Q2 update — April

2014 Equipment Leasing & Finance U.S. Economic Outlook

EQUIPMENT LEASING & FINANCE
FOUNDATION
Your Eye on the Future

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

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

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

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TABLE OF CONTENTS

About The Outlook **1**

Summary **2**

Equipment & Software Investment Outlook **3**

Foundation-Keybridge U.S. Equipment & Software Investment Momentum Monitor 3

Annual Growth Forecast 6

U.S. Capital Investment and Credit Markets 7

Overview of the U.S. Economy **9**

Overview & Latest Trends 9

Projections for Key Economic Indicators 11

Quarterly Data **12**

Monthly Data **13**

About Keybridge **14**

ABOUT THE OUTLOOK

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

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

This Q2 report is the first update to the 2014 Annual Outlook, and will be followed by two more quarterly updates before the publishing of the 2015 Annual Outlook in December. This research was guided by a steering committee of dedicated industry volunteers who gave their time and expertise by providing comments and suggestions throughout the development of the report.

ABOUT THE MOMENTUM MONITOR

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

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

SUMMARY

Despite the deceleration in Q4 2013, the U.S. economy still expanded 3.4% in the second half of 2013, relative to 1.8% in the first, suggesting that economic fundamentals are solidifying. In particular, consumer spending and exports were strong in Q4. Looking forward, a budget agreement and reduced policy uncertainty from Washington could help the economy to break out from its "start-stop" growth pattern.

A severely cold winter slowed a variety of economic indicators from home sales to nonfarm payroll growth, and may trim 1.0% off GDP growth in the first quarter. However, positive cyclical forces continue to shift towards the pro-growth direction. The sustainable housing market recovery, low natural gas prices, robust auto sales, record high household wealth, steadily improving credit availability, and employment gains all point to a year stronger growth and the possibility of "break out" growth close to 3.0%. However, downside risks from adverse weather in Q1 2014, high oil prices, soft patches in international growth, and political wild cards during an election year remain potential headwinds.

Overall, we expect the U.S. economy to grow 2.8% in 2014, the fastest pace since the 2008-09 recession.

Growth in equipment and software investment accelerated from a 2.2% annualized rate in Q3 2013 to 8.9% in Q4. Looking ahead, we expect modest sector growth for the coming year, with an overall forecast of 4.2% growth in 2014.

- Agriculture Machinery investment will likely see slow growth in the first half of 2014 as both farm yields and commodity prices ease.
- Construction Machinery investment will see stronger growth later in the year, but the year-over-year growth figures will appear weak due to a high base year effect.
- Materials Handling Equipment investment will experience slightly stronger growth over the next 3 to 6 months.
- All Other Industrial Equipment investment will likely see moderate growth over the next 3 to 6 months as the manufacturing sector's competitiveness improves.
- Medical Equipment investment will grow, but at a more moderate pace than the second half of 2013.
- Mining & Oilfield Machinery is currently decelerating, but looks to rebound later in the year.
- Aircraft investment will likely slow after a strong Q4, and growth will be about average for the year.
- Ships & Boats investment will likely continue at a below-average pace over the next year.
- Railroad Equipment investment will improve from its recent contraction towards modest growth.
- Investment in Trucks will exhibit high-single digit growth over the next 3 to 6 months as economic activity improves and diesel prices remain competitive.
- Computers investment will be muted in the next 3 to 6 months after strong replacement demand over the past few quarters.
- Software investment will be moderate in the next 3 to 6 months as companies focus on upgrading to new technology.

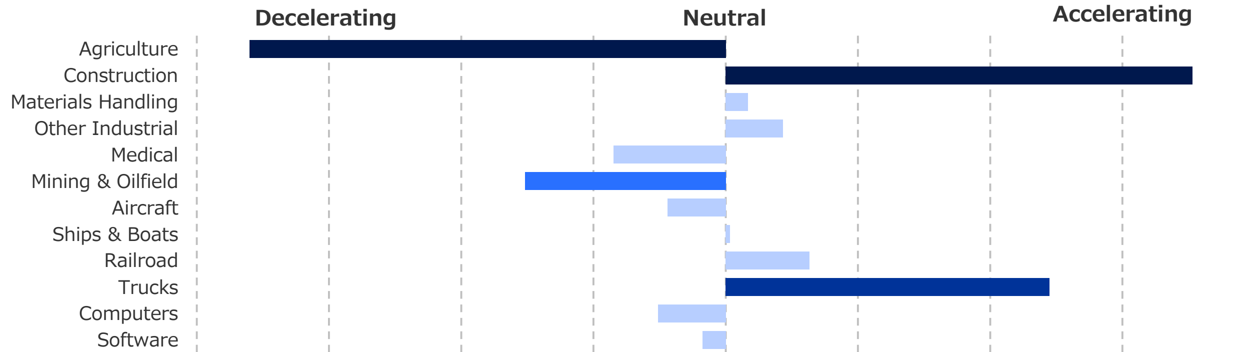
Credit market conditions remain highly accommodative, and the Federal Reserve will continue to implement a two-pronged policy agenda in 2014. First, the Fed will take "measured steps" in its tapering of monthly asset purchases, unless economic conditions materially change – which sets the program to end in late 2014. Secondly, the Fed has now reevaluated its guidance on short term interest rates and zero interest rate policy. With the unemployment rate near the 6.5% "threshold", the FOMC has now moved towards a more "qualitative guidance", focusing on a number of economic indicators in order to assess the proper path of zero interest rate policy. However, there is internal pressure from FOMC members who want to tighten monetary conditions, citing financial market imbalances. If economic data show an accelerating trend over the course of 2014, it is very possible that the Fed could be