Short-Term Tailwinds, Long-Term Headwinds

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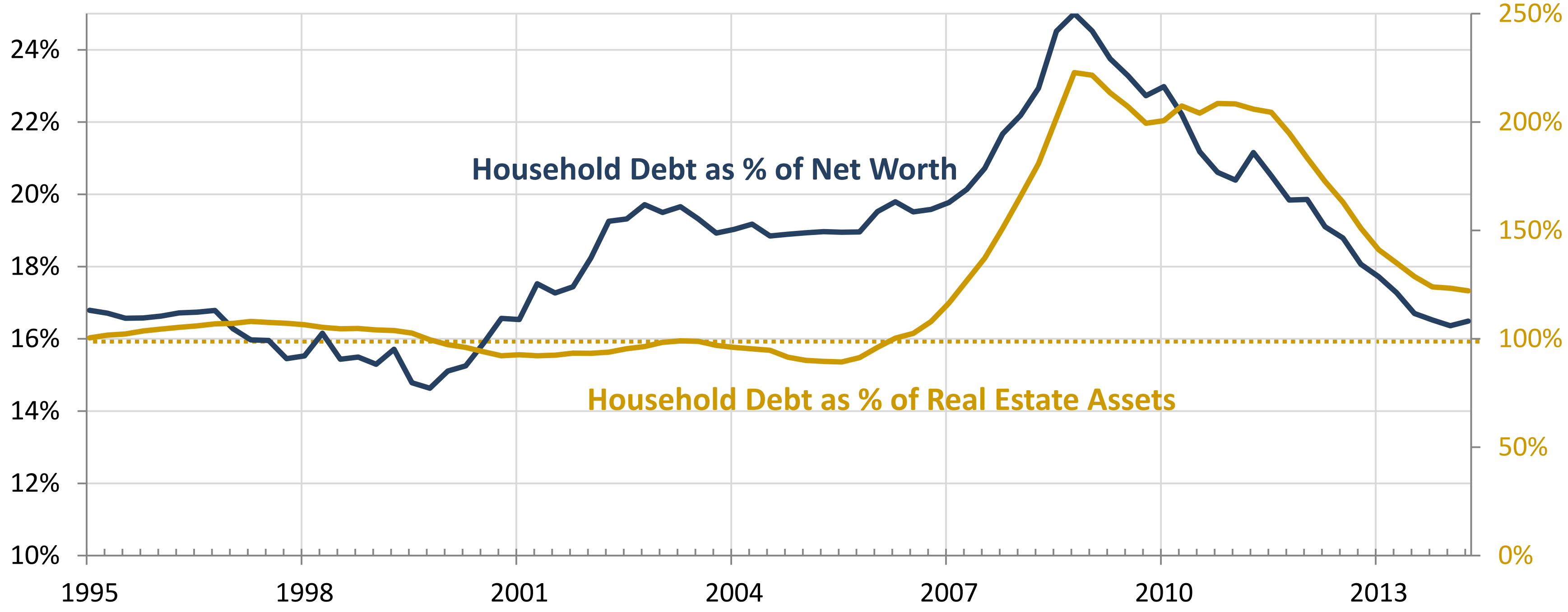
Equity Prices Reflect Short-Term Tailwinds and Strong Corporate Profits, Bond Prices Reflect Longer-Term Challenges

Deleveraging Process Appears Complete

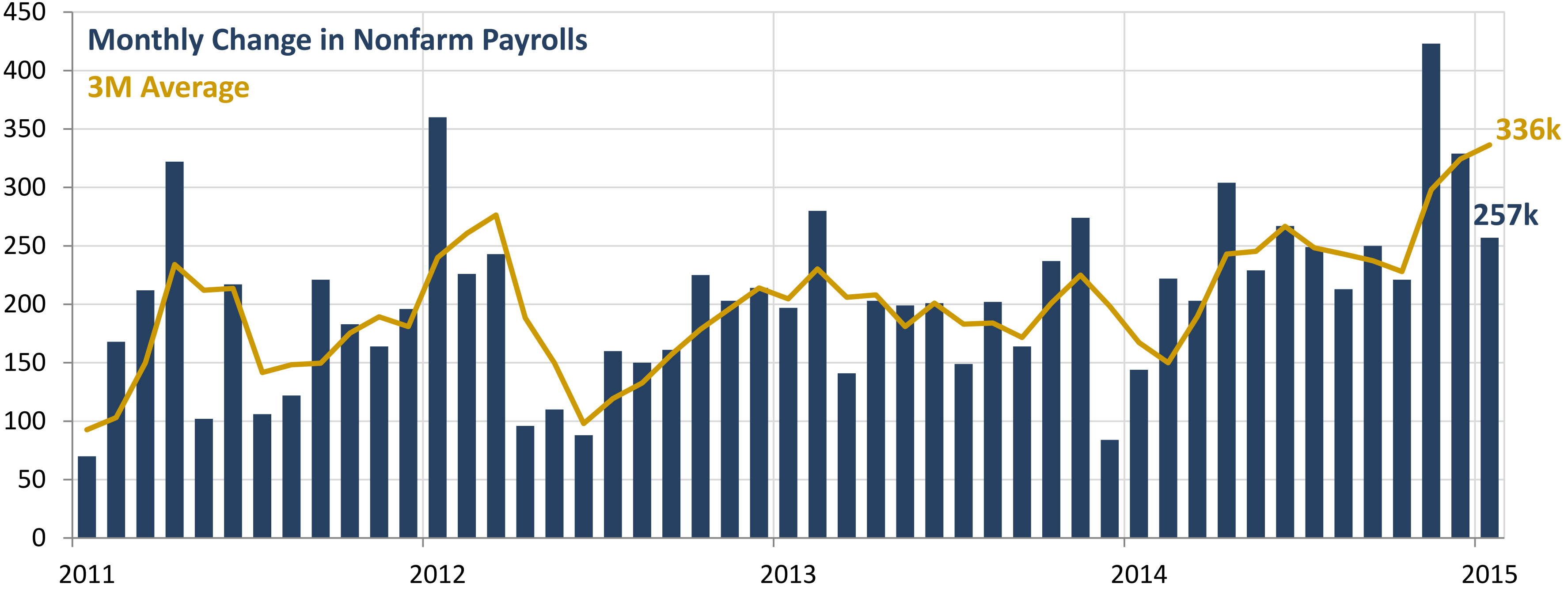
Debt as a percentage of net worth and real estate assets appears to have leveled off ending the deleveraging process for the consumer.



Sources: Federal Reserve Flow of Funds Report, Vining Sparks

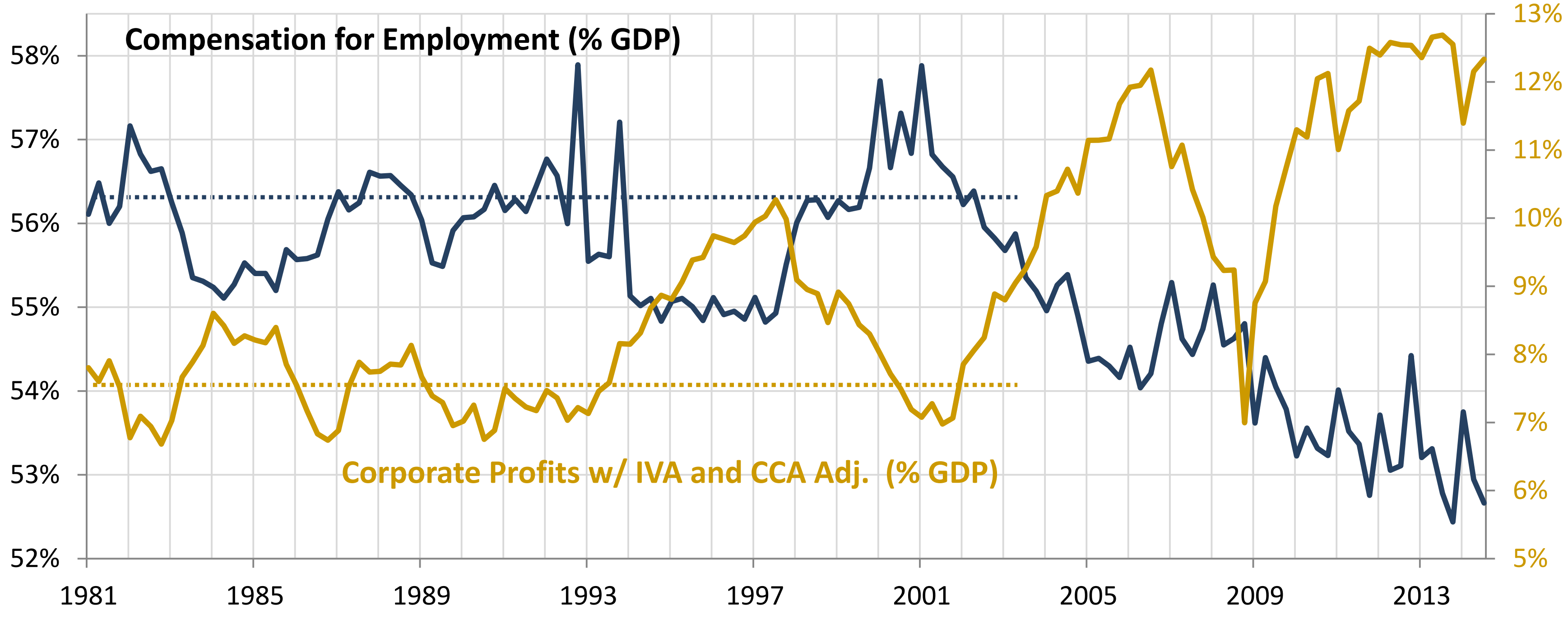
Best Nonfarm Payroll Growth Since ‘97

The economy, having added over one million payrolls in the last three months, is showing the best pace of job growth since 1997.



Waiting on Wage Growth

Corporations have taken an increasingly larger share of profits in lieu of distributing them through employee compensation. This has historically been cyclical.



