Q3 update — July

2014 Equipment Leasing & Finance U.S. Economic Outlook

EQUIPMENT LEASING & FINANCE FOUNDATION
Your Eye on the Future

The Foundation is the only research organization dedicated solely to the equipment finance industry.

The Foundation accomplishes its mission through development of future-focused studies and reports identifying critical issues that could impact the industry.

The Foundation research is independent, predictive and peer-reviewed by industry experts. The Foundation is funded solely through contributions. Contributions to the Foundation are tax deductible.

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ABOUT THE OUTLOOK

The Equipment Leasing & Finance Foundation (the Foundation) recognizes that with the wide variety and increasing complexity of economic data available to the public, the best way to utilize key equipment investment data is to have it all in one place, where business leaders can access it easily and quickly, thus assisting them in making the best business decisions.

The Foundation partnered with Keybridge LLC to produce this economic outlook, highlighting key trends in equipment investment and placing them in the context of the broader U.S. economic climate. The outlook report also includes an analysis of domestic capital spending as well as an evaluation of how capital spending is affected by various related and exogenous factors, both currently and in the foreseeable future. Additionally, new for 2014, the outlook includes custom leading indicators for 12 equipment and software verticals. The Foundation-Keybridge U.S. Equipment & Software Investment Momentum Monitor ("Momentum Monitor"), described below, is published on a monthly basis.

This Q3 report is the second update to the 2014 Annual Outlook, and will be followed by one more quarterly update before the publishing of the 2015 Annual Outlook in December. This research was guided by a steering committee of dedicated industry volunteers who gave their time and expertise by providing comments and suggestions throughout the development of the report.

ABOUT THE MOMENTUM MONITOR

Business leaders require actionable forward-looking intelligence to make strategic decisions. Accordingly, the Foundation commissioned Keybridge LLC to develop a series of custom leading indicators for the equipment sector. The Momentum Monitor consists of indices for 12 equipment and software investment verticals. These indices are designed to identify turning points in their respective investment cycles with a 3 to 6 month lead time.

The Momentum Monitor is based on Keybridge's extensive research which shows that not all movements in economic data are reliable signals of future economic trends. Keybridge has operationalized its research by constructing indices, each comprised of between 10 to 20 high-frequency indicators. These indicators undergo rigorous testing to determine the optimal thresholds at which their short-term fluctuations are economically meaningful. In simpler terms, the Momentum Monitor sifts out the "noise" in the data and identifies the dominant trends. As a result, each Momentum Monitor index is statistically optimized to signal turning points in the investment cycle without giving false readings of shifts in momentum.

SUMMARY

Harsh winter weather and sluggish global demand hurt the U.S. economy's momentum, as real GDP contracted sharply by 2.9% in the first quarter. Business and residential investment stalled, inventories were drawn down, exports contracted, and personal consumption posted weak growth even with outsized winter heating/utility bills. The contraction, however, is expected to be temporary, as an array of forces – the housing recovery, energy renaissance, and accommodative credit markets – will support stronger growth in the second-half of the year.

The largest negative contribution in first quarter GDP came from a drawdown in private inventories, which subtracted 1.7 percentage points from top-line growth, while a ballooned trade deficit shaved off an additional 1.5 percentage points from growth. Looking forward, there should a modest "payback" effect from the weak first quarter, yet not as much as previously expected. Surveys of businesses' new orders are encouraging, suggesting that business equipment spending will bounce back, and as exports pick up, the trade deficit should narrow. Consumer spending, however, which accounts for over two-thirds of the U.S. economy, grew at a weak pace in April and May, indicating that Q2 GDP will not have as robust a rebound as originally thought. Even with positive underlying fundamentals supporting above potential growth through the rest of the year, it will be mathematically difficult for the US economy to grow above 2.0% in 2014 due to the weak first quarter.

Our U.S. economic forecast reflects a "tale of two halves" with a very weak start to the year followed by 3% growth in the second half. Overall, we expect the U.S. economy to grow 1.5% in 2014.

Growth in equipment and software investment decelerated from expanding at an 8.9% annualized rate in Q4 2013 to contracting 1.8% in Q1. Looking ahead, we expect a rebound in Q2, modest sector growth for the coming year, with an overall forecast of 2.6% growth in 2014.

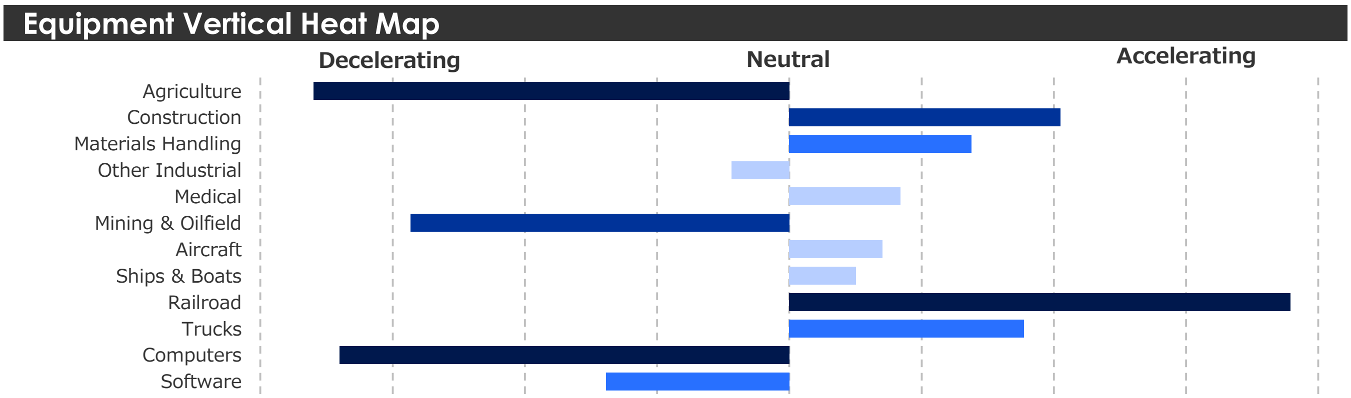
- Agriculture Machinery investment will likely see slow growth, and potentially a contraction, through the rest of 2014, as both farm yields and commodity prices remain subdued.
- Construction Machinery investment will continue to experience strong growth, and the year-over-year growth figures will begin to trend positive as multiple quarters of expansion take hold amidst the housing recovery.
- Materials Handling Equipment investment will experience stronger growth over the next 3 to 6 months.
- All Other Industrial Equipment investment will likely see moderate growth over the next 3 to 6 months as the "re-shoring" of manufacturing continues to be a dominant economic story in 2014.
- Medical Equipment investment will grow, but begin to level off near the end of the year.
- Mining & Oilfield Machinery will likely slow after a relatively strong Q1.
- Aircraft investment will likely experience about long-term average growth for the year.
- Ships & Boats investment will likely rebound to an above-average pace through the end of this year.
- Railroad Equipment investment will improve from its recent contraction towards modest growth.
- Investment in Trucks will exhibit high-single digit growth over the next 3 to 6 months as economic activity improves and competitive diesel prices keep trucking transport competitive.
- Computers investment will remain muted in the short-term after strong replacement demand over the past few quarters.
- Software investment will be moderate in the next 3 to 6 months as companies continue to make investments in software and cloud technologies.

