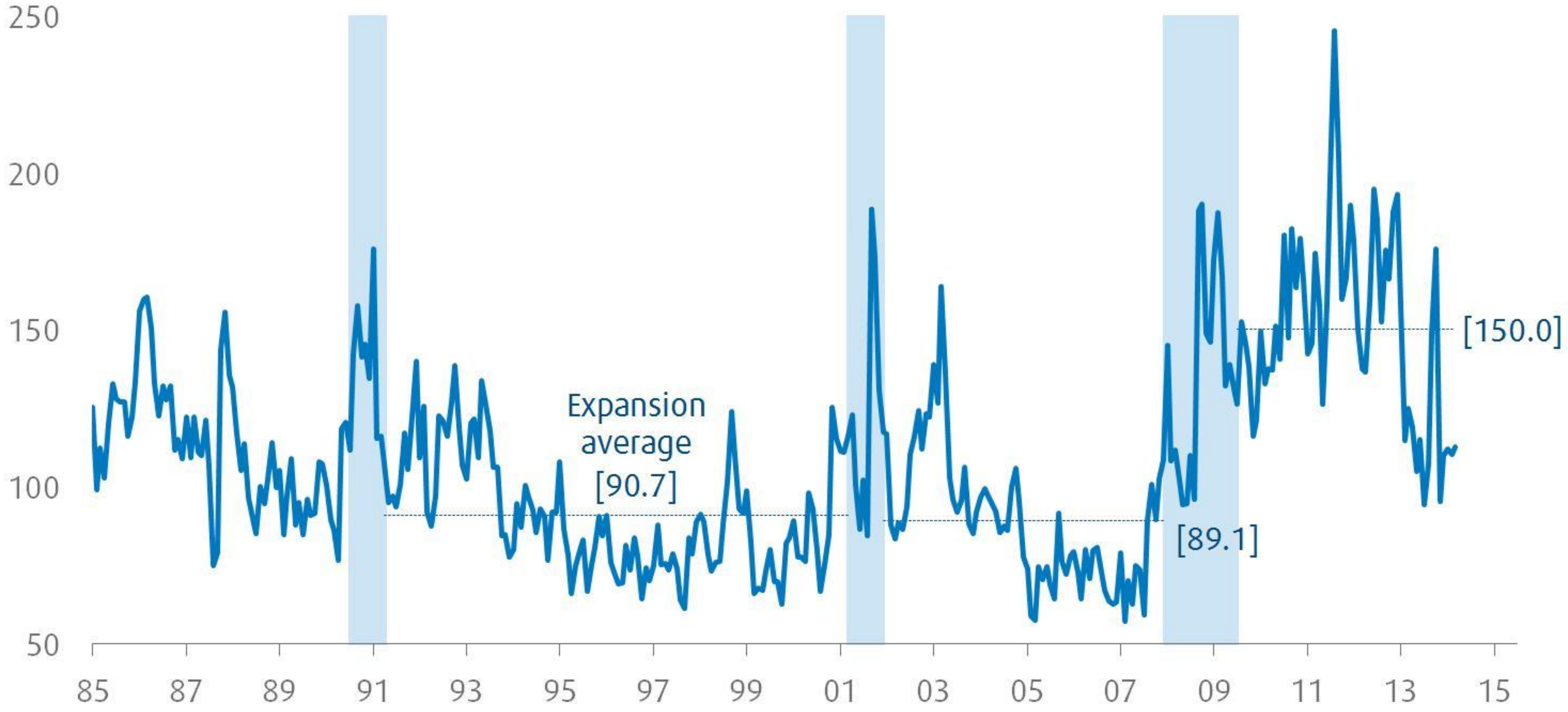
Fiscal and monetary policy uncertainty soared this cycle

United States (1985-09 = 100)

Economic Policy Uncertainty Index



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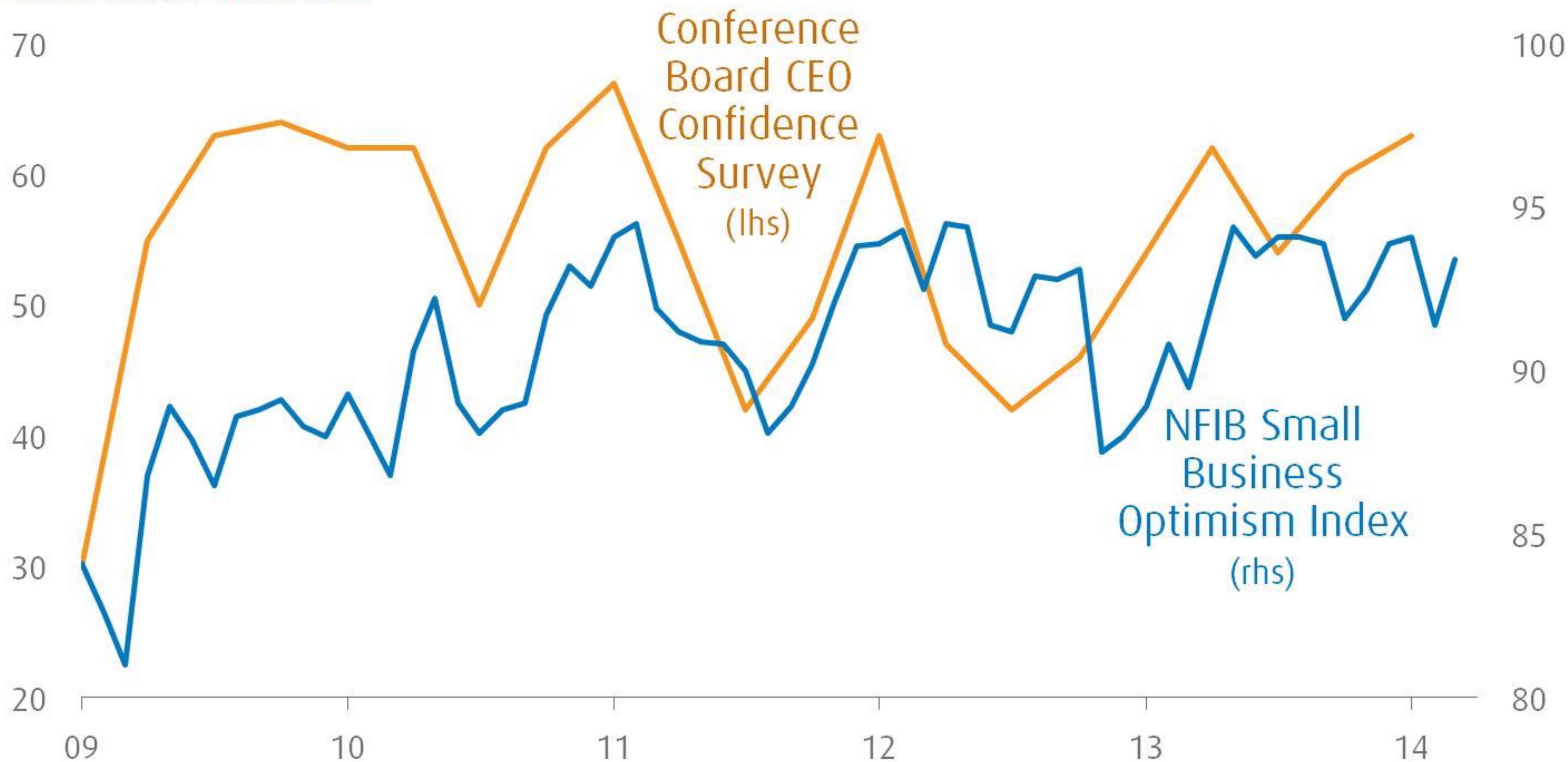
Business confidence has been easily bruised