Sources: Bureau of Economic Analysis, Vining Sparks

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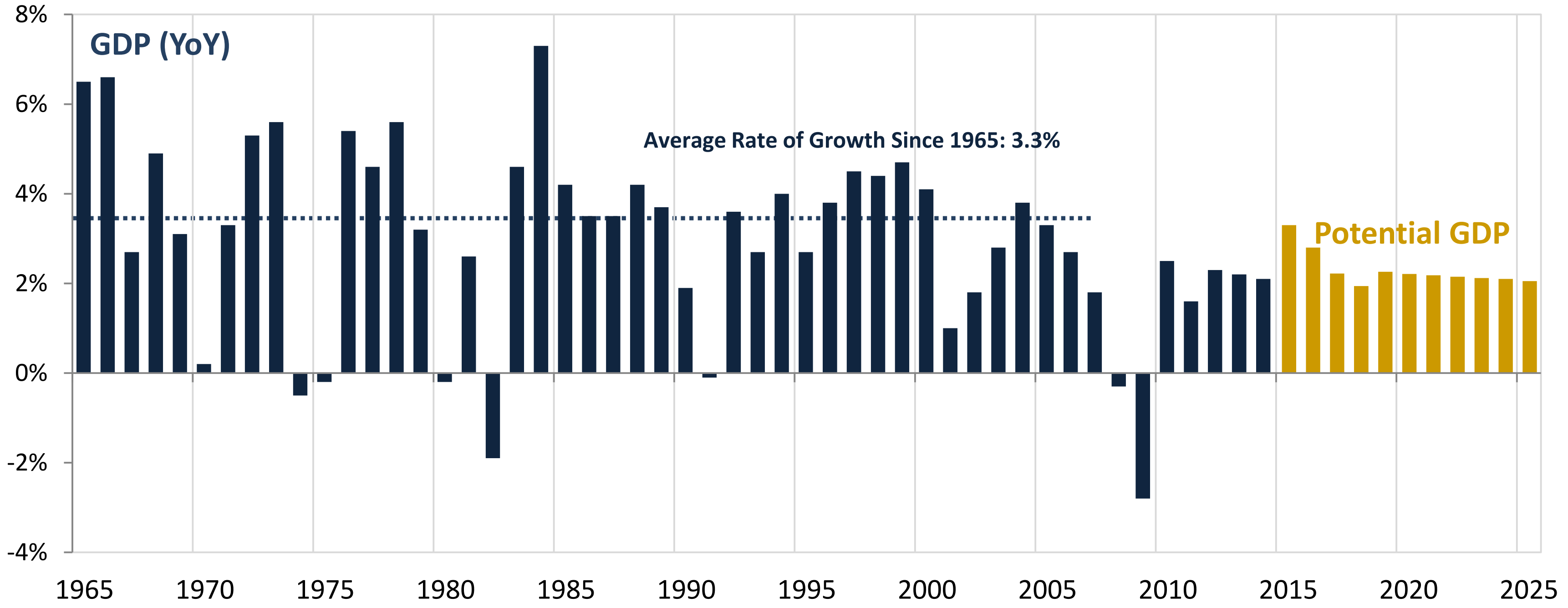
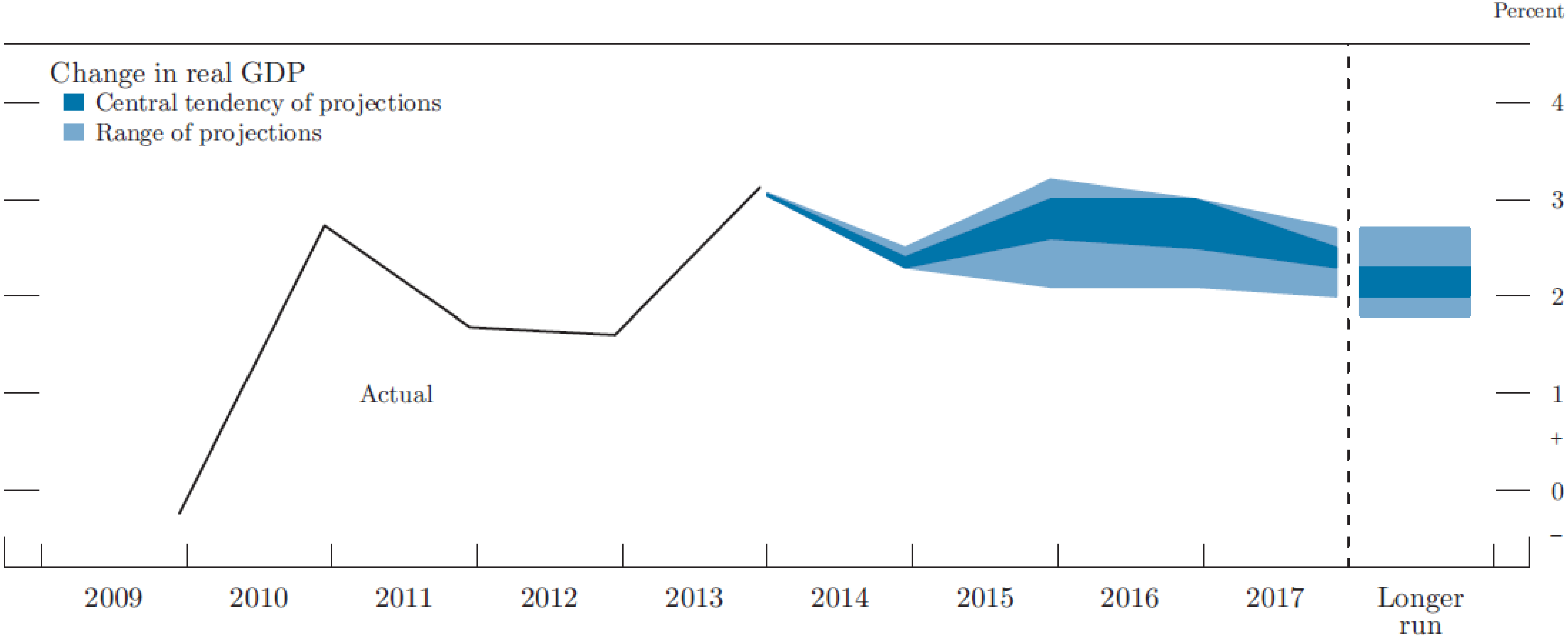
CBO's GDP Projections

The Congressional Budget Office projects that GDP growth will slow from 3.3% (from 1965 to 2007) to 2.3% (from 2015 to 2025)



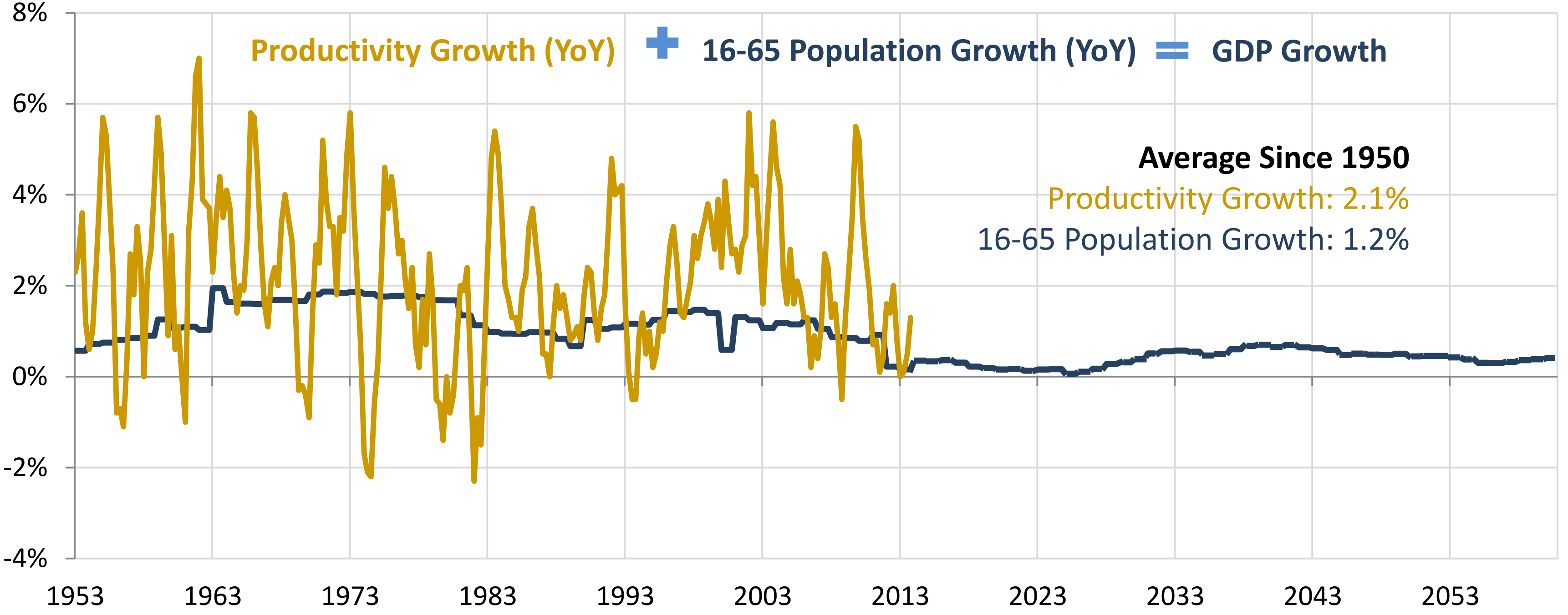
Federal Reserve's GDP Projections

While the Fed believes GDP will grow in the mid-2.0% range for the next three years, they also project that growth will slow to 2.0 to 2.3% over the longer-run



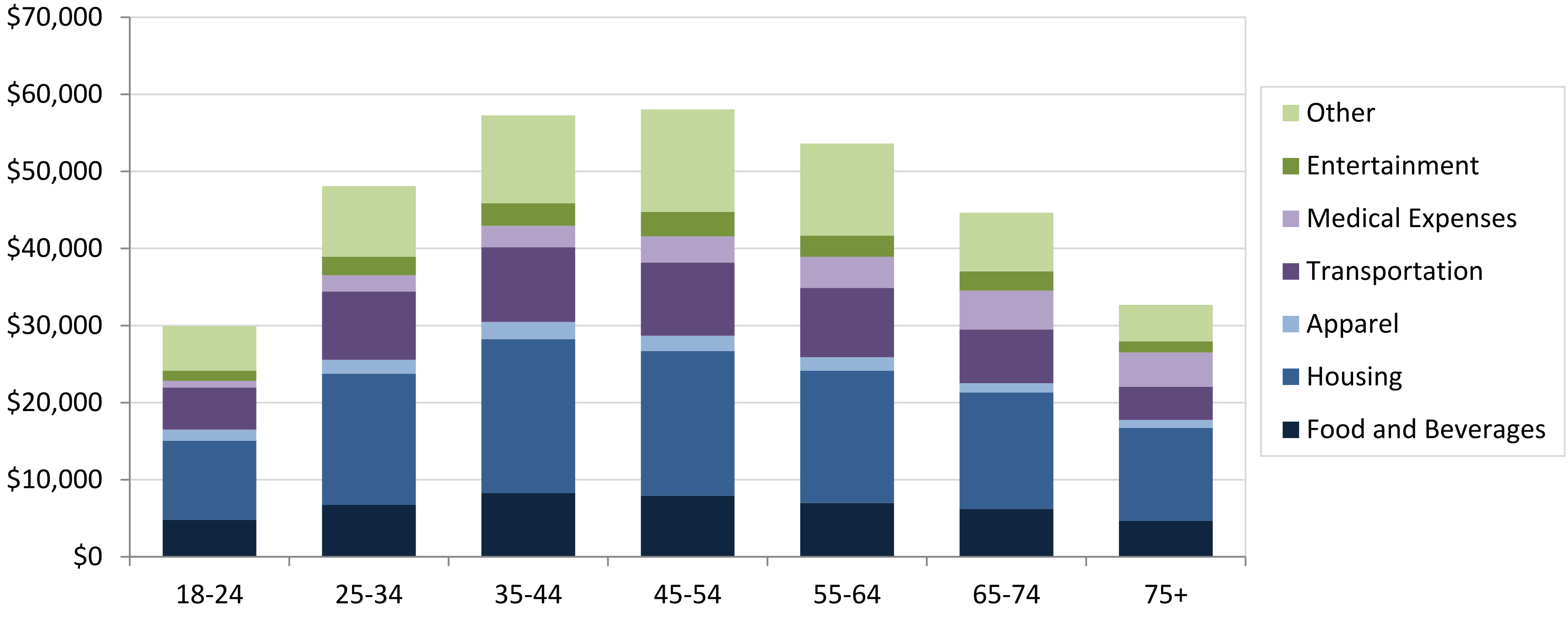
Change in Output Potential

If workers continue to retire between 65 and 67 years-of-age, pool of available labor growth slows to 0.1% over the next 10 years, 0.4% through 2060.