Credit market conditions remain highly accommodative, and the Federal Reserve will continue to implement a two-pronged policy agenda in 2014. QE3 is all but certain to wind down by year's end. As such, there has already been a shift in the monetary policy debate as to the appropriate time to raise short term interest rates, along with the added question mark of how and when the Fed will shrink its massive balance sheet. Divisions between the "New Hawks" and the "Doves" are likely to increase as decisions on policy tightening and turnover of members come into the forefront. Looking forward to the rest of 2014, policy uncertainty has been less of a factor for most businesses, which has helped reduce market volatility. Overall, equipment investment continues to be driven predominantly by replacement demand rather than expansions.

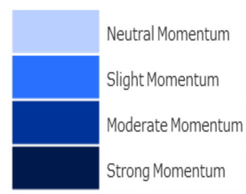
EQUIPMENT & SOFTWARE INVESTMENT OUTLOOK

Foundation-Keybridge U.S. Equipment & Software Investment Momentum Monitor

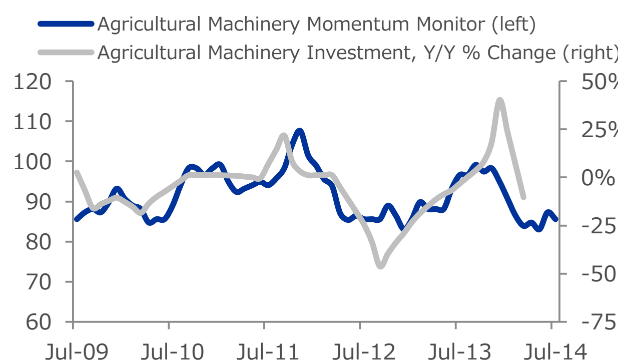
Equipment and software investment declined at an annualized rate of 1.8% in Q1 2014, following the 8.9% surge in Q4 2013. The decline is attributable to transitory effects from the cold winter weather that stalled the economy in Q1, as well as businesses pulling forward investment in Q4 2013 as Section 179 tax incentives expired. Despite these effects, however, replacement demand, reduced political uncertainty, rising capacity utilization, and solidifying economic fundamentals should drive equipment and software spending back into positive growth territory. Overall, we expect equipment and software investment to grow 2.6% in 2014 as economic conditions solidify and business confidence continues to recover.



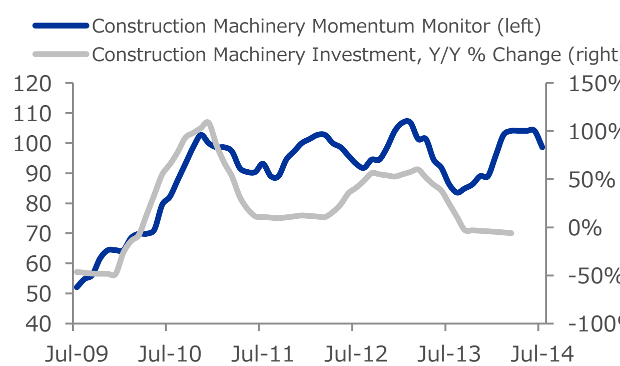
The Equipment Vertical Heat Map summarizes the latest movements in each of the 12 Equipment & Software Investment Momentum Indices. Verticals exhibiting strong recent momentum are shaded darker, while verticals exhibiting weak recent momentum are shaded lighter. The heat map provides a snapshot of the expected trends in equipment & software investment over the next 3 to 6 months. Note that trends in equipment financing activity may differ from overall investment volumes. The legend to the right provides an interpretation of the heat map color-coding.



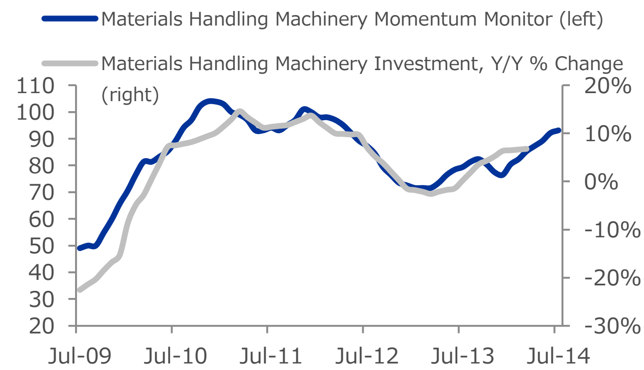
Agricultural Machinery: Investment in Agriculture Machinery decreased in Q1 2014 at an annualized rate of 67.9% and is now down 10.4% from one year ago. The Agriculture Momentum Index decreased from 87.3 (revised) in June to 85.6 in July. Over the past few months, data has bounced back from near-term lows, including Leases of New and Used Agriculture Equipment and Red Meat & Poultry Production. Overall, we believe that investment will remain subdued throughout 2014, as the Index remains at a below-average level.