United States

Confidence indices



Both reflecting and contributing to economic "soft patches"

Are the clouds of global uncertainty parting?

Euro Area

China

Japan

Emerging markets

Geopolitics

The case for steady 3%-range growth

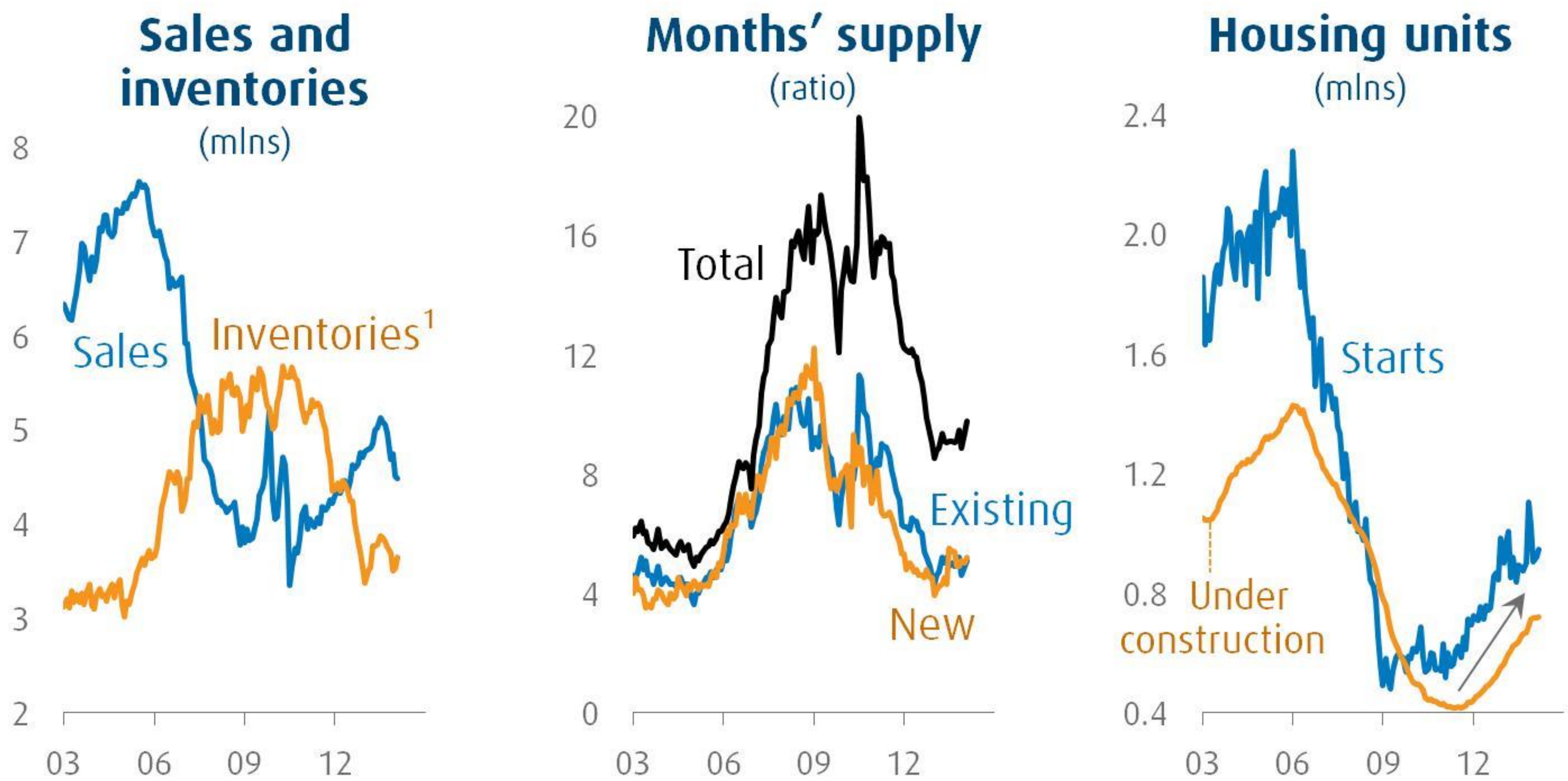
Headwinds ebbing

Tailwinds:

