Over the past few years, U.S. economic activity has remained sluggish and well below potential. The U.S. economy has yet to show convincing signs of shifting from a path of sluggish growth toward one of accelerating growth. We saw growth rates of -2.8 percent, 2.5 percent, 1.9 percent, 2.8 percent and 1.8 percent in 2009, 2010, 2011, 2012 and 2013, respectively.

Initial data show U.S. real gross domestic product (GDP) grew at an annual rate of 0.1 percent in first quarter 2014 (Chart 1). That rate of growth marks a second quarter of slowing after three quarters of accelerating growth. Many experts attribute the sharp slowing in first quarter to severe winter weather disrupting economic activity.

After first quarter 2014, a gradual improvement in U.S. economic activity can be expected, with growth rates of 2.7 percent and 3.3 percent in 2014 and 2015, respectively.

Contributions to U.S. Economic Growth

During 2013, U.S. real GDP grew at an average annual rate of 1.9 percent (Table 1). Consumer spending, business fixed investment and residential investment made the largest contributions. Net exports and inventory investment made smaller contributions. Government purchases made negative contributions.

The sharp slowdown in first quarter 2014 was mostly evident in reduced business fixed investment and residential investment. Reduced state and local government spending lowered overall government purchases. Exports were sharply down—creating a relatively normal trade balance when averaged with fourth quarter 2013. Inventories also were reduced sharply after having been built up considerably in the first three quarters of 2013.

For second quarter 2014, we expect an overall increase in final domestic sales—with a slight decline in the contribution of consumer spending, positive contributions from business fixed investment and residential investment and about the same negative contribution from government purchases (Table 2). We also expect to see net exports at zero and a continued reduction in inventories.
Table 1. Contributions to the Growth of U.S. Real GDP

<table>
<thead>
<tr>
<th></th>
<th>2012</th>
<th>2013</th>
<th>2013Q1</th>
<th>2013Q2</th>
<th>2013Q3</th>
<th>2013Q4</th>
<th>2014Q1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP (percent change annual rate)</td>
<td>2.8</td>
<td>1.9</td>
<td>1.1</td>
<td>2.5</td>
<td>4.1</td>
<td>2.6</td>
<td>0.1</td>
</tr>
<tr>
<td>Contributions to Real GDP Growth</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Final Domestic Sales</td>
<td>2.49</td>
<td>1.60</td>
<td>0.49</td>
<td>2.13</td>
<td>2.33</td>
<td>1.65</td>
<td>1.52</td>
</tr>
<tr>
<td>Personal Consumption</td>
<td>1.52</td>
<td>1.37</td>
<td>1.54</td>
<td>1.24</td>
<td>1.36</td>
<td>2.22</td>
<td>2.04</td>
</tr>
<tr>
<td>Business Fixed Investment</td>
<td>0.85</td>
<td>0.33</td>
<td>-0.57</td>
<td>0.56</td>
<td>0.58</td>
<td>0.68</td>
<td>-0.25</td>
</tr>
<tr>
<td>Residential Investment</td>
<td>0.32</td>
<td>0.33</td>
<td>0.34</td>
<td>0.40</td>
<td>0.31</td>
<td>-0.26</td>
<td>-0.18</td>
</tr>
<tr>
<td>Government Purchases</td>
<td>-0.20</td>
<td>-0.43</td>
<td>-0.62</td>
<td>-0.07</td>
<td>0.08</td>
<td>-0.99</td>
<td>-0.09</td>
</tr>
<tr>
<td>Net Exports</td>
<td>0.10</td>
<td>0.12</td>
<td>-0.28</td>
<td>-0.07</td>
<td>0.14</td>
<td>0.99</td>
<td>-0.83</td>
</tr>
<tr>
<td>Exports</td>
<td>0.48</td>
<td>0.36</td>
<td>-0.18</td>
<td>1.04</td>
<td>0.52</td>
<td>1.23</td>
<td>-1.07</td>
</tr>
<tr>
<td>Imports</td>
<td>-0.38</td>
<td>-0.24</td>
<td>-0.10</td>
<td>-1.10</td>
<td>-0.39</td>
<td>-0.24</td>
<td>0.24</td>
</tr>
<tr>
<td>Inventory Investment</td>
<td>0.20</td>
<td>0.16</td>
<td>0.93</td>
<td>0.41</td>
<td>1.67</td>
<td>-0.02</td>
<td>-0.57</td>
</tr>
</tbody>
</table>

Note: Data are reported at seasonally adjusted annual rates. Source: U.S. Bureau of Economic Analysis