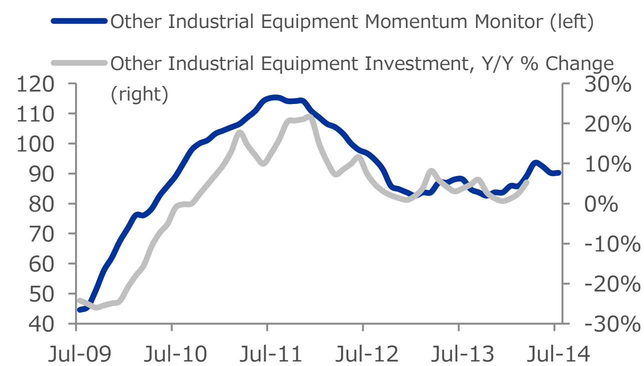
Construction Machinery: Investment in Construction Machinery increased at a 21.2% annualized rate in Q1 2014, yet is still down 6.1% year-over-year due to a base effect from elevated levels in Q1 2013. The Construction Momentum Index declined from 104.1 (revised) in June to 98.6 in July. Shipments of Mobile Homes increased over the past month, yet were offset by a decline in Manufacturers' Shipments of Construction Machinery and a 15.6% decline in Permits for Multi-family homes. Overall, despite the drop in the Index, we believe that the continued housing recovery will drive demand for construction equipment over the next three to six months.



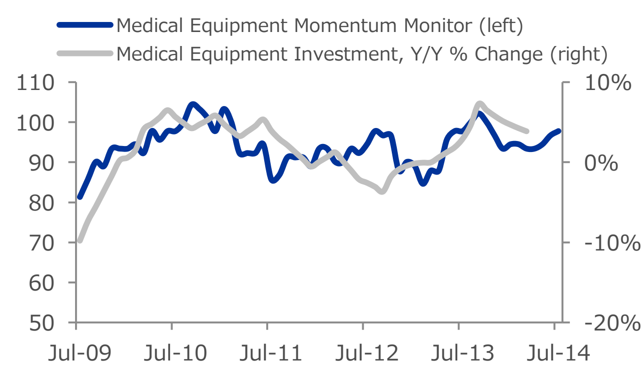
Materials Handling Equipment: Investment in Materials Handling Equipment increased at a 1.8% annualized rate in Q1 2014 and is now up 6.8% year-over-year. The Materials Handling Momentum Index increased from 92.2 in June to 93.1 in July. Industrial Production posted a strong 0.6% monthly gain over the past month, while Wholesalers' Sales of Machinery increased 1.7% as of the latest data. Overall, the Index continues to increase at a steady pace, signaling slightly stronger investment over the next three to six months.



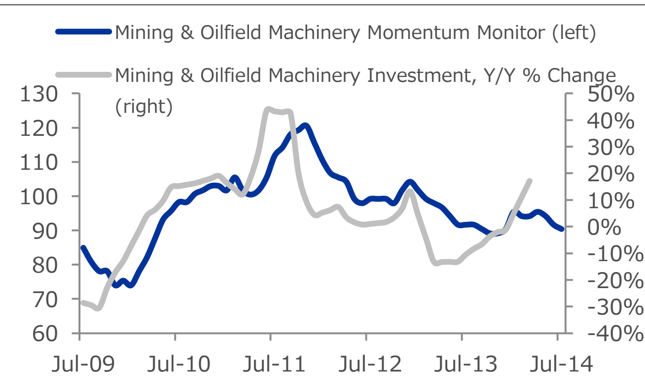
Other Industrial Equipment: Investment in all Other Industrial Equipment rebounded at a 20.5% annualized rate in Q1 2014 and is now up 5.3% year-over-year. The Other Industrial Equipment Momentum Index held steady from 90.2 (revised) in June to July. Despite a sizable gain in the Industrial Production Index for Durable Equipment Parts, Copper Warehouse Stocks declined on the month, dragging the Index down. Overall, the Index's recent movement suggests growth in investment will hold relatively steady over the next three to six months.



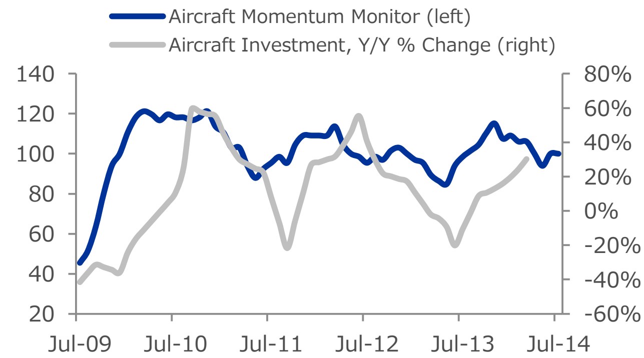
Medical Equipment: Investment in Medical Equipment increased at a 5.0% annualized rate in Q1 2014 and is now up 3.8% year-over-year. The Medical Equipment Momentum Index increased from 96.7 (revised) in June to 97.8 in July. Social Security Benefits Awards data increased steadily over the past few months, while there was a strong increase in Medicare Outlays. Education & Health Services employment also increased over the last month. Overall, the Index suggests that growth in medical equipment investment will level-off over the next three to six months.



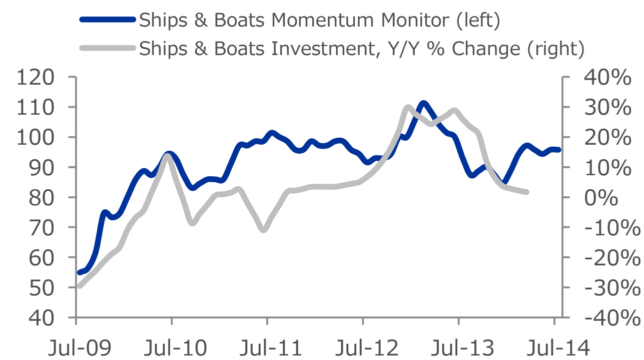
Mining & Oilfield Machinery: Investment in Mining & Oilfield Machinery increased at a 5.9% annualized rate in Q1 2014 and is now up 16.8% year-over-year, the fastest growth rate in ten quarters. The Mining & Oilfield Machinery Momentum Index decreased from 91.7 (revised) in June to 90.4 in July. Unfilled Orders for Mining, Oil Field & Gas Field Machinery Equipment declined over the past month, while Industrial Production for Natural Gas Distribution declined as well. Despite an upswing in Imports of Energy-Related Petroleum Products, a decline in Policy Uncertainty, and a solid gain in New Orders for Mining, Oil Field & Gas Field Machinery and Equipment, the Index nonetheless still ticked down over the past month. Overall, the Index suggests that investment will slow over the next three to six months.



