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## 10 Year U.S. Treasury Note Yield Forecast

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## 10 Year U.S. Treasury Rates Forecast

Yield in Percent per year Constant Maturity Rate. Average of Month

Month	Date	Forecast Value	50% Correct +/-	80% Correct +/-
0	Feb 2014	<b>2.710</b>	0.00	0.00
1	Mar 2014	<b>2.67</b>	0.07	0.16
2	Apr 2014	<b>2.72</b>	0.10	0.22
3	May 2014	<b>2.62</b>	0.12	0.27
4	Jun 2014	<b>2.62</b>	0.14	0.31
5	Jul 2014	<b>2.51</b>	0.16	0.35
6	Aug 2014	<b>2.54</b>	0.17	0.38

Updated Wednesday, March 12, 2014

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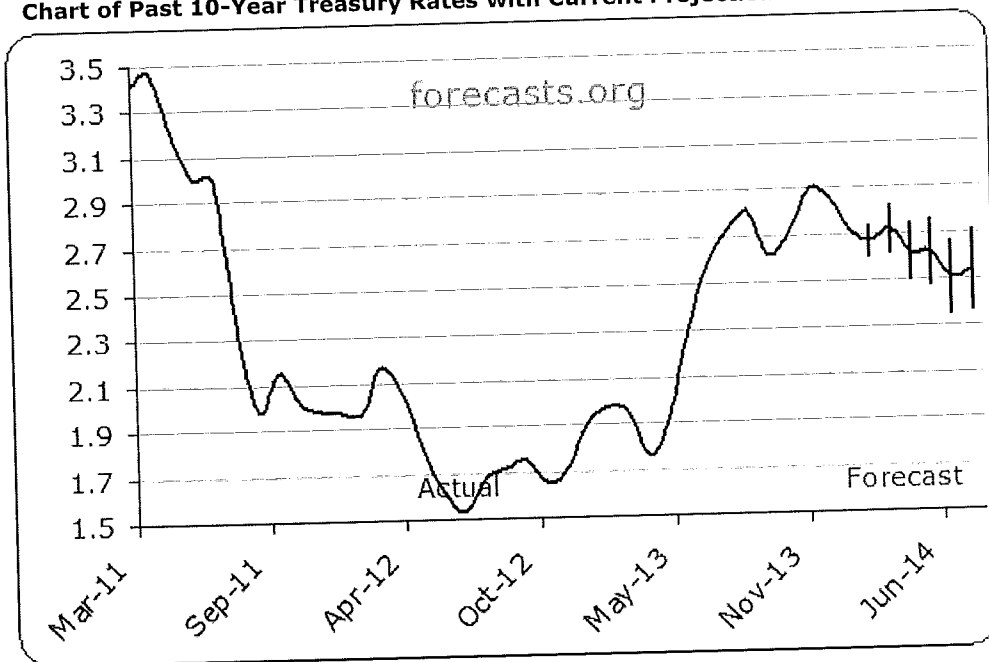
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### Ten Year U.S. Treasury Securities Yield

Chart of Past 10-Year Treasury Rates with Current Projection



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Current Money Rates	
March 13, 2014 (Close of Day)	
Indicator	Value
Prime Rate	3.25
30 Year Treasury Bond	3.60
10 Year Treasury Note	2.66
91 Day Treasury Bill	0.05
Fed Funds	0.08
3 Month EuroDollar	0.26
Mortgage Rate 30 Year	4.37

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## 30-Year U.S. Treasury Bond Yield Forecast

# 13.2% 2013 Annuity Return

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## 30-Year U.S. Treasury Bond Rates Forecast

30 Year Maturity. Percent/Year. Average of Month.

Month	Date	Forecast Value	50% Correct +/-	80% Correct +/-
0	Feb 2014	<b>3.660</b>	0.00	0.00
1	Mar 2014	<b>3.64</b>	0.07	0.16
2	Apr 2014	<b>3.70</b>	0.10	0.22
3	May 2014	<b>3.59</b>	0.12	0.27
4	Jun 2014	<b>3.58</b>	0.14	0.31
5	Jul 2014	<b>3.56</b>	0.16	0.35
6	Aug 2014	<b>3.60</b>	0.17	0.38

Updated Wednesday, March 12, 2014

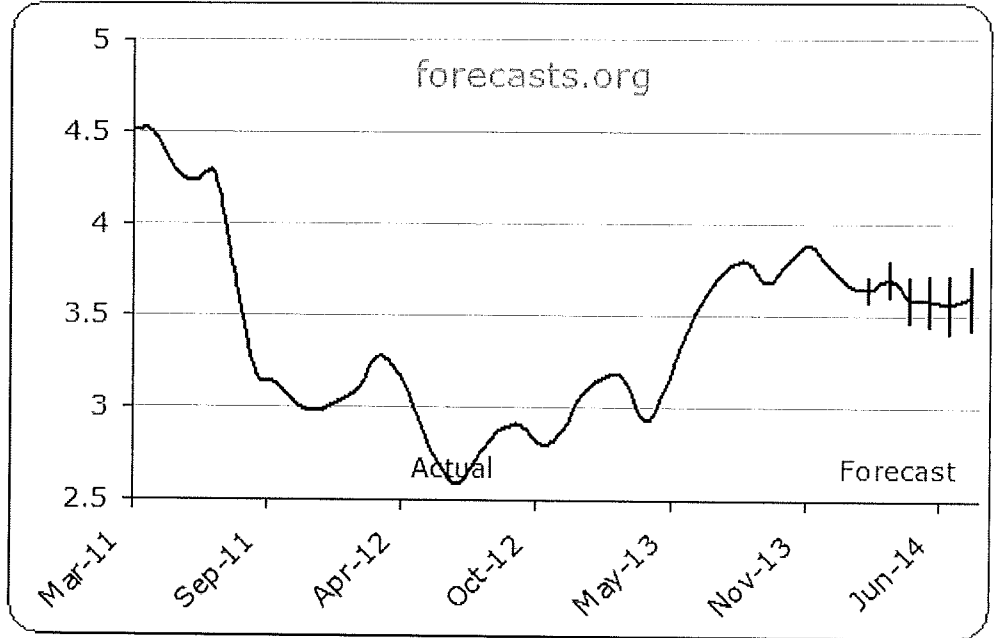
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### Thirty Year U.S. Treasury Bond Rates Chart of 30-Year Treasury Rates with Current Projection.



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# MOODY'S

## INVESTORS SERVICE

### Rating Action: Moody's upgrades MidAmerican Energy and its US utility subsidiaries; outlooks stable

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Global Credit Research - 30 Jan 2014

#### Approximately \$24 billion of debt affected

New York, January 30, 2014 -- Moody's Investors Service upgraded the ratings of MidAmerican Energy Holdings Co. (MEHC, including its senior unsecured to A3 from Baa1) and its subsidiaries PacifiCorp (including its Issuer Rating to A3 from Baa1); MidAmerican Funding, LLC (its senior unsecured to A2 from A3); MidAmerican Energy Company (MEC, including its Issuer Rating to A1 from A2); NV Energy Inc. (NVE, including its senior unsecured to Baa2 from Baa3); Nevada Power Company (NPC, including its Issuer Rating to Baa1 from Baa2); and Sierra Pacific Power Company (SPPC, including its Issuer Rating to Baa1 from Baa2). These rating actions completes Moody's review of MEHC and its US utility subsidiaries initiated on November 8, 2013. The outlook for all these entities is stable.

#### RATING RATIONALE

The primary driver of today's rating action was Moody's more favorable view of the relative credit supportiveness of the US regulatory environment, as detailed in our September 2013 Request for Comment titled "Proposed Refinements to the Regulated Utilities Rating Methodology and our Evolving View of US Utility Regulation."

"MidAmerican Energy Holdings' credit quality has benefited from improvements in the regulatory environments throughout its many jurisdictions," said Moody's senior vice president Mihoko Manabe.

MEHC's A3 rating befits one of the largest, diversified portfolio of regulated assets among US utility holding companies. Moody's notes that just last month, MEHC closed on its \$10 billion purchase of NVE, bolstering its position as a leading owner of regulated utilities. This acquisition adds NVE as MEHC's second-largest subsidiary (20% of pro forma EBITDA as of LTM September 30, 2013) behind PacifiCorp (33% of pro forma EBITDA) and Nevada to an already long list of regulatory jurisdictions in which it operates. Leverage will spike from the acquisition debt, but Moody's expects it will be managed back down over the next few years with the substantial free cash flow and tax credits that will be generated by MEHC's now expanded organization. This acquisition is also positive for MEHC's business risk profile as the company has lately focused on renewable investments that provide less durability than regulated assets. Still, unregulated businesses (8% of pro forma EBITDA) remain minor in the scheme of MEHC's large balance sheet.

For NVE and its subsidiaries NPC and SPPC, this merger is a credit-positive event as they become a part of a larger, well-capitalized organization that has a demonstrated track record within the regulated utility space of being a long-term investor, attentive to credit quality and able to strengthen regulatory and end-use customer relationships. Moreover, given NVE's service territory and the reliance on the gaming and mining sectors which can lead to boom-or-bust cycles, being a part of a deep-pocketed parent will be a favorable credit development.

NVE is an improving credit, having been upgraded three times over the last three years, the last time in May 2013 to investment-grade just before the merger with MEHC was announced. These upgrades were driven by a more credit-supportive regulatory environment in Nevada accompanying the company's improving financial position. The company generates healthy cash flow, but the disparity between the utility subsidiary ratings at NVE (NPC and SPPC both at Baa1) and MEHC's other utility subsidiaries PacifiCorp (A3) and MEC (A1) reflects NVE's still relatively high leverage. As of LTM September 2013, NPC and SPPC's cash flow pre-working capital-to-debt ratios were in the high 15% range, distinctly weaker than 20% at both PacifiCorp and MEC.

PacifiCorp's A3 rating is supported by the geographically diverse and relatively constructive regulatory environments in the six western states where it operates. In the context of Moody's more favorable view of US utility regulation, Moody's assesses PacifiCorp's overall regulatory treatment as average. Although PacifiCorp has been filing rate cases every year or so in its largest jurisdictions and getting reasonable outcomes, regulatory lag remains an ongoing challenge. The company however has made strides in obtaining multi-year rate increases, notably in Utah (by far its biggest jurisdiction comprising 44% of PacifiCorp's 2012 retail electricity volumes), and energy cost adjustment mechanisms in all its jurisdictions now except Washington (a minor jurisdiction at 7% of

electricity volumes). Under MEHC's ownership since 2006, PacifiCorp's capital structure has strengthened organically as a result of both retained earnings and substantial equity contributions from MEHC.

MidAmerican Funding (A2), MEHC's third-largest US utility platform (pro forma 14% LTM September 2013 EBITDA), is rated the highest among them. MidAmerican Funding's utility subsidiary MEC is the largest utility in Iowa, where Moody's views it receives above-average regulatory treatment compared to its peers. The features of its regulatory scheme, such as an earnings sharing mechanism and pre-authorization of capital projects at higher than industry-average ROEs result in stronger credit metrics than those of its sister companies. MEC is in midst of its first base rate case in nearly 20 years, in which it has reached a two-year settlement with most of its intervenors, and which is expected to be approved this quarter. This settlement, as proposed, will bring visibility to future revenues during its term, maintain many of the positive features in its current regulatory scheme, and importantly, introduce an energy adjustment clause which will be a significant improvement in its cost recovery mechanism.

The ratings of intermediate holding companies MidAmerican Funding and NVE are notched off those of its operating subsidiaries to reflect structural subordination.

#### WHAT COULD CHANGE RATINGS -- UP

MEHC's ratings are unlikely to be upgraded again in the foreseeable future given that the holding company's leverage has increased with the NVE acquisition. For its US utility subsidiaries, upgrades are possible if their regulatory treatment improves much more, enabling them to sustain stronger credit metrics. For example, the following levels of cash flow from operations pre-working capital-to-debt ratios could indicate upgrades: around 20% for MEHC, above 18% for NVE and its subsidiaries, the mid-20% range for PacifiCorp, and the 30% range for MEC.

#### WHAT COULD CHANGE RATING -- DOWN

MEHC's ratings could be downgraded if business risk increases materially; major investments are financed with excessive leverage; and credit metrics sustain a decline. For example, the following levels of cash flow from operations pre-working capital-to-debt ratios could indicate downgrades: in the low teens for MEHC, below 15% for NVE, the mid-teens for PacifiCorp, and the low 20% range for MEC.

The principal methodology used in these ratings was Regulated Electric and Gas Utilities published in December 2013. Please see the Credit Policy page on [www.moody.com](http://www.moody.com) for a copy of this methodology.

Headquartered in Des Moines, Iowa, MidAmerican Energy Holdings Co. is a diversified utility holding company privately owned by Berkshire Hathaway Inc.

#### Actions Taken:

MidAmerican Energy Holdings Co. :

Senior Unsecured Rating to A3 from Baa1

Senior Unsecured Bank Credit Facility to A3 from Baa1

Outlook to Stable from Under Review for Upgrade

MidAmerican Funding, LLC :

Senior Unsecured Rating to A2 from A3

Outlook to Stable from Under Review for Upgrade

MidAmerican Energy Company:

Long Term Issuer Rating to A1 from A2

First Mortgage Bonds to Aa2 from Aa3

Senior Secured to Aa2 from Aa3

Senior Secured Shelf to (P)Aa2 from (P)Aa3

Senior Unsecured Shelf to (P)A1 from (P)A2

Subordinate Shelf to (P)A2 from (P)A3

Outlook to Stable from Under Review for Upgrade

PacifiCorp:

Long Term Issuer Rating to A3 from Baa1

Senior Unsecured MTN to (P)A3 from (P)Baa1

Senior Unsecured Bank Credit Facility to A3 from Baa1

Preferred Stock to Baa2 from Baa3

First Mortgage Bonds to A1 from A2

Senior Secured to A1 from A2

Senior Secured MTN to (P)A1 from (P)A2

Outlook to Stable from Under Review for Upgrade

NV Energy Inc. :

Long Term Issuer Rating to Baa2 from Baa3

Senior Unsecured to Baa2 from Baa3

Outlook to Stable from Under Review for Upgrade

Sierra Pacific Power Company:

Long Term Issuer Rating to Baa1 from Baa2

First Mortgage Bonds to A2 from A3

Outlook to Stable from Under Review for Upgrade

Nevada Power Company:

Long Term Issuer Rating to Baa1 from Baa2

First Mortgage Bonds to A2 from A3

Senior Secured to A2 from A3

Outlook to Stable from Under Review for Upgrade

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## Summary:

### PacifiCorp

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Business Risk

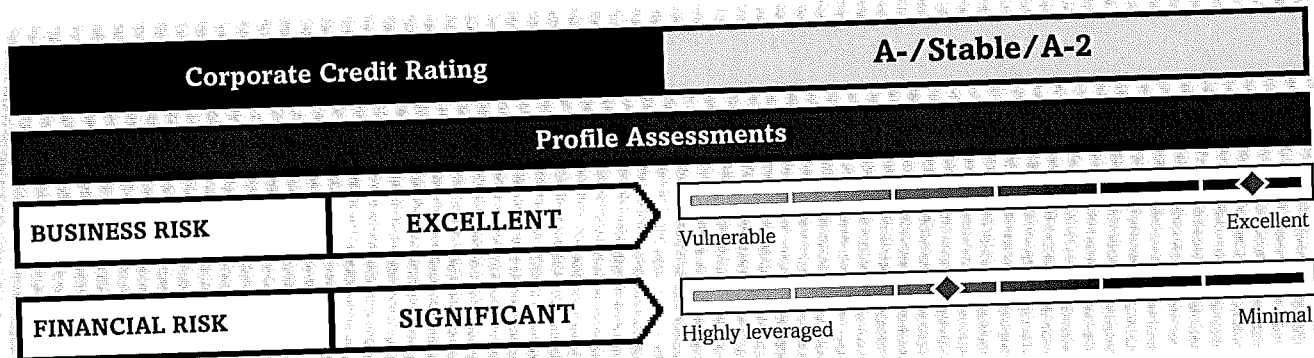
Financial Risk

Liquidity

Recovery Analysis

Related Criteria And Research

Summary:  
**PacifiCorp**



**Rationale**

<b>Business Risk: Excellent</b>	<b>Financial Risk: Significant</b>
<ul style="list-style-type: none"> <li>• Stable operating cash flow from the regulated utility operations supports the credit profile</li> <li>• Roughly 65% of revenue from "less credit supportive" regulatory environments</li> <li>• About 70% of retail revenue is derived from residential and commercial customers, which provides cash flow diversity and at least a base level of usage</li> <li>• Prudent management of coal-fired generating units to meet growing environmental compliance requirements</li> <li>• Parent MidAmerican Energy Holdings Co. (MEHC) does not expand nonregulated operations to a level that would result in a change to the business risk profile</li> </ul>	<ul style="list-style-type: none"> <li>• Net cash flow to capital spending to remain less than 100%</li> <li>• Discretionary cash flow to remain negative</li> <li>• Over the next several years, capital spending remains about the same because previously planned spending levels by PacifiCorp have been curtailed.</li> <li>• EBITDA growth consisting of revenue increases and customer growth expected to be about the same as in recent years</li> <li>• Berkshire Hathaway could acquire businesses riskier than the current businesses of MEHC, which has been used as the holding company for energy assets</li> <li>• Sizable parent level debt remains a rating consideration</li> </ul>

## Outlook: Stable

The stable rating outlook on PacifiCorp reflects our expectation that management will continue to focus on its core utility operations and reach construction regulatory outcomes to avoid any meaningful business risk rise. The outlook also includes our projection that cash flow measures will decrease as construction projects move forward and bonus depreciation benefits decrease. Our base forecast includes adjusted funds from operations (FFO) to total debt of about 18%, adjusted debt to EBITDA of roughly 4x, and adjusted debt to total capital hovering at 50%. These measures are consistent with our expectations for the rating.

### Downside scenario

We could lower ratings if financial measures consistently underperform our base forecast and remain at less credit-supportive levels, including adjusted FFO to total debt of less than 17%, adjusted debt to EBITDA that exceeds 5x, and adjusted debt to total capitalization of more than 54%.

### Upside scenario

We do not contemplate positive rating actions because of near-term capital needs, but we could raise ratings if financial measures strengthen and consistently exceed our base forecast, including FFO to total debt greater than 22%, debt to EBITDA less than 4x, and debt to total capital of no more than 47%.

## Standard & Poor's Base-Case Scenario

Our base case scenario results in moderate EBITDA growth, negative discretionary cash flow, and mostly steady debt to capital.

**Assumptions**

- EBITDA growth from average retail sales growth of about 1.5% and incremental cost recovery through various rate mechanisms, including base rate increases
- Rate recovery through surcharge mechanisms for capital projects, if requested
- Capital spending and dividend payouts that result in negative discretionary cash flow, indicating external funding needs

**Key Metrics\***

	2012A	2013E	2014E
FFO/Total debt (%)	19.5%	16%-19%	15%-18%
Debt/EBITDA (x)	4.5x	3.8x-4.3x	3.8x-4.3x
Total debt/Total capital (%)	50.3	48%-52%	48%-52%

A--Actual. E--Estimate. \*Standard & Poor's adjusted consolidated financial measures for PacifiCorp include adjustments to debt for pension-related items (\$382 mil.), accrued interest not in reported debt (\$113 mil.) and asset retirement obligations (\$83 mil.). EBITDA adjustments include pension-related items (\$23 mil.) and asset retirement finance costs (\$5 mil.). FFO adjustments include pension-related items (\$38 mil.) and operating leases (\$6 mil.). We do not expect these adjustments to change materially in 2013 and 2014.

**Business Risk: Excellent**

Our assessment of PacifiCorp's business risk profile as "excellent" reflects that it is a vertically integrated electric utility with geographical, market, and regulatory diversity over its six-state service territory. PacifiCorp provides power to its 1.7 million retail customers in Utah, Wyoming, and Idaho as Rocky Mountain Power and in Oregon, Washington, and California as Pacific Power. Utah and Oregon are the most important markets for the company, providing about 45% and 25% of annual retail sales, respectively.

There are provisions between MEHC and PacifiCorp that provide for raising the utility's rating above MEHC's 'BBB+' corporate credit rating. PacifiCorp's stand-alone credit measures and business risk profile must also support the higher rating. MEHC is privately held and majority owned by Berkshire Hathaway Inc. Our criteria provide that our corporate credit rating on PacifiCorp can be no more than three notches above the MEHC consolidated credit rating. PacifiCorp is currently rated one notch higher than parent MEHC.