Change in Consumption Habits

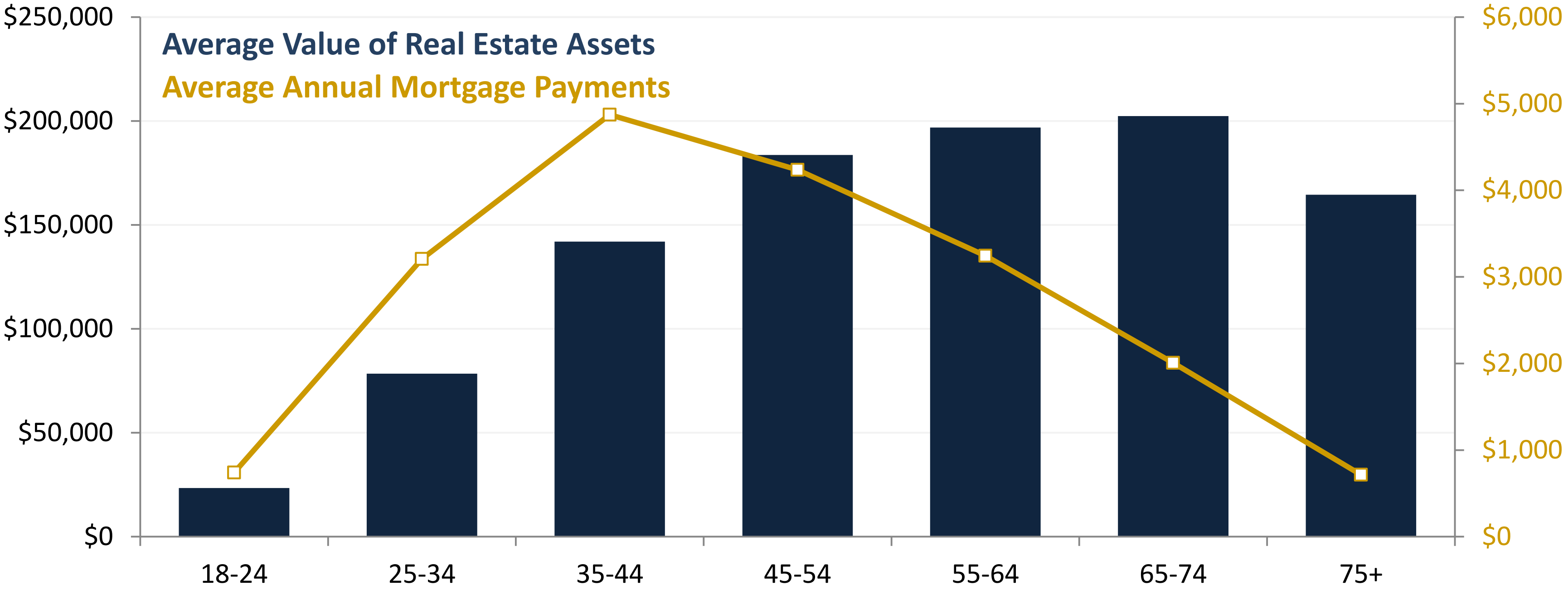
People consume goods and services differently as they age also, spending more on medical expenses but spending much less overall.



Sources: Federal Reserve Consumer Expenditure Survey, Vining Sparks

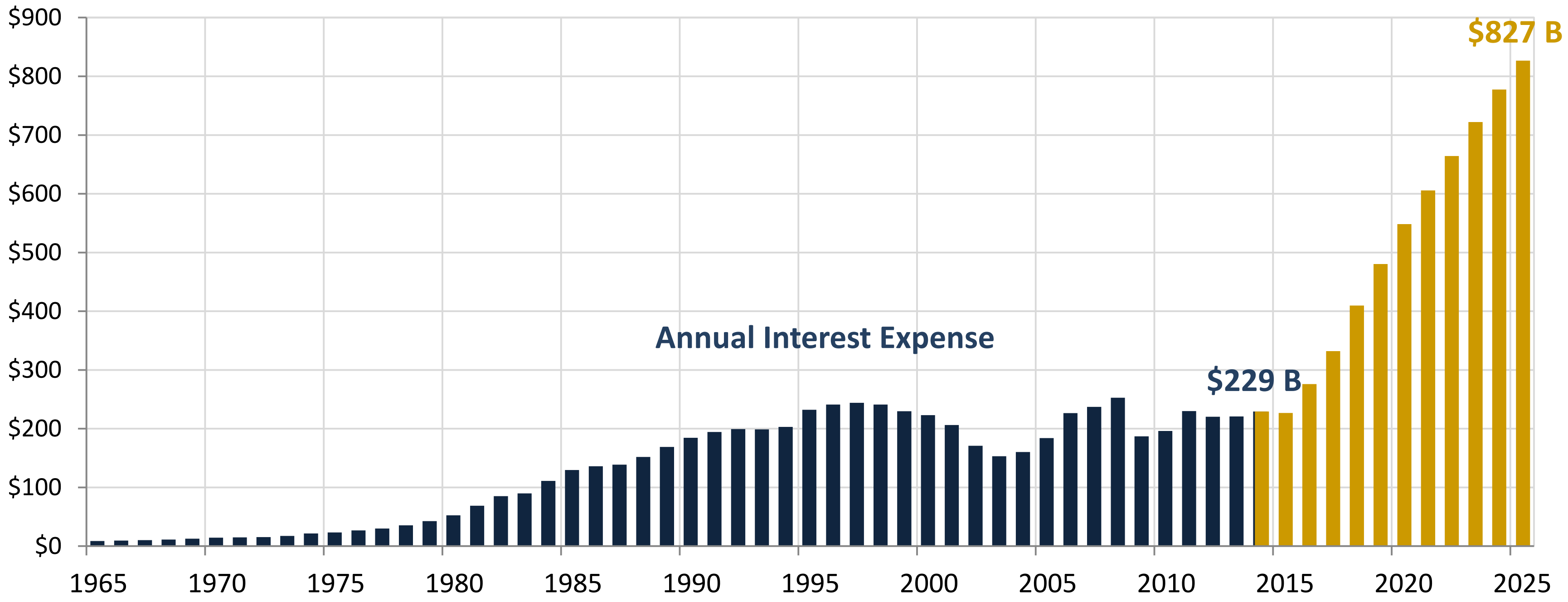
Change in Leverage Habits

Aging households do not leverage like younger households, slowing the velocity of money.



Net Interest Expense

The severity of the problem is acute with interest expense projected to increase $600 billion over the next 10 years.