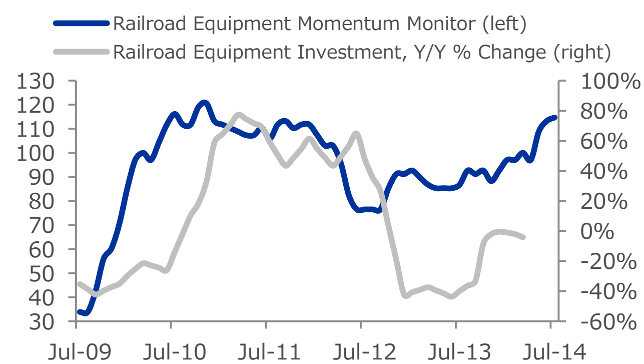
Aircraft: Investment in Aircraft decreased at an annualized rate of 21.2% in Q1 2014. On a year-over-year basis, investment in Aircraft is still up 30.2%. The Aircraft Momentum Index held steady at 100.0 (revised) from June to July. Exports of Computers and Electronic Products declined 8.1% over the past month, while the ISM New Orders index increased to over 60 for the first time since January 2011. Overall, the Index continues to signal a moderation of investment over the next three to six months, closer to the long-term average of about 5% to 6% year-over-year.



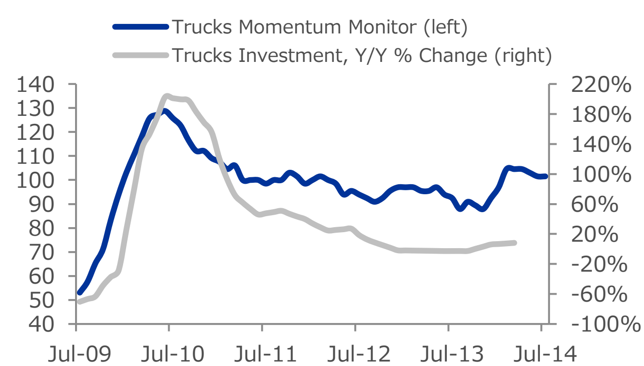
Ships & Boats: Investment in Ships & Boats declined at a 5.9% annualized rate in Q1 2014. Investment is now up 2.1% from one year ago, the slowest annual growth in ten quarters. The Ships & Boats Momentum Index held steady at 95.8 (revised) from June to July. New Orders of Ships & Boats surged over the past month, yet was counterbalanced by sharp declines in the Trade Balance for Agriculture, Forestry and Fishing Materials. Overall, the Index indicates a moderate positive shift in momentum over the next three to six months.



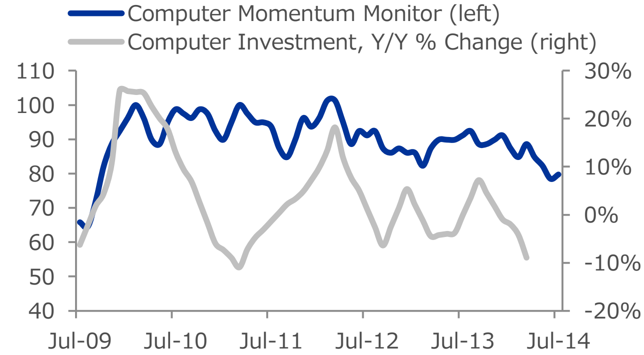
Railroad Equipment: Investment in Railroad Equipment increased at a 33.3% annualized rate in Q1 2014, yet is still down 4.2% year-over-year. The Railroad Equipment Momentum Index increased from 113.2 (revised) in June to 114.7 in July – reaching its highest point in thirty-two months. Average Weekly Hours for Manufacturing Employees increased over the past month, while there was an added positive boost from Industrial Production of Energy Materials. Overall, the Index is signaling a modest improvement in investment over the next three to six months.



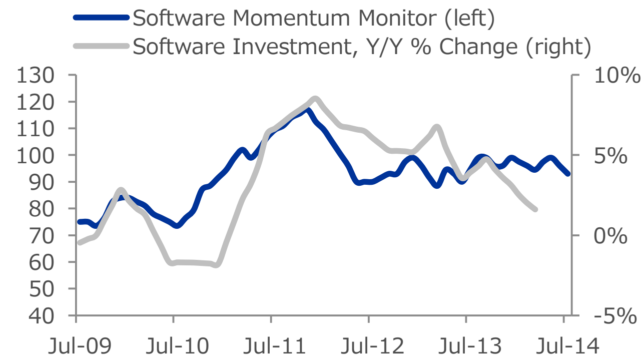
Trucks: Investment in Trucks increased at a 9.5% annualized rate in Q1 2014 and is now up 7.8% year-over-year. The Trucks Momentum Index held steady at 101.5 (revised) from June to July. Shipments of Light Trucks & Utility Vehicles increased 0.9% on the month, while Industrial Production of Energy Materials posted a solid 1.1% increase. Despite the pause in the upward momentum of the Index, trends in underlying data point to increased investment due to replacement demand and overall improving economic conditions over the next three to six months.



Computers: Investment in Computers decreased at an annualized rate of 39.9% in Q1 2014 and is down 8.9% on a yearly basis, the sharpest annual rate of decline in over three years. The Computers Momentum Index increased slightly from 78.5 (revised) in June to 79.7 in July. Despite the monthly increase in the Index, levels of Shipments of Electronic Computers and Retail Sales of Appliance, Television, and Camera Stores remain at subdued levels. Overall, the Index's position continues to indicate muted investment in Computers over the next three to six months.



Software: Investment in Software increased at a 1.5% annualized rate in Q1 2014 and is now up 1.6% year-over-year. The Software Momentum Index slipped from 96.0 (revised) in June to 93.0 in July. The ISM Services Employment Index increased 1.1 points over the past month and the Intuit Small Business Revenue Index for Professional, Scientific & Technical Services Firms posted a 0.3% gain. This positive momentum, however, was outweighed by declines in Producer Prices for Software Publishers. Overall, the Index is pointing towards below average growth over the next three to six months.