PacifiCorp has made modest strides in improving key business and regulatory aspects. Despite the sluggish economic recovery in the company's Pacific Northwest territory, its western states, especially Utah, continue to exhibit some growth. PacifiCorp has been able to eke out rate increases that are in line with our expectations, and the utility was granted a fuel and purchased power adjuster in Utah last year. Fuel adjustment mechanisms exist for all states but Washington. A key ongoing challenge for PacifiCorp is whether it will be able to achieve rate relief at levels necessary to sustain the company's capital investment program. The program has been at high levels and will remain so in the next few years, despite the sluggish economic recovery. MEHC has been consistent in its investment strategy for PacifiCorp, with ongoing capital spending that will continue to result in the need for regular revenue increases,

requiring prudent cost recovery management.

## Financial Risk: Significant

We consider PacifiCorp's financial risk profile "significant" based on its consolidated financial measures, which include adjusted financial measures (FFO to total debt of 19.5%, debt to EBITDA of 4.5x, and debt to total capital of 50%, all for the 12 months ended Dec. 31, 2012) that are in line with the rating. Also, we consider the company's financial policies to be aggressive. Capital spending and dividend payments translate to rising negative discretionary cash flow over the forecast period, indicating external funding needs and vigilant cost recovery by management to maintain cash flow measures. Our base-case forecast suggests FFO to total debt weakening to about 18%, due in part to the waning benefits of bonus depreciation. We also expect other debt leverage measures to vary, with debt to EBITDA decreasing to about 4x and total debt to total capital remaining at about 51%.

## Liquidity: Adequate

PacifiCorp's stand-alone liquidity position is considered "adequate" under our liquidity methodology. We expect that its liquidity sources over the next 12 months will exceed its uses by 1.2x. We do expect PacifiCorp will need over the next few years to externally fund a portion of its liquidity needs for capital spending and debt maturities.

Principal Liquidity Sources	Principal Liquidity Uses
<ul style="list-style-type: none"> <li>• FFO of roughly \$1.4 billion in 2013</li> <li>• Assumed credit facility availability of about \$1.2 billion in 2013</li> </ul>	<ul style="list-style-type: none"> <li>• Debt maturities of \$261 million in 2013</li> <li>• Working capital outflows of \$35 million</li> <li>• Capital spending of about \$1.6 billion in 2013</li> <li>• Distributions of about \$100 million in 2013</li> </ul>

## Covenants

PacifiCorp had an adequate cushion of compliance with its one financial covenant (consolidated debt, including current maturities, to total capitalization to be less than 65%). Headroom could erode if debt rises rapidly without adequate growth in equity during a capital spending phase or due to high dividend payouts.

## Recovery Analysis

We assign recovery ratings to first mortgage bonds (FMBs) issued by U.S. utilities, which can result in issue ratings being notched above a corporate credit rating (CCR) on a utility depending on the rating category and the extent of the collateral coverage. The FMBs issued by U.S. utilities are a form of "secured utility bond" (SUB) that qualify for a recovery rating as defined in our criteria (see "Collateral Coverage and Issue Notching Rules for '1+' and '1' Recovery Ratings on Senior Bonds Secured by Utility Real Property", published Feb. 14, 2013).

The recovery methodology is supported by the ample historical record of 100% recovery for secured bondholders in utility bankruptcies in the U.S. and our view that the factors that enhanced those recoveries (limited size of the creditor



class and the durable value of utility rate-based assets during and after a reorganization given the essential service provided and the high replacement cost) will persist in the future.

Under our SUB criteria, we calculate a ratio of our estimate of the value of the collateral pledged to bondholders relative to the amount of FMBs outstanding. FMB ratings can exceed a CCR on a utility by up to one notch in the 'A' category, two notches in the 'BBB' category, and three notches in speculative-grade categories depending on the calculated ratio.

PacifiCorp's FMBs benefit from a first-priority lien on substantially all of the utility's real property owned or subsequently acquired. Collateral coverage of more than 1.5x supports a recovery rating of '1+' and an issue rating two notches above the CCR.

## Related Criteria And Research

- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008
- Business Risk/Financial Risk Matrix Expanded, Sept. 18, 2012
- 2008 Corporate Ratings Criteria: Ratios And Adjustments, April 15, 2008
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Collateral Coverage and Issue Notching Rules for '1+' and '1' Recovery Ratings on Senior Bonds Secured by Utility Real Property, Feb. 14, 2013
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008
- 2008 Corporate Criteria: Commercial Paper, April 15, 2008
- Corporate Criteria: Assessing U.S. Utility Regulatory Environments, Nov. 7, 2007
- Corporate Criteria: Standard & Poor's Methodology For Imputing Debt For U.S. Utilities' Power Purchase Agreements, May 7, 2007
- Parent/Subsidiary Links; General Principles; Subsidiaries/Joint Ventures/Nonrecourse Projects; Finance Subsidiaries; Rating Link to Parent, Oct. 28, 2004

### Business And Financial Risk Matrix

Business Risk	Financial Risk					
	Minimal	Modest	Intermediate	Significant	Aggressive	Highly Leveraged
Excellent	AAA/AA+	AA	A	A-	BBB	--
Strong	AA	A	A-	BBB	BB	BB-
Satisfactory	A-	BBB+	BBB	BB+	BB-	B+
Fair	--	BBB-	BB+	BB	BB-	B
Weak	--	--	BB	BB-	B+	B-
Vulnerable	--	--	--	B+	B	B- or below

**Note:** These rating outcomes are shown for guidance purposes only. The ratings indicated in each cell of the matrix are the midpoints of the likely rating possibilities. There can be small positives and negatives that would lead to an outcome of one notch higher or lower than the typical matrix outcome. Moreover, there will be exceptions that go beyond a one-notch divergence. For example, the matrix does not address the lowest rungs of the credit spectrum (i.e., the 'CCC' category and lower). Other rating outcomes that are more than one notch off the matrix may occur for companies that have liquidity that we judge as "less than adequate" or "weak" under our criteria, or companies with "satisfactory" or better business risk profiles that have extreme debt burdens due to leveraged buyouts or other reasons. For government-related entities (GREs), the indicated rating would apply to the standalone credit profile, before giving any credit for potential government support.

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**McGRAW-HILL**

**APRIL 29, 2013 7**

# MOODY'S

## INVESTORS SERVICE

### Credit Opinion: PacifiCorp

Global Credit Research - 08 May 2013

Portland, Oregon, United States

#### Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Baa1
First Mortgage Bonds	A2
Senior Secured	A2
Sr Unsec Bank Credit Facility	Baa1
Senior Unsecured MTN	(P)Baa1
Pref. Stock	Baa3
Commercial Paper	P-2
<b>Ult Parent: Berkshire Hathaway Inc.</b>	
Outlook	Stable
Issuer Rating	Aa2
Senior Unsecured	Aa2
ST Issuer Rating	P-1
<b>Parent: MidAmerican Energy Holdings Co.</b>	
Outlook	Stable
Sr Unsec Bank Credit Facility	Baa1
Senior Unsecured	Baa1
Commercial Paper	P-2

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#### Key Indicators

[1]PacifiCorp	2012	2011	2010	2009
(CFO Pre-W/C + Interest) / Interest Expense	4.9x	4.8x	5.3x	5.2x
(CFO Pre-W/C) / Debt	21.1%	21.0%	25.7%	26.0%
(CFO Pre-W/C - Dividends) / Debt	18.4%	13.5%	25.7%	26.0%
Debt / Book Capitalization	38.3%	39.8%	38.8%	42.4%

[1] All ratios calculated in accordance with the Global Regulated Electric Utilities Rating Methodology using Moody's standard adjustments.

Note: For definitions of Moody's most common ratio terms please see the accompanying [User's Guide](#).

#### Opinion

## Rating Drivers

Reasonably supportive regulatory environment  
Diversification to mitigate exposures to environmental spending, economic cycles  
Solid credit metrics  
Benefits from Berkshire Hathaway affiliation

## Corporate Profile

PacifiCorp (Baa1 senior unsecured, stable) is a vertically integrated electric utility company headquartered in Portland, Oregon serving 1.8 million retail electric customers in six states, including Utah (44% of PacifiCorp's 2012 retail electricity volumes), Oregon (23%), Wyoming (17%), Washington (7%), Idaho (7%), and California (2%). PacifiCorp also has ancillary operations in wholesale power marketing (18% of 2012 electricity volumes, as a result of excess electricity generation or other system balancing activities) and coal mining services, both which support its core utility business.

PacifiCorp is the largest subsidiary of MidAmerican Energy Holdings Company (MEHC: Baa1 senior unsecured, stable), accounting for roughly 40% of MidAmerican's operating income in 2012. MEHC, in turn, is a consolidated subsidiary of Berkshire Hathaway Inc. (BRK: Aa2 Issuer Rating, stable).

## SUMMARY RATING RATIONALE

PacifiCorp's ratings are supported by the stability of the utility's regulated cash flows, the geographically diverse and relatively constructive regulatory environments in which it operates, the diversification of its generation portfolio, and solid credit metrics. The rating also considers PacifiCorp's position as a subsidiary of MEHC, a holding company whose subsidiaries are primarily engaged in regulated activities, and the benefits from its affiliation with BRK.

## DETAILED RATING CONSIDERATIONS

Reasonably supportive regulatory environment

PacifiCorp's rating recognizes the rate-regulated nature of its electric utility operations which generate stable and predictable cash flows. PacifiCorp operates in regulatory jurisdictions that Moody's considers as average in terms of framework, consistency and predictability of decisions along with an expectation of timely recovery of costs and investments. This "average" assessment is in line with Moody's views of most US state jurisdictions compared to regulatory environments elsewhere in the world.

Regulatory lag is a challenge for PacifiCorp, which has long maintained large capital programs to meet load growth as well as regulatory requirements for emissions control, renewable standards, and reliability. Although PacifiCorp has been filing rate cases every year or so in its largest jurisdictions and getting reasonable outcomes, the large capital investments cause its actual returns on equity to be in the 7%- 8% range compared to the roughly 10% that it is allowed.

Expecting weak load growth over the next decade, the company has cut future capital expenditures to roughly \$1.1 billion a year, down considerably from the \$1.5 billion it has spent in recent years. Almost half of the reduction is in generation. Less capital spending will reduce the need for rate relief and, consequently, regulatory lag.

The most significant of the 2012 rate orders was in Utah, by far its biggest jurisdiction, where \$154 million in rate increases (8.5%) will be staged in over 2 years. Sizable rate cases have been filed in Oregon and Washington in Q1 2013, requesting increases of \$56 million (5%) and \$43 million (14%), respectively. These cases should be decided by year-end 2013.

Future rate filings will arise from its \$6 billion Energy Gateway transmission program, with multiple segments currently under construction, and its Lake Side 2 gas plant, which is expected to come online in 2014. The ability to use a forward test year in its rate requests helps to limit regulatory lag in Utah, Oregon, Wyoming, and California. The company has been successful in getting approvals for its major projects; however, it is exposed to some disallowances in most of its jurisdictions, where pre-approvals on projects or cash returns on construction work in progress are not granted.

The company has obtained energy cost adjustment mechanisms in all its jurisdictions now except Washington. Such mechanisms to recover fuel and purchased power costs -- a large, volatile expense -- are more established in other parts of the country. While this development is supportive of credit quality, there remains some lag in recovering portions of energy costs. For example, in Utah, Wyoming, and Idaho, the majority of the difference between the actual power costs and costs established in its base rates is deferred. This difference is then recovered or refunded after an annual filing.

Diversification to mitigate exposures to environmental spending, economic cycles

PacifiCorp benefits from a well diversified generation portfolio. Its 11,224 MW of net generating capacity is comprised primarily of its low cost base-load coal plants (55% of the company's generation), along with 25% from its gas assets and 10% from hydro.

With coal accounting for a slight majority of its generation capacity, PacifiCorp is subject to numerous emissions standards, but the company is well positioned to comply with the vast majority of its plants already equipped with sulfur dioxide and nitrogen oxide controls.

Reflecting a common strategic imperative among MEHC affiliates, PacifiCorp has been investing heavily to increase its non-carbon generation resources, and in so doing, has become the second-largest utility owner of wind generation facilities in the US. Owning this much wind capacity not only mitigates exposure to stricter environmental rules for coal plants, but also helps in meeting ambitious renewable portfolio standards in Oregon, Washington, and California.

The market and customer diversity of PacifiCorp's six-state service territory is favorable, because it mitigates the economic and regulatory impacts in any one jurisdiction. This benefit is demonstrated by the recent economic impact on retail sales. Load has been declining for five straight years in the Pacific Northwest from still weak industrial demand, while the Rocky Mountain states have enjoyed some commercial and industrial growth from oil and gas activity, which has been offset by self-generation among its industrial customers.

Solid credit metrics

PacifiCorp's overall key credit metrics in 2012 mapped to the low A range in the Regulated Utilities Methodology. The ratio of cash from operations before changes in working capital (CFO pre-W/C) to Debt, calculated in accordance with Moody's standard adjustments, was unchanged from 2011 at 21%, compared to 26% in both 2010 and 2009. Its CFO pre-W/C interest coverage was 4.9x in 2012 versus 4.8x in 2011 and the 5x range in 2010 and 2009.

PacifiCorp's credit metrics - like the rest of the utilities industry - have been buoyed by the effects of bonus depreciation, a temporary tax benefit which will extend through 2013. Normalized to exclude bonus depreciation, CFO pre-W/C to Debt would have been in the upper-teens and CFO pre-W/C interest expense coverage would have been in the mid to lower 4 times range during 2009-2011. After bonus depreciation ends in 2013, PacifiCorp's credit metrics will return to more normal, sustainable levels.

Benefits from Berkshire Hathaway affiliation

PacifiCorp paid dividends of \$200 million to MEHC in 2012, and \$550 million in 2011, which was its first since being acquired by MEHC in 2006. MEHC had made equity contributions in each of the previous five years totaling \$1.1 billion to help PacifiCorp finance its capital expenditures during this period. The dividends were intended to manage PacifiCorp's equity ratio (as measured by unadjusted equity to equity plus debt) around 50% after it had accreted to 53% as of year-end 2010. PacifiCorp is not held to a regular dividend, but will likely make additional dividends periodically, depending on its capital requirements and equity ratio.

From a credit perspective, the company's ability to retain its earnings as an entity that is privately held, particularly by a deep-pocketed sponsor like BRK, is an advantage over most other investor owned utilities that are typically held to a regular dividend to their shareholders. An additional tangible benefit from PacifiCorp's BRK affiliation is an equity commitment agreement, expiring on February 28, 2014, between MEHC and BRK, under which BRK has committed to provide up to \$2 billion through February 2014. Equity from this agreement may be requested to fund MEHC's debt obligations or to provide capital to MEHC's regulated subsidiaries, including PacifiCorp. This agreement thus provides PacifiCorp with an additional source of alternate liquidity. We do not expect the commitment to be renewed, thus somewhat weakening the liquidity profile in 2014 and beyond, but we see no reason why BRK would not be supportive in the event of extraordinary and unanticipated difficulty at MEHC.

## Liquidity Profile

PacifiCorp has good near-term liquidity, with \$133 million in cash and two \$600 million revolvers expiring in 2017 and 2018, of which about \$888 million was available as of March 31, 2013. In 2012, the company generated cash flow from operations before working capital changes of \$1.5 billion which will more than cover the \$1.1 billion a year it plans on capital expenditures. Excluding minor amounts of revenue bonds, significant upcoming debt maturities include \$200 million due on September 15, 2013 and \$200 million due on August 15, 2014. The roughly \$400 million reduction in annual capital expenditures will reduce the need for long and short term borrowings.

PacifiCorp uses its credit facilities to backstop its commercial paper program and to support its variable rate tax-exempt bonds. These credit agreements do not require MAC representation for borrowings, which Moody's views positively. The sole financial covenant is a limitation on debt to 65% of total capitalization. As of March 31, 2013, PacifiCorp had ample headroom under that covenant with that ratio at 47% as defined in the agreement.

## Rating Outlook

The stable outlook incorporates Moody's expectation that PacifiCorp will continue to receive reasonable regulatory treatment for the recovery of its capital expenditures, and that the funding requirements will be financed in a manner consistent with management's commitment to maintain a healthy financial profile. After the bonus depreciation ends in 2013, Moody's anticipates that PacifiCorp's credit metrics will return to the levels more typical before 2009, with CFO pre-W/C to Debt just below 20%.

## What Could Change the Rating - Up

While the size of the company's capital expenditures limits the prospects for a rating upgrade in the near-term, the rating could be upgraded if reasonable regulatory support and a conservatively financed capital expenditure program results in a sustained improvement in credit metrics. This would include, for example, PacifiCorp's ratios of CFO pre-W/C to Debt sustained in the mid 20% range.

## What Could Change the Rating - Down

The ratings could be adjusted downward if PacifiCorp's planned capital expenditures are funded in a manner inconsistent with its current financial profile, or if there were to be adverse regulatory rulings on current and future rate cases such that we would anticipate a sustained deterioration in financial metrics as demonstrated, for example, by a ratio of CFO pre-W/C to Debt falling to the mid teens.

## Rating Factors

### PacifiCorp

Regulated Electric and Gas Utilities Industry [1][2]	12/31/2012		Moody's 12-18 month Forward View* As of May 2013	
	Measure	Score	Measure	Score
<b>Factor 1: Regulatory Framework (25%)</b>		Baa		Baa
a) Regulatory Framework				
<b>Factor 2: Ability To Recover Costs And Earn Returns (25%)</b>		Baa		Baa
a) Ability To Recover Costs And Earn Returns				
<b>Factor 3: Diversification (10%)</b>		A		A
a) Market Position (5%)		Baa		Baa
b) Generation and Fuel Diversity (5%)				
<b>Factor 4: Financial Strength, Liquidity And Key Financial Metrics (40%)</b>		A		A
a) Liquidity (10%)	5.0x	A	4.5x-4.9x	A
b) CFO pre-WC + Interest/ Interest (3 Year Avg) (7.5%)	22.5%	A	18%-	Baa
c) CFO pre-WC / Debt (3 Year Avg) (7.5%)				

d) CFO pre-WC - Dividends / Debt (3 Year Avg) (7.5%)	19.0%	A	20%	A
e) Debt/Capitalization (3 Year Avg) (7.5%)	39.0%	A	16%-18%	A
			36%-39%	A
<b>Rating:</b>				
a) Indicated Rating from Grid		Baa1		Baa1
b) Actual Rating Assigned		Baa1		Baa1

\* THIS REPRESENTS MOODY'S FORWARD VIEW; NOT THE VIEW OF THE ISSUER; AND UNLESS NOTED IN THE TEXT DOES NOT INCORPORATE SIGNIFICANT ACQUISITIONS OR DIVESTITURES

[1] All ratios are calculated using Moody's Standard Adjustments. [2] As of 12/31/2012(LTM); Source: Moody's Financial Metrics

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Harvey S. Katz | January 29, 2014



## The Federal Reserve Has Few Surprises For Investors - January 29, 2014



The Federal Reserve's Federal Open Market Committee (FOMC) has concluded its latest meeting within the last hour and it ended this get together by voting to do what almost everyone watching this periodic drama had believed it would, namely to reduce its bond purchases by \$10 billion a month.

Specifically, the FOMC will taper its very popular program by going from purchasing \$75 billion in Treasuries and mortgage-backed securities each month to \$65 billion. In mid-December, the bank had voted to reduce such buying from \$85 billion monthly to \$75 billion.

Moreover, the Fed also indicated that it expected to reduce future bond purchases in measured steps at upcoming meetings. Our

sense is that the FOMC will wrap up this program later this year, unless the economy suddenly stumbles or there are new shocks around the globe. Apparently, the recent flare-up of economic and currency woes in the emerging markets did not qualify as such a shock. Note that this was the last Fed meeting at which Ben S. Bernanke will preside; he will be replaced as new Fed Chair by Janet Yellen on Saturday.

Behind this latest move was a sense that the FOMC believes growth in economic activity had picked up sufficiently in recent quarters for there to be less of a need for aggressive support. Within this aggregate business picture, labor market indicators were mixed, but showing improvement; household spending and business fixed investment were advancing somewhat more quickly than before; there was less of a restraint from fiscal policy, and long-term inflation expectations were remaining stable, although currently such pricing was below the 2% target that the Fed views as healthy.