Table 2. Forecast Contributions to the Growth of U.S. Real GDP

<table>
<thead>
<tr>
<th></th>
<th>2014Q2</th>
<th>2014Q3</th>
<th>2014Q4</th>
<th>2015Q1</th>
<th>2015Q2</th>
<th>2015Q3</th>
<th>2015Q4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP (percent change annual rate)</td>
<td>1.9</td>
<td>2.7</td>
<td>3.0</td>
<td>3.0</td>
<td>3.2</td>
<td>3.2</td>
<td>3.3</td>
</tr>
<tr>
<td>Contributions to Real GDP Growth</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Final Domestic Sales</td>
<td>2.2</td>
<td>2.6</td>
<td>2.9</td>
<td>3.0</td>
<td>3.2</td>
<td>3.3</td>
<td>3.4</td>
</tr>
<tr>
<td>Personal Consumption</td>
<td>1.8</td>
<td>1.8</td>
<td>1.9</td>
<td>1.9</td>
<td>2.0</td>
<td>2.0</td>
<td>2.0</td>
</tr>
<tr>
<td>Business Fixed Investment</td>
<td>0.3</td>
<td>0.4</td>
<td>0.5</td>
<td>0.5</td>
<td>0.6</td>
<td>0.6</td>
<td>0.7</td>
</tr>
<tr>
<td>Residential Investment</td>
<td>0.2</td>
<td>0.4</td>
<td>0.4</td>
<td>0.5</td>
<td>0.5</td>
<td>0.6</td>
<td>0.6</td>
</tr>
<tr>
<td>Government Purchases</td>
<td>-0.1</td>
<td>0.0</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
</tr>
<tr>
<td>Net Exports</td>
<td>0.0</td>
<td>0.1</td>
<td>0.0</td>
<td>-0.1</td>
<td>-0.1</td>
<td>-0.2</td>
<td>-0.2</td>
</tr>
<tr>
<td>Inventory Investment</td>
<td>-0.3</td>
<td>0.0</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
</tr>
</tbody>
</table>

Note: Data are reported at seasonally adjusted annual rates. Source: U.S. Bureau of Economic Analysis

Consumer Spending

Consumer spending is the largest component of U.S. real GDP expenditures, accounting for 68.0 percent. From 1947 through 2012, the annual growth rate in real consumer spending averaged 3.4 percent. Real consumer spending grew at a fairly anemic 2.0 percent annual rate during 2013. In doing so, it contributed only slightly more than its usual share to the growth of U.S. real GDP, but was a source of strength in first quarter 2014. After dipping slightly in second quarter, we look for a gradual acceleration in consumer spending.

Private Investment

Private investment spending is a fairly substantial component of U.S. real GDP, accounting for about 16.4 percent. From 1947 through 2012, the annual growth rate of private investment averaged 3.7 percent. Private investment grew at a 5.4 percent rate during 2013. Within the private investment category, residential investment grew at a 12.2 percent annual rate, and business fixed investment grew at a 2.7 percent annual rate. Moderate gains in business fixed investment and accelerating gains in residential investment can be expected during 2014 and 2015. After an inventory decumulation in the first half of 2014, inventory investment should become relatively normal.

Government Spending

Total government spending (including federal, state and local) on goods and services accounts for 18.4 percent of U.S. real GDP. From 1947 through 2012, the annual growth rate of total government spending on goods and services was 2.8 percent. During 2013, total government spending on goods and services declined by 2.2 percent.

Nearly all the easy and tough cuts have been made in government spending. With an improving economy generating increased tax revenue, look for government spending to show moderate growth through 2015.

Net Exports

Exports were a pillar of strength in the early stages of the U.S. economic recovery. In 2013, net exports grew by 2.7 percent. A strong surge in fourth quarter prevented net exports from making a negative contribution for the year. Those gains were nearly offset by declining net exports in first quarter 2014. After net exports return to normal in second quarter 2014, a gradually strengthening U.S. economy will boost foreign investment into the United States, and net exports will gradually shift toward negative.
A Strengthening Economy

Individuals, firms and the financial sector are all in sufficiently good shape to support the strong spending necessary to drive a recovery in U.S. economic activity. Uncertainty about U.S. economic policy has been relatively high since the recession’s end (Chart 2), which has slowed the recovery. As the economy strengthens and uncertainty lifts, U.S. economic activity should accelerate.

A strengthening economy, reduced uncertainty, increased confidence, financing and strong consumption and investment spending go together. As one of these aspects of the economy makes gains, so will the others. As that happens over the next few years, economic growth will improve, and output will close toward its potential. As of first quarter 2014, the gap between U.S. real GDP and its potential was 4.3 percent (Chart 3). By the end of 2015, the gap will close to 2.7 percent.
Energy Prices and Economic Activity

As the result of projections of growing demand and fears of disruptions in Libya, world oil prices rose by a little more than 10 percent from November 2013 to April 2014, and the futures market shows gains can be expected through June 2014. Nonetheless, oil prices have not reached the heights that would cause a recession (Chart 4). Moreover, the futures market shows real oil prices expected to fall by about 10 percent from June 2014 to December 2015. Known as “backwardation,” the decline in oil prices in the futures market indicates the current strength of oil prices is partially the result of temporary factors.