Equipment & Software Investment Growth Forecast

Year/Year % Growth Rates

Sector	10-Year Average	Last Quarter	Next 12 Months
Agricultural Machinery	0.3%	-10.4%	-3.7%
Construction Machinery	13.5%	-6.1%	9.3%
Materials Handling Equipment	1.9%	6.8%	7.2%
Other Industrial Equipment	1.9%	5.3%	6.1%
Medical Equipment	4.6%	3.8%	4.0%
Mining & Oilfield Equipment	14.0%	16.8%	3.5%
Aircraft	6.5%	30.2%	16.4%
Ships & Boats	5.4%	2.1%	8.0%
Railroad Equipment	8.4%	-4.2%	17.5%
Trucks	18.2%	7.8%	41.2%
Computers	7.7%	-8.9%	-2.7%
Software	4.5%	1.6%	5.7%

Source: Macrobond Financial, Keybridge (forecasts)

U.S. Capital Investment and Credit Markets

Review of Recent Trends

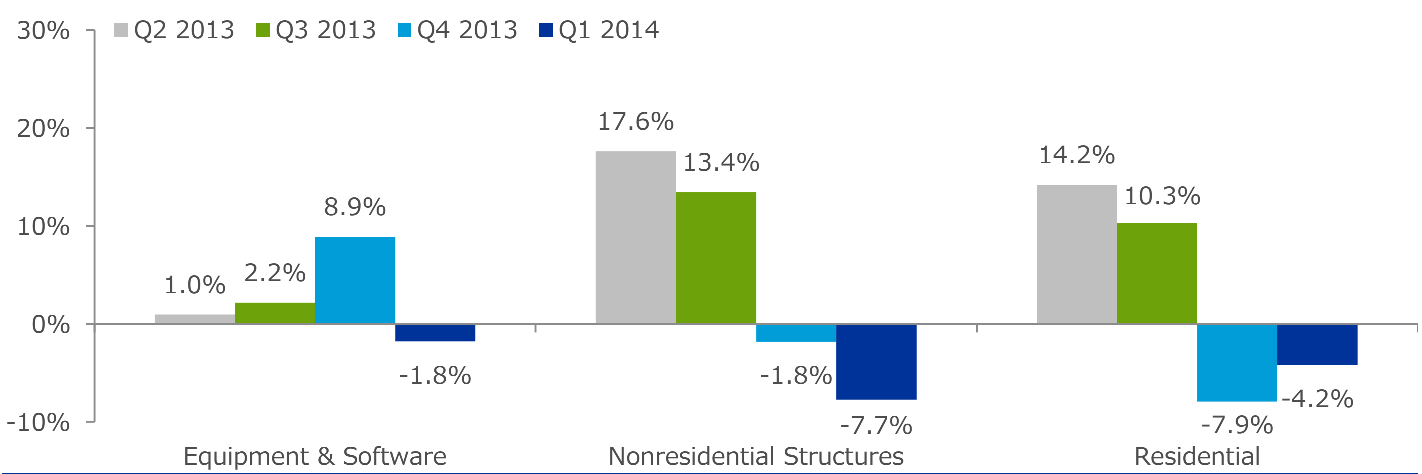
Equipment and Software Investment contracted at a 1.8% annualized rate in Q1, a substantial decline from 8.9% growth in Q4 2013. Residential investment contracted at a 4.2% annualized rate, a sign that the cold weather prevented residential home building in the first quarter. Investment in Nonresidential Structures weakened even further from the previous quarter, contracting at a 7.7% annualized rate in Q1.

Within the major equipment and software verticals, investment in railroad equipment expanded at the fastest pace, growing 33.3% at an annualized rate. However, investment in this vertical is notoriously choppy on a quarterly basis. The vertical with the fastest deceleration was Agriculture machinery, which decreased at an annualized rate of 67.9% after accelerating rapidly in Q4 and cold weather likely delayed some equipment demand. Other key movements included a 21.2% pick-up in Construction machinery and a sharp 39.9% decline in Computers.

The pace of equipment and software investment decelerated in the first quarter, while residential investment growth also contracted due to harsh winter weather conditions. Equipment and software investment is expected to steadily grow over the next 6 months across most verticals due to reduced policy uncertainty, stronger economic fundamentals, and replacement demand. Credit supply continues to improve, and credit demand has held steady – for all business sizes. Financial stress remains under control across multiple sectors.

Investment Growth Rates

Quarter-Quarter, Seasonally Adjusted Annualized Growth Rate



Source: Macrobond Financial

May's Equipment Leasing & Finance Association's Monthly Leasing and Financing Index (MLFI-25) reported new business volume of $6.0 billion – down 8.0% from April's. On a cumulative year-to-date basis, new business volumes for 2014 are still up 2.8% from 2013. Losses as a percentage of net receivables held steady at 0.2%, while the credit approval ratio dropped 4 percentage points to 77.4%. The Equipment Leasing & Finance Foundation's Monthly Confidence Index for the Equipment Finance Industry (MCI-EFI) was at 61.4 in June, decreasing from its two-year high in May. In the latest survey, 5.9% of respondents believe business conditions will worsen over the next four months, up from no respondents in May.

The minutes from the FOMC's mid-June meeting revealed "business as usual" conditions, as the board once again elected to trim monthly asset purchases by another $10 billion. Even with the weak first quarter data, the prevalent view among FOMC members is that recent weakness is transitory, and that the economy will bounce back in short order. Despite improving economic data, demand for U.S. Treasuries has held strong over the past few months. Uncertainty about Federal Reserve policy, geopolitical instability, and the relative attractiveness of U.S. government debt on a risk adjusted basis has sent massive amounts of capital into the $12 trillion market for U.S. debt. This demand has kept the yield on the 10-year Treasury lower than most *a priori* expectations at the beginning of the year, as the yield is currently hovering around 2.6%.

Our credit outlook hinges on a balance of four primary factors that will continue to result in upward pressure on long-term interest rates:

(1) "Risk-on" attitudes will spread from financial markets to the real economy as businesses gain confidence in the sustainability of stronger economic momentum in the second half of the year.

(2) Lenders will continue to loosen supply constraints and the cost of capital will remain historically low.

(3) The Fed will remain accommodative in its unconventional monetary policy – short-term interest rates will remain near zero in 2014. The expected rise in long-term interest rates will likely not be rapid enough to negatively affect business investment decisions in a material way. In fact, uninterrupted tapering and more "hawkish" rate expectations from FOMC officials are signals of stronger growth expectations and could induce businesses to invest more. Beyond 2014, the outlook for short-term interest rates is less clear. A recent Bloomberg survey of economists showed that there is an increasing consensus that the Fed will raise rates faster than originally anticipated.

(4) Relative valuations make U.S. Treasuries look attractive on a global basis, which will drive demand and keep yields in check.