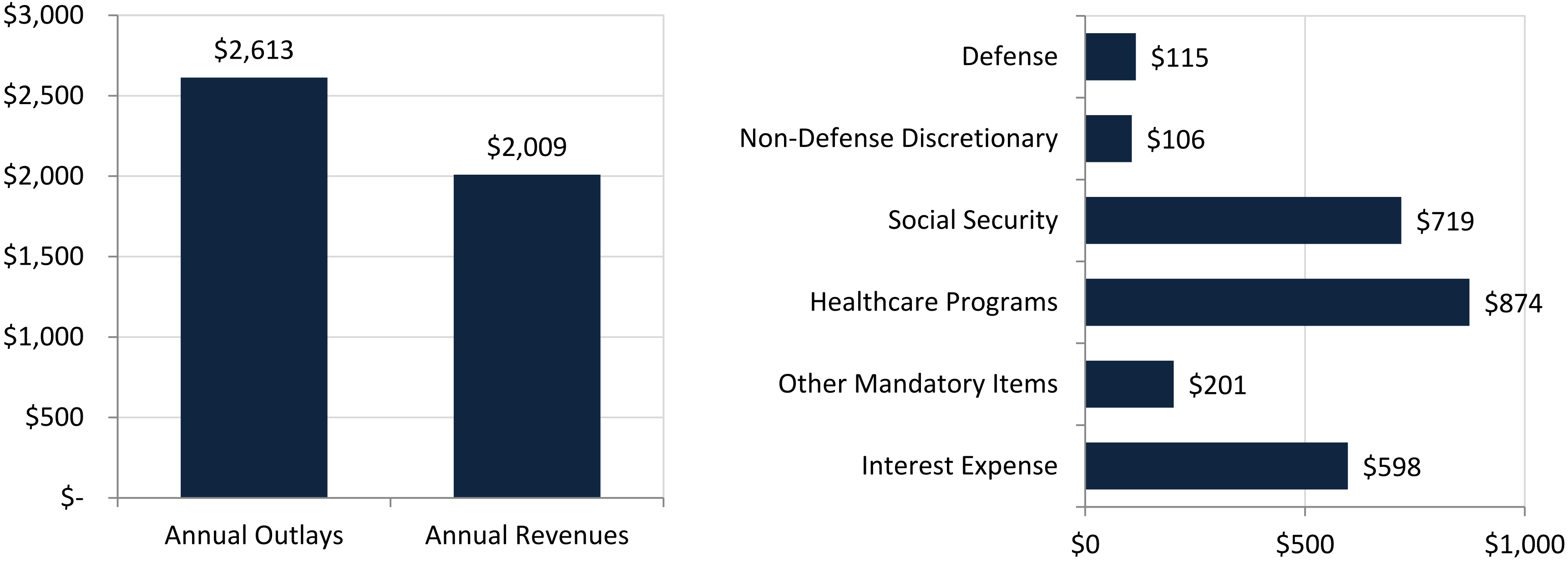


Sources: Congressional Budget Office, Vining Sparks

Growth of Debt Difficult to Slow

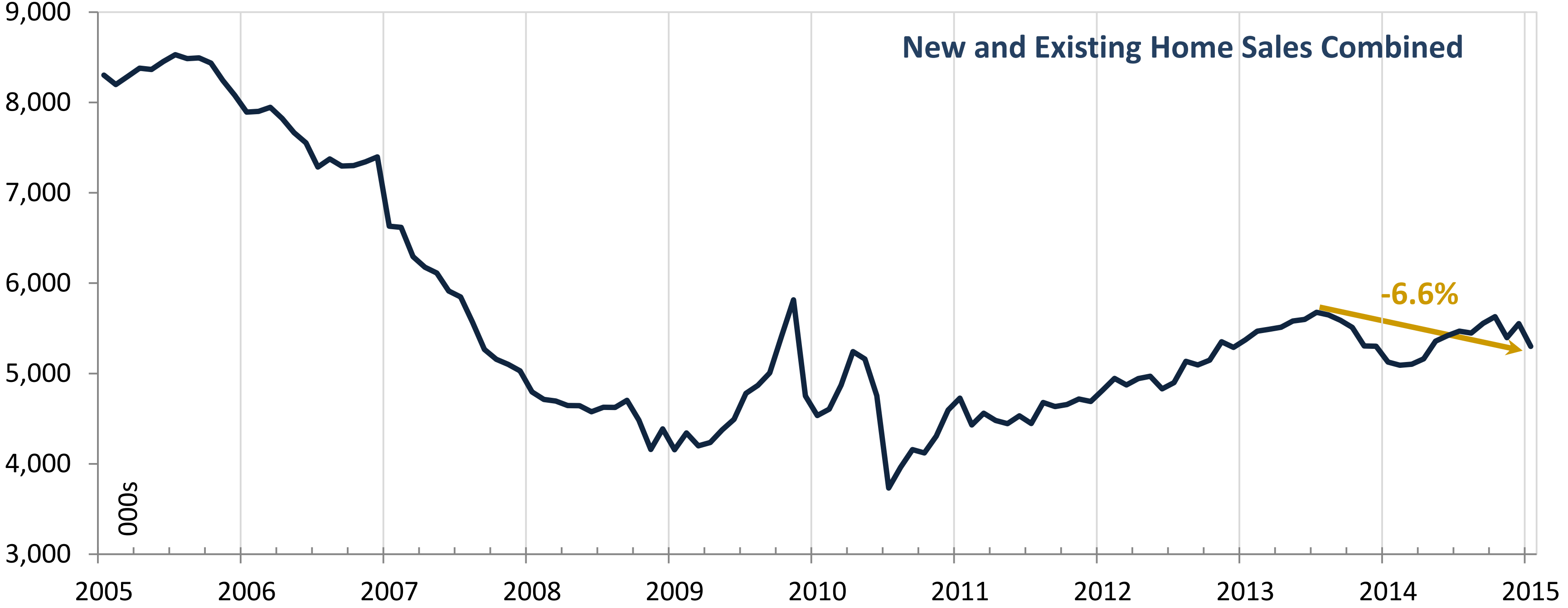
Inflating the country out of its debt problem is not an option this time. Growth in spending is primarily in mandatory items and interest expense which will be very difficult to cut.

Projected Growth in Annual Outlays and Revenues from 2014 to 2025



Changing Dynamics in Housing

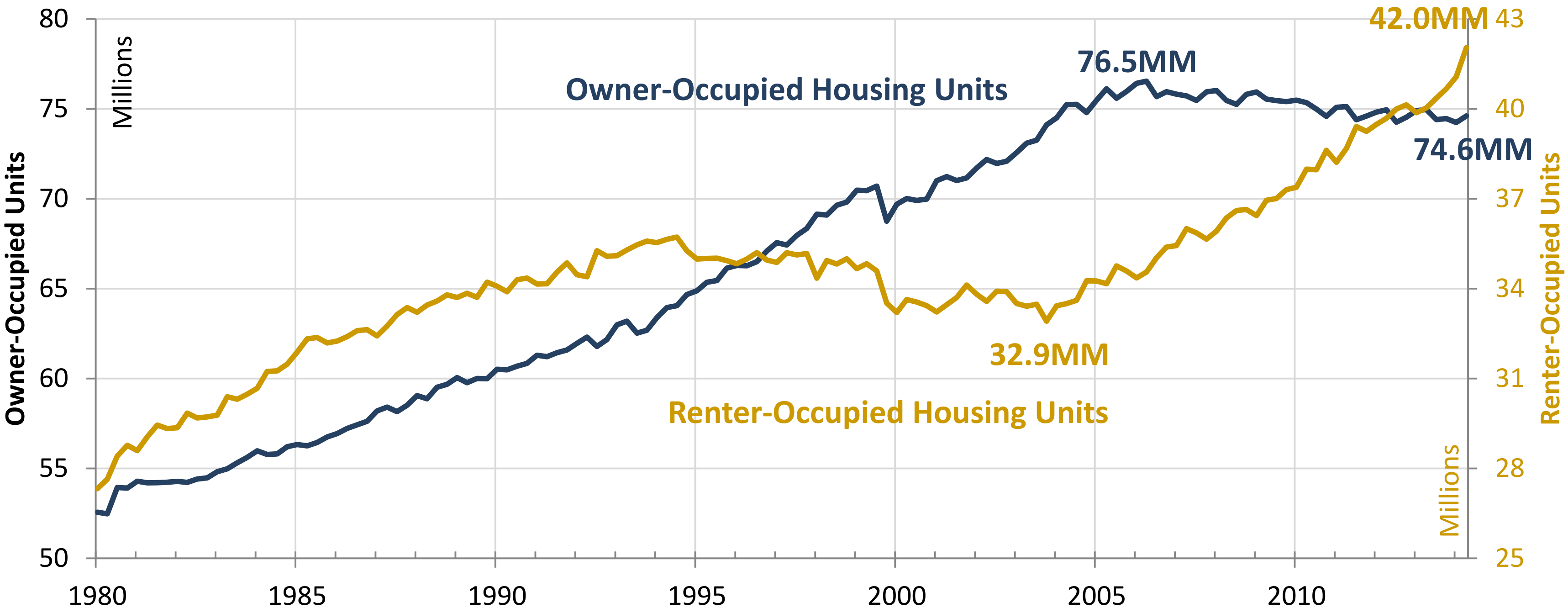
New and existing homes sales have fallen 6.6% from their 2013 peak after a marginal increase in mortgage rates.



Sources: National Association of Realtors, Vining Sparks

Changing Dynamics in Housing

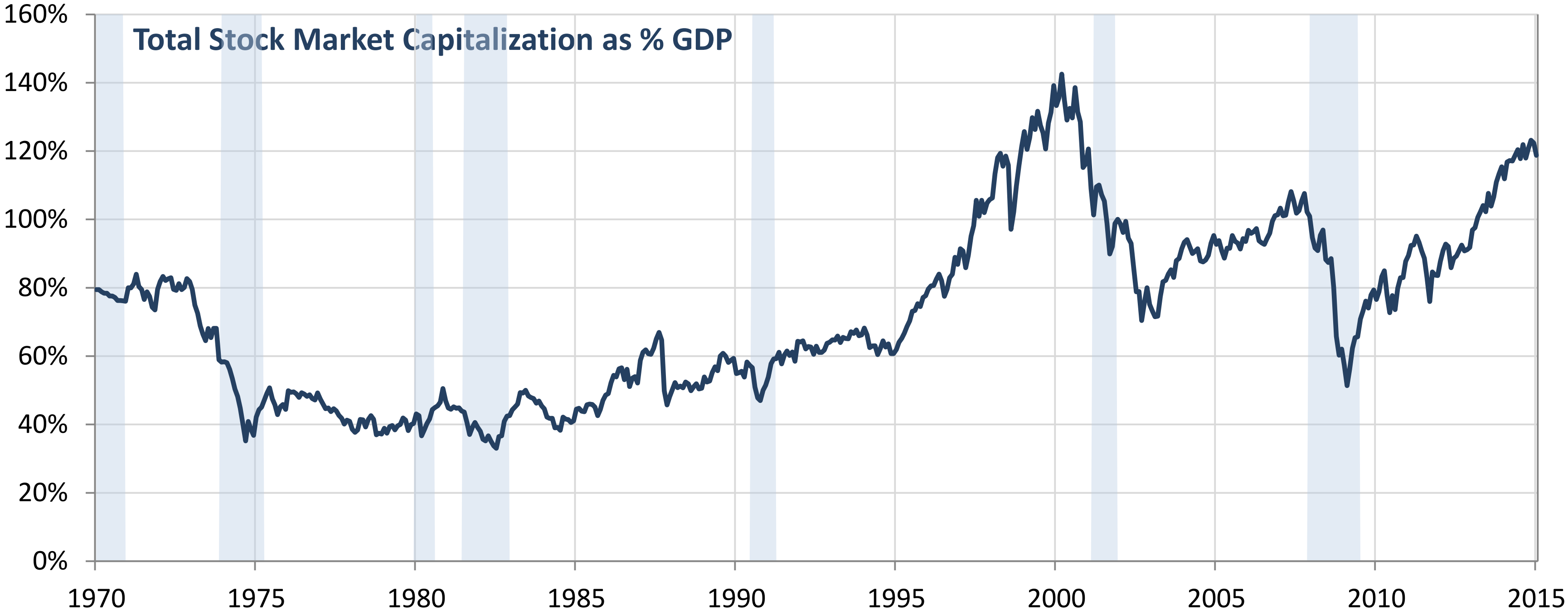
Housing market appears to be more rate-sensitive during this cycle than in the 80s or 90s because of who is purchasing homes – investors.