Taking all of this into account, the Committee continues to believe that the economy is pressing forward at a satisfactory gait. As a result of this constructive outlook, the Fed believes that it was prudent to "make a further measured reduction in the pace of its asset purchases."

Such a modest tapering should keep some downward pressure on long-term interest rates--the main goal of this program--securely in place for the time being. Moreover, the Fed suggested that it will continue to buy such securities until the outlook for the labor market has brightened substantially. We take that to mean late in 2014--at the earliest.

All in all, this seems like a sensible approach. At some point, the training wheels will need to come off the economy to see whether or not it can go towards full employment on its own. We probably are not there yet, but we are getting closer, in our opinion. It should be noted that the vote to undertake this additional tapering was unanimous, with both Mr. Bernanke and Ms. Yellen among the voters.

*At the time of this article's writing, the author did not have positions in any of the companies mentioned.*

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## Beige Book - March 5, 2014

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### Full Report

#### Summary of Commentary on Current Economic Conditions by Federal Reserve District

Prepared at the Federal Reserve Bank of Atlanta and based on information collected before February 24, 2014. This document summarizes comments received from businesses and other contacts outside the Federal Reserve and is not a commentary on the views of Federal Reserve officials.

Reports from most of the twelve Federal Reserve Districts indicated that economic conditions continued to expand from January to early February. Eight Districts reported improved levels of activity, but in most cases the increases were characterized as modest to moderate. New York and Philadelphia experienced a slight decline in activity, which was mostly attributed to the unusually severe weather experienced in those regions. Growth slowed in Chicago, and Kansas City reported that conditions remained stable during the reporting period. The outlook among most Districts remained optimistic.

Retail sales growth weakened since the previous report for most Districts, as severe winter weather limited activity. However, Richmond, St. Louis, and Minneapolis reported modest sales growth since the beginning of the year. Weather was also cited as a contributing factor to softer auto sales in many Districts, with the exception of Cleveland, which saw strong gains. Tourism increased in a number of Districts but declined in Philadelphia and was reported to have been mixed in New York and Minneapolis.

The demand for nonfinancial services was mixed compared with the last report; however, both Boston and San Francisco reported strong demand for technology related services. Manufacturing sales and production in several Districts were negatively impacted by severe winter weather; however, modest improvements were noted in Boston, Atlanta, Minneapolis, and Dallas.

Residential real estate markets continued to improve in several areas, albeit modestly. Boston and New York gave mixed reports on sales, and Philadelphia, Cleveland, Minneapolis, and Kansas City noted a decrease in sales. Many Districts cited low inventories of housing and continued home price appreciation. Commercial real estate leasing expanded, according to most reports, while reports on construction activity were mixed. Demand for commercial real estate loans was solid in Boston, improved slightly in Dallas, and continued to grow steadily in Chicago and Kansas City.

Of the Districts that reported on agriculture, conditions softened in Kansas City and Dallas as dry soil adversely affected wheat crops. Districts reported that energy production and demand continued to increase as a result of increased demand due to the unusually cold winter.

Employment levels improved gradually for most Districts, and shortages of specialized skilled labor continued to be reported. Price pressures remained subdued, with the exception of upward cost pressures for some energy and construction products. Wage pressures remained stable for most Districts.

#### Consumer Spending and Tourism

Most Districts reported sales growth had softened from January to early February. New York reported noticeable weakness; however, Richmond, St. Louis, and Minneapolis reported modest growth since the beginning of the year. The extreme winter weather conditions reportedly contributed to the decline in sales in some markets; however, Richmond, Chicago, and Minneapolis reported that weather-related goods contributed to positive sales growth. Reports from furniture retailers in Boston and Minneapolis indicated strong sales. Contacts in Cleveland, Richmond, Kansas City, Dallas, and San Francisco expected retail spending to improve going forward. Vehicle sales varied across Districts. Severe weather conditions resulted in softer vehicle sales as reported by New York, Philadelphia, Richmond, Chicago, Kansas City, and Dallas. Cleveland noted a modest increase in auto sales compared with a year ago. New York cited upcoming auto shows as an expected boost for future sales, while Chicago anticipates that sales incentives will increase near-term sales.

Travel and tourism was generally strong across most reporting Districts except for Philadelphia who recorded a slight decrease. San Francisco stated that the level of travel and tourism increased in their region. Recent winter weather conditions benefited many ski resorts in Kansas City, Richmond, and Minneapolis. Atlanta and Boston also indicated that hotels fared well from the weather, but that restaurants, museums, and other attractions were negatively impacted. New

York reported mixed activity from January to early February. Hotel occupancy rates in Manhattan and New Jersey increased, buoyed by the Super Bowl, while hotel business was down in western New York State due to the harsh winter storms. Airline contacts from Dallas indicated solid to slightly stronger demand, with some temporary disruptions due to severe winter weather across the nation. The majority of Districts reported a solid start in the first quarter for hotel bookings, occupancy, and revenue with an optimistic outlook for the remainder of the year.

#### **Nonfinancial Services**

Reports from Districts mentioning nonfinancial business services indicated that activity has been mixed since the previous report. Both New York and Philadelphia reported that severe winter weather reduced demand for services in their region. Activity in Minnesota and San Francisco's professional business service firms improved since their last report. Boston said that demand for software and information technology was stronger than expected, and demand for cloud computing remained strong according to San Francisco's report. Richmond service providers noted flat revenue in recent weeks, while sales were characterized as stable among Kansas City service providers. The outlook among contacts was mixed, as well. Planned activity in St. Louis was described as negative, while contacts in Minneapolis and Dallas noted optimism. Contacts in Kansas City anticipate activity will pick up, while software and IT professionals in San Francisco are cautiously optimistic and anticipate revenue growth will be positive this quarter.

Transportation activity since the previous report was mixed. Severe weather reportedly disrupted supply chains and delayed shipments in several Districts. In Dallas, railroad cargo volumes fell slightly below year earlier levels, with winter weather conditions across the country largely to blame. Port activity in Atlanta and Richmond reflected increases in auto shipments, while Dallas reported declines in container volumes. Atlanta and Dallas indicated air cargo was down, compared with year earlier levels. Kansas City cited increasing optimism about future transportation activity, while Cleveland noted expectations that demand in 2014 will be the same or only moderately higher than a year ago.

#### **Manufacturing**

Manufacturing activity expanded at a moderate pace from January through early February in most Districts. Several Districts reported that severe winter weather had a negative effect on sales and production during this period, including Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, and Dallas. The weather was cited to have caused utility outages, disrupted supply chains and production schedules, and resulted in a slowing of sales to affected customers. Philadelphia and Richmond reported that shipments and orders declined during the first half of February. Steel producers in Cleveland indicated that they have excess capacity, and San Francisco reported low capacity utilization rates at steel mills. Boston and San Francisco indicated that semiconductor sales had been particularly strong. High-tech contacts in Dallas reported a slight improvement in orders, as demand for memory chips remained strong and demand for logic devices remained weak but stable. San Francisco also cited growth in the commercial aerospace industry due to a backlog in orders for commercial aircraft, while defense-related manufacturers reported sluggish overall conditions and expected sales to trend downward. Auto production was strong in Chicago despite weather-related slowdowns in sales, and Cleveland reported auto production to be higher than a year ago. Most Districts were optimistic about the future and expect manufacturing activity to rise in the coming months.

#### **Real Estate and Construction**

Reports on residential housing markets were somewhat mixed. Many Districts continued to report improving conditions but noted that growth had slowed. Most of the Districts indicating otherwise attributed the slowing pace of improvement to unusually severe winter weather conditions. Home sales increased in Richmond, Atlanta, Chicago, St. Louis, and Dallas, while sales were down in Philadelphia, Cleveland, Minneapolis, and Kansas City. Boston and New York reported that the trend in sales for their Districts was mixed. New home construction increased in Richmond, Atlanta, Chicago, St. Louis, and Minneapolis, and remained flat in Kansas City, and was down slightly from the previous period in Philadelphia. Most Districts reported low levels of home inventories and indicated that home prices continued to appreciate. The outlook for sales and residential construction was positive in Boston, Philadelphia, Cleveland, Atlanta, and San Francisco.

Strong multifamily construction was cited in New York, Cleveland, Richmond, Atlanta, and Dallas, while Boston indicated that its pipeline of multifamily construction was declining. Dallas experienced rent growth above its historical average, while New York reported mixed trends in rent growth. Cleveland noted that it expects healthy growth in rents this year.

Many Districts, including New York, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, and San Francisco, indicated that commercial real estate activity had increased and that conditions continued to improve since the previous report. Philadelphia noted that there was very little activity to report in construction or leasing due to severe winter weather. The outlook for nonresidential construction was fairly optimistic in Boston, Philadelphia, Cleveland, Atlanta, Minneapolis, Kansas City, Dallas, and San Francisco.

#### **Banking and Financial Services**

District reports of loan demand and volume were mixed. Demand for residential mortgages decreased in New York, Richmond, St. Louis, and Kansas City, and softened in Philadelphia and Dallas. Cleveland and Atlanta noted increased demand for new purchase mortgages, while mortgage refinancing declined in New York, Richmond, Atlanta, and Kansas City. Demand for consumer loans grew slightly in Philadelphia, Cleveland, Chicago, and Dallas, and held steady in Kansas City. Decreased demand for consumer loans was noted by Richmond and St. Louis, and among small to medium-sized banks in New York. Boston reported commercial real estate loans were highly competitive and demand was solid. Richmond businesses looked for shorter-term commercial real estate loans in order to benefit from lower interest rates those loans offered. Chicago and Kansas City reported steady growth in commercial real estate loans, and demand for such loans improved marginally in Dallas. Small to medium-sized banks in New York reported no change in commercial real estate loan demand.

New York noted modest declines in delinquency rates. Cleveland reported delinquencies were stable or trended lower, and St. Louis indicated delinquencies for most types of loans decreased. Loan quality in Kansas City improved compared with a year ago and continued to strengthen in Dallas. Bankers in Cleveland and Atlanta voiced concerns about recently enacted regulations and the potential negative impact on lending.

#### **Agriculture and Natural Resources**

Agricultural conditions softened since the previous report. Severe winter weather affected several Districts with some crop damage being reported by Richmond and Atlanta, while Chicago noted disruptions in the flow of agricultural products. Both Kansas City and Dallas cited dry conditions adversely affecting wheat crops, while San Francisco reported concerns about water shortages and water costs. Several Districts noted falling feed prices had a positive effect

for cattle and hog producers. Kansas City indicated farmland price appreciation moderated from the rapid pace seen in the past few years. Crop prices received in January by farmers fell from a year earlier for corn, wheat, soybeans, hogs, and chickens; prices increased for cotton, rice, oranges, cattle, milk, eggs, and turkeys.

District reports showed continued strength in energy production and demand for oil and gas; much of the increased demand was driven by unusually cold winter weather. Cleveland, Richmond, and St. Louis reported coal production was down, with steam coal plant closures in Richmond. Cleveland, Atlanta, and Dallas described growth in drilling (both inland and offshore) and refining activity. In contrast, Minneapolis indicated that oil and gas exploration decreased slightly from recent months, primarily due to the extremely cold weather. Inventory drawdowns and supply shortages of natural gas and propane were reported in Atlanta, Chicago, and Dallas due to increased withdrawals that were exacerbated by the severe weather. Nearly all Districts attributed energy price surges to increased demand during the unusually cold weather; yet, Boston reported that natural gas prices were also driven up by pressure on pipeline capacity in New England. Some firms in the Richmond and Chicago Districts indicated that they elected to delay production and/or reduce usage rather than pay high prices. Dallas indicated that increases in the price of West Texas Intermediate (WTI) crude oil were being bolstered by debottlenecking at Cushing, Oklahoma.

#### **Employment, Wages, and Prices**

Since the previous report, the pace of hiring had reportedly softened in Boston, Richmond, and Chicago, with those Districts attributing at least part of the recent slowdown to unusually bad winter weather. Despite a pickup in hiring in some sectors across New York, Cleveland, Atlanta, and St. Louis, notably in manufacturing, overall employment growth for these Districts remained sluggish. In Philadelphia, as outlooks for long-term overall economic growth improved, firms reportedly continued to expand their headcounts cautiously. In contrast, labor markets in the Minneapolis District tightened slightly. The rate at which temporary employees were converted to permanent hires remained strong across Boston, while contacts in Richmond reported this conversion was happening at a slightly faster pace than previously noted. Many Districts continued to note shortages for particular types of specialized, technical skilled labor, such as healthcare professionals and information technology workers. Atlanta and Dallas also noted shortages for freight truck drivers.

Inflation pressures remained largely unchanged across most Districts. Price pressures were described as minimal or roughly steady in Boston, New York, Philadelphia, Cleveland, Atlanta, Chicago, Minneapolis, Dallas, and San Francisco. There were some mentions of rising raw materials prices passing through to final goods. Boston indicated that higher material costs and rising costs of overseas labor could have an upward influence on apparel prices. Chicago, Minneapolis, and Dallas noted that unseasonably cold weather had pushed up costs for some energy products. Construction materials prices remained a source of upward cost pressure, according to contacts in Atlanta and Kansas City. Retail contacts in New York and Philadelphia reported deep product discounting; however, reports from Dallas indicated that retail prices were stable.

Most Districts noted that wage pressures were largely steady since the last report; however, a few Districts cited upward wage pressures in some highly skilled jobs in industries such as information technology, transportation, and construction. Reports from Cleveland, Kansas City, and San Francisco indicated that businesses were anticipating wage growth to increase from the recent mild pace as the year progresses. Contacts in Chicago indicated that higher healthcare premiums increased non-wage labor costs, while a growing number of employers in Cleveland reported passing through rising healthcare costs to their employees.

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#### **First District--Boston**

Business contacts in the First District continue to report modest increases in revenues and sales. Respondents in several sectors cite negative effects of severe winter weather. Firms report little hiring and wage increases remain very modest. Price pressures are reportedly minimal, but a few contacts note specific items for which prices are rising or are expected to rise. The outlook is generally positive, albeit cautiously so.

#### **Retail and Tourism**

This round's retail contacts completed their 2013 fiscal years at the end of December or in mid-February. Most report 2013 year-over-year sales increases ranging from 3 percent to the mid-single digits, though one cites an increase in the mid-teens. Several respondents report continued good results so far in 2014, but two retailers indicate that the pace of sales has slowed a bit. Some of this softness is said to be due to weather-related issues or to tough year-over-year comparisons with the post-Hurricane Sandy rebound. A furniture retailer reports that President's Day sales were extremely strong. Prices remain steady overall, though contacts say a modest increase in apparel prices is coming, reflecting a rise in some raw material prices and overseas labor costs. Retail respondents expect continued overall improvement in U.S. economic conditions and consumer sentiment in 2014.

Boston area hotels attained new record highs for hotel occupancy rates and revenues in 2013, building on the strong records set in 2012. Expectations are for continued strong growth in 2014, though hotels expect to see revenue growth but not increases in occupancy rates; these are forecast at 80 percent, a 1 percentage point increase over 2013. Severe winter weather in January and February had hotels faring well, but restaurants, museums, and other venues losing revenue due to the harsh weather conditions. An industry contact says that this pattern seems to hold for much of the eastern seaboard.

#### **Manufacturing and Related Services**

Of 13 manufacturers contacted this round, nine report higher sales than the same period a year earlier. Two firms, a toy manufacturer and a publisher, cite flat sales but the reasons appear to be idiosyncratic. Two others, a manufacturer of electrical equipment for residential and commercial buildings and a maker of membranes, report falling sales but both attribute the drop to the weather. The direct effect of the storms was the loss of several days of production in February. In addition, demand fell both because some of their products are intermediate goods for other plants in afflicted areas and because end users demanded less. For example, reduced construction meant that there was less demand for electrical supplies. Three firms in the semiconductor industry report strong sales, confirming the end of that sector's slowdown, which began in 2011. Two firms, a maker of electrical equipment and a tool maker, both reported that residential investment was a significant driver of growth.

The news on inventories is mixed. Six contacts say that they continue to make a concerted effort to reduce inventories.

However, one contact was building inventory on the assumption that the drop in sales due to the winter weather would lead to an increase in demand in the second quarter to make up for it. An electrical equipment supplier said that in some product lines, bad weather led to higher demand for replacement parts which reduced inventories. None of our contacts report any major pricing pressure, up or down, either from suppliers or customers. One contact said that pressure on pipeline capacity in New England is driving up natural gas prices.

Most firms report increased capital spending in 2013 and plans to increase again in 2014. However, most of those plans were already in place and there is little evidence of positive revisions in recent months. Five contacts report flat employment, four note positive hiring, and four cite reduced staffing. Respondents say engineering staff remains somewhat difficult to find, but otherwise none of our contacts have complaints about the labor market.

Eleven of 13 contacts report positive or very positive outlooks for 2014. The exceptions are a toy maker, who is generally cautious, and a publisher anticipating falling sales.

#### **Software and Information Technology Services**

First District software and information technology services contacts generally report stronger-than-expected business activity through February, with revenue growth exceeding earlier forecasts. For example, a healthcare contact expected a large year-over-year revenue decline due to the expiration of federal stimulus for health records software; however, the firm ended the year with just a marginal dip in revenues and positive net income growth. Only one contact, a provider of payment and banking software, reports accelerated growth, with year-over-year revenue increases in the 15 percent range. The majority of firms are maintaining headcount; one contact added positions in sales and marketing. Wages remain steady, with firms awarding (and in one case reinstating) merit increases in the 2.5 percent to 3.5 percent range. Both selling prices and capital and technology spending have gone largely unchanged. The outlook among software and IT contacts is cautious optimism, with expectations of modest revenue growth through the end of the quarter. Contacts remain concerned about general macroeconomic conditions and uncertainty surrounding healthcare reform.

#### **Staffing Services**

New England staffing contacts report softened business conditions in recent months, attributed to both the holiday season and the large number of snowstorms occurring throughout the Northeast. Although revenues are up slightly year-over-year, they are down on a quarter-over-quarter basis. Despite these difficulties, labor demand remains strong across most industries, with contacts noting particularly high demand in the software, engineering, legal, specialty manufacturing, and healthcare sectors. Demand has weakened in the defense sector. On the supply side, contacts cite a shortage of candidates to fill nursing, specialized manufacturing, and IT roles. This reportedly reflects a skills mismatch, amplified by the holidays and severe weather. In response, firms continue to invest in social media initiatives to reach a broader audience of candidates. The temporary-to-permanent conversion rate remains strong. Bill rates and pay rates have generally held steady, with the exception of two contacts reporting an upward trend in pay rates and one contact reporting a slight increase in bill rates. Looking forward, staffing contacts are optimistic that growth will accelerate as weather conditions improve, expecting mid-single-digit revenue growth through the next few months. Several contacts express concerns about continued uncertainty regarding how healthcare reform will affect the staffing industry.

#### **Commercial Real Estate**

Commercial real estate activity was mixed across the First District, but contacts report that leasing fundamentals were largely stable in recent weeks. In Providence, demand for multifamily housing remains strong downtown, while industrial leasing activity is still weak. In Boston, office demand continues to be uneven within the city, with strength in the Seaport District, increasing demand in some suburban areas, and comparative weakness—including downward pressure on rents—in the Financial District. In Boston and Hartford, severe winter weather modestly reduced office leasing inquiries. Also, according to one contact, investment sales activity slowed in the region in the aftermath of a year-end surge in transactions. At the same time, contacts indicate that investment demand for commercial real estate remains strong across the region, and especially strong in Boston. A Portland contact characterizes leasing activity as solid and notes that land sales continue to gather momentum. Planned developments in Portland include a diverse mix of structures: recreational facilities, hotels, office space, and specialty retail. According to a regional banking contact, the bank lending environment for commercial real estate remains highly competitive, with solid loan demand across numerous sectors, albeit including fewer condominium development loans than had been expected. Recent trends in construction activity persist, with slow growth in the institutional sector, a declining pipeline of multifamily structures, and an increase in planned mixed-use developments and speculative office construction in parts of Boston.

While contacts are mostly optimistic concerning the outlook for commercial real estate in their respective markets, some downside risks are noted, including renewed macroeconomic uncertainty stemming from recent, weaker-than-expected employment reports, an uncertain future path of interest rates, and fallout from unrest in the Ukraine, Syria, and Venezuela. Other factors seen as restraining growth include rising construction and maintenance costs, and, in Rhode Island, political stagnation stemming from the current gubernatorial election.