Businesses are gaining clarity about the capital investment environment, as policy uncertainty has been a relative non-factor thus far in 2014 and replacement demand is driving capex across multiple verticals. We believe that businesses will recognize that first quarter weaknesses are transitory and thus will ramp up investment spending and financing activity in the second half of the year. Additionally, long-term interest rates have trended back down after peaking during the beginning of the year, and a comparison of the latest trends in equipment finance volumes to overall equipment and software investment suggests that the propensity to finance increased in Q1 2014.

Summary of Credit Conditions

Factor	Conditions Compared With Last Quarter
Supply	No Change
Demand	Moderate Improvement
Financial Stress	Moderate Improvement

- **Credit Supply & Pricing:** The supply of credit across multiple sectors continues to improve. The Q2 Federal Reserve survey of banks' senior lending officers showed a steady balance of loosening standards for C&I loans for businesses of all sizes. The benchmark 10-year Treasury rate has held unexpectedly low at around 2.6% as of late, which has been driven by stronger demand for U.S. Treasuries. Thus, capital is likely to remain inexpensive for the foreseeable future.

- **Credit Demand:** Credit demand has remained strong, even as businesses temporarily hit the pause button on expansion during the chilly first quarter. The Fed survey shows, on balance, strong demand for C&I loans, while business lending by the six largest U.S. commercial banks was up 8.3% in Q1 on a year-over-year basis. Specifically for small businesses, the Thomson Reuters/PayNet Small Business Lending Index was up 4% in March and 10% in April, reaching its highest level since March 2007. For larger businesses, in the latest BRT CEO Economic Outlook Survey, 44% of CEOs expected to increase capital spending over the next six months.

- **Financial Stress:** With cleaner balance sheets and the added tailwinds of favorable monetary policy and improving economic conditions, financial stress remains subdued across many sectors. The FRB St. Louis Financial Stress Index has reached an all-time low. Specifically for households, the financial obligation ratio is down 12 basis points on the year, and near a 30-year low. And for businesses, the lease delinquency rate ticked down 4 basis points to 0.84% in Q1. Nonfinancial sector debt as a percentage of GDP stands at 81.0% and has risen above its pre-recession peak, a sign that debt aversion has diminished. Corporate bond yields are declining from their peaks in late 2013, and the spread between corporate grade and treasuries remains narrow.

OVERVIEW OF THE U.S. ECONOMY

Harsh winter weather and sluggish global demand hurt the U.S. economy's momentum, as real GDP contracted sharply by 2.9% in the first quarter. Business and residential investment stalled, inventories were drawn down, exports contracted, and personal consumption posted weak growth even with outsized winter heating/utility bills. The contraction, however, is expected to be temporary, as an array of forces – the housing recovery, energy renaissance, and accommodative credit markets – will support stronger growth in the second-half of the year.

The largest negative contribution in first quarter GDP came from a drawdown in private inventories, which subtracted 1.7 percentage points from top-line growth, while a ballooned trade deficit shaved off an additional 1.5 percentage points from growth. Looking forward, there should a modest "payback" effect from the weak first quarter, yet not as much as previously expected. Surveys of businesses' new orders are encouraging, suggesting that business equipment spending will bounce back, and as exports pick up, the trade deficit should narrow. Consumer spending, however, which accounts for over two-thirds of the U.S. economy, grew at a weak pace in April and May, indicating that Q2 GDP will not have as robust a rebound as originally thought. Even with positive underlying fundamentals supporting above potential growth through the rest of the year, it will be mathematically difficult for the US economy to grow above 2.0% in 2014 due to the weak first quarter.

The June average of the Economist Poll of Forecasters for 2014 GDP growth declined from 2.6% in May to 2.4%, while the Federal Reserve's most recent "central tendency" forecast for growth is in the range of 2.1% to 2.3% – a significant downward revision from the Fed's March 2014 forecast. These consensus figures have yet to be updated since the latest downward revision of Q1 GDP growth from -1.0% annualized to -2.9% annualized.

Our U.S. economic forecast reflects a "tale of two halves" with a very weak start to the year followed by 3% growth in the second half.

Indicator	Recent Activity
Consumption	Consumer spending grew at a 1.0% pace due to transitory factors
Equipment & Software Investment	Equipment & Software Investment decreased at a 1.8% annualized rate in Q1, the first decline in six quarters
Residential Investment	Residential Investment declined again in Q1, a sign that the harsh weather interrupted the housing market's recovery.
Government Expenditures	Government expenditures declined a modest 0.8% in Q1 and were only a slight drag on growth. State and local spending declined the most in ten quarters.
Net Exports	Exports fell by the sharpest amount since the recession, while Imports ticket up slightly in Q1.

Headline CPI inflation reached 2.0% in April and 2.1% in May. Gains in food and shelter costs have help driven the index higher over the past few months, in addition to base effects, while less demand for energy stocks has pulled prices in the energy component down. Given the considerable slack remaining in the labor market, slightly-higher readings of inflation will not cause FOMC officials to materially change their policy stance, as these readings are not a sign of latent price pressures building. Moreover, the Fed's preferred measure of inflation – the personal consumption expenditures ("PCE") price index – is only up 1.8% year-over-year. Unless price pressures, inflation expectations, and activity in the labor market accelerate faster than expected, the Fed's outlook on inflation is unlikely to change materially. One potential wildcard on the inflationary outlook is, however, rising oil prices. Instability in both Iraq and Ukraine's eastern region is heating up, which has led Brent Crude Oil prices to hover around $114 per barrel over the past week. If oil prices remain elevated heading into summer and flow through to gasoline prices, it will push up inflation and erode real consumer spending. One such estimate concludes that for every 1 cent increase in gasoline prices, all else equal, US real disposable income can be reduced by up to $1.4 billion.

The central themes affecting our outlook in the near-term are weak Q2 data; but stronger job growth, improved business lending, and more stable fiscal and monetary policies during the second half of the year.

Data available thus far for Q2 show that key components of GDP are off to a relatively weak start. Most importantly, April and May personal consumption expenditures ("PCE") were sluggish, and weekly ICSC-Goldman Sachs suggest June's PCE reading will also be lackluster. April and May exports rebounded, but not as much as imports, indicating a widening trade gap and additional drag on GDP. Shipments of non-defense capital goods excluding aircraft are showing a slight rebound in Q2, but not enough to carry the economy. Overall, the data point to second quarter growth in the range of 2.0% to 2.5%.