Sources: Census Bureau, Vining Sparks

Asset Bubbles - Stocks

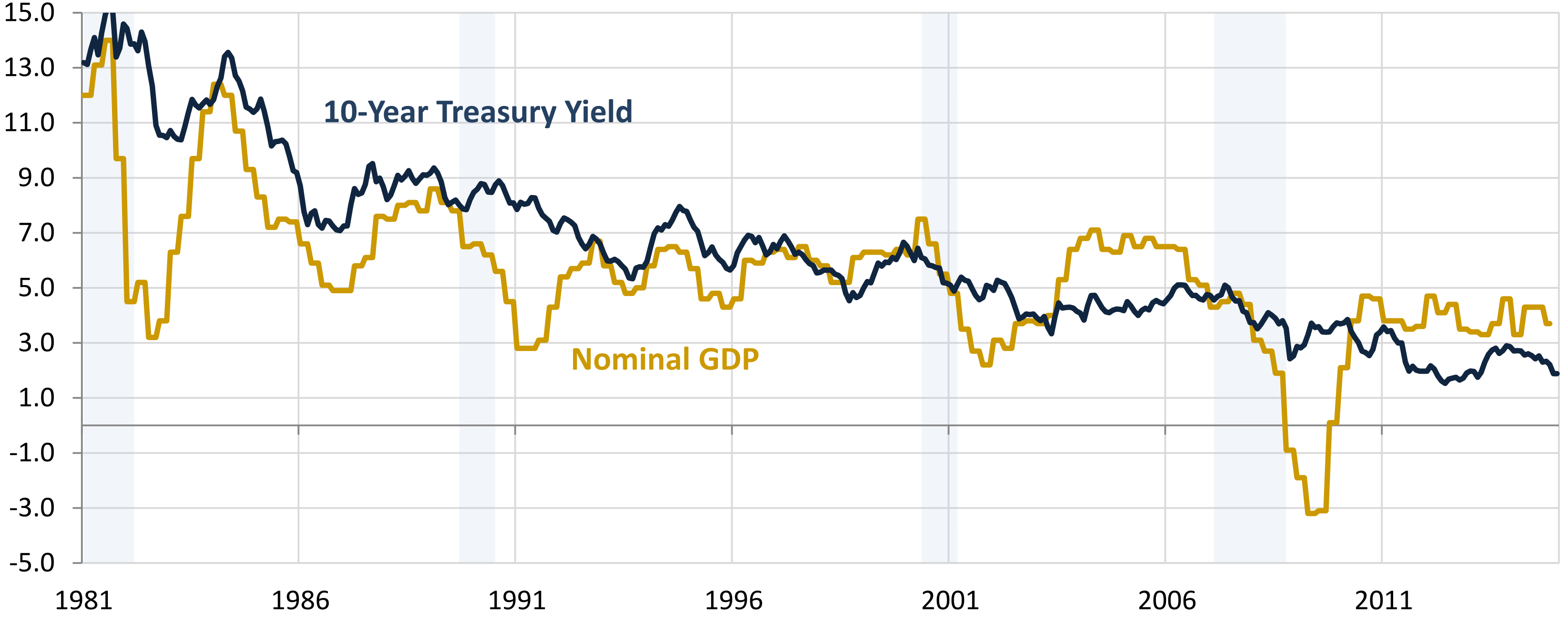
Stock valuations have not been this high in relation to overall GDP since the Tech Bubble.



Sources: Wilshire 5000 as % of GDP, Bloomberg, Bureau of Economic Analysis, Vining Sparks

Asset Bubbles - Bonds

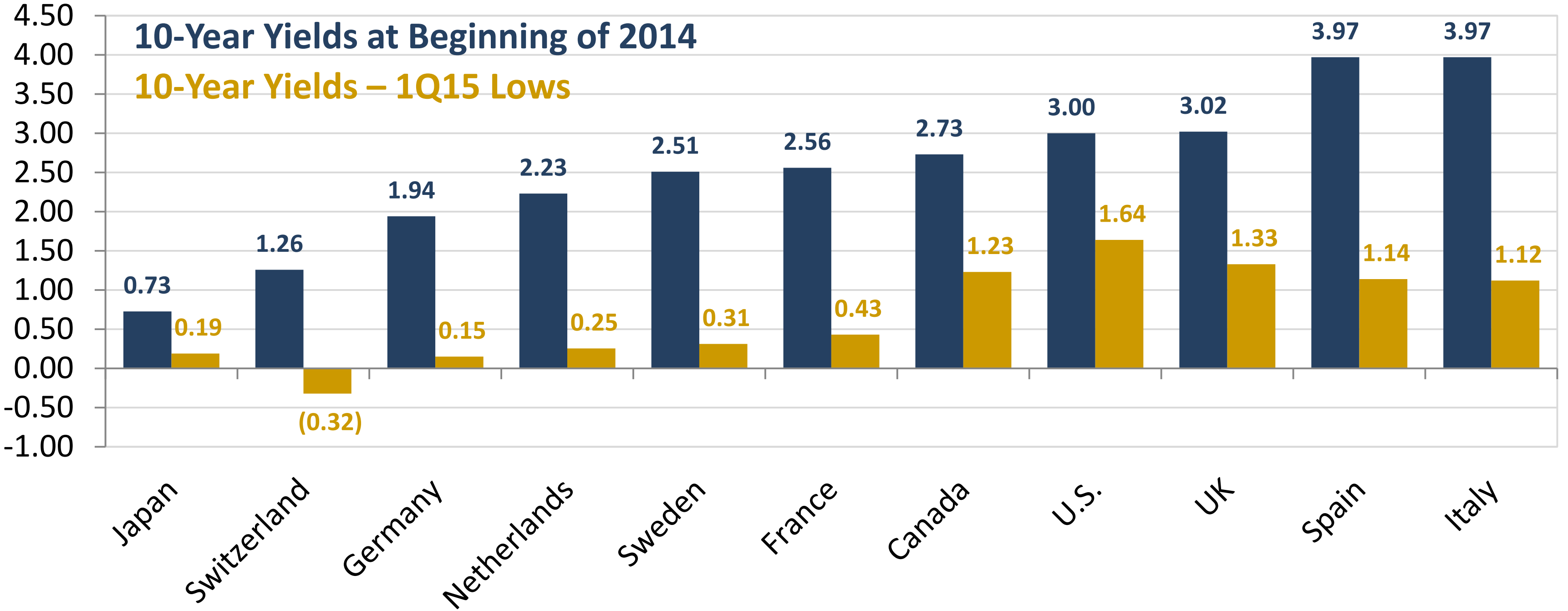
With the 10-year Treasury yield trading almost 200 bps below nominal GDP, this reflects another distorted market.



Sources: Bureau of Economic Analysis, Bloomberg, Vining Sparks

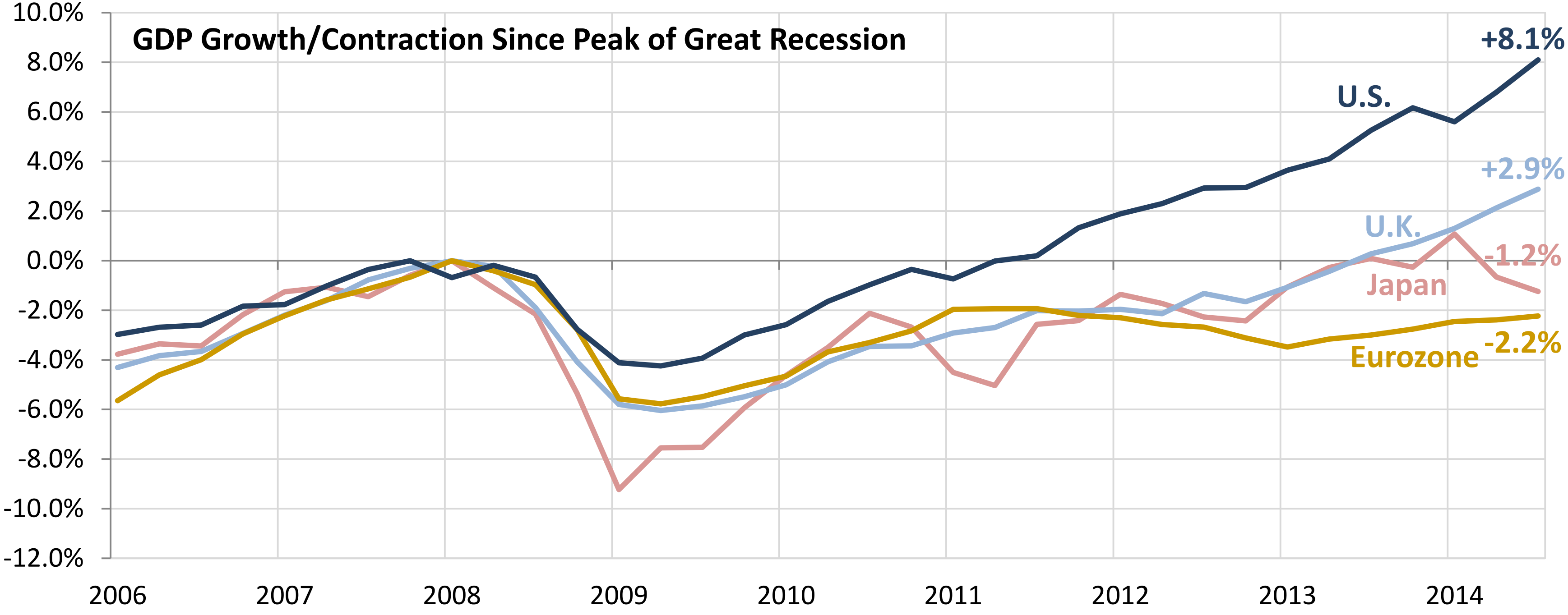
ECB QE Pushing Global Yields Lower

As ECB has eased monetary policy, Eurozone yields have fallen pushing global yields lower as well.



Global Weakness Abounds

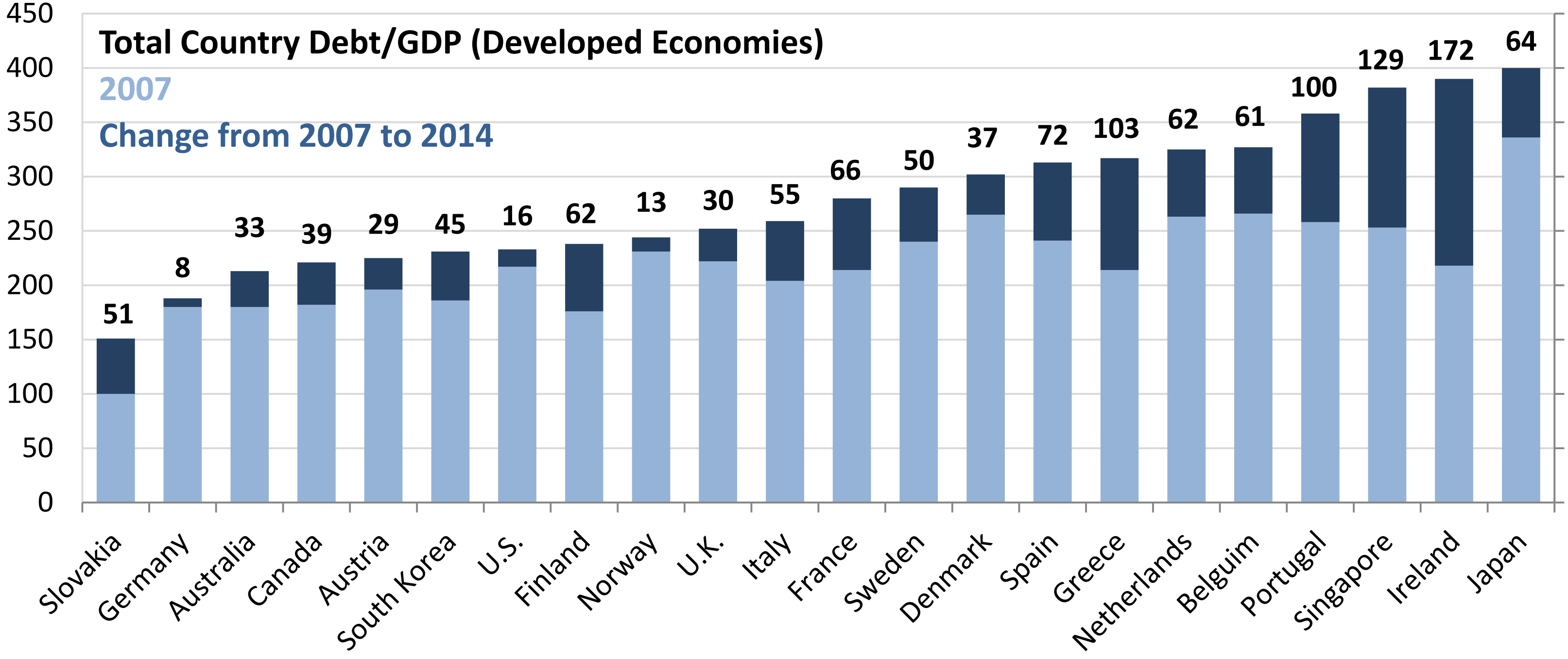
The U.S. is the lone bright spot in an otherwise weak-growing global economy. The question is if the U.S. can drag others along with it, or if others will drag down U.S. growth.