#### **Residential Real Estate**

The First District experienced mixed results for sales of single family houses and condominiums in December. Contacts in New Hampshire and Rhode Island cite declines in sales of single family homes, while Massachusetts experienced no change, and respondents in Connecticut, Maine, and Vermont cite increases in sales relative to December 2012. Scarce inventory is said to be the most significant constraint on the growth of sales, while uncertainty from new qualified mortgage rules and flood insurance reforms are also believed to be causing buyers to remain cautious about making offers. Contacts in Connecticut say that sales are being affected by weak consumer confidence and a shortage of stable employment opportunities. Median sale prices increased year-over-year in four of the six New England states, decreasing only in Connecticut and Vermont. In Massachusetts, particularly in the Greater Boston area, price appreciation driven by low inventory levels has become a concern as realtors caution that high prices could keep first time home buyers out of the market.

Pending sales suggest the market for single family houses and condos is off to a good start in 2014, increasing in all states except Rhode Island. Contacts express optimism about local housing markets looking forward but say they expect the snowy winter to depress sales in the near term.

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Second District--New York

Economic activity in the Second District declined modestly in the first few weeks of 2014, hampered by inclement weather. Contacts report some broadening of price pressures in the service sector, though retail prices remain mostly stable. Manufacturers in the District report that activity was stable whereas service-sector firms report some weakening, on balance. Labor market conditions have continued to improve gradually since the last report. General merchandise retailers report that sales were below plan and down sharply from a year earlier, due to unusually harsh weather in January and early February. New auto sales weakened noticeably in January but showed signs of rebounding in the first half of February. Tourism activity was mixed in January and early February, hampered by harsh weather but boosted by the Super Bowl. Housing markets were mixed, while commercial real estate markets firmed slightly. Finally, banks report some further weakening in loan demand from the household sector, little change in credit standards, and steady to declining delinquency rates.

#### **Consumer Spending**

General merchandise retailers report that sales weakened noticeably in early 2014, running below plan and well below year-ago levels. Two major retail chains indicate that sales during the first six weeks of the year were down sharply from comparable 2013 levels, mainly due to the weather. One contact notes exceptionally low gift card redemptions—viewed as a likely harbinger that much of the shortfall in sales will be made up when warmer weather arrives. Similarly, contacts at major malls in upstate New York report that sales were weak in January and early February, due largely to heavy snow and extremely cold weather, particularly during weekends. Not surprisingly, one category that has performed reasonably well is cold-weather outerwear. Inventories are mostly at or modestly above desired levels. Prices are reported to be little changed, though some retail contacts describe the environment as increasingly promotional.

After a strong 2013, auto dealers in upstate New York report that new vehicle sales weakened noticeably in January but showed some signs of rebounding in early February. Inclement weather is viewed as having been an inhibiting factor in January, but not the only one; conversely, some of the pickup in February is attributed to a major auto show in Buffalo, and an upcoming show in Rochester is expected to provide some boost as well. Wholesale and retail credit conditions for auto purchases remain favorable.

Tourism activity has been mixed thus far in 2014. Despite the bad weather, attendance at Broadway theaters is up about 7 percent year-to-date, from 2013 levels, and total revenues are up 12 percent; however, it should be noted that there are roughly 15 percent more shows running in 2014 than in 2013. Manhattan hotels report that occupancy rates were little changed from a year earlier in January, though room rates were up sharply—cold and snowy weather dampened demand but this was largely offset by business related to the Super Bowl, which buoyed occupancy and especially room rates in late January and early February. Hotels in northern New Jersey, where occupancy rates are typically much lower this time of year, reportedly saw a more pronounced boost during the weeks around the Super Bowl. Hotels in western New York State, on the other hand, report that winter storms depressed business in January—particularly in Rochester and Niagara Falls.

Finally, consumer confidence improved in January: the Conference Board's surveys of residents of both the Middle Atlantic states (NY, NJ, Pa) and New York alone show confidence surging to a six-year high, while Siena College's survey of New York State residents indicates a more moderate increase, to a six-month high.

#### **Construction and Real Estate**

The District's housing markets have been mixed since the last report. Contacts in western New York State note some softening in both activity and prices in early 2014—largely a function of the unusually cold and snowy weather, but also reflecting increased difficulty obtaining credit. More broadly, though, home sales across New York State showed resilience in January, slipping only slightly from the elevated level of a year earlier, while prices reportedly rose 10 percent. Sales activity in New York City's co-op and condo market slowed somewhat in January and early February, as weather greatly inhibited buyer traffic. Sales prices for apartments were flat in Manhattan but continued to trend up in Brooklyn. Similarly, the market for apartment rentals has remained steady, with rents edging down in Manhattan but rising in Brooklyn. Weather has also been a factor in northern New Jersey since mid-December for both sales and new construction, though the underlying fundamentals also remain weak: mortgage delinquencies remain high, and a stubbornly high inventory of distressed properties is dampening market conditions. The multi-family market in northern New Jersey (mostly rentals) is reported to be faring well.

Commercial real estate markets were stable to slightly stronger in early 2014. In New York City, office leasing activity was characterized as very brisk; but this was accompanied by several new spaces becoming available in both Downtown and Midtown Manhattan, leaving the overall availability rate little changed. Asking rents for office space, however, continued to rise and were up 6 to 9 percent from a year earlier. Elsewhere around the District both office availability rates and rents were little changed in early 2014. In general, the market for prime (Class A) space has underperformed the rest of the office market. Industrial vacancy rates were mostly steady to down slightly across the District, while asking rents were little changed.

#### **Other Business Activity**

The labor market has shown further signs of gradual improvement in early 2014. Business contacts in both the manufacturing and service sector report steady to rising employment; and more firms plan to increase than reduce staffing levels in the months ahead—particularly in the manufacturing sector. Separately, a major employment agency specializing in office jobs reports that the market continues to improve gradually, though weather appears to have been somewhat of a deterrent to hiring. Many job postings are challenging to fill because they call for specialized skills; salaries generally remain flat.

Manufacturing firms in the District report a slight pickup in activity in early 2014, on net, whereas service sector businesses have seen a pullback—apparently driven, in large part, by the inclement weather. Still, business contacts remain widely optimistic about the near-term outlook. Overall, price pressures remain stable and generally subdued in the manufacturing sector but have grown increasingly widespread among service-sector businesses.

#### **Financial Developments**

Small to medium-sized banks across the District report a further decrease in demand for consumer loans and residential mortgages but no change in demand for commercial mortgages and commercial & industrial loans. Bankers also indicate a decrease in demand for refinancing. Respondents note that credit standards were unchanged across all loan categories. Respondents indicate a decrease in spreads of loan rates over costs of funds for commercial loans and commercial & industrial loans, but report no change in other categories. Respondents indicate little or no change in average deposit rates. Finally, bankers report modest declines in delinquency rates, on balance, for all loan categories.

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### Third District--Philadelphia

Severe winter weather caused aggregate business activity in the Third District to decline slightly during the current Beige Book period (beginning with the first full week of January). Nearly all sectors were impacted; however, only a few sectors are expected to suffer permanent losses, according to contacts. For example, while many general retailers have had to realize their losses by heavily discounting their winter inventory, auto dealers anticipate a release of pent-up demand when spring arrives.

The general services sector was the only one to maintain some growth in this period, but even it slowed to a modest growth rate. After growing in the previous Beige Book period, general retail sales and residential construction declined moderately; auto sales, existing home sales, and commercial real estate construction declined modestly; and manufacturing, commercial leasing activity, and tourism declined slightly. Staffing services showed little net change after growing modestly over previous periods. Lending volumes also changed little but credit quality continued to improve. Contacts reported slight overall increases in wages, home prices, and general price levels—similar to the last Beige Book period.

Despite the temporary declines in many sectors, most contacts remained optimistic although they now expect only modest growth over the next six months. Contacts in most sectors continued to express confidence in the underlying economy. In regard to hiring and capital expenditure plans, firms continued to expand cautiously.

#### Manufacturing

Third District manufacturers reported deteriorating levels of activity through the current Beige Book period, as severe winter weather repeatedly disrupted sales and production. A slight pace of growth in orders and shipments as reported for the last period continued for several weeks then gave way to slight overall declines by the end of this Beige Book period. The share of all firms reporting increases in general activity fell from about one-third to one-fourth, while the share reporting decreases rose from about one-fourth to one-third. The makers of paper products, fabricated metals, industrial machinery, and instruments have reported gains since the last Beige Book. Reports of decreases came from the makers of food products, chemicals, primary metals, and electronic and other electric equipment. About 40 percent of manufacturers cited negative impacts from the severe winter weather, including lower demand or sales, disruptions to supply channels and to deliveries, fuel and power outages, lost production days, and cost of snow removal.

Optimism that business conditions will improve over the next six months remained nearly as high as last period and continued to be widespread across sectors. Over half of the firms continued to anticipate increases in activity; however, firms were somewhat less optimistic about new orders and shipments six months out. Contacts reported similar expectations of future hiring and greater expenditures for future capital spending plans than during the prior Beige Book.

#### Retail

Third District retailers reported that malls and stores lost shopping days to snow storms and power outages, including significant holiday weekends, resulting in an overall moderate decline in sales since the last Beige Book. According to one mall contact, Valentine's Day weekend typically accounts for 40 percent of February sales, but the holiday's sales were off 40 percent this year due to a weekend snowstorm. Retailers have engaged in heavy discounting to move winter gear due to a dearth of shoppers. Also, spring inventory is not moving yet. In addition, retailers' margins have eroded from higher heating bills and snow removal costs. Brick-and-mortar retailers expressed uncertainty as to whether consumers have held on to their holiday gift cards or used them at online retailers. Although most of the lost sales opportunities are gone, retailers are hopeful that some pent-up demand will emerge as temperatures rise and that the prior pace of retail sales growth will resume.

Auto dealers have reported a modest decline in sales since the last Beige Book period—another casualty of the recurring winter snowstorms. Dealers' lots were covered with snow; car buyers were scarce. Pennsylvania dealers expect sales to be off at least 15 percent (year over year) in February, while January sales were up a little. New Jersey dealers reported relative softness, adjusting for seasonal trends through January, although last year's comparative sales were boosted by replacement vehicles following Hurricane Sandy. Contacts in both states described dealers as currently "pretty grouchy, but upbeat for the year." Auto dealers harbor greater hopes than general retailers that spring sales will capture pent-up demand from the winter losses. The outlook for 2014 remains positive.

#### Finance

Third District financial firms reported little overall change in total loan volume. Many loan categories appeared to decline slightly in volume. Credit card lending fell faster; however, that is a typical seasonal trend as consumers pay down their post-holiday balances. In contrast, other consumer credit loans and home equity lines have grown slightly since the last Beige Book period. Contacts continued to characterize the lending environment as steady, very slow, and highly competitive. Real estate lending softened considerably as the wintry weather reduced the pace of new contracts. Despite this current softness, contacts described an improving lending environment with a stronger labor market, greater consumer confidence, and healthier balance sheets. Overall, most bankers remained optimistic for continued slow, steady growth and for some pickup from pent-up demand for housing, autos, and other loans when the spring thaw finally arrives.

#### Real Estate and Construction

Third District homebuilders have reported that both new home sales and construction activity were depressed by the unusually severe winter weather, generating moderate declines from the prior-period construction levels. One builder reported production at 60 percent of plan, while sales were only about 50 percent of plan. Builders expect to accelerate production and catch up with prior schedules as the weather permits, and they are hopeful that spring sales may rebound. However, extra overtime coupled with increased demand from future sales may create labor shortages and escalate other input costs. According to residential real estate brokers, sales of existing homes were flat to down (year over year) in many of the Third District's major metropolitan areas in January. Pending sales and new listings were also reported as declining at a modest pace; February closings, traffic, and sales are expected to be negative throughout most of the District. Brokers are somewhat less bullish for a significant increase in 2014 over 2013 levels.

Nonresidential real estate contacts indicated some weather disruptions have delayed ongoing construction activity. Modest declines in current construction are expected to be offset in the near future as contractors hustle to resume their schedules. Leasing activity was quiet—as businesses were often shuttered—but is expected to resume its modest pace

next period. Little change was reported in leasing activity. Two more major buildings were announced for Center City Philadelphia since the last Beige Book: a 59-story major office tower and a 32-story residential tower. Added to the two 47-story office/residential towers already slated for groundbreaking in 2014, these four projects have caused most contacts to become increasingly optimistic for stronger growth as the year progresses. Meanwhile, most contacts speak of incremental improvement, despite the winter lull.

#### Services

Third District service-sector firms have slowed to a modest pace of growth since the last Beige Book--again with weather dampening demand for a variety of services. Although the District's ski resorts benefited from the additional snowfall, even they were plagued by the storms' timing, which made travel to the resorts difficult on several weekends. In addition, school districts that have amassed too many snow days may shorten spring breaks resulting in cancelation of vacation bookings. Some have already interfered with the Presidents' Day weekend by holding classes.

Other service firms reported mostly modest growth rates--whittled down from recent moderate rates, as heavy snowfalls and power outages prevented workers from commuting and businesses from opening. As with general retail, some of the service-sector revenue will not be recouped after the snow has melted. For example, staffing firms cite the loss of billable hours that will not be made up. Other segments of the staffing industry offset those losses with slight growth. Overall, most of service-sector losses were viewed as manageable, and most contacts expect current activity to resume and grow.

#### Prices and Wages

Overall, Third District contacts reported no change to the steady, slight pace of price level increases, similar to other recent Beige Books. Manufacturing firms reported that prices paid and prices received tended to rise slightly, but more modestly than before. Auto dealers reported little change in pricing, general retailers reported deep discounting, and most builders reported holding prices steady. Many contacts continued to report tight, or narrowing, margins. Generally, real estate contacts continued to report rising prices for lower-priced homes, while higher-priced homes are aligned to local market conditions. Very few contacts are seeing wage pressures, other than for a few highly skilled occupations.

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### Fourth District--Cleveland

Overall business activity in the Fourth District continued at a moderate pace early in 2014. While the severe weather contributed to some temporary slowing across industry sectors, it was viewed mainly as an inconvenience. Demand for manufactured products remained at a moderate to robust level. Activity in the construction sector slackened a bit compared to the same time period a year ago. Post-holiday retail purchases were characterized as disappointing. In contrast, January's auto sales showed strong gains month-over-month. The energy sector was little changed: shale gas activity stayed at a high level, and coal production trended lower. Freight volume was slightly higher. Demand for business credit showed little movement, whereas consumer credit usage was somewhat better than expected.

Hiring was sluggish across most industry sectors, though we are seeing a pickup in manufacturing jobs. Staffing-firm representatives reported that the number of job openings is trending higher, while placements are flat. Vacancies were found primarily in manufacturing and healthcare. Wage pressures were contained. Input and finished goods prices saw little change, apart from some increases in building materials, energy, and diesel fuel.

#### Manufacturing

Reports from District factories indicated that demand stayed at a moderate to robust level during the past six weeks. Any production declines were attributed to the severe winter weather disrupting raw material deliveries or to seasonal variation. Supply chain disruptions were viewed more as an annoyance than an event that could negatively impact business activity. Compared to a year ago, production levels were generally consistent or somewhat higher. Almost all of our respondents expect production will rise relative to current levels in the upcoming months, with the strongest demand coming from the aerospace, capital equipment, housing, and oil and gas industries. Since the beginning of the year, steel shipments grew slightly--mainly a seasonal effect. Producers predicted that their industry will not exhibit strong growth until there is considerable strengthening in the construction sector and a greater sense of confidence in the economy at large. Steel shipments for the remainder of the first quarter are expected to pick up only slightly. Auto production at District plants increased along seasonal trends during January on a month-over-month basis. Compared to a year ago, production was moderately higher.

Several factory representatives commented that capacity utilization rates were above their normal range or were increasing in the last six weeks, while steel producers noted significant open capacity. Capital budgets for 2014 are generally higher than last year, although very few contacts are allocating monies for capacity expansion. Outlays are being used primarily for equipment purchases, product development, and maintenance. Raw material prices were mainly flat to lower. We heard a few reports of an upward drift in scrap metal and agricultural commodity prices after coming off of last year's low level. Energy prices (electricity and natural gas) rose, which was attributed to the severe weather. Some producers of industrial durables raised prices at the beginning of the year with little pushback. Otherwise, most manufacturers reported that their ability to raise prices has been limited. Job markets are showing some signs of strengthening, with half of our respondents indicating that they are hiring production and salaried workers. Wage increases are expected to be slightly higher in 2014 compared to the past couple of years. A growing number of employers are passing through rising healthcare costs to their employees.

#### Construction

Sales of new and existing single-family homes across much of the District were significantly higher in 2013 relative to the prior year, while average sale prices showed a moderate increase. Builders reported that sales of new single-family homes slowed during the first few weeks of 2014, which they attributed to the extreme cold. Web traffic trended higher. New-home contracts were found mainly in the mid-price category, and the selling prices of new homes continued to stabilize. Reports indicated that multifamily housing remains the strongest segment in the District's construction sector, and some believe there is a risk of overbuilding. Nonetheless, rents are expected to rise 3 to 4 percent this year. Builders anticipate that the housing market will grow at a steady pace in 2014.

The pace of activity in nonresidential construction has slowed a bit relative to the same time period a year ago. Builders said that while inquiries, many from first-time customers, are strong, projects keep dropping out of the pipeline due to financing issues or a last minute decision not to proceed. Backlogs are down slightly, and the severe winter weather has



slowed fieldwork. Demand was strongest for industrial and institutional building, including flex-space, distribution, manufacturing, student housing, and senior living. Our contacts remain fairly optimistic about near-term prospects, and they are anticipating moderate growth this year.

Prices for drywall, steel, and plumbing fixtures are trending higher. General contractors reported satisfaction with current staffing levels and will only hire for replacement or if business activity rises above expectations. Reports of rising costs related to healthcare were widespread. There is concern among small builders that employees may lose their employer-paid insurance. One report indicated that a growing number of builders are offering employees a lump sum payment to purchase their own health insurance rather than offering it as a benefit.

#### Consumer Spending

Almost all retailers we contacted expressed disappointment with January sales. Revenues were below those seen in December, and they were down compared to a year earlier. Cold-weather gear and consumables were in highest demand. Most of the decline was attributed to persistently poor weather conditions. However, two retailers commented that part of the decline is related to a fundamental shift in how consumers spend money. A furniture dealer reported that his customers are less inclined to buy quality goods that can be handed down. Rather, consumers are buying only what they need and are looking for the best value. Projections for the second quarter call for sales to be modestly higher relative to those in the first quarter. Vendor and shelf prices held steady, though a few retailers noted that they are running more promotions than normal. One contact reported that he has been introducing more products at a lower price point. This year's capital budgets will be mainly higher than in 2013. Most of the monies are allocated for opening new stores and e-commerce expansion. Hiring will be limited to staffing new stores and e-commerce support.

The number of new motor vehicles sold in January was significantly higher than in December. On a year-over-year basis, sales showed a modest increase. Buyers continued to shift from smaller, fuel-efficient cars to SUVs, crossovers, and light trucks. One dealer told us that truck sales in the southwest region of the District rose 11 percent last year, which he believes reflects an uptick in commercial and construction activity. New-vehicle inventories were described as slightly elevated, which was attributed to leftover 2013 models and the extreme weather. Used-vehicle purchases during January were slightly ahead of those in December and on a year-over-year basis. Expectations for sales of new and used vehicles are positive. Dealers cited the arrival of income tax returns and interest generated by regional auto shows. Used inventory will start building due to the expiration of 2011 leases. Payrolls held steady.

#### Banking

Demand for business credit showed little movement. Brisk competition continues to put downward pressure on loan pricing. Consumer credit demand grew slightly since our last report, primarily for auto loans and home equity products. Residential mortgage activity picked up a little, more so in the new-purchase market. Several bankers raised concerns about recently enacted regulations and their potential negative impact on lending. Delinquency rates were stable or trended lower. Bankers reported no significant changes to loan-application standards. On net, core deposits were flat: increases by consumers were offset by declines in commercial deposits. Little net growth in staffing is expected. Many new job openings are in the areas of regulatory compliance and IT.