- Continuing housing recovery
- Unleashing pent-up demand
- Increasing wealth effects
- Rising energy production
- Strong corporate balance sheets
- Accommodative monetary policy

Continuing housing recovery

Homes – United States

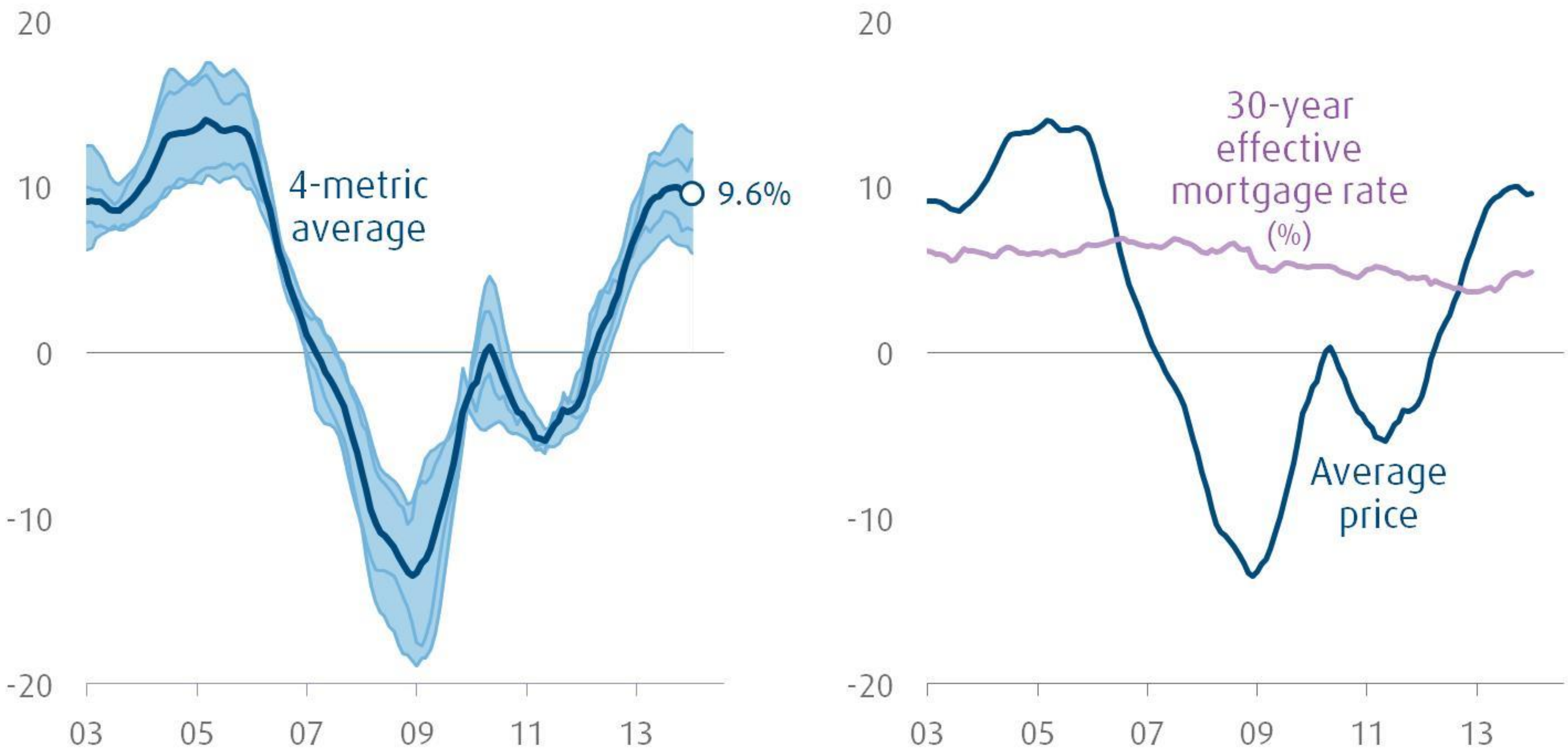


Tighter real estate markets

[1] (nsa) include new and existing homes available for sale, and homes in foreclosure

House prices outpacing mortgage costs

Home price indices – United States (y/y % chng)



Average prices recovered 48% of October '06 – February '12 plummet

Shaded area represents range of: CoreLogic, FHFA, S&P/Case-Shiller, Zillow

Housing still historically very affordable

United States

Applications plummeted:
reaction to mortgage rate spike, weather, qualified mortgage rule

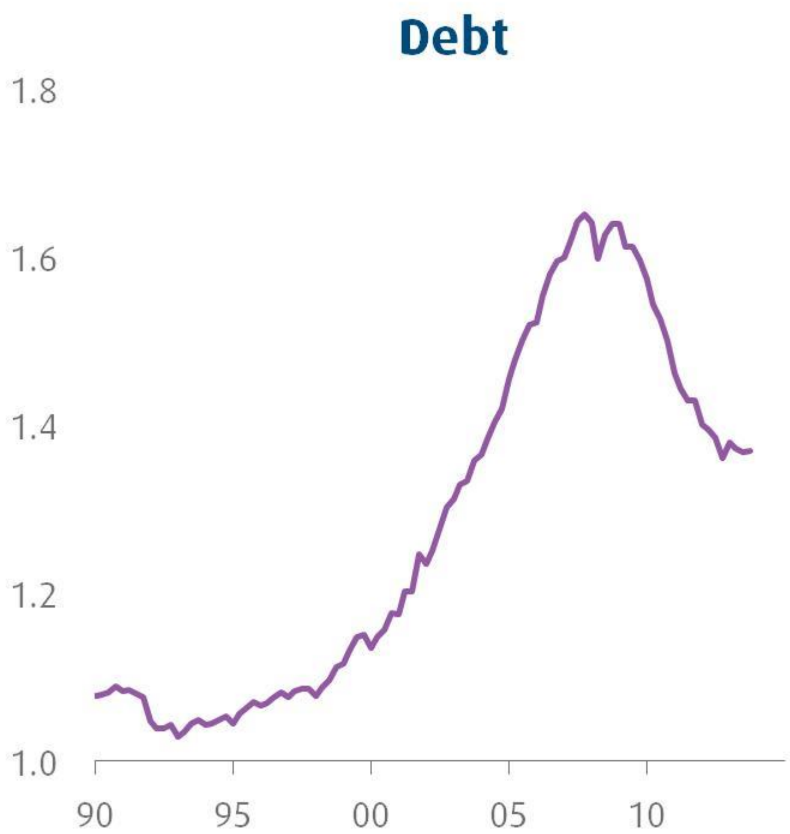
[1] Mortgage applications for purchase (4-wk ma : lhs) [2] 30-year fixed-rate mortgages (% : rhs)