Even if they don’t trigger a recession, elevated energy prices can reduce consumer spending on other activities. The overall effect depends largely on the delivered prices for refined products and natural gas. Jet fuel prices showed much smaller gains than crude oil, but gasoline and natural gas prices showed larger gains.

From November 2013 to April 2014, U.S. gasoline prices rose by 12.3 percent. The gains are the result of rising crude oil prices and seasonal factors—which are at their strongest around the Memorial Day and Labor Day holidays. Gasoline futures show falling prices after May, but the summer driving season should keep gasoline prices from falling very much before September.

As the result of severe winter weather, spot natural gas prices rose by 75.0 percent from August 2013 to February 2014, but none of the gains were passed forward to residential and commercial customers in the form of higher delivered prices because nearly all of the natural gas delivered to those sectors was under contract. The industrial and electric power sectors did see higher prices, but because much of the natural gas delivered to those sectors also was under contract, the gains were smaller than those of the spot price. Since February, much of the gain in spot prices for natural gas has been reversed.

1 Economic analysis shows that 9 of the 11 post-WWII recessions have occurred when real oil prices are higher than they have been in the past three years—as highlighted in red on Chart 4. As the chart shows, real oil prices have provided four false indications of recession since WWII.
Interest Rates

The outlook for interest rates is dominated by monetary policy. With the economy operating below potential, the Federal Open Market Committee (FOMC) can be expected to hold short-term interest rates at extremely low levels through about mid-2015 (Chart 5). By mid-2015, the economy should be strong enough for the FOMC to gradually permit short-term rates to rise. Quantitative easing is currently holding long-term interest rates at relatively low levels. The Fed has announced a policy of tapering off its quantitative easing, which will let long-term interest rates rise. A variety of long rates, such as those for 10-year Treasury bills and conventional mortgages can be expected to rise.

Housing Markets

Over the past two years, the Case-Shiller Index shows that U.S. housing prices have increased at an annual double-digit rate (Chart 6). The gains are largely a correction of the collapse in housing prices that occurred during the Great Recession. The U.S. housing market remains tight, however, which will mean increased prices and more construction. As the economy continues its recovery, housing construction accelerates and interest rates rise, the gains in housing prices can be expected to gradually moderate toward annual rates of about 2.5 percent—just above the expected overall rate of inflation. Regional variation will be substantial—with some areas seeing much stronger price gains.
Industrial Production

With natural gas prices at relatively low levels and the United States reindustrializing to some extent, U.S. industrial production has grown faster than overall economic activity in recent years (Chart 7). A strong pace is likely to continue throughout 2014 before moderating slightly in 2015.

Employment

As shown in Chart 8, a slowly expanding economy has generated fairly robust employment growth in recent years. Over the past year, we saw employment growth of about 194,000 jobs per month. In 2014 and 2015, we look for employment growth of about 190,000 and 250,000 jobs per month, respectively.

As a point of reference, we normally think that monthly employment growth of about 120,000 jobs as necessary to hold the U.S. unemployment rate steady. That figure represents the number of new entrants to the labor force during a period of normal economic growth.
Unemployment

As of March, the U.S. unemployment rate stood at 6.7 percent. Even as the economy adds jobs at robust rates during 2014 and 2015, we can expect to see only moderate reductions in the unemployment rate (Chart 9). Workers returning to the labor force will increase the number of new jobs necessary to reduce the unemployment rate. By the end of 2014, a 6.5 percent unemployment rate is likely. An unemployment rate of about 6.1 percent is likely at yearend 2015. Sustained economic growth will gradually reduce the U.S. unemployment rate toward 5.6 percent, which we currently calculate as the natural rate of unemployment.

Risks to the Outlook

The outlook assumes that the economy is entering a phase in the cycle where the considerable strength of private balance sheets will allow an increase in consumer and business confidence to feed accelerating spending and GDP growth. If uncertainty remains high, sluggish economic growth can be expected.

The Federal Reserve System has substantially increased financial liquidity. The Fed will have a delicate job of reducing that liquidity as the economy improves. A misstep could lead to a sharp uptick in inflation or weaker economic activity.

Stronger economic activity in Asia Pacific could lead to escalating commodity prices, necessitating tighter monetary policy which could lead to slowing economic growth.

If workers do not return to the labor force as the economy accelerates, the unemployment rate will drop more quickly, but employment, real GDP and potential GDP will grow more slowly.

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