#### Energy

January's aggregate coal production across the District fell below year-ago levels. Going forward, little change in output is projected. Spot prices for metallurgical and steam coal were flat. The number of drilling rigs in Ohio's Utica shale region has increased since the beginning of the year. Natural gas production was stable and continuing at a high level. Cold weather helped boost wellhead prices for natural gas and oil. Reports on capital spending were mixed, although one respondent commented that his firm plans to increase funding to its drilling-program in Marcellus and Utica shales by 80 percent year-over-year. Production equipment and materials prices were flat. Hiring was for replacement only.

#### Freight Transportation

Freight executives reported that it is difficult to gauge changes in shipping volume due to supply chain disruptions attributed to severe weather. Nonetheless, most respondents believe volume has risen slightly year-over-year. Shipments of motor vehicles and machinery were strong. The industry outlook for 2014 is somewhat less favorable than in our previous report. Most of our contacts now expect volume will be in-line or moderately higher than a year ago. Recently enacted environmental and safety regulations are constraining capacity and putting upward pressure on rates. Diesel fuel prices moved higher in January. Operators have been unable to pass through the entire increase via surcharges. Reports on capital spending plans for 2014 were mixed. The industry is hiring primarily for replacement and to maintain capacity.

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### Fifth District--Richmond

Economic activity in the Fifth District increased modestly on balance, despite snow, ice, and unusually cold temperatures that caused many business closings. Manufacturing operations generally slowed as winter storms closed some plants, although a few firms reported an uptick in new orders. Retail sales increased modestly overall, even though many stores and auto dealerships closed during the snow storms. While some retailers benefitted from increased demand for cold-weather items, auto sales declined. Non-retail service providers reported flat revenues in recent weeks. In contrast, tourism and corporate travel picked up, and hoteliers reported strong bookings. Consumer borrowing slowed since the start of the year, while commercial lending remained strong, with several bankers reporting a healthy pipeline for business lending. Residential real estate strengthened, with Realtors reporting faster absorption in some submarkets. In addition, construction of single family homes has been slowly improving, while multi-family housing remained strong. Non-residential construction was generally soft. Commercial leasing ranged from no change to a slight increase since our last report. Agricultural activity slowed seasonally, while contacts were optimistic about a good year ahead. In the energy sector, natural gas production accelerated. In contrast, coal mining fell and some steam coal plants closed. District labor markets were mixed in recent weeks, as extreme weather affected production and services. However, demand was high for semi-skilled workers; also, more quality temp employees were being offered permanent work. According to our latest survey, employment declined at retail establishments and increased at non-retail services firms, while average wages rose across the service sector. Manufacturing employment slowed and average wages ticked up. Service sector prices advanced more quickly, while manufacturing prices increased at a slower pace.

#### Manufacturing

Manufacturing activity slowed in recent weeks, with winter storms affecting business operations throughout the District.

There were a few weather-related plant closures since our last report, totaling between three and four days. In one instance, a North Carolina food manufacturer stated that recent storms caused his plant to close for a few days, resulting in lost wages, hours, and production. A few District plant managers said that the facility downtime would reduce shipments, and in February, survey respondents also indicated that shipments and new orders declined. However, some manufacturers reported that new orders have risen slightly and plants are working to catch up after a slow start in January. A metals manufacturer in South Carolina reported an increase in January sales, slight growth in export sales, and a stronger March forecast. Overall, contacts expected improvement in the spring. Prices of raw materials and finished goods rose at a slower pace, according to our survey.

#### Ports

Reports from port officials were mixed but indicated that activity increased overall. Auto imports remained robust, and container volume continued to be strong and growing year over year, particularly at the Port of Virginia. Exports of agricultural materials leveled off in Baltimore, while in Charleston, South Carolina, exports of containerized grains and soybeans were very strong. International coal exports declined slightly while coal shipments to domestic locations fell sharply. Dockworkers at the Port of Baltimore with unresolved labor contracts have remained on the job as mediators work toward a conclusion. Seasonal slowdowns related to the Chinese New Year are expected to last into mid-March.

#### Retail

District retailers reported modest revenue growth, restrained in part by the unusually cold temperatures and multiple winter storms that forced many stores and auto dealerships to close temporarily. An auto dealership in West Virginia reported getting 18 to 20 inches of snow, with only one customer on the lot the next day. Sales of weather-related goods were up for a chain hardware merchant in central Virginia, and the manager of a West Virginia sporting goods store said that the weather helped sales, despite declining foot traffic. Post-holiday discounting boosted sales at several stores in January following mediocre results in December. The manager of a discount department store in the Tidewater area of Virginia reported little change in recent weeks and noted that 2013 had ended with sales below the previous year. Looking ahead, a representative of central Virginia retailers stated that with Easter falling in late April, merchants have more time for promotions, especially for warm-weather apparel. Retail price growth accelerated moderately.

#### Services

Revenues at non-retail services firms remained flat since our last report. An executive at a national freight trucking firm reported that he still expects double-digit tonnage growth in the first quarter, despite closed roads and terminals as winter storms moved across the country. However, several other businesses reported no change in demand for their services, and an executive at a wealth management firm in central Virginia described business as "status quo," even with improved client optimism. An executive at a North Carolina healthcare system reported that flu cases were below typical seasonal levels. Services prices edged up at a slightly faster pace.

Tourism was booming at winter resorts, as natural snowfalls were abundant and colder temperatures allowed additional snowmaking. In several locations, mid-February bookings were solid because Valentine's Day and Presidents' Day sandwiched a weekend. However, an hotelier commented that this pushed bookings into one good weekend instead of two. A hotel manager in western North Carolina reported strong bookings and also noted a shift to more transient visits than conference or group bookings in recent weeks. In contrast, a contact in Baltimore saw increased corporate travel. On the Outer Banks of North Carolina, visitors now expect a package "experience" when renting a home, such as included linens, tickets to events, and restaurant coupons.

#### Finance

Since our last report, consumer borrowing slowed considerably while commercial lending remained strong. Several contacts indicated that residential mortgage lending had nearly come to a halt, in part because of this winter's extreme weather. However, a Virginia lender believed that the demand for new homes is there, but that people are "just trying to survive the weather right now." Mortgage refinancing activity also declined in most areas. Interest rates flattened recently, after a decline in January. Meanwhile, credit standards remained tight, according to two bankers.

According to sources, commercial lending picked up. Several bankers reported that loan volumes were robust and that they had a healthy pipeline for the future. One lender said that businesses were looking for shorter term commercial real estate loans in order to benefit from the lower interest rates that those loans offer.

#### Real Estate

Residential real estate strengthened since our last report. Several brokers reported a slight increase in home sales in recent weeks and generally higher sale prices. In addition, buyer traffic and pending sales rose in the past four to six weeks, although a few Realtors noted slowness due to winter weather conditions. A Northern Virginia Realtor commented that sales were more robust than expected, particularly in the high-end market. However, most brokers indicated steady improvement in the \$200,000 to \$500,000 price range. Realtors reported a mild decrease in housing inventory, with faster absorption in some submarkets.

Construction of multifamily housing remained strong since our last report. In addition, single-family residential construction is returning throughout the district, according to contacts, but has been "slow to come out of the ground" primarily due to weather conditions. Other than in Washington, D.C., non-residential construction was softer. Commercial leasing ranged from unchanged to slightly stronger, with inquiries mainly for small spaces. While most Realtors reported little change in concessions and incentives, some in Washington D.C. and Northern Virginia saw more concessions, in the form of tenant improvements. Reports on vacancy rates varied across location and submarket. Lease rates were unchanged and sale prices rose mildly. Realtors reported either no change or a slight increase in demand for Class A office space.

#### Agriculture and Natural Resources

According to agriculture contacts, crop prices declined in recent weeks. Falling feed costs and higher cattle prices led contacts to believe it will be a good year for livestock producers. Also, farmers expect an increase in poultry production. However, a North Carolina respondent was concerned about an increase in swine virus in his region. A Virginia nursery owner stated that recent cold weather damage, if any, will not be known for a month or two; even so, he expects a ten percent increase in year-over-year sales this spring. A North Carolina agri-business contact reported that tobacco and vegetable producers in his region were cautiously optimistic for the year ahead. In South Carolina, recent ice storms have caused timber damage that is still being assessed.

Natural gas production remained robust. A West Virginia executive reported "incredible" industry growth and noted that

shale gas has fundamentally changed the industry outlook. Contacts remarked that energy prices had risen due to increased demand during the extremely cold weather, and a few businesses reduced usage as a result of the higher cost. An executive also noted that two nuclear power plants are expected to shut down because of high licensing costs. Coal mining continued to soften. Several observers have stated that while steam coal plants experienced closings, metallurgical coal is holding its own—but overall the coal industry is weak at best. In West Virginia, leaking chemicals from a coal processing plant were found in public drinking water, and in North Carolina coal ash was discovered leaking into a river.

#### **Labor Markets**

Reports on labor were mixed, as weather-related shutdowns slowed hiring slightly. Demand was strong for semi-skilled workers, project-based laborers, government and healthcare workers, and experienced administrative professionals. Increasingly, quality temporary workers were being offered permanent positions. Turnover remained high among low skill positions. According to our latest survey, retailers reduced employment and average retail wages declined slightly, while non-retail services providers moderately increased payrolls and average wages rose. Manufacturing employment slowed and average wages edged up.

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#### **Sixth District--Atlanta**

Sixth District business contacts described economic activity as expanding slowly in January and early February. Some weather related effects were noted for a few sectors late in the period. However, the outlook remains generally optimistic as most contacts expect near-term growth to be sustained at, or slightly above, current levels.

Overall, retailers cited sluggish sales growth for the beginning of the year. The District's tourism industry remained a bright spot with activity being bolstered by international visitors. Homebuilders and brokers noted home sales and prices were above year-ago levels for new and existing homes, while commercial real estate markets continued to witness steady improvements. Manufacturers reported increases in new orders and production. Reports from bankers suggested that loan demand increased for purchases but decreased for refinances. On balance, District employment gains were subdued and prices generally remained stable.

#### **Consumer Spending and Tourism**

Merchants reported a slow start to the year with sales growth declining. Many contacts noted that the drop in sales growth was partially attributed to the unusual winter weather experienced in parts of the region. Others indicated that increased healthcare premiums were having a negative impact. Sales for vehicles were lower than expected.

Hospitality contacts reported an increase in business and convention bookings. Reports also indicated that the favorable U.S. dollar exchange rate was a contributing factor to a rise in international visitors. However, contacts did convey that some of the region affected by the unusual winter weather in January and February experienced losses in revenue due to closures of attractions and restaurants, although most hotels were not as adversely affected. Hoteliers still expect only slight growth in occupancy rates for the first quarter of 2014 compared to the same period last year, while room rates and revenue per available room are expected to grow more robustly.

#### **Real Estate and Construction**

District brokers indicated that growth in existing home sales had picked up modestly in recent months. Most brokers said sales were slightly up compared with a year earlier and more contacts noted that sales activity was in line with their plan for the period. By most accounts, inventory levels had fallen on a year-over-year basis. The majority of contacts reported that home prices remained ahead of the year earlier level but that price gains have slowed on a month-over-month basis. The outlook among residential brokers continued to improve since our last report.

Reports from District builders were more positive than previous reports. Most contacts agreed that recent activity was in line with their plan for the period. The majority of builders reported that construction activity and new home sales were ahead of the year earlier level, although most reports indicated that unsold inventory levels had remained unchanged from a year ago. The majority of contacts also reported modest home price appreciation. The outlook for new home sales and construction activity remained positive, although many builders expressed concern about dwindling lot inventories and their inability to secure the financing needed to develop new lots.

District brokers noted that demand for commercial real estate continued to improve. Absorption was picking up, although contacts cautioned that the rate of improvement still varied by metropolitan area, submarket, and property type. Construction activity continued to increase at a modest pace from last year; most contacts reported that their backlog was ahead of year earlier levels. Looking ahead, contacts expect that construction activity in apartments will continue to be somewhat strong in 2014 and that there will be a modest increase in construction activity across other property types. The outlook among District commercial real estate contacts remained positive with further improvements expected over the course of the year.

#### **Manufacturing and Transportation**

Manufacturing contacts in the region cited expanding activity from January through mid-February, but the pace of growth was moderate. Contacts reported improvements in new orders and production. However, a number of contacts stated that the unusual winter weather affected production in late January and output was lower than planned for that month. That said, nearly two-thirds of purchasing managers polled expect production levels to be higher over the next three to six months.

District transportation firms reported mixed results. Air cargo contacts cited nearly double-digit declines in overall tonnage from a year ago. Port contacts reported year-over-year volume increases in container traffic, bulk cargo, and automotive and machinery. Total rail carloads were down slightly over the same period last year; however, intermodal volumes continued to experience modest gains.

#### **Banking and Finance**

Banking and credit union contacts expressed mixed concern about the implementation of the new Qualified Mortgage Rules. Some community bankers reported that they have exited the residential mortgage business altogether because of increased regulatory burdens, while others indicated that they do not believe it will have a negative effect on overall mortgage lending. A number of lenders reported increases in purchase mortgages, but not enough to offset the declines

in refinances. Regional credit unions were reportedly offering highly competitive rates on CDs to attract deposits in order to sustain lending activity.

#### **Employment and Prices**

Since the last report, job growth remained muted across the District. Contacts in construction, manufacturing, energy, hospitality, and real estate noted modest growth in employment. Trucking companies continued to cite driver shortages even amidst rising pay. Rather than adding to payrolls, businesses reportedly continued to rely on technology to enhance output. Some employers continued to show reluctance in large-scale hiring due to concerns about healthcare reform.

Most contacts reported modest and relatively stable labor and material cost pressures. Construction industry contacts remained a notable exception, indicating strong upward pressure on labor costs and some materials prices. According to the Atlanta Fed's February business inflation expectations (BIE) survey, costs were up 1.7 percent from a year ago and were expected to pick up slightly to 2.0 percent over the coming 12 months. In general, businesses continued to indicate that they had little to no pricing power.

#### **Natural Resources and Agriculture**

Strong production growth coupled with higher pipeline capacity continued to supply Gulf Coast refiners with ample light sweet crude. Natural gas storage levels were reported as notably low due to increased withdrawals that were exacerbated by the unusually severe weather. Commercial and residential demand for utilities increased significantly as a result of the weather, yet industrial usage remained fairly consistent with seasonal norms. The energy industry remains optimistic regarding their outlook for demand, pricing, and productivity.

Recent rains improved soil conditions in parts of Florida and Georgia while portions of Alabama, Louisiana, Mississippi, and Tennessee experienced dry soil conditions. Meanwhile, freezing temperatures and cold winds had farmers and livestock producers taking precautions to mitigate damage to crops and livestock throughout much of the District. There were mixed reports of the impact on Florida crops with some indicating damage to vegetable and strawberry crops and others suggesting no damage to citrus. However, the Florida citrus crop continues to be adversely affected by citrus greening causing diminished production and increased expense battling the disease. On a year-over-year basis, prices paid to farmers for corn, soybeans, hogs, and broilers were down; while cotton, rice, oranges, beef, and eggs were up. The most recent domestic crop production forecasts for corn, rice, soybeans, oranges, and cotton were unchanged from a month ago. Similarly, pork and broilers projections were down moderately while beef projections were up slightly.

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### **Seventh District--Chicago**

Growth in economic activity in the Seventh District slowed in January and February, as severe winter weather affected activity in a number of sectors. The modest pace of growth to start the year tempered contacts' expectations only somewhat, as most generally maintained their optimistic outlook for 2014. Growth in consumer and business spending slowed. Manufacturing production growth and construction activity were modest. Credit conditions were little changed on balance. Cost pressures remained generally mild, though extreme temperatures caused energy prices to spike. Prices for corn, soybeans, and livestock were up slightly.

#### **Consumer Spending**

Growth in consumer spending slowed to a modest pace in January and February. Some retail categories initially benefitted from the poor winter weather, in large part reflecting increased outlays for necessities. However, retail contacts said that once necessary items were purchased, the persistent bad weather led to declining customer traffic and sales. Auto dealers also noted that the weather contributed to lower showroom traffic and sales. However, some contacts pointed to wavering consumer confidence as an alternative reason for lower auto sales. Many dealers expected incentives to increase in the near-term in an effort to rejuvenate sales.

#### **Business Spending**

Growth in business spending also slowed to a modest pace in January and February. Inventories remained at comfortable levels for most retailers and manufacturers. Growth in capital spending slowed somewhat, while plans for future capital expenditures edged higher. Several manufacturing contacts reported plans to purchase new equipment to increase capacity. Contacts in the manufacturing, banking and finance, and retail sectors reported plans for expansion, either by building or buying new structures or through mergers and acquisitions. The pace of hiring slowed, as did expectations of future hiring, though expectations for the coming year remained positive. A staffing firm reported continued growth in demand for its industrial services, despite some weather-related closures. In contrast, growth in demand for its professional services weakened. A banking contact noted an increase in layoffs due to declining mortgage refinancing. Many contacts noted continuing strength in the demand for skilled workers, with positions often difficult to fill in engineering, information technology, accounting, and other technical occupations.

#### **Construction and Real Estate**

Construction and real estate activity again increased modestly in January and February. However, the pace of growth slowed over the reporting period, with homebuilders reporting that the unusually cold weather had added to costs and led to construction delays. The weather also affected home sales, as several contacts indicated that the cold had dampened new buyer activity. Overall, however, the housing market continued to improve slowly, with home prices and residential rents rising modestly. Real estate brokers noted that the supply of homes for sale remains low, and many homes continue to be purchased with cash because lending standards remain tight. In addition, several contacts indicated that the continued limited availability of new construction financing has kept new home inventories near record lows. Nonresidential construction grew slowly, with one contact noting that industrial building activity had paused in recent weeks. Commercial real estate activity ticked up, as vacancies declined and rents rose. Niche, high-income properties remain a source of strength for the sector, particularly for restaurants and office buildings.

#### **Manufacturing**

Manufacturing production growth slowed to a modest pace in January and February, as unusually bad winter weather dampened the demand for manufactured goods and disrupted supply chains. However, manufacturing contacts remained optimistic, generally believing that overall economic conditions remained positive. The auto industry remained a source of strength for the District, even with a weather-related slowdown in sales. The weather also had a significant effect on the demand for steel, though contacts were preparing to meet any pent-up demand that developed during the reporting period. The severe weather conditions also affected the production and transportation of goods. For example, a

steel industry contact reported that there were seven days in the last six weeks where his firm could not send shipments, a first in his thirty-five years of experience. Steel service centers reported reduced demand, while specialty metal manufacturers cited mixed but overall modest growth in new orders. Manufacturers of construction materials noted fewer shipments because of the weather, but continued to have a positive near-term outlook for the housing market. Demand for heavy machinery remained soft, as weakness in the mining and agricultural industries overshadowed increasing strength in the construction and energy industries.

#### **Banking and Finance**

Credit conditions were little changed on balance over the reporting period. Equity market volatility increased and corporate bond spreads widened some. Banking contacts reported slow but steady growth in business loan demand, but greater demand for purchases of equipment and owner-occupied real estate. Activity in the leveraged loan market picked up, with contacts noting increased competition from commercial finance companies and greater demand on the secondary market. Agricultural contacts reported that banks were helping farms restructure costs for the coming season to shore up margins. However, in some cases troubled farmers were forced to search for new lenders when denied credit. Growth in consumer loan demand remained modest, again led by the relative strength of auto lending. Contacts noted moderate downward pressure on pricing and standards across a variety of loan categories.

#### **Prices and Costs**

Cost pressures remained mild overall. However, the severe winter weather pushed up prices for energy commodities, creating supply shortages and disruptive price spikes in some areas, especially for propane and natural gas. For instance, a contact reported that a grain elevator withdrew its propane from storage and resold it for home use. Another business contact reported that because homes have priority in natural gas delivery, her company faced a supply shortage and was forced to shift its production schedule. Other producers chose to delay production rather than pay high prices. Most contacts expected energy markets to return to normal once warmer weather arrives. Prices for cement, drywall, lumber, copper, and rare earth metals rose. Prices for steel, scrap, and iron ore were lower even though the winter weather interrupted shipments. Wage pressures edged up, and were stronger for skilled workers. Many contacts indicated that non-wage labor costs increased because of higher healthcare premiums.