Unleashing pent-up demand

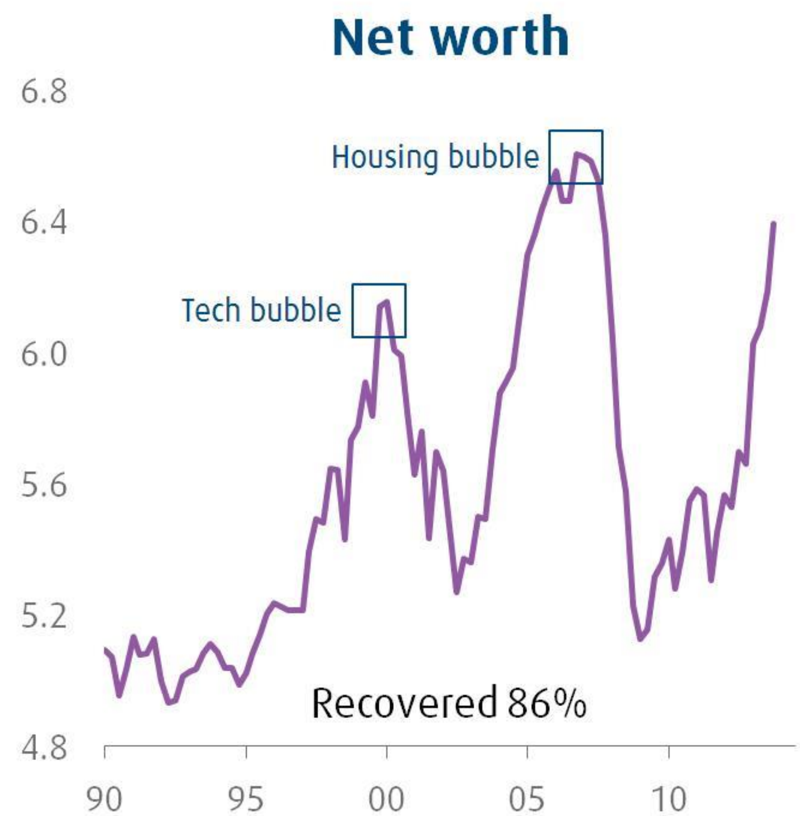
Average age of US vehicles now a record-high 11.4 years

Strengthening balance sheets, increasing wealth effects

Households – United States (ratio to disposable personal income)