Job growth averaged a stronger than expected 238,000 over the past three months, which should provide a boost to consumer spending and housing. Additionally, initial claims for unemployment insurance are hovering near pre-recession levels, and the quit rate for private sector industries is inching up – both indicators of a gradually strengthening labor market. Secondly, increased demand for credit across multiple sectors of the economy is a welcome sign. Credit is flowing readily throughout the economy. Commercial & Industrial ("C&I") loans are up 10.4% as of April, and households have taken on more mortgage debt for three consecutive quarters – for the first time since the 2008-09 crisis.

Another central theme through the rest of 2014 is a more positive fiscal situation. In Q1, Federal government spending was a slight positive contribution to GDP growth for the first time in ten quarters, while State & Local government spending remained marginally negative. The improving fiscal situation is also noticeable in public sector hiring, as government payrolls have increased by a net of 37,000 jobs over the past three months.

The course of monetary policy remains the other central theme for the rest of 2014. QE3 is all but certain to continue to be wound down. As such, there has already been a shift in the monetary policy debate as to the appropriate time to raise short term interest rates, along with the added question mark of how and when the Fed will unwind its balance sheet. Divisions between the "New Hawks" and the "Doves" are already increasing as decisions on policy tightening and turnover of members come into the forefront.

Recent meeting minutes and public statements from FOMC officials reaffirm that the division between the "Doves" and the "Hawks" is growing. There is noticeable dispersion as to the appropriate timing of rate hikes and what the proper long-run equilibrium federal funds rate should be. There is also an emerging debate among FOMC members about the sequencing of policy tightening – how and in what order should rate hikes and balance sheet reductions proceed. The latest FOMC statement and press conference offered no new news, yet upcoming public statements by officials and late-2014 meeting minutes will likely hint that this is a developing debate on which FOMC members are focused.

Secondly, the turnover of FOMC membership so far in 2014 and upcoming in 2015 will be a driving force behind the scope of the policy debate. As of the FOMC's June 18-19 meeting, there are three new voting members – Stanley Fischer, Lael Brainard, and Loretta Mester. This change will increase focus on members' public statements, also known as "forward guidance", regarding the appropriate timing and sequencing of policy tightening. Looking further out onto the horizon, beginning in 2015, regional bank presidents from Chicago, Richmond, San Francisco, and Atlanta will take over as voting FOMC members. This shuffling adds additional variables to the calculus of when rate hikes may occur.

Additional Factors to Watch

Our sector-level analysis repeats many of the same themes as in recent quarters, but the following trends have been a useful narrative for the U.S. outlook this year:

Unintended Inventory Decumulation: Unintended inventory decumulation, that is, inventories drawn down faster than desired, was a main contributor to weak Q1 growth. Inventories subtracted 1.7 percentage points from top-line GDP growth, the largest subtraction in five quarters. Businesses inventories increased 0.6% in April and should provide a boost to economic growth in the second half of the year.

Geopolitical Risks: With continuing unrest in Ukraine's Eastern region and in Iraq, geopolitical conflicts remain a threat to global stability. Escalating tensions could weigh on the U.S. economy through an oil price spike or by undermining business and investor confidence.

Mixed Global Conditions: The World Bank recently downgraded its 2014 global growth forecast from 2.8% to 2.4%, citing a "bumpy" start to the year. In Europe, growth and inflation remain weak, which has caused an almost three percent drop in the Euro this past month. ECB Governor Draghi's recent moves to ease monetary policy – including negative interest rates and new credit channels to encourage lending – offer hope of a broader economic revival. Elsewhere, a cooling housing market and a recent deceleration in industrial production in China have sparked renewed concerns of a slowdown. Real estate sales are down nearly 8% year-over-year in the first four months, and there is significant evidence that credit markets are overheated. As the Chinese economy is increasingly the hub of the entire Asian economy, a slowdown could dampen U.S. exports to the Asia-Pacific region.

Projections for Key Economic Indicators

Indicator	2012	2013	2014e	2014 Quarterly Estimates			
				Q1	Q2e	Q3e	Q4e
Real GDP (SAAR %)	2.8%	1.9%	1.5%	-2.9%	2.2%	3.0%	3.0%
Real Investment in Equipment & Software (SAAR %)	7.2%	3.5%	2.6%	-1.8%	5.0%	0.2%	2.3%
Inflation (annualized rate)	2.1%	1.5%	2.0%	1.5%	2.0%	2.1%	2.2%
Federal funds (effective, end of period)	0.15%	0.15%	0.15%	0.15%	0.15%	0.15%	0.15%
10-year Treasury Rate (end of period)	1.80%	2.90%	3.0%	2.7%	2.70%	2.80%	3.0%
Total Payrolls (in thousands)	+2,236	+2,331	+2,669	+569	+650	+700	+750

Note: SAAR% refers to the annualized rate of change in seasonally adjusted data from one quarter to the next, which is the Bureau of Economic Analysis' standard method for reporting growth in the national accounts data.

QUARTERLY DATA

Indicator	2012				2013				2014
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Real Gross Domestic Product (SAAR %)									
GDP	3.7%	1.2%	2.8%	0.1%	1.1%	2.5%	4.1%	2.6%	-2.9%
Consumer Spending	2.9%	1.9%	1.7%	1.7%	2.3%	1.8%	2.0%	3.3%	1.0%
Gross Private Fixed Investment	10.5%	-1.6%	6.5%	-2.4%	4.7%	9.2%	17.2%	2.5%	-11.7%
Inv: Equipment & Software	6.7%	5.5%	-2.1%	9.0%	3.1%	1.0%	2.2%	8.9%	-1.8%
Inv: Agricultural Machinery	-5.9%	-52.4%	-60.8%	45.2%	93.2%	-30.9%	-40.4%	386.4%	-67.7%
Inv: Construction Machinery	9.5%	85.6%	149.3%	7.6%	31.8%	2.8%	-38.7%	1.6%	21.7%
Inv: Materials Handling Equipment	4.7%	2.4%	-6.4%	-6.2%	0.2%	7.4%	14.0%	4.3%	1.8%
Inv: All Other Industrial Equipment	-23.8%	14.9%	4.2%	13.6%	0.6%	-5.4%	16.4%	-7.5%	20.5%
Inv: Medical Equipment	8.9%	-8.5%	-9.6%	9.1%	10.7%	-1.4%	11.2%	0.7%	5.4%
Inv: Mining & Oilfield Machinery	58.1%	25.9%	9.3%	-24.4%	-45.6%	26.6%	46.3%	-5.1%	7.2%
Inv: Aircraft	1.3%	78.5%	-67.3%	218.7%	-50.6%	-21.1%	12.5%	311.1%	-21.2%
Inv: Ships & Boats	18.8%	-23.5%	66.2%	87.5%	0.1%	-11.6%	28.8%	1.5%	-7.5%
Inv: Railroad Equipment	10.5%	13.9%	-38.0%	-86.0%	54.8%	-25.4%	23.2%	-31.2%	33.3%
Inv: Trucks	4.1%	22.0%	-4.7%	-23.4%	2.2%	19.5%	-4.2%	7.8%	10.7%
Inv: Computers	24.4%	-17.5%	-33.6%	80.7%	-15.9%	-15.0%	2.3%	31.6%	-39.9%
Inv: Software	1.6%	6.3%	3.7%	9.4%	7.7%	-5.9%	8.6%	2.8%	1.5%
Credit Conditions									
Nonfinancial Sector Debt (% of SAAR GDP)	75.3%	75.7%	76.1%	77.6%	77.9%	78.9%	79.2%	79.6%	81.0%
Loan Delinquency Rate	1.5%	1.4%	1.2%	1.2%	1.1%	1.0%	1.0%	0.9%	0.9%
Lease Delinquency Rate	0.9%	0.8%	0.7%	0.8%	0.9%	0.9%	0.9%	0.9%	0.8%
Net Tightening of C&I Loan Standards	5.4%	-6.9%	-9.5%	-7.6%	-7.4%	-19.1%	-18.1%	-8.3%	-13.7%

Note: SAAR% refers to the annualized rate of change in seasonally adjusted data from one quarter to the next, which is the Bureau of Economic Analysis' standard method for reporting growth in the national accounts data.

Monthly Data

Indicator	2013 May	2013 Jun	2013 Jul	2013 Aug	2013 Sep	2013 Oct	2013 Nov	2013 Dec	2014 Jan	2014 Feb	2014 Mar	2014 Apr	2014 May
Employment													
Change in Total Payrolls (thousands)	199	201	149	202	164	237	274	84	144	222	203	282	217
Change in Private Payrolls (thousands)	222	201	170	180	153	247	272	86	166	201	200	270	216
Unemployment Rate	7.5%	7.5%	7.3%	7.2%	7.2%	7.2%	7.0%	6.7%	6.6%	6.7%	6.7%	6.3%	6.3%
Business Activity													
Industrial Production	99.4	99.6	99.4	100.0	100.7	100.8	101.4	101.6	101.4	102.5	103.3	103.0	103.7
Capacity Utilization	77.8%	77.8%	77.5%	77.8%	78.3%	78.2%	78.5%	78.5%	78.1%	78.8%	79.3%	78.9%	79.1%
PMI Composite Index	50.0	52.5	54.9	56.3	56.0	56.6	57.0	56.5	51.3	53.2	53.7	54.9	55.4
NFIB Small Business Optimism Index	94.4	93.5	94.1	94.1	93.9	91.6	92.5	93.9	94.1	91.4	93.4	95.2	96.6
Consumer Activity													
Consumer Confidence	74.3	82.1	81.0	81.8	80.2	72.4	72.0	77.5	79.4	78.3	83.9	81.7	83.0
Personal Consumption (M/M % Chg)	0.1%	0.2%	0.1%	0.2%	0.2%	0.3%	0.5%	-0.1%	-0.3%	0.3%	0.6%	-0.2%	-0.1%
Retail Sales (M/M % Chg)	0.6%	0.6%	0.4%	0.0%	0.0%	0.6%	0.4%	-0.1%	-0.9%	0.9%	1.5%	0.5%	0.3%
Lending Activity													
C&I Loans (M/M % Chg)	0.3%	0.9%	0.9%	0.2%	0.4%	1.0%	0.3%	0.9%	0.6%	2.2%	1.2%	1.0%	0.7%
MLFI-25 New Business Volume (Bil. $)	7.5	8.6	7.2	6.4	7.7	7.6	6.6	10.7	6.0	5.4	7.0	8.0	6.9
MLFI-25 Avg Losses as a % of Net Rec.	0.3	0.3	0.3	0.4	0.4	0.4	0.3	0.3	0.3	0.4	0.2	0.2	0.2
MLFI-25 Credit Approval Ratio	78.8	78.5	78.6	79.1	77.3	77.6	76.5	78.3	76.9	75.3	77.8	77.4	76.1
Interest Rates (% end of period)													
Fed Funds Target Rate (Lower Bound)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
1-Year Treasury Rate	0.12	0.14	0.12	0.13	0.12	0.12	0.12	0.13	0.12	0.12	0.13	0.11	0.10
3-Year Treasury Rate	0.40	0.58	0.64	0.70	0.78	0.63	0.58	0.69	0.78	0.69	0.82	0.88	0.83
10-Year Treasury Rate	1.93	2.30	2.58	2.74	2.81	2.62	2.72	2.90	2.86	2.71	2.72	2.71	2.56
30-Year Treasury Rate	3.11	3.40	3.61	3.76	3.79	3.68	3.80	3.89	3.77	3.66	3.62	3.52	3.39
AAA Corporate Bond Yield	3.89	4.27	4.34	4.54	4.64	4.53	4.63	4.62	4.49	4.45	4.38	4.24	4.16
BAA Corporate Bond Yield	4.73	5.19	5.32	5.42	5.47	5.31	5.38	5.38	5.19	5.10	5.06	4.90	4.76
Prices													
Headline Inflation (Y/Y % Chg)	1.4%	1.8%	2.0%	1.5%	1.1%	0.9%	1.2%	1.5%	1.6%	1.1%	1.5%	2.0%	2.1%
Core Inflation (Y/Y % Chg)	1.7%	1.6%	1.7%	1.8%	1.7%	1.7%	1.7%	1.7%	1.6%	1.6%	1.6%	1.8%	1.9%
Oil Price (West Texas Int., $/barrel)	91.93	96.36	105.10	107.98	102.36	96.29	92.55	98.17	97.55	102.88	101.57	100.07	103.40

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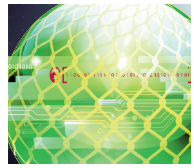


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