#### **Agriculture**

Severe winter weather disrupted the flow of agricultural products between farms and markets during the reporting period. Crops that were sold stayed on farms longer than intended as transportation problems delayed shipments. Contacts also reported shortages of trucks and drivers to deliver inventories from the large harvest last fall. Demand for crops has been better than expected, particularly for corn, pushing inventories lower and prices higher. Soybean prices drifted up as uncertainty regarding the harvest in South America weighed on markets. Concerns about high costs for land rentals were also widespread. Livestock producers reported improving bottom lines driven by higher prices for milk, hogs, and cattle combined with lower feed costs. However, some hog farms reported losses of young pigs because of disease. Dairy producers have seen a boost in demand from exports.

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### **Eighth District--St. Louis**

The economy of the Eighth District has continued to grow at a moderate pace since the previous survey. Recent reports of planned activity in manufacturing have been positive, while reports in services have been negative on net. Residential and commercial real estate market conditions have continued to improve. Lending at a sample of District banks was little changed during the fourth quarter of 2013. Wage increases have been moderate, while prices and employment levels have increased modestly.

#### **Consumer Spending**

Contacts reported that retail sales in the past three months increased slightly compared with the same period last year. Two thirds of contacts noted somewhat higher sales, while one third saw no change. Half of the retailers reported that sales levels met their expectations, while the other half reported that sales were below expectations. Three fourths of contacts noted that inventories were at desired levels, and the rest noted that inventories were too low. Three fourths of contacts noted no change in the mix of high- and low-end products, while the rest noted more sales of high-end relative to low-end products.

Reports from auto dealers about sales in the past three months were mixed. One in four car dealers surveyed saw increased sales compared with the same period last year; half saw no change, and the rest saw decreased sales. Half of contacts reported an increase in used car sales relative to new car sales; 12 percent reported the opposite, and the rest saw no change. Thirty-eight percent of contacts reported increased sales of low-end vehicles relative to high-end vehicles; 25 percent reported the opposite, and the rest saw no change. Sixty-three percent of contacts noted that inventories were at desired levels, while 37 percent noted that inventories were too high.

#### **Manufacturing and Other Business Activity**

Reports of plans for manufacturing activity have been positive since our previous report. Several manufacturing firms reported plans to add workers or expand operations in the Eighth District, while a smaller number of manufacturers reported plans to reduce employment. Firms in automobile, plastic products, auto parts, appliance, food, alcoholic beverage, and machinery manufacturing plan to hire new employees and expand operations in the Eighth District. In contrast, firms that manufacture television sets, semiconductor devices, metal products, and carbonated beverages reported plans to lay off workers. According to a recent survey, manufacturers saw increased sales over the past three months, compared with a year ago. Several industrial contacts noted disruptions in operations because of cold weather; disruptions included gas or electricity outages, difficulty commuting to work, and delays in logistics.

Reports of planned activity in the District's service sector have been negative on net since the previous report. Firms in mortgage, telephone answering, disinfecting and pest control, pharmaceutical benefit management, and social security benefit management services reported plans to lay off workers or reduce employee hours. In contrast, firms in health care, telecommunication, computer-system consulting, legal, fitness and recreation, online shopping, and food distribution services reported new hiring and expansion plans in the District.

#### **Real Estate and Construction**

Home sales have continued to increase throughout most of the Eighth District on a year-over-year basis. Compared with the same period in 2012, December 2013 year-to-date home sales were up 16 percent in Louisville, 17 percent in Little

Rock, 7 percent in Memphis, and 4 percent in St. Louis. December 2013 year-to-date single-family housing permits increased in the largest metro areas of the District, compared with the same period in 2012. Permits increased 8 percent in Louisville, 12 percent in Memphis, and 11 percent in St. Louis. In contrast, permits decreased 9 percent in Little Rock.

Commercial and industrial real estate market conditions in the District have continued to improve. A contact in northwest Kentucky reported that office leasing continued to struggle while the demand for industrial space continued to improve. A contact in northwest St. Louis County in northeast Arkansas noted modest improvement in commercial real estate. A contact in northwest St. Louis County reported that office leasing in 2013 increased for the fourth consecutive year and expected a strong start in 2014. Commercial and industrial construction improved throughout most of the District. A contact in Louisville noted several on-going commercial construction projects in Hardin County, Kentucky, and in downtown Louisville. Contacts in Memphis continued to report new commercial construction in Jonesboro and Paragould. A contact noted a new office building project in northwest St. Louis County and a new industrial manufacturing plant in Wentzville, Missouri. A contact in Little Rock reported a plan for a mixed-use project that includes commercial space and a plan for an outlet mall in Little Rock.

#### **Banking and Finance**

A survey of District banks found little change in overall lending activity during the fourth quarter of 2013. During this period, credit standards and creditworthiness of applicants for commercial and industrial loans increased slightly, while demand improved moderately and delinquencies decreased moderately. Credit standards and creditworthiness of applicants for prime residential mortgage loans increased moderately. Demand was much weaker overall, with some respondents reporting substantial weakness, and delinquencies decreased moderately. Credit standards and creditworthiness for auto loans and credit cards remained mostly unchanged, while demand decreased moderately and delinquencies edged down slightly. Credit standards, creditworthiness of applicants, demand, and delinquencies for other consumer loans decreased.

#### **Agriculture and Natural Resources**

Red meat production in the District for 2013 was 1.2 percent higher than in 2012. The production increase was driven by the District's largest producers in Illinois, Indiana, and Missouri. Coal production in the District for January 2014 was 6.2 percent lower compared with January 2013.

#### **Prices, Wages, and Employment**

A survey of Eighth District businesses indicated that wages grew at a moderate pace, while prices and employment increased modestly over the past three months. Sixty-seven percent of contacts reported that prices during the past three months remained about the same relative to the same period last year, while 21 percent of contacts indicated that prices were somewhat higher. Fifty-seven percent of respondents indicated that wages during the past three months have stayed about the same relative to a year ago, while 33 percent noted somewhat higher wages. Finally, 72 percent of contacts reported that employment levels have remained the same over the past three months, compared with a year ago, while 20 percent reported an increase and 11 percent reported a decrease.

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### **Ninth District--Minneapolis**

The Ninth District economy experienced moderate growth since the last report. Increased activity was noted in consumer spending, residential and commercial construction, commercial real estate, professional services, manufacturing, and energy and mining. Tourism was mixed, while residential real estate activity decreased and agricultural conditions weakened for farmers. Labor markets tightened since the last report, and wage increases were moderate. Prices generally remained level with a few exceptions noted.

#### **Consumer Spending and Tourism**

Retail sales activity increased moderately. A Minnesota-based restaurant and bar chain reported that recent same-store sales were up 2 percent to 5 percent from a year ago. A mall manager in Minnesota noted that apparel retailers reported an increase in resort wear sales and that restaurants and bars were busy. Two furniture retailers were expanding showroom space in North Dakota and Montana. A car dealership in Minnesota noted that mechanics were working overtime to meet demand for repairs in large part due to cold, wintry weather. A Montana auto dealer reported solid sales activity in January.

Tourism was mixed, as extremely cold weather was balanced by strong snow depth in several areas of the district. Cold weather slowed the number of visitors to the Upper Peninsula of Michigan. A Minnesota ski resort reported that cold weather slowed ski lift sales on a number of days. However, several ski resorts in Montana reported that lift ticket sales and lodging were up over last year, as the region benefited from good snow conditions. Looking ahead, Minneapolis' convention and tourism bureau anticipates that attendance at events in 2014 will be the largest in more than 10 years.

#### **Construction and Real Estate**

Commercial construction activity continued to grow since the last report. New hotels are planned or under construction in several Minnesota markets. In the Minneapolis-St. Paul area, a large retail mall and several industrial as well as mixed-use developments were planned. The retail vacancy rate dropped 50 basis points in the fourth quarter from the third quarter of 2013 in the Minneapolis-St. Paul area. However, the value of January commercial permits in Sioux Falls, S.D., was down slightly from a year ago. Overall residential construction activity increased. In the Minneapolis-St. Paul area, the value of January residential permits grew by 28 percent from January 2013. The value of January multifamily residential building permits in Billings, Mont., increased from January 2013, but single-family decreased. The value of January residential building permits in Sioux Falls decreased significantly from a year earlier.

Activity in commercial real estate markets increased since the last report. A recent report by a Minneapolis-St. Paul area real estate analytics firm noted that absorption of space is solid and that investors expect more activity across all property types. Residential real estate market activity decreased since the last report. In the Sioux Falls area, January home sales were down 13 percent and inventory was down 4 percent, while the median sale price increased 5 percent relative to a year earlier. In La Crosse, Wis., January home sales and the median price decreased from January 2013. Meanwhile, January home sales were down 13 percent from the same period a year ago in the Minneapolis area; the inventory of homes for sale was down 11 percent, while the median sale price rose 12 percent.

#### **Services**

Activity at professional business services firms increased since the last report. A February Minneapolis Fed ad hoc

survey of lawyers, accountants, engineers, architects, IT consultants and other professional business services firms noted optimism. Most respondents expected more orders and increasing billable hours. A lawyer noted that transactional activity was up and that clients' business increased during the past two years; the lawyer expected this to continue. Recent revenue was up at several Minnesota advertising agencies compared with a year earlier.

#### **Manufacturing**

District manufacturing activity increased moderately since the last report. Purchasing managers responding to a January survey by Creighton University (Omaha, Neb.) reported that manufacturing activity increased in Minnesota and the Dakotas. A company in the early stages of planning a \$1.7 billion nitrogen fertilizer plant in North Dakota exceeded its fundraising goals. South Dakota's state government withdrew \$13 million in loan commitments for a shuttered Aberdeen beef slaughter plant that declared bankruptcy and was sold last December.

#### **Energy and Mining**

Activity in the energy sector remained brisk. Mid-February oil and gas exploration in Montana and North Dakota decreased slightly from recent months, primarily due to extreme cold; however, production remains at record levels. Unexpected demand for propane to dry corn at harvest time, along with severe cold, led to a surge in demand for the fuel. A judge's decision opened the doors for approval of a \$250 million solar power development in Minnesota. Overall mining activity was stable. District iron ore mines were operating at near capacity. Meanwhile, fourth quarter 2013 palladium and platinum production was up in Montana compared with the same period in 2012.

#### **Agriculture**

Conditions continued to soften for district farmers, while livestock and dairy producers remained in better shape. More than half of respondents to the Minneapolis Fed's fourth quarter (January) Survey of Agricultural Credit Conditions said farm incomes decreased in the last three months of 2013, and two-thirds expected incomes to fall in the first quarter of this year. Cattle and hog producers continued to benefit from high prices and falling feed costs, as did dairy producers, according to survey comments. Informal survey results suggest that farmers are reacting to falling corn prices and intend to plant fewer acres of corn and a potentially record high acreage of soybeans this coming spring. January prices received by farmers fell from a year earlier for corn, wheat, soybeans, hogs and chickens; prices increased for cattle, milk, eggs and turkeys.

#### **Employment, Wages, and Prices**

Labor markets tightened slightly since the last report. A software company expansion in North Dakota will result in 150 construction jobs, followed by increased employment of up to 180 new workers over the next few years. A home improvement retailer announced plans to hire about 1,000 workers in the Minneapolis-St. Paul area to fill spring positions. A workforce center in western Minnesota noted strong demand for welders and health care workers, such as certified nursing assistants. In contrast, a Minnesota-based retailer announced plans to lay off 400 to 500 employees, while another Minnesota company will lay off more than 180 employees in its legal publishing division. A printing plant in Minnesota will close, laying off 170 workers.

Overall wage increases were moderate. Wages remained at high levels in the oil-drilling areas of North Dakota and Montana, but the pace of increase has moderated recently.

Prices were generally level with a few exceptions noted. Minnesota gasoline prices remained level since the last report. Some metals prices were down slightly. Meanwhile, District consumers of residential propane faced prices two to three times higher than a year ago due to strong demand and supply constraints.

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### **Tenth District--Kansas City**

The Tenth District economy remained stable in January and February and was expected to improve during the next few months. Consumer spending declined moderately as a decrease in automobile, retail, and restaurant sales outweighed an increase in tourism activity. Manufacturing activity expanded moderately, and expectations for future activity remained positive. Construction and residential real estate activity decreased slightly, while commercial real estate activity strengthened. Contacts anticipated stronger real estate and construction activity in the coming months as the weather improves and demand remains strong. Bankers continued to report steady overall loan demand, improved loan quality, and stable deposit levels. Agricultural growing conditions for winter wheat deteriorated, while livestock and crop prices edged higher. Energy activity remained strong, and capital expenditures were expected to increase along with drilling activity. Prices increased slightly for both finished goods and raw materials, with further gains expected in the next few months. Wages rose modestly in most industries, and contacts continued to report difficulty finding workers for some skilled positions.

#### **Consumer Spending**

Consumer spending declined moderately in January and February but was expected to increase modestly in the coming months. Contacts noted a variety of reasons for the recent slowdown including typical seasonal patterns, extreme winter weather, regulatory and political uncertainty, and a softening in consumer confidence. Although retail sales fell over the past month, sales remained slightly above year-ago levels. Automobile sales decreased moderately in recent months and fell to levels that were well below one year ago. However, automobile inventories continued to build, and contacts anticipated modest improvement in sales over the next few months. Restaurant sales also dipped sharply in February, but were consistent with year-ago levels and were expected to rise in the next few months. Tourism activity was significantly stronger than one year ago, with hotel occupancy rates and room rates both higher. Increased snowfall improved skiing conditions in the District and led to more ski-related tourism.

#### **Manufacturing and Other Business Activity**

Manufacturing and transportation activity increased moderately since the last survey period, while other business activity was unchanged. Manufacturing activity picked up for both durable goods and nondurable goods, with production, shipments and new orders expanding at a faster pace among durable goods manufacturers. Overall, manufacturing activity and capital expenditures remained above year-ago levels, and expectations for the future were positive. Contacts in professional and high-tech services, healthcare services, and wholesale trade reported roughly stable sales since the last survey period and anticipated activity to pick up in the coming months. Transportation companies reported stronger sales in February, and contacts were increasingly optimistic about future activity.

### Real Estate and Construction

Construction and residential real estate sales decreased slightly, while commercial real estate activity strengthened from the previous survey period. Residential sales declined slightly, while inventories remained low and fell further. Low- and medium-priced homes continued to drive sales, while higher-priced home sales remained sluggish in most of the District. Residential realtors reported additional home price gains, and expected residential real estate activity to improve in the near-term as demand increases due to seasonality. Builders reported that the number of starts was flat during the survey period, but construction activity was expected to strengthen in the coming months, with prices and buyer traffic both expected to increase. Mortgage activity fell slightly compared to the last survey period and compared to a year ago, but was expected to increase in the coming months as a rise in home purchase loans was anticipated to outweigh the decrease in refinancings. Commercial real estate contacts reported a decline in vacancy rates, a slight increase in absorption, and higher sales. Commercial real estate construction softened slightly but was still up over last year and was expected to increase in the coming months.

### Banking

Bankers reported steady overall loan demand, improved loan quality, and stable deposit levels in February. Most respondents reported steady demand for commercial and industrial loans, commercial real estate loans, consumer installment loans, and agriculture loans. Demand for residential real estate loans declined during the survey period. Bankers reported improved loan quality compared to a year ago, and all bankers expected the outlook for loan quality to either improve or remain the same over the next six months. Credit standards remained unchanged in all major loan categories, and respondents reported stable deposits.

### Agriculture

Crop growing conditions deteriorated, while livestock prices strengthened since the last survey period. Slightly more than half of the winter wheat crop was rated in fair to poor condition as scattered snowfalls provided only marginal soil moisture. Crop prices edged up from recent lows due to an uptick in export demand and concern that South American corn and soybean production would be lower than previously expected. Feeder cattle prices rose further with historically low cow inventories, and strong export demand supported higher fed cattle prices. Hog prices rose amid an intensifying swine virus outbreak that was expected to constrain pork supplies. In addition, production costs for livestock feeders edged down due to lower feed prices. Agricultural bankers indicated that farmland price appreciation moderated from the rapid pace seen the past few years, and most expected values would level off in 2014.

### Energy

District energy activity remained solid in January and February and was expected to remain steady in the coming months. Oil rigs increased slightly in the District, particularly in Oklahoma and Colorado. Natural gas rigs edged down despite the surge in natural gas spot prices and record-high withdrawals from storage. Although futures prices for March and April natural gas contracts have risen recently, energy contacts expected natural gas prices to decrease slightly in the coming weeks as storage is restocked. Crude oil prices were expected to remain steady. Propane prices increased significantly for many consumers due to already low propane stocks and unusually cold weather. Capital expenditures were projected to increase in the coming months, particularly in drilling for oil and natural gas liquids.

### Wages and Prices

Prices of finished goods increased modestly, while raw material prices rose moderately in January and February. Wages ticked up and were expected to continue to move higher in the months ahead. Retail, automobile, restaurant and manufacturing contacts noted price increases for both inputs and finished products. However, raw material prices were reportedly rising at a faster pace. These contacts anticipated additional price increases in the months ahead. Builders also reported an uptick in the price of construction materials, particularly roofing. Wages rose modestly in most industries, with transportation and automobile contacts reporting larger increases. Retail and restaurant respondents expected wages to increase at a faster pace over the next six months after minimal gains in recent months. Contacts in the professional and technical services, construction, and transportation industries expected the largest wage gains in the coming months. Some contacts continued to report difficulty finding skilled workers including technicians, engineers, construction trade laborers, and experienced supervisors.

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## Eleventh District--Dallas

The Eleventh District Economy grew at a moderate pace over the past six weeks. Manufacturing activity increased overall, although there were a few reports of slowing demand. Retail and automobile sales were slightly weaker but contacts' outlooks were positive. Demand improved in most nonfinancial services industries with the exception of transportation services, which was negatively impacted by severe national weather. Sales of new single-family homes remained on an upward trend, and office and industrial real estate leasing activity remained strong. Loan demand held relatively steady. Energy activity remained solid, while agricultural conditions worsened. Price increases were noted in several industries, although most were modest. Outlooks were optimistic across most industries.

### Prices

Most responding firms said prices were stable to up slightly over the reporting period. There were a few instances of accelerating prices. Fabricated metals producers noted continued increases in selling prices and expect more in the next six months. Food producers said that selling prices had moved up due to rising input costs, especially for dairy and beef. One airline reported a modest increase in ticket prices. Some transportation firms expected increases in shipping rates in coming months due to higher fuel costs. Retail prices were stable overall and auto selling prices were unchanged.

Natural gas prices rose marginally over the course of the last six weeks, peaking at \$7.63 in early February and ending the reporting period at \$5.35. This was driven by the exceptionally cold winter, which led to a drawdown of inventories to the bottom of its 5-year range. The price of WTI also rose over the last six weeks, trading as high as \$100.35 at the end of the period. This price behavior was driven in part by heating oil demand, which has also been bolstered by the severe winter, and debottlenecking at Cushing, OK.

### Labor Market

Employment levels held steady or increased slightly at most responding firms. Staffing firms said employment levels were up modestly and expected to hire additional workers. Accounting and legal firms reported a modest increase in employment levels. One transportation services firm expected to increase payrolls significantly this year while another one continued with an incentivized buyout to reduce employment. Fabricated metals and food manufacturing firms



reported increased hiring due to stronger demand. A recreational vehicle producer noted employment was up moderately and expected to continue hiring. Labor shortages were reported for engineers, truck drivers, mechanics, machinists and construction workers.

There were some reports of upward wage pressure. High-tech respondents noted moderate wage pressure for high-skilled workers including electrical engineers. Primary metals contacts and food producers noted slight increases in wage pressures for skilled and technical workers. Airlines reported upward pressure on wages, and one airline had increased salaries modestly. In addition, a transportation services firm noted wages were up slightly, and accounting contacts reported marginal wage pressure. Single-family housing contacts continued to note rising wage pressures.

#### **Manufacturing**

Reports from manufacturers were mostly positive and outlooks were optimistic. Construction-related manufacturers said that demand increased since the last report, despite bad weather locally. Fabricated metals producers reported strong demand, a result of robust commercial and residential construction. Contacts noted demand is well above last year's levels. Demand for primary metals softened seasonally since the last report, although most contacts said demand was somewhat better than this time last year. Energy-related manufacturing contacts and food producers noted steady demand at healthy levels. Paper manufacturers said demand was flat to up and running slightly ahead of expectations. Demand for transportation equipment was mixed, in part due to bad weather in the region, but it was still well above year-ago levels.