Stabilized



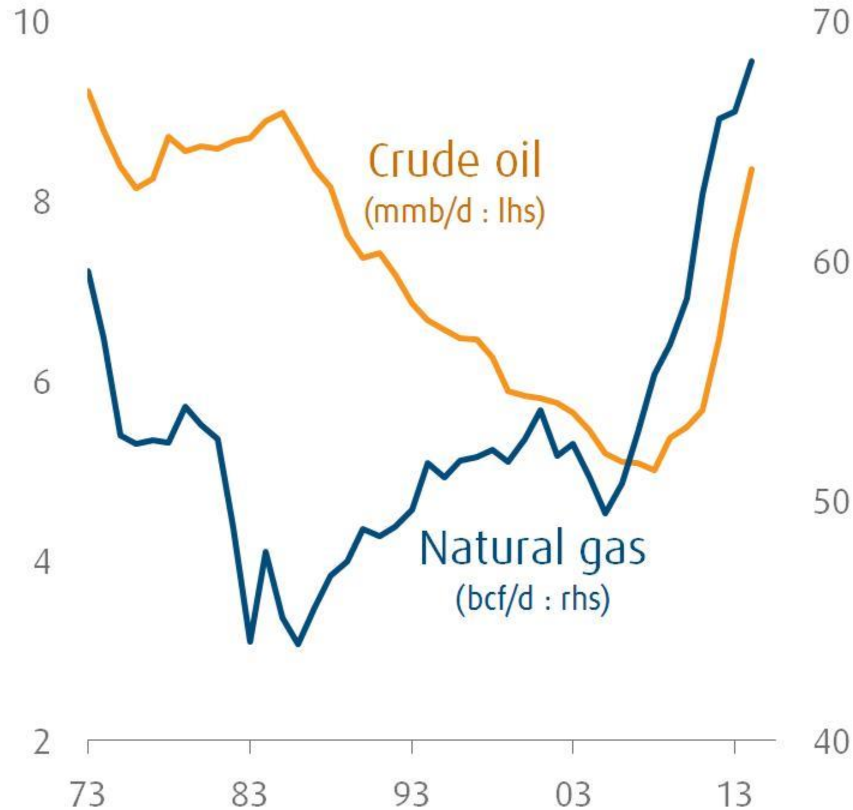
Record equity prices

Includes households, nonprofits and unincorporated businesses

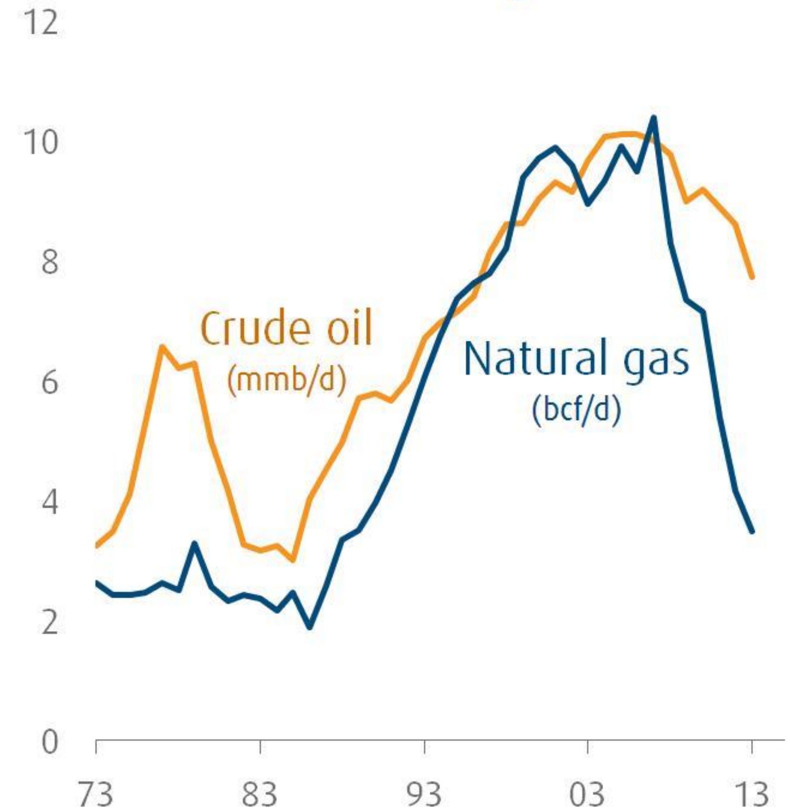
Rising energy production… Hail shale!

United States

Production



Net imports



IEA: US top crude oil producer by 2016

Source: Energy Information Administration, BMO Capital Markets Economics [2013-14]

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Strong corporate balance sheets

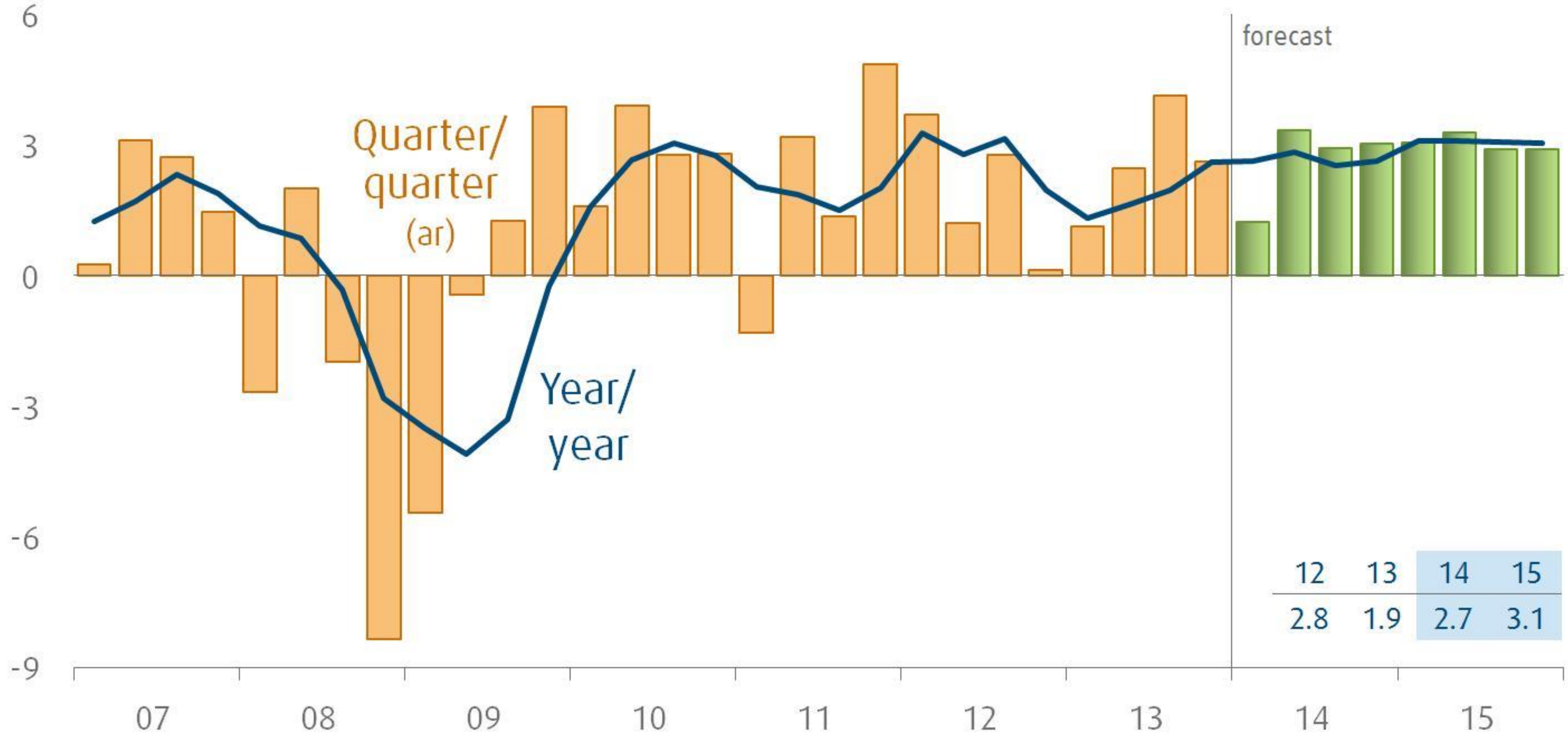
United States (% of GDP : 4-qtr ma)

Corporate Profits

Picking up steam

United States (% chng)