Sources: Eurostats, UK ONS, ESRI Japan, BEA, Vining Sparks

Global Debt Has Grown $57T Since '07

"High debt levels, whether in the public or private sector, have historically placed a drag on growth and raised the risk of financial crises that spark deep economic recessions." *McKinsey 2015*



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Evolving Fed Guidance

FOMC forward rate guidance has now evolved one more step to focus on inflation.

~~2013~~

~~2014~~

~~2015~~

~~6.5% Unemployment Rate~~

~~Well Past 6.5% Unemployment Rate~~

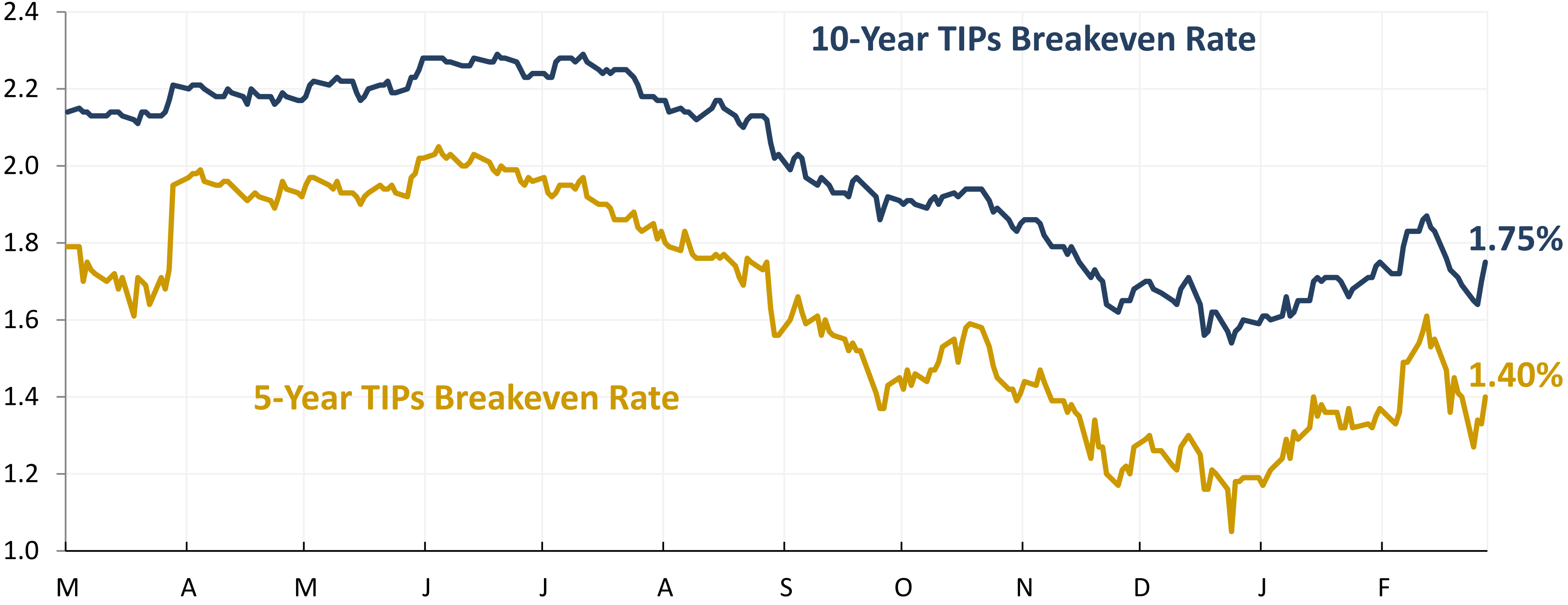
~~Considerable Time~~

~~Patient~~

Reasonably Confident

Market Expects Lower Inflation

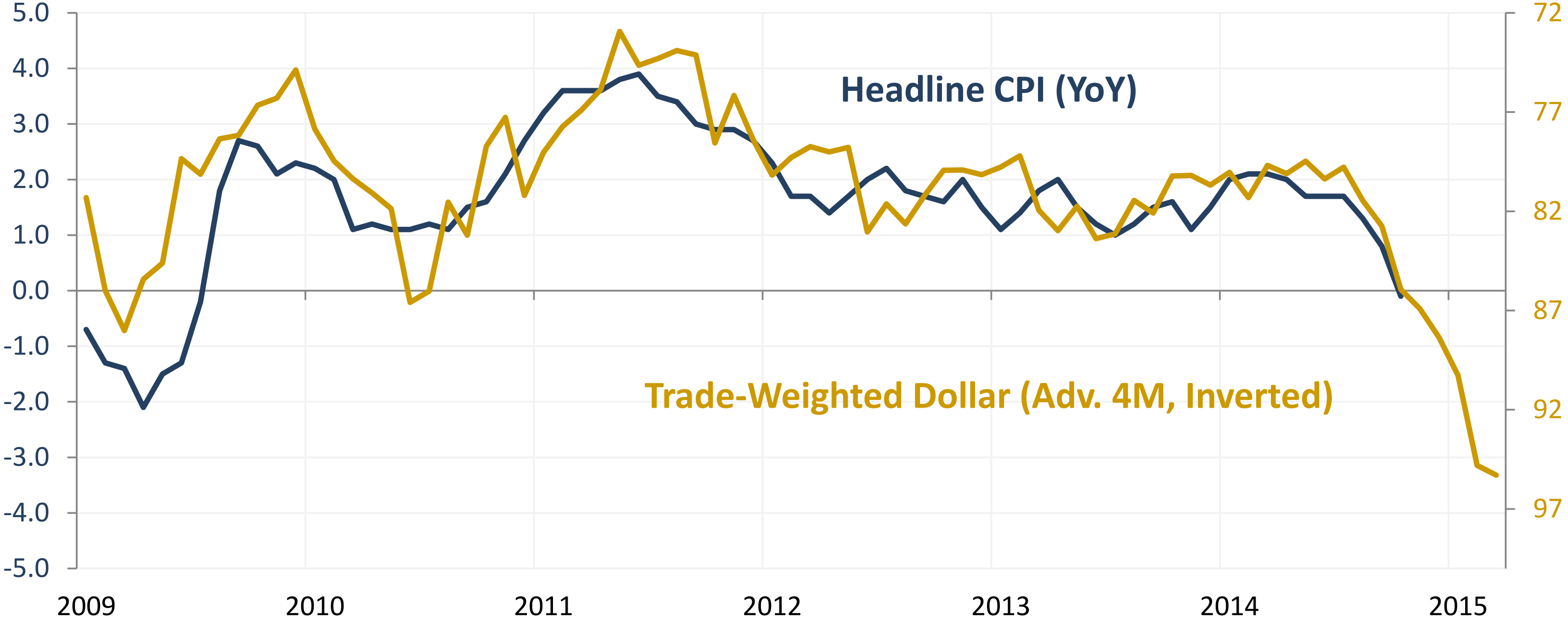
Market-based measures of inflation point to below-2.0% inflation for years to come. The Fed argues that this is being distorted by liquidity issues.



Sources: Bloomberg, Vining Sparks

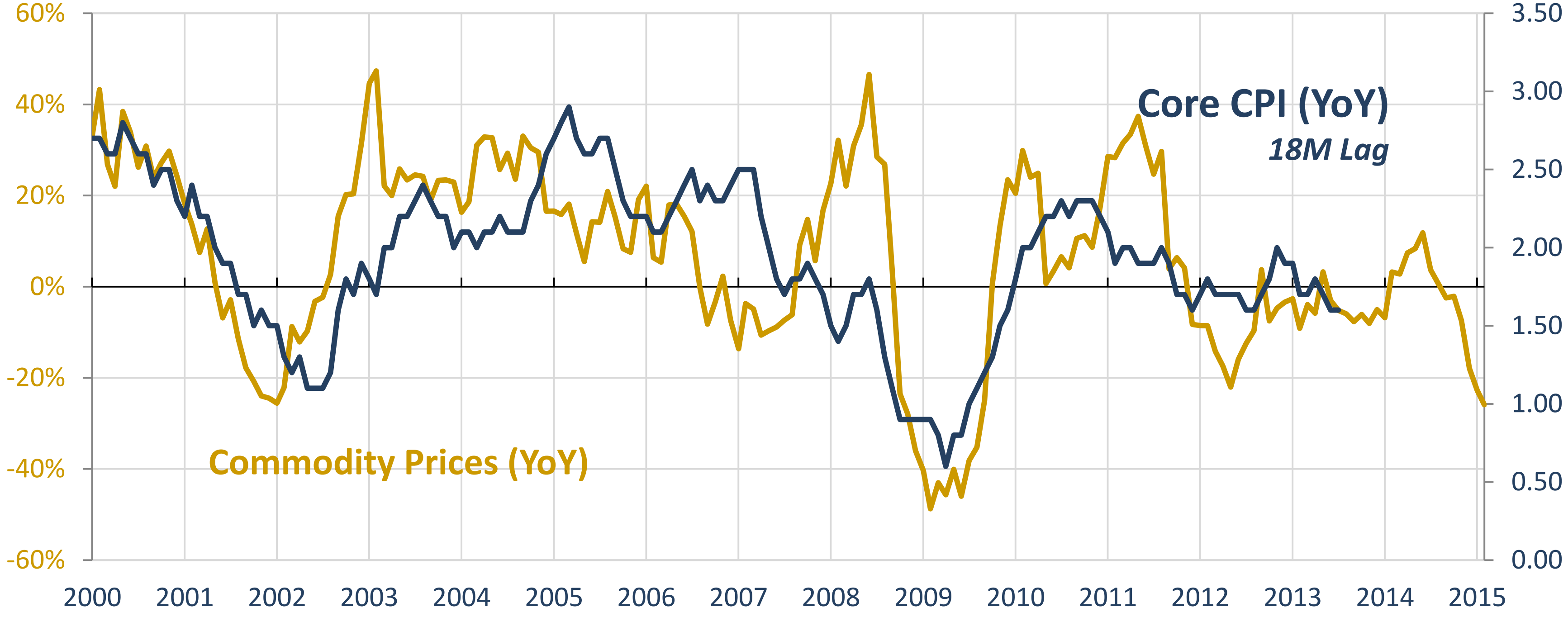
Strong Dollar Points to Lower Inflation

The fact that the Fed is the only major central bank in a tightening pattern is pushing the Dollar higher and working to keep inflation below the Fed's stated target.