Contacts in high-tech manufacturing reported a slight improvement in orders since the last survey period. Responding firms said that demand for memory chips remained strong and demand for logic devices remained weak but stable. Inventories were reported as stable and employment levels were flat to slightly up. Most contacts expect stronger demand this year as they expect the world economy to pick up moderately and replacement rates of high tech devices to increase.

Refinery contacts noted that utilization rates fell slightly, in part due to weather effects. The production growth of major chemicals was mixed. Refinery and petrochemical margins remained healthy.

#### **Retail Sales**

Retail sales were a little weaker this reporting period due in part to bad weather nationally but year-over-year growth remained positive. According to three national retailers, demand in Texas slightly outperformed the nation since the last report. Contacts' outlooks for the rest of this quarter and the remainder of the year are positive.

Automobile sales softened slightly since the previous report. In north Texas, this was attributed to cold weather. Year-over-year demand ranged from down slightly to up slightly. Inventory levels varied by manufacturer, and generally were not a source of concern. Contacts' outlooks for the remainder of the quarter and the year were mostly optimistic.

#### **Nonfinancial Services**

Staffing firms said demand was up more than expected, and that they plan to increase hiring. One contact noted requests for IT professionals started rising again after maintaining an already high level over the past several months. Contacts were more optimistic than at the time of the last report. Accounting firms said demand continued to trend upward, although there was some softness in tax services. Outlooks were cautiously positive. Legal firms noted a slight increase in demand over the past six weeks and it was up notably from last year. Transportation service firms noted mixed demand. Railroad cargo volumes fell slightly below year-ago levels, with severe weather nationally largely to blame. Coal, grain and nonmetallic minerals saw good growth, and chemicals and petroleum shipments rose modestly. Weakness was seen in shipments of lumber and wood and motor vehicles. The outlook remained positive with strong growth expected in the first part of 2014. Small parcel shipping decelerated since the last report but was up from a year ago. Retail trade continued to be the largest driver of growth, and the outlook was optimistic. Air cargo volumes were up since the last report but down slightly from a year ago. Respondents in the maritime shipping industry said loaded container volume declined slightly, but that for 2013 as a whole container volumes rose moderately.

Airline demand was solid to slightly stronger according to contacts. Severe winter weather across the nation caused some temporary disruptions, but demand rebounded quickly. Demand was in line with or slightly above year ago levels. Outlooks were optimistic.

#### **Construction and Real Estate**

Single-family home sales remained on an upward trend over the past six weeks, although one contact noted a slight slowdown in the pace of new home sales in recent weeks. Inventories of new and existing homes remained at extremely low levels. One respondent noted the low inventory of developed lots could hamper single-family building activity later in the year. Apartment demand remained solid and construction activity continued at high levels. Rental rate growth was above the historical average in most major metros. One contact was concerned about possible overbuilding in urban areas.

Office and industrial leasing activity was strong. Sales activity remained at high levels and contacts expect it to increase this year, noting a more friendly lending environment. Outlooks were positive and commercial development is expected to continue to rise this year.

#### **Financial Services**

Financial sector performance remained relatively level over the past six weeks. Demand improved marginally for commercial real estate, middle-market, mergers and acquisitions, and consumer loans. Some softness was reported in residential real estate lending. Loan pricing remained relatively unchanged at competitive levels, and loan quality continued to strengthen. Deposit volumes increased slightly on net after fluctuations in the beginning of the year; rates remain low and static. Respondents' outlooks are hopeful for a better year, noting less client uncertainty and potentially growing interest in loans.

#### **Energy**

Eleventh District demand for oil field services remained healthy over the past six weeks. Contacts noted that activity in Texas is particularly strong, both inland and offshore, and they were moderately more optimistic for the first half of 2014 than in prior reporting periods.

#### **Agriculture**

After gradually easing throughout the fall, district drought conditions worsened slightly in January and early February.

Wheat crop and pasture conditions deteriorated somewhat due to lack of sufficient rainfall. Cotton prices have rallied since December, which may lead more farmers to favor cotton over other row crops when making planting decisions this spring.

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## Twelfth District--San Francisco

Economic activity in the Twelfth District expanded at a moderate pace during the reporting period of late December through mid-February. Price increases for most final goods and services were minimal, and wage gains remained quite modest on net. The pace of retail sales stepped down, although demand for business and consumer services rose. District manufacturing activity was mixed. Production activity in agricultural and resource-related industries expanded on balance. Activity in residential and commercial real estate markets continued to expand. Financial institutions reported that loan demand increased overall.

### Prices and Wages

Contacts observed minimal price increases for most final goods and services. Fruit and produce prices moved up, and many contacts expect food and water price inflation to pick up in the near term as a consequence of the drought in California. Prices edged up for some construction-related inputs, including wood, insulation, and cement. A higher supply of recycled metals in Asia resulted in lower exports of such metals from the United States, which contributed to downward pressure on U.S. steel input costs and on final prices for steel products.

Wage gains remained quite modest on net, although contacts pointed to signs of building upward wage pressures in areas with particularly strong regional economic activity. Wages for some worker types, notably software developers and engineers, continued to increase rapidly. Reports suggested that the rising cost of living in the San Francisco Bay Area may be pushing up wage pressures.

### Retail Trade and Services

The pace of retail sales stepped down. Traditional brick-and-mortar retailers faced fierce competition from online vendors, but recent reports indicated that both in-store and online sales were soft. Retail grocers observed increasing price sensitivity on the part of consumers and noted that even upscale retail grocery establishments experienced pressure on margins. Despite the recognition of some weakness in current conditions, most contacts expect consumer spending to improve or stay the same over the next 12 months. In particular, contacts were optimistic in their outlook for spending on autos and home furnishings.

Demand for business and consumer services rose. Demand for cloud computing services remained strong, although contacts noted that many small and medium-sized businesses have continued to invest in their own data centers. Contacts noted that activity in the food service industry continued to improve. Providers of health-care services expect increased demand for services as a result of expanded coverage under the Affordable Care Act. The level of Hawaiian travel and tourism activity in 2013 surpassed past-year records despite a slowdown in the fourth quarter. Contacts also indicated that tourism picked up in Southern California, with occupancy rates in San Diego hotels reaching historic highs. Overall tourism conditions in Las Vegas improved slightly.

### Manufacturing

District manufacturing activity was mixed during the reporting period of late December through mid-February. Contacts noted that year-over-year growth in the electronic components industry resumed after several quarters of decline. Semiconductor sales hit record levels in 2013 and are expected to grow modestly in 2014. The sustained backlog of orders for commercial aircraft supported growth in the commercial aerospace industry, although contacts expect the pace of new orders to slow this year. Defense-related manufacturers reported sluggish overall conditions, and they expect sales, new orders, and capacity utilization to trend downward. Wood and steel product manufacturers noted that extreme weather conditions across the country created problems along their supply chains. Demand for steel used in private nonresidential construction projects continued to improve slowly, although contacts reported low capacity utilization rates at steel mills.

### Agriculture and Resource-related Industries

Production in agricultural and resource-related industries expanded on balance. Demand was stable for most crop and livestock products. Concerns about water costs and availability may cause farmers in the California Central Valley to scale back planting. Contacts expect growers to allocate water to more permanent plantings, such as almond and walnut orchards, before allocating water to annual crops, such as corn. In addition, dairy and meat producers may face higher feed costs due to water shortages. Year-over-year crude oil production increased robustly, although consumer demand for petroleum and gasoline rose more modestly. Demand for electricity and gas by industrial customers grew further.

### Real Estate and Construction

Activity in residential and commercial real estate markets continued to expand. Home prices across most of the District climbed further, albeit at a bit slower pace, and contacts indicated that the pace of home sales was below historical averages in many areas. Contacts noted that while mortgage application volume in Idaho increased, completed sales transactions dropped. Most contacts expect homebuilding activity to strengthen this year. Occupancy rates for commercial real estate trended up in some areas, and increasing permit activity and sales of empty lots suggest that commercial construction may pick up further. In other areas, contacts noted that existing available square footage, especially in retail-oriented properties, has stifled new construction. Public infrastructure projects, as well as a large number of high-rise commercial construction projects, have been announced or are under way in Honolulu, Seattle, Los Angeles, and the San Francisco Bay Area.

### Financial Institutions

Financial institutions reported that loan demand increased overall. Lending grew robustly in selected areas, and contacts noted that asset quality improved at most banks. Contacts noted that credit remains cheap and available for large firms but less accessible by smaller businesses. Ample liquidity in the marketplace continued to perpetuate substantial competition among lenders for business from high-quality commercial borrowers. Contacts indicated that some financial institutions relaxed underwriting standards in an effort to win new business or maintain existing business relationships. In the District's Internet and digital media sectors, there were several notable mergers and acquisitions during the reporting period, and the pace of initial public offerings picked up slightly. Private equity activity was mostly stable, and venture capital financing was strong. The volume of venture capital deals in the second half of 2013 reached mid-2007 levels,

## Board of Governors of the Federal Reserve System

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### Press Release



*Release Date: January 30, 2013*

#### For immediate release

Information received since the Federal Open Market Committee met in December suggests that growth in economic activity paused in recent months, in large part because of weather-related disruptions and other transitory factors. Employment has continued to expand at a moderate pace but the unemployment rate remains elevated. Household spending and business fixed investment advanced, and the housing sector has shown further improvement. Inflation has been running somewhat below the Committee's longer-run objective, apart from temporary variations that largely reflect fluctuations in energy prices. Longer-term inflation expectations have remained stable.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee expects that, with appropriate policy accommodation, economic growth will proceed at a moderate pace and the unemployment rate will gradually decline toward levels the Committee judges consistent with its dual mandate. Although strains in global financial markets have eased somewhat, the Committee continues to see downside risks to the economic outlook. The Committee also anticipates that inflation over the medium term likely will run at or below its 2 percent objective.

To support a stronger economic recovery and to help ensure that inflation, over time, is at the rate most consistent with its dual mandate, the Committee will continue purchasing additional agency mortgage-backed securities at a pace of \$40 billion per month and longer-term Treasury securities at a pace of \$45 billion per month. The Committee is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction. Taken together, these actions should maintain downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative.

The Committee will closely monitor incoming information on economic and financial developments in coming months. If the outlook for the labor market does not improve substantially, the Committee will continue its purchases of Treasury and agency mortgage-backed securities, and employ its other policy tools as appropriate, until such improvement is achieved in a context of price stability. In determining the size, pace, and composition of its asset purchases, the Committee will, as always, take appropriate account of the likely efficacy and costs of such purchases.

To support continued progress toward maximum employment and price stability, the Committee expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the asset purchase program ends and the economic recovery strengthens. In particular, the Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored. In determining how long to maintain a highly accommodative stance of monetary policy, the Committee will also consider other information, including additional measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. When the Committee decides to begin to remove policy accommodation, it will take a balanced approach consistent with its longer-run goals of maximum employment and inflation of 2 percent.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; James Bullard; Elizabeth A. Duke; Charles L. Evans; Jerome H. Powell; Sarah Bloom Raskin; Eric S. Rosengren; Jeremy C. Stein; Daniel K. Tarullo; and Janet L. Yellen. Voting against the action was Esther L. George, who was concerned that the continued high level of monetary accommodation increased the risks of future economic and financial imbalances and, over time, could cause an increase in long-term inflation expectations.

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### Press Release

*Release Date: January 29, 2014*

#### For immediate release

Information received since the Federal Open Market Committee met in December indicates that growth in economic activity picked up in recent quarters. Labor market indicators were mixed but on balance showed further improvement. The unemployment rate declined but remains elevated. Household spending and business fixed investment advanced more quickly in recent months, while the recovery in the housing sector slowed somewhat. Fiscal policy is restraining economic growth, although the extent of restraint is diminishing. Inflation has been running below the Committee's longer-run objective, but longer-term inflation expectations have remained stable.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee expects that, with appropriate policy accommodation, economic activity will expand at a moderate pace and the unemployment rate will gradually decline toward levels the Committee judges consistent with its dual mandate. The Committee sees the risks to the outlook for the economy and the labor market as having become more nearly balanced. The Committee recognizes that inflation persistently below its 2 percent objective could pose risks to economic performance, and it is monitoring inflation developments carefully for evidence that inflation will move back toward its objective over the medium term.

Taking into account the extent of federal fiscal retrenchment since the inception of its current asset purchase program, the Committee continues to see the improvement in economic activity and labor market conditions over that period as consistent with growing underlying strength in the broader economy. In light of the cumulative progress toward maximum employment and the improvement in the outlook for labor market conditions, the Committee decided to make a further measured reduction in the pace of its asset purchases. Beginning in February, the Committee will add to its holdings of agency mortgage-backed securities at a pace of \$30 billion per month rather than \$35 billion per month, and will add to its holdings of longer-term Treasury securities at a pace of \$35 billion per month rather than \$40 billion per month. The Committee is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction. The Committee's sizable and still-increasing holdings of longer-term securities should maintain downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative, which in turn should promote a stronger economic recovery and help to ensure that inflation, over time, is at the rate most consistent with the Committee's dual mandate.

The Committee will closely monitor incoming information on economic and financial developments in coming months and will continue its purchases of Treasury and agency mortgage-backed securities, and employ its other policy tools as appropriate, until the outlook for the labor market has improved substantially in a context of price stability. If incoming information broadly supports the Committee's expectation of ongoing improvement in labor market conditions and inflation moving back toward its longer-run objective, the Committee will likely reduce the pace of asset purchases in further measured steps at future meetings. However, asset purchases are not on a preset course, and the Committee's decisions about their pace will remain contingent on the Committee's outlook for the labor market and inflation as well as its assessment of the likely efficacy and costs of such purchases.

To support continued progress toward maximum employment and price stability, the Committee today reaffirmed its view that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the asset purchase program ends and the economic recovery strengthens. The Committee also reaffirmed its expectation that the current exceptionally low target range for the federal funds rate of 0 to 1/4 percent will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored. In determining how long to maintain a highly accommodative stance of monetary policy, the Committee will also consider other information, including additional measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. The Committee continues to anticipate, based on its assessment of these factors, that it likely will be appropriate to maintain the current target range for the federal funds rate well past the time that the unemployment rate declines below 6-1/2 percent, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal. When the Committee decides to begin to remove policy accommodation, it will take a balanced approach consistent with its longer-term goals of maximum employment and inflation of 2 percent.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; Richard W. Fisher; Narayana Kocherlakota; Sandra Pianalto; Charles I. Plosser; Jerome H. Powell; Jeremy C. Stein; Daniel K. Tarullo; and Janet L. Yellen.

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## Statement Regarding Purchases of Treasury Securities and Agency Mortgage-Backed Securities

January 29, 2014

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FAQs: Agency MBS Purchases

FAQs: Purchases of Longer-term Treasury Securities

On January 29, 2014, the Federal Open Market Committee (FOMC) directed the Open Market Trading Desk (the Desk) at the Federal Reserve Bank of New York to purchase additional agency mortgage-backed securities (MBS) at a pace of about \$30 billion per month and longer-term Treasury securities at a pace of about \$35 billion per month, beginning in February 2014. The existing January schedules for agency MBS purchases at a pace of \$35 billion per month and Treasury securities purchases at a pace of \$40 billion per month remain in effect until that time. The FOMC also directed the Desk to maintain its existing policies of reinvesting principal payments from the Federal Reserve's holdings of agency debt and agency MBS in agency MBS and of rolling over maturing Treasury securities at auction. The Committee's sizable and still-increasing holdings of longer-term securities should maintain downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative.

Purchases of agency MBS will continue to be concentrated in newly-issued agency MBS in the To-Be-Announced (TBA) market, and purchases of longer-term Treasury securities will continue to be distributed using the existing set of sectors and approximate weights. These purchase distributions could change if market conditions warrant.

The amount of agency MBS to be purchased each month and the tentative schedule of Treasury purchase operations for the following calendar month will continue to be announced on or around the last business day of each month. Additionally, the planned amount of purchases associated with reinvestments of principal payments on holdings of agency securities that are anticipated to take place over each monthly period will be announced on or around the eighth business day of the month.

Consistent with current practices, the purchases of agency MBS and Treasury securities will be conducted with the Federal Reserve's eligible counterparties through a competitive bidding process and results will be published on the Federal Reserve Bank of New York's website. The Desk will continue to publish transaction prices for individual operations at the end of each monthly period. All other purchase details remain the same at this time.

Additional information on the purchases of agency MBS and longer-term Treasury securities can be found in a set of Frequently Asked Questions for each asset class in the following locations:

[FAQs: Agency MBS Purchases »](#)

[FAQs: Purchases of Longer-term Treasury Securities »](#)

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### Press Release

*Release Date: January 29, 2014*

#### For immediate release

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Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee expects that, with appropriate policy accommodation, economic activity will expand at a moderate pace and the unemployment rate will gradually decline toward levels the Committee judges consistent with its dual mandate. The Committee sees the risks to the outlook for the economy and the labor market as having become more nearly balanced. The Committee recognizes that inflation persistently below its 2 percent objective could pose risks to economic performance, and it is monitoring inflation developments carefully for evidence that inflation will move back toward its objective over the medium term.

Taking into account the extent of federal fiscal retrenchment since the inception of its current asset purchase program, the Committee continues to see the improvement in economic activity and labor market conditions over that period as consistent with growing underlying strength in the broader economy. In light of the cumulative progress toward maximum employment and the improvement in the outlook for labor market conditions, the Committee decided to make a further measured reduction in the pace of its asset purchases. Beginning in February, the Committee will add to its holdings of agency mortgage-backed securities at a pace of \$30 billion per month rather than \$35 billion per month, and will add to its holdings of longer-term Treasury securities at a pace of \$35 billion per month rather than \$40 billion per month. The Committee is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction. The Committee's sizable and still-increasing holdings of longer-term securities should maintain downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative, which in turn should promote a stronger economic recovery and help to ensure that inflation, over time, is at the rate most consistent with the Committee's dual mandate.

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Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; Richard W. Fisher; Narayana Kocherlakota; Sandra Pianalto; Charles I. Plosser; Jerome H. Powell; Jeremy C. Stein; Daniel K. Tarullo; and Janet L. Yellen.

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## Accessible Version

Advance release of table 1 of the Summary of Economic Projections to be released with the FOMC minutes

Percent

Variable	Central tendency <sup>1</sup>					Range <sup>2</sup>					Longer run
	2013	2014	2015	2016	Longer run	2013	2014	2015	2016		
Change in real GDP	2.2 to 2.3	2.8 to 3.2	3.0 to 3.4	2.5 to 3.2	2.2 to 2.4	2.2 to 2.4	2.2 to 3.3	2.2 to 3.6	2.1 to 3.5	1.8 to 2.5	
September projection	2.0 to 2.3	2.9 to 3.1	3.0 to 3.5	2.5 to 3.3	2.2 to 2.5	1.8 to 2.4	2.2 to 3.3	2.2 to 3.7	2.2 to 3.5	2.1 to 2.5	
Unemployment rate	7.0 to 7.1	6.3 to 6.6	5.8 to 6.1	5.3 to 5.8	5.2 to 5.8	7.0 to 7.1	6.2 to 6.7	5.5 to 6.2	5.0 to 6.0	5.2 to 6.0	
September projection	7.1 to 7.3	6.4 to 6.8	5.9 to 6.2	5.4 to 5.9	5.2 to 5.8	6.9 to 7.3	6.2 to 6.9	5.3 to 6.3	5.2 to 6.0	5.2 to 6.0	
PCE inflation	0.9 to 1.0	1.4 to 1.6	1.5 to 2.0	1.7 to 2.0	2.0	0.9 to 1.2	1.3 to 1.8	1.4 to 2.3	1.6 to 2.2	2.0	
September projection	1.1 to 1.2	1.3 to 1.8	1.6 to 2.0	1.7 to 2.0	2.0	1.0 to 1.3	1.2 to 2.0	1.4 to 2.3	1.5 to 2.3	2.0	
Core PCE inflation <sup>3</sup>	1.1 to 1.2	1.4 to 1.6	1.6 to 2.0	1.8 to 2.0		1.1 to 1.2	1.3 to 1.8	1.5 to 2.3	1.6 to 2.2		
September projection	1.2 to 1.3	1.5 to 1.7	1.7 to 2.0	1.9 to 2.0		1.2 to 1.4	1.4 to 2.0	1.6 to 2.3	1.7 to 2.3		

Note: Projections of change in real gross domestic product (GDP) and projections for both measures of inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation and core PCE inflation are the percentage rates of change in, respectively, the price index for personal consumption expenditures (PCE) and the price index for PCE excluding food and energy. Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated. Each participant's projections are based on his or her assessment of appropriate monetary policy. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy. The September projections were made in conjunction with the meeting of the Federal Open Market Committee on September 17-18, 2013.

1. The central tendency excludes the three highest and three lowest projections for each variable in each year. [Return to table](#)

2. The range for a variable in a given year includes all participants' projections, from lowest to highest, for that variable in that year. [Return to table](#)

3. Longer-run projections for core PCE inflation are not collected. [Return to table](#)

Figure 1. Central tendencies and ranges of economic projections, 2013-16 and over the longer run

Central tendencies and ranges of economic projections for years 2013 through 2016 and over the longer run. Actual values for years 2008 through 2012.

Change in real GDP  
Percent

2008 2009 2010 2011 2012 2013 2014 2015 2016 Longer Run

Actual	(2.8)	(0.2)	2.8	2.0	2.0	-	-	-	-	-
Upper End of Range	-	-	-	-	-	2.4	3.3	3.6	3.5	2.5
Upper End of Central Tendency	-	-	-	-	-	2.3	3.2	3.4	3.2	2.4
Lower End of Central Tendency	-	-	-	-	-	2.2	2.8	3.0	2.5	2.2
Lower End of Range	-	-	-	-	-	2.2	2.2	2.2	2.1	1.8

**Unemployment rate**  
Percent

	2008	2009	2010	2011	2012	2013	2014	2015	2016	Longer Run
Actual	6.9	9.9	9.5	8.7	7.8	-	-	-	-	-
Upper End of Range	-	-	-	-	-	7.1	6.7	6.2	6.0	6.0
Upper End of Central Tendency	-	-	-	-	-	7.1	6.6	6.1	5.8	5.8
Lower End of Central Tendency	-	-	-	-	-	7.0	6.3	5.8	5.3	5.2
Lower End of Range	-	-	-	-	-	7.0	6.2	5.5	5.0	5.2

**PCE inflation**  
Percent

	2008	2009	2010	2011	2012	2013	2014	2015	2016	Longer Run
Actual	1.5	1.2	1.3	2.6	1.7	-	-	-	-	-
Upper End of Range	-	-	-	-	-	1.2	1.8	2.3	2.2	2.0
Upper End of Central Tendency	-	-	-	-	-	1.0	1.6	2.0	2.0	2.0
Lower End of Central Tendency	-	-	-	-	-	0.9	1.4	1.5	1.7	2.0
Lower End of Range	-	-	-	-	-	0.9	1.3	1.4	1.6	2.0

Note: Definitions of variables are in the general note to the projections table. The data for the actual values of the variables are annual.

Figure 2. Overview of FOMC participants' assessments of appropriate monetary policy

**Appropriate timing of policy firming**

	2014	2015	2016
Number of participants	2	12	3

Note: In the upper panel, the height of each bar denotes the number of FOMC participants who judge that, under appropriate monetary policy, the first increase in the target federal funds rate from its current range of 0 to ¼ percent will occur in the specified calendar year. In September 2013, the numbers of FOMC participants who judged that the first increase in the target federal funds rate would occur in 2014, 2015, and 2016 were, respectively, 3, 12, and 2.

**Appropriate pace of policy firming**

Number of participants with projected targets

Target federal funds rate at year-end (Percent)	2013	2014	2015	2016	Longer run
0.25	17	15	3		
0.50			3	1	
0.75		1	4		
1.00			2	1	
1.25		1	1	1	
1.50			1	2	
1.75				4	
2.00			1	1	
2.25					
2.50				2	
2.75			1	1	
3.00				1	
3.25			1	1	
3.50					4



3.75					2
4.00				1	9
4.25				1	2

Note: In the lower panel, each shaded circle indicates the value (rounded to the nearest ¼ percentage point) of an individual participant's judgment of the appropriate level of the target federal funds rate at the end of the specified calendar year or over the longer run.

Last update: December 18, 2013

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# Statement on Longer-Run Goals and Monetary Policy Strategy

As amended effective January 28, 2014

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The Federal Open Market Committee (FOMC) is firmly committed to fulfilling its statutory mandate from the Congress of promoting maximum employment, stable prices, and moderate long-term interest rates. The Committee seeks to explain its monetary policy decisions to the public as clearly as possible. Such clarity facilitates well-informed decisionmaking by households and businesses, reduces economic and financial uncertainty, increases the effectiveness of monetary policy, and enhances transparency and accountability, which are essential in a democratic society.

Inflation, employment, and long-term interest rates fluctuate over time in response to economic and financial disturbances. Moreover, monetary policy actions tend to influence economic activity and prices with a lag. Therefore, the Committee's policy decisions reflect its longer-run goals, its medium-term outlook, and its assessments of the balance of risks, including risks to the financial system that could impede the attainment of the Committee's goals.

The inflation rate over the longer run is primarily determined by monetary policy, and hence the Committee has the ability to specify a longer-run goal for inflation. The Committee reaffirms its judgment that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate. Communicating this inflation goal clearly to the public helps keep longer-term inflation expectations firmly anchored, thereby fostering price stability and moderate long-term interest rates and enhancing the Committee's ability to promote maximum employment in the face of significant

economic disturbances.

The maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market. These factors may change over time and may not be directly measurable. Consequently, it would not be appropriate to specify a fixed goal for employment; rather, the Committee's policy decisions must be informed by assessments of the maximum level of employment, recognizing that such assessments are necessarily uncertain and subject to revision. The Committee considers a wide range of indicators in making these assessments. Information about Committee participants' estimates of the longer-run normal rates of output growth and unemployment is published four times per year in the FOMC's Summary of Economic Projections. For example, in the most recent projections, FOMC participants' estimates of the longer-run normal rate of unemployment had a central tendency of 5.2 percent to 5.8 percent.

In setting monetary policy, the Committee seeks to mitigate deviations of inflation from its longer-run goal and deviations of employment from the Committee's assessments of its maximum level. These objectives are generally complementary. However, under circumstances in which the Committee judges that the objectives are not complementary, it follows a balanced approach in promoting them, taking into account the magnitude of the deviations and the potentially different time horizons over which employment and inflation are projected to return to levels judged consistent with its mandate.

The Committee intends to reaffirm these principles and to make adjustments as appropriate at its annual organizational meeting each January.

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Harvey S. Katz, CFA | March 19, 2014

## The Fed Continues To Taper



The Federal Reserve concluded its latest Federal Open Market Committee meeting, the first one under the stewardship of Janet Yellen, within the past hour, noting that the nation's economy had slowed during the winter months from the healthy pace seen when the Committee last met in January. The FOMC blamed what it termed the adverse weather for much of the deceleration in activity in the past six weeks.

Overall, the Committee noted that labor market conditions were mixed, but, on balance, it saw improvement. The Fed observed, however, that the unemployment rate remained elevated. Also, "household spending and business fixed investment continued to advance, while the recovery in the housing sector remained slow."

The Fed also observed that fiscal policies were restraining economic growth, although the extent of that restraint had begun to lessen in recent months. Of note, inflation, the FOMC maintained, "has been running below the Committee's longer-run objective." Such a below-trend pricing situation raises the ultimate risk of deflation. Although the FOMC did not raise that possibility in specific terms, at this latest confab, it did opine that inflation below the 2% objective, where it is now, "could pose risks to economic performance."

Meanwhile, sensing that things are slowly getting better from an economic standpoint, the current disinflation notwithstanding, the Fed did indicate that it would be paring its current bond-buying initiative by another \$10 billion -- the third such reduction in as many meetings. This latest adjustment will bring the aggregate monthly purchases down from \$65 billion to \$55 billion.

Finally, the Fed noted that it would continue to closely monitor the situation as it continues its asset purchase endeavors, until the outlook for the labor market has improved substantially in a context of price stability. While no timetable for concluding this program was advanced, the general assumption has been that the central bank will wind up its efforts later this year. The Fed also held its near-zero level of short-term interest rates (i.e., the federal funds rate target) intact.

On balance, this policy initiative was in line with expectations and it suggests that the Fed, under the current lead of Janet Yellen, seems to be moving in tandem with the Ben Bernanke-led central bank that preceded it.

*At the time of this article's writing, the author did not have any positions in any of the companies mentioned.*

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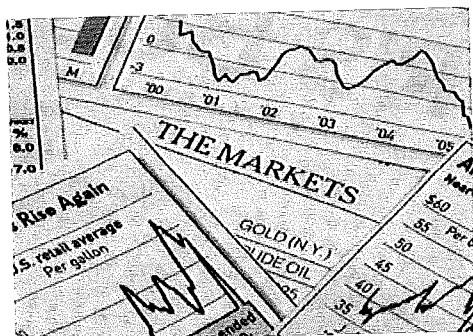
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Marek Mscichowski | March 11, 2014

## Equity Risk Premiums And Stocks Today



Stocks may appear to be at expensive levels. Looking at **Price to Earnings (P/E) multiples** of equities and comparing them to their historical averages, however, some commentators (namely, former Federal Reserve Chairman Alan Greenspan and NYU professor Aswath Damodaran) have recently pointed to equity risk premiums as another useful metric for valuing stocks. Unlike P/E multiples, equity premiums take interest rates, some currently at historically low levels historically, into account.

The equity premium is the total expected return (including capital growth and dividends) minus the risk-free rate. The total expected return is currently around 8.5%. The ten-year Treasury yield, an estimate of the risk-free rate, is about 3%. Hence, by our rough

arithmetic, the equity premium that compensates investors for the added risk of holding corporate equity over theoretically risk-free U.S. government interest payments is currently about 5.5%.

Historically, the equity premium required by investors has averaged in the range of 3% to 7%. So this premium is about average, while interest rates, in some cases, are at historic lows.

The main reason that interest rates are so low is the Federal Reserve's massive asset-buyback program and abnormally low inflation. Through this lens, the elevated high P/E ratios make more sense, as investors search for returns in a low interest-rate environment. However, the Fed lowered the amount of monthly buybacks by \$10 billion, from \$85 billion to \$75 billion, as 2013 came to a close. It then pared another \$10 billion assets in January of this year. The Fed's efforts should eventually increase interest rates, though the timeframe appears to depend on the depth and breadth of an economic recovery. This has lent more urgency to speculation on Fed moves.

If interest rates go up and the required premium stays the same, this will decrease equity prices, all else being equal, as future cash flows are discounted by greater expected total returns. However, Professor Damodaran, who periodically posts his own equity risk premium estimate, argues that over the past decade, estimated returns have circled around the same mean, with equity risk premiums have largely compensated for falling interest rates, which have been in the hands of the Federal Reserve. Still, there are historical precedents for shifts in the total expected return because of either changes in the risk-free rate or equity premiums.

Besides interest rates and required equity premiums, another variable that can affect returns is earnings growth, which ultimately supplies money for returns in the form of dividends and buybacks. In recent years, corporations have been doing well, and the global economy seems to be firming up. Future earnings figures will also affect valuations. Damodaran provides a model (similar to a dividend discount model for a stock) for one to determine the intrinsic value of the S&P 500 Index by providing estimates for the risk-free rate, equity premium, as well as cash returns in the form of buybacks and their assumed growth rates.

What are some possible scenarios and how would they affect investors? Our previous discussion should shed some light. In the worst case scenario, interest rates will grow sharply, while the pace of earnings slow (compared to expectations, at least). This may mean equities are relatively overvalued now. For investors, the best case would be if earnings continue to grow nicely, while interest rates remain subdued. This may mean that the intrinsic value of equities is above the current price. With markets recently reaching all-time highs in some indexes and many stocks trading at premium P/E multiples compared to recent years, looking at the equity risk premium may provide investors with new insights into equity valuation and where stocks can go from here.

Value Line subscribers can compare our total return estimates with current bond yields for an idea of equity risk premium as they differ for each individual stock (In general, riskier stocks require higher premiums). Investors should also focus on our earnings and dividend estimates and projections, when considering if an investment is right for them on a fundamental basis.

*At the time of this article's writing, the author did not have positions in any of the companies mentioned.*

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3/10/14	3.73
3/11/14	3.7
3/12/14	3.66
3/13/14	3.6
3/14/14	3.59
3/17/14	3.63
3/18/14	3.62
3/19/14	3.66
3/20/14	3.67
3/21/14	3.61
3/24/14	3.57
3/25/14	3.59
3/26/14	3.55
3/27/14	3.52
3/28/14	3.55
3/31/14	3.56
4/1/14	3.6
4/2/14	3.65
4/3/14	3.62
4/4/14	3.59
4/7/14	3.56
4/8/14	3.54
4/9/14	3.57

OCS 1.8D  
30YR US SPOT YIELDS  
Risk Premium

3/11/14	5.14
3/12/14	5.11
3/13/14	5.05
3/14/14	5.05
3/17/14	5.1
3/18/14	5.1
3/19/14	5.15
3/20/14	5.13
3/21/14	5.07
3/24/14	5.03
3/25/14	5.03
3/26/14	4.99
3/27/14	4.95
3/28/14	4.98
3/31/14	4.99
4/1/14	5.03
4/2/14	5.07
4/3/14	5.04
4/4/14	4.99
4/7/14	4.95
4/8/14	4.95
4/9/14	4.96

Bee Coop. Spot Price

Risk Premium

2009-01	3.13
2009-02	3.59
2009-03	3.64
2009-04	3.76
2009-05	4.23
2009-06	4.52
2009-07	4.41
2009-08	4.37
2009-09	4.19
2009-10	4.19
2009-11	4.31
2009-12	4.49
2010-01	4.6
2010-02	4.62
2010-03	4.64
2010-04	4.69
2010-05	4.29
2010-06	4.13
2010-07	3.99
2010-08	3.8
2010-09	3.77
2010-10	3.87
2010-11	4.19
2010-12	4.42
2011-01	4.52
2011-02	4.65
2011-03	4.51
2011-04	4.5
2011-05	4.29
2011-06	4.23
2011-07	4.27
2011-08	3.65
2011-09	3.18
2011-10	3.13
2011-11	3.02
2011-12	2.98
2012-01	3.03
2012-02	3.11
2012-03	3.28
2012-04	3.18
2012-05	2.93
2012-06	2.7
2012-07	2.59
2012-08	2.77
2012-09	2.88
2012-10	2.9
2012-11	2.8
2012-12	2.88
2013-01	3.08
2013-02	3.17
2013-03	3.16
2013-04	2.93
2013-05	3.11
2013-06	3.4
2013-07	3.61
2013-08	3.76
2013-09	3.79
2013-10	3.68
2013-11	3.8
2013-12	3.89
2014-01	3.77
2014-02	3.66
2014-03	3.62

30 YEAR US TREAS

2009-01	3.46
2009-02	3.83
2009-03	3.78
2009-04	3.84
2009-05	4.22
2009-06	4.51
2009-07	4.38
2009-08	4.33
2009-09	4.14
2009-10	4.16
2009-11	4.24
2009-12	4.4
2010-01	4.5
2010-02	4.48
2010-03	4.49
2010-04	4.53
2010-05	4.11
2010-06	3.95
2010-07	3.8
2010-08	3.52
2010-09	3.47
2010-10	3.52
2010-11	3.82
2010-12	4.17
2011-01	4.28
2011-02	4.42
2011-03	4.27
2011-04	4.28
2011-05	4.01
2011-06	3.91
2011-07	3.95
2011-08	3.24
2011-09	2.83
2011-10	2.87
2011-11	2.72
2011-12	2.67
2012-01	2.7
2012-02	2.75
2012-03	2.94
2012-04	2.82
2012-05	2.53
2012-06	2.31
2012-07	2.22
2012-08	2.4
2012-09	2.49
2012-10	2.51
2012-11	2.39
2012-12	2.47
2013-01	2.68
2013-02	2.78
2013-03	2.78
2013-04	2.55
2013-05	2.73
2013-06	3.07
2013-07	3.31
2013-08	3.49
2013-09	3.53
2013-10	3.38
2013-11	3.5
2013-12	3.63
2014-01	3.52
2014-02	3.38
2014-03	3.35

20 YR US TREAS



2009-01	2.52
2009-02	2.87
2009-03	2.82
2009-04	2.93
2009-05	3.29
2009-06	3.72
2009-07	3.56
2009-08	3.59
2009-09	3.4
2009-10	3.39
2009-11	3.4
2009-12	3.59
2010-01	3.73
2010-02	3.69
2010-03	3.73
2010-04	3.85
2010-05	3.42
2010-06	3.2
2010-07	3.01
2010-08	2.7
2010-09	2.65
2010-10	2.54
2010-11	2.76
2010-12	3.29
2011-01	3.39
2011-02	3.58
2011-03	3.41
2011-04	3.46
2011-05	3.17
2011-06	3
2011-07	3
2011-08	2.3
2011-09	1.98
2011-10	2.15
2011-11	2.01
2011-12	1.98
2012-01	1.97
2012-02	1.97
2012-03	2.17
2012-04	2.05
2012-05	1.8
2012-06	1.62
2012-07	1.53
2012-08	1.68
2012-09	1.72
2012-10	1.75
2012-11	1.65
2012-12	1.72
2013-01	1.91
2013-02	1.98
2013-03	1.96
2013-04	1.76
2013-05	1.93
2013-06	2.3
2013-07	2.58
2013-08	2.74
2013-09	2.81
2013-10	2.62
2013-11	2.72
2013-12	2.9
2014-01	2.86
2014-02	2.71
2014-03	2.72

10 YR US TREAS

2009-01	8.14
2009-02	8.08
2009-03	8.42
2009-04	8.39
2009-05	8.06
2009-06	7.5
2009-07	7.09
2009-08	6.58
2009-09	6.31
2009-10	6.29
2009-11	6.32
2009-12	6.37
2010-01	6.25
2010-02	6.34
2010-03	6.27
2010-04	6.25
2010-05	6.05
2010-06	6.23
2010-07	6.01
2010-08	5.66
2010-09	5.66
2010-10	5.72
2010-11	5.92
2010-12	6.1
2011-01	6.09
2011-02	6.15
2011-03	6.03
2011-04	6.02
2011-05	5.78
2011-06	5.75
2011-07	5.76
2011-08	5.36
2011-09	5.27
2011-10	5.37
2011-11	5.14
2011-12	5.25
2012-01	5.23
2012-02	5.14
2012-03	5.23
2012-04	5.19
2012-05	5.07
2012-06	5.02
2012-07	4.87
2012-08	4.91
2012-09	4.84
2012-10	4.58
2012-11	4.51
2012-12	4.63
2013-01	4.73
2013-02	4.85
2013-03	4.85
2013-04	4.59
2013-05	4.73
2013-06	5.19
2013-07	5.32
2013-08	5.42
2013-09	5.47
2013-10	5.31
2013-11	5.38
2013-12	5.38
2014-01	5.19
2014-02	5.1
2014-03	5.06

Baa Corp.

2009-01	5.05
2009-02	5.27
2009-03	5.5
2009-04	5.39
2009-05	5.54
2009-06	5.61
2009-07	5.41
2009-08	5.26
2009-09	5.13
2009-10	5.15
2009-11	5.19
2009-12	5.26
2010-01	5.26
2010-02	5.35
2010-03	5.27
2010-04	5.29
2010-05	4.96
2010-06	4.88
2010-07	4.72
2010-08	4.49
2010-09	4.53
2010-10	4.68
2010-11	4.87
2010-12	5.02
2011-01	5.04
2011-02	5.22
2011-03	5.13
2011-04	5.16
2011-05	4.96
2011-06	4.99
2011-07	4.93
2011-08	4.37
2011-09	4.09
2011-10	3.98
2011-11	3.87
2011-12	3.93
2012-01	3.85
2012-02	3.85
2012-03	3.99
2012-04	3.96
2012-05	3.8
2012-06	3.64
2012-07	3.4
2012-08	3.48
2012-09	3.49
2012-10	3.47
2012-11	3.5
2012-12	3.65
2013-01	3.8
2013-02	3.9
2013-03	3.93
2013-04	3.73
2013-05	3.89
2013-06	4.27
2013-07	4.34
2013-08	4.54
2013-09	4.64
2013-10	4.53
2013-11	4.63
2013-12	4.62
2014-01	4.49
2014-02	4.45
2014-03	4.38

Aaa Corp