Real GDP



Fed policy to remain accommodative

Fed to end QE by Q4

United States

Ending QE
(US$ blns)

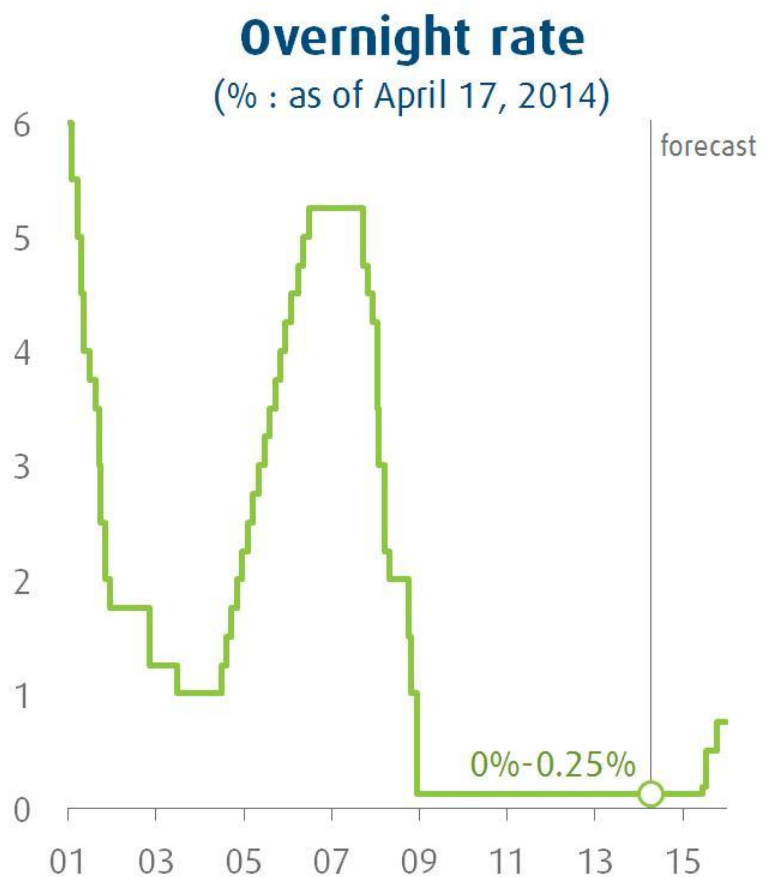
FOMC Meeting	Treasuries Taper	Treasuries Pace[1]	MBS Taper	MBS Pace[1]	Total Taper	Total Pace[1]
18-Dec-13	-5	40	-5	35	-10	75
29-Jan-13	-5	35	-5	30	-10	65
19-Mar-14	-5	30	-5	25	-10	55
30-Apr-14	-5	25	-5	20	-10	45
18-Jun-14	-5	20	-5	15	-10	35
30-Jul-14	-5	15	-5	10	-10	25
18-Sep-14	-5	10	-5	5	-10	15
29-Oct-14	-10	0	-5	0	-15	0

[1] Beginning of the next month

Tapering is "not on a preset course"

$450 bln added to $4.0 trln balance sheet during tapering process

Fed to start hiking rates by 2015:Q3



Sooner liftoff:

Abandoning the unemployment and inflation thresholds afforded the FOMC flexibility not to tighten if the jobless rate falls further, and to tighten if inflation is still low

Yellen: *"...considerable period... probably means something on the order of around six months..."*

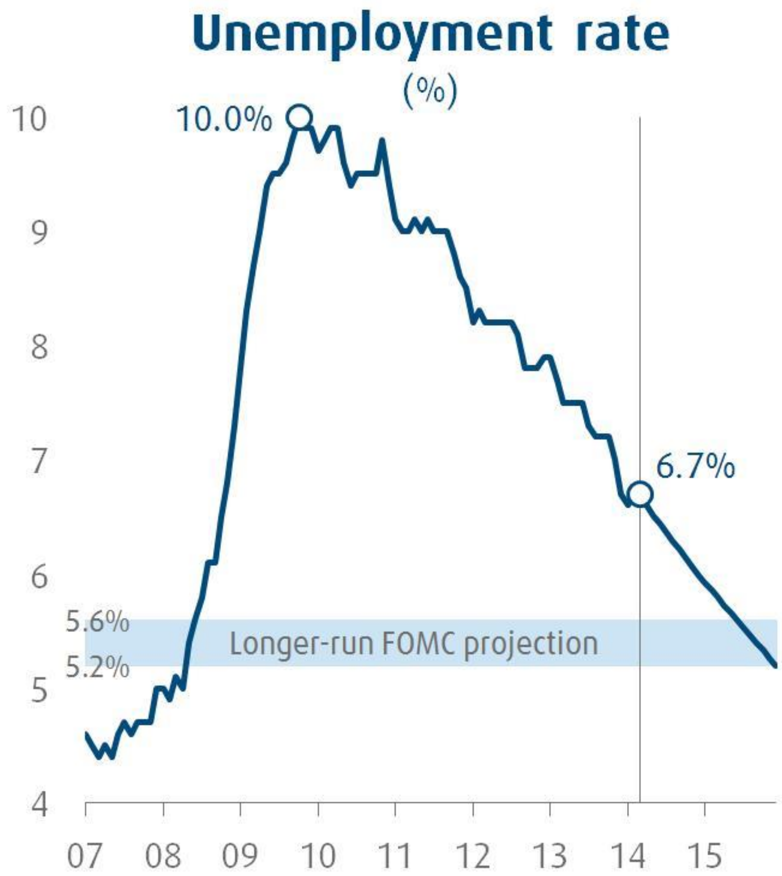
Flatter trajectory:

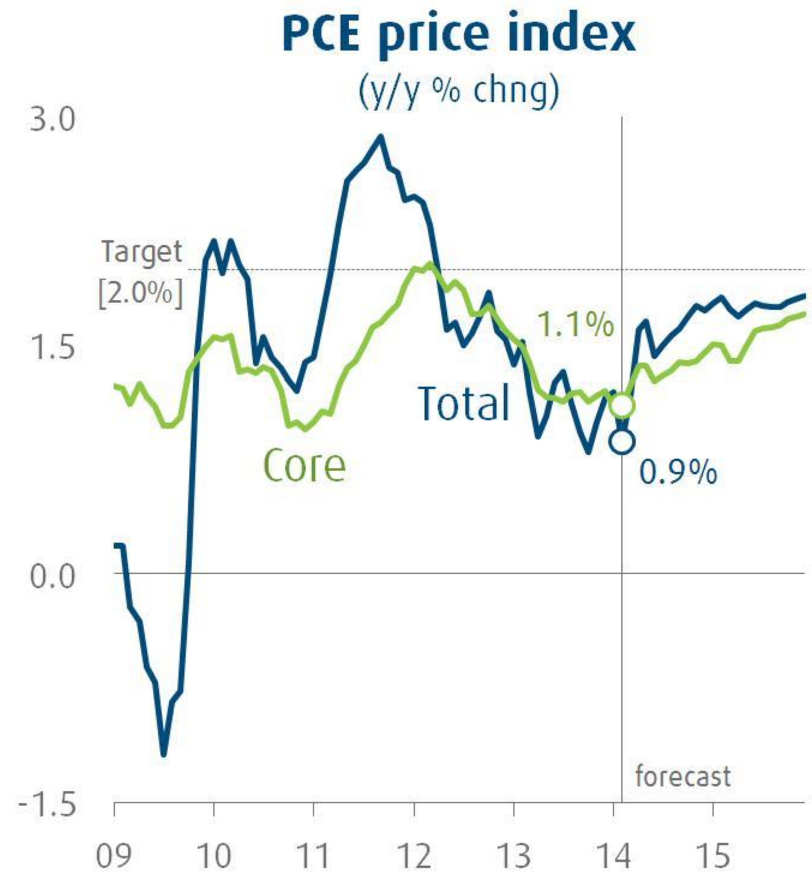
FOMC: *"...economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run."*

Yellen: *"...a shallower glide path..."*

Labor market tightening

United States

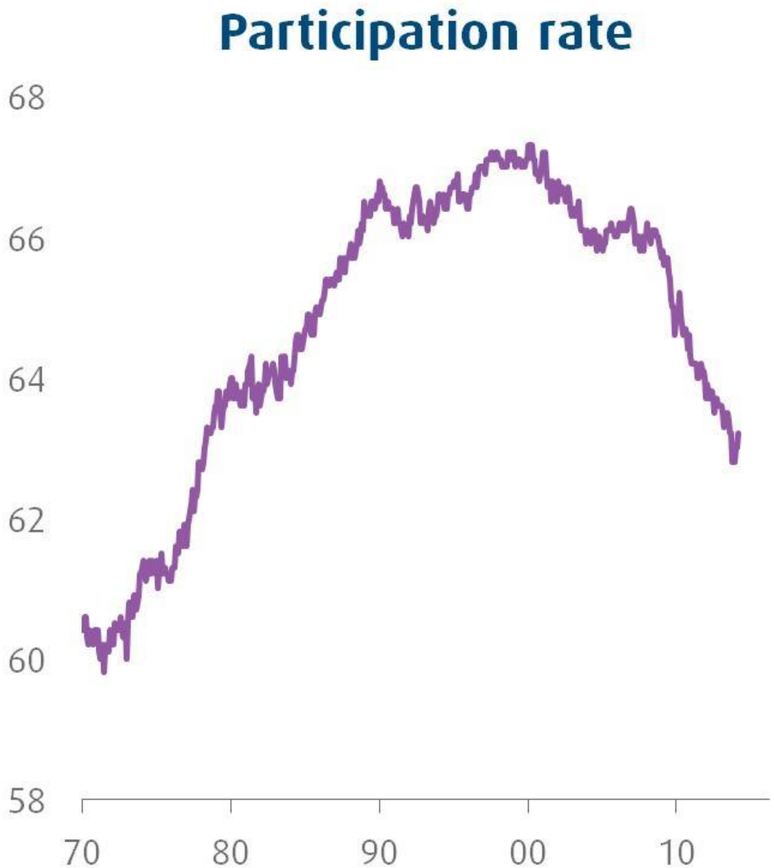




Wage pressures to build but not stoke a wage-price spiral… for now

"Part rate" drops

United States (% of adult population)



Structural:

Aging population
Better disability benefits
Affordable Care Act

Cyclical:

Discouraged job seekers
Education/re-training enrollment

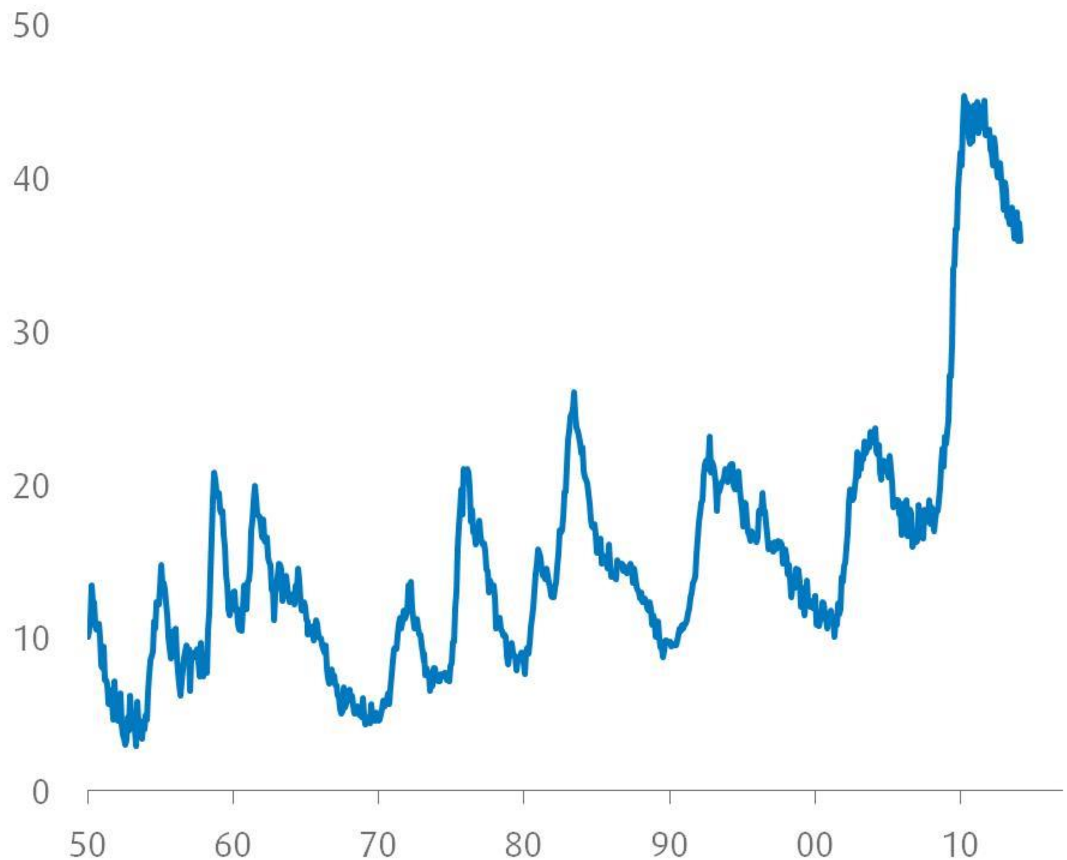
One-time factor:

Expiry of extended UI benefits

Prognosis: Run flat to slightly lower

Stubborn long-term joblessness

Long-term unemployed[1] – United States (percent)



Skills deterioration

Skills mismatch

Negative home equity impinging mobility

Discrimination against long-term unemployed

[1] Unemployed for 27 weeks and over (% of total unemployed)

Short-term jobless rate relatively low

United States (percent)

Unemployment rate

Relative wages (≤26 weeks/≥27 weeks) have to rise

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Longer-term Treasury yields: Moderately rising trend ahead

United States (% : as of April 17, 2014)

10-year Treasuries

Actuals: Daily closes   Forecast: Monthly averages

Reasons for rise:

QE ending

Stronger economic growth

Whetted risk appetites

Reasons for moderate rise:

Relatively flat policy rate trajectory

Inflation in check

Stronger greenback ("risk-on/risk-off" driver being replaced by economic growth/monetary policy driver)

Treasury supply growth slowing (record budget improvement last year)

Key risks to our 10-year Treasury yield forecast

A Rise faster to 3.5%-to-4.0% range

Real GDP growth well above 3% (stronger household wealth effect)

Wage growth accelerates more

Fed policy liftoff pulled forward to early 2015, trajectory steepened

B Rise slower to 3.5%-to-4.0% range

Real GDP growth still 3% but jobless rate stubborn as "part rate" moves up

Wage growth accelerates less

Fed policy liftoff pushed back to late 2015, trajectory flattened

C Stay in current 2.5%-to-3.0% range

Real GDP growth stays stuck in lower-2% rut

Wage growth stays same

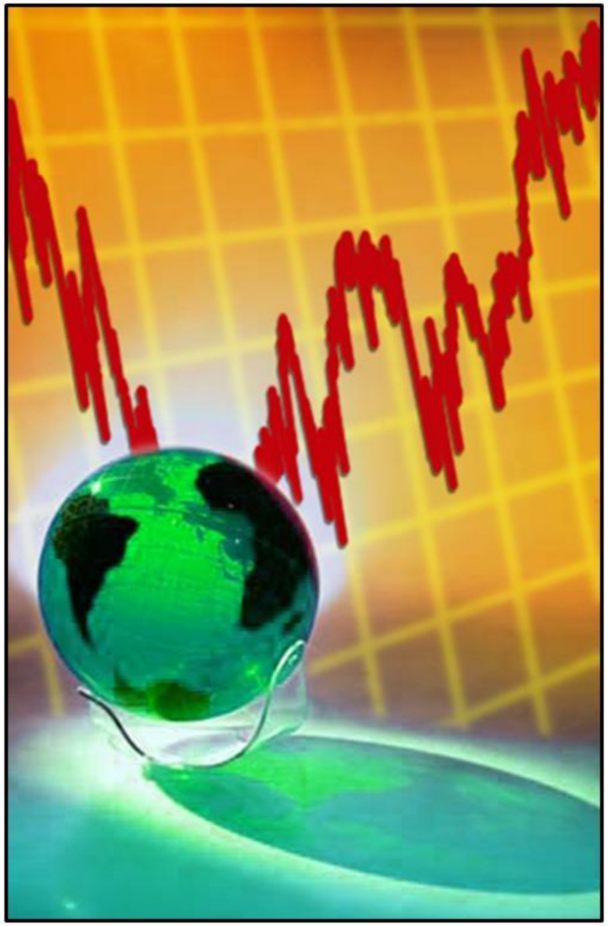
Fed policy liftoff pushed back to 2016

D Fall below 2.5% again

Not economic… Financial market or geopolitical

Fed policy impact depends on economic feedback

Outlook in a nutshell



Economy to shake off winter's shackles

Growth to run close to 3%, supported by ebbing headwinds and continuing tailwinds

Unemployment rate to keep drifting down, mostly owing to job growth but also to the "part rate"

Inflation on the ground to remain contained

Fed continues tapering, ends QE by Q4

Policy rate liftoff by 2015:Q3, but timing/trajectory ultimately determined by wage-price dynamics

10-year bond yield on ratcheting trend to 4%

Greenback to gain on Fed tapering and eventual tightening

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Q AND A