Commodities Point to Lower Inflation

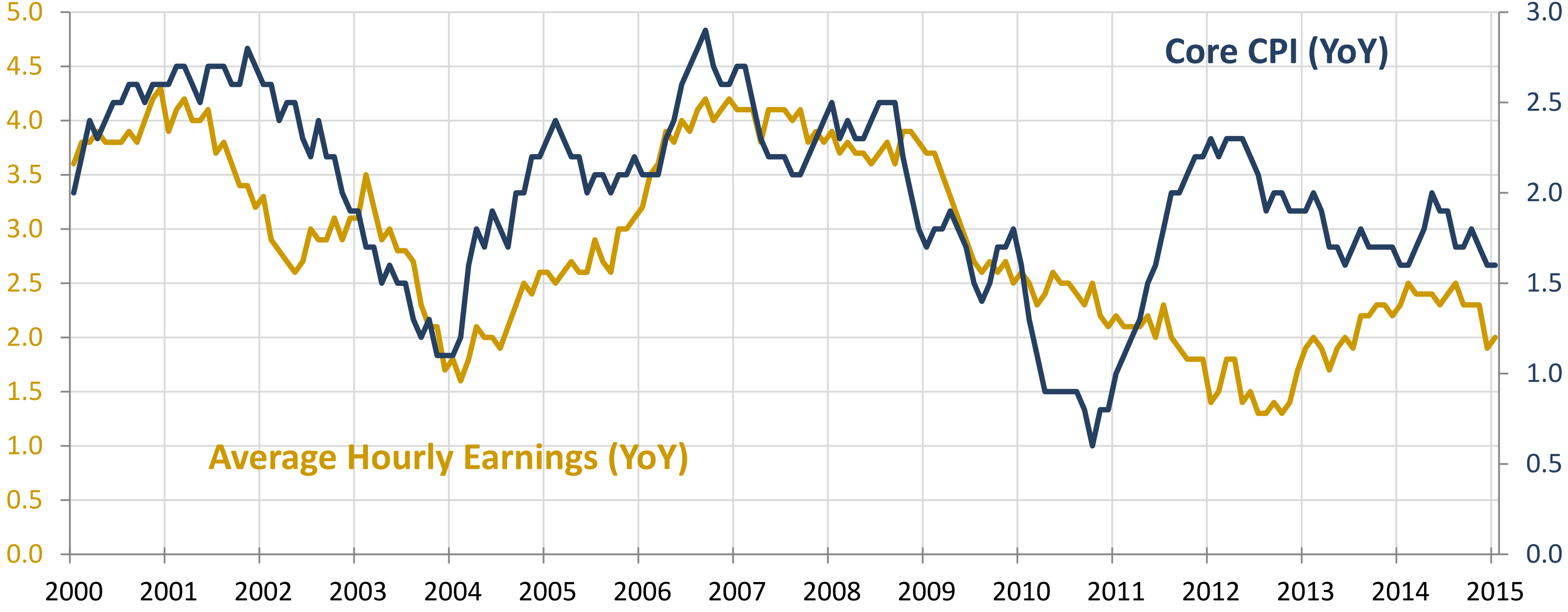
Commodity prices, which leads core inflation by 18 months, points to lower inflation in the coming years also.



Sources: CRB Commodity Price Index, BLS, Vining Sparks

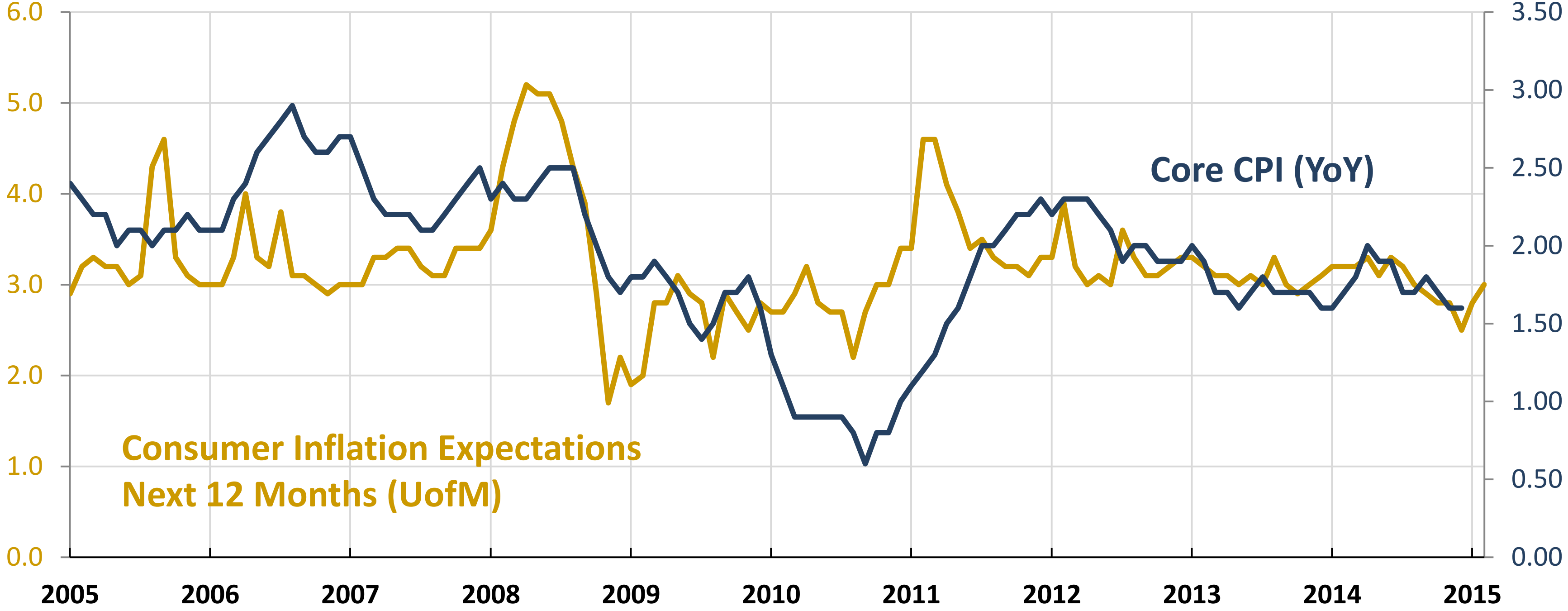
Earnings Growth Remains Weak

There does not appear to be any source of significant inflation in the near term absent a rebound in earnings growth – which has not yet materialized.



Consumer Inflation Expectations Key

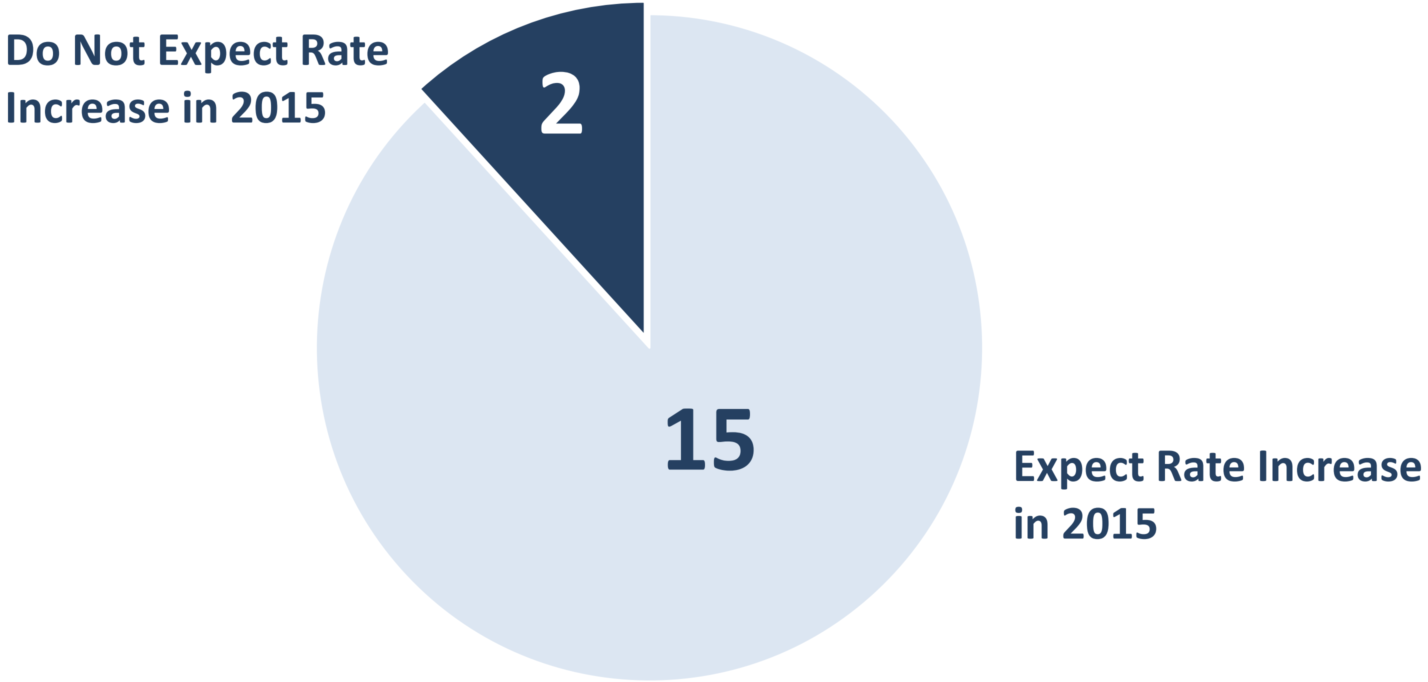
Consumer inflation expectations are one of the key metrics being watched by the FOMC as they anticipate when to raise rates.



Sources: University of Michigan, Bureau of Labor Statistics, Vining Sparks

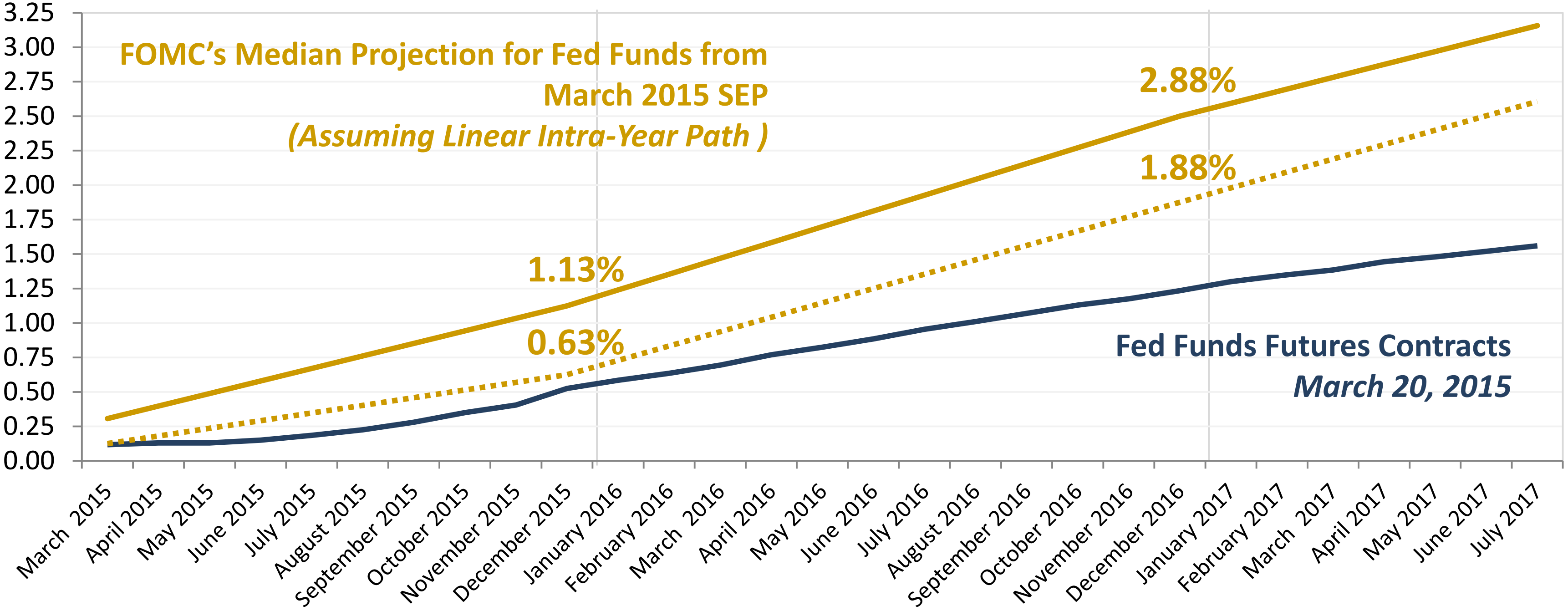
Fed Thinks They Will Raise Rates

While there are compelling arguments on both sides of the issue, 15 of 17 FOMC participants project that the Overnight Target rate will be raised in 2015.



FOMC and Market Rate Expectations

In their March SEP, the FOMC significantly dropped its rate projections to 0.625% by year-end 2015 and 1.875% by year-end 2016.



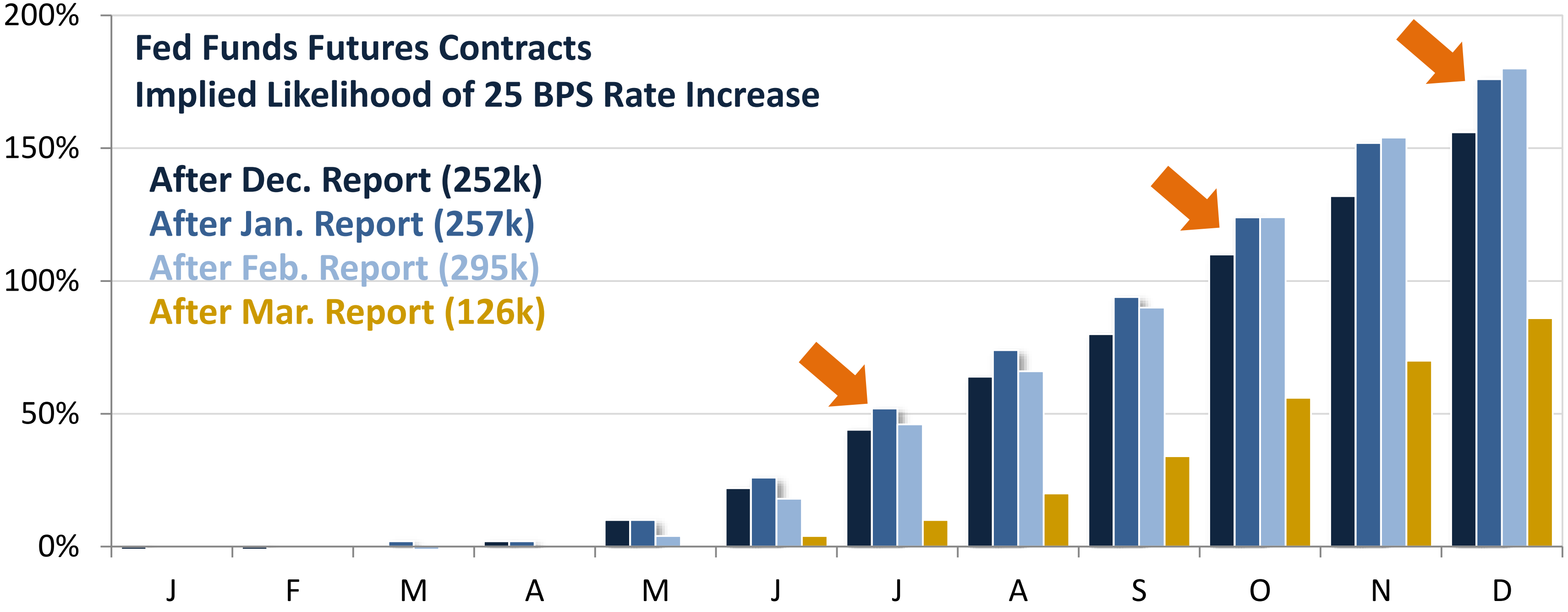
A Yellen “Collar”?

Bernanke had his “put,” but if Dudley is prescient, Yellen may try to “collar” the market.

- Dudley On the Pace of Tightening:
  - “If financial-market conditions do not tighten much in response to higher short-term interest rates, we might have to move more quickly”
  - “In contrast, if financial conditions tighten unduly, then this will likely cause us to go much more slowly or even to pause for a while.”

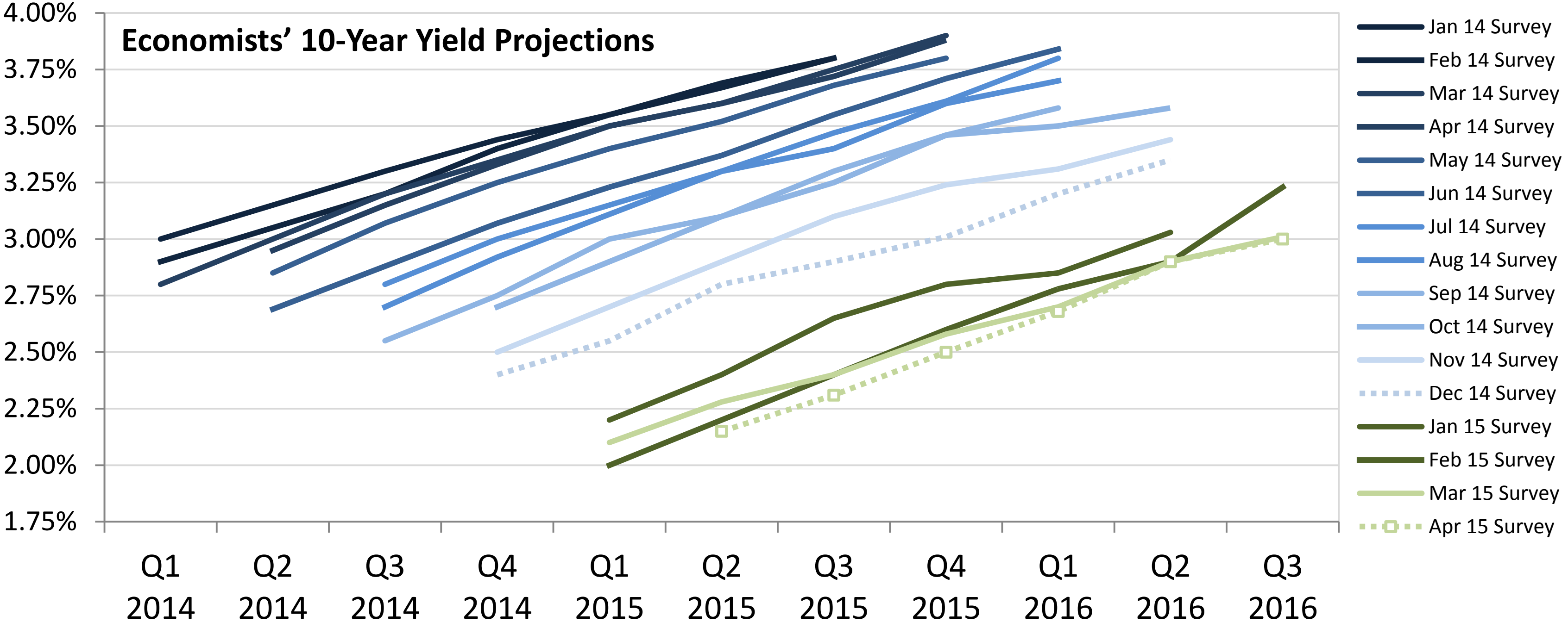
Market Expectations Evolving Also

Prior to the disappointing March jobs report, market generally expected a 50/50 chance of increase by summer, a 100% chance of an increase by October, and possibly two increases this year.



Economists' 10-Year Yield Forecasts

As 2014 progressed, economists gradually but steadily brought their longer-term yield forecasts lower and lower. In 2015, the same is occurring.



Few Changes from 1Q15 Outlook

The consumer has not been the catalyst it was expected to be, although there is sufficient pent up savings to drive a solid rebound. Market changes complicating Fed decision.

- Consumer Poised to Drive Economy at Decent Pace <u>Once They Begin Spending Gasoline Savings</u>
- Wage Growth Likely to Finally Take Hold
- All Signs Point to Housing Being <u>Stronger-than-Expected</u>
- Tectonic Shifts in Markets, as Other Economies Struggle, <u>Likely</u> Prolong Fed Decision
- Slow Moving Fed Should Eventually Hike Rates This Year, <u>but Maybe Only Once</u>
- Yield Curve Likely to Continue to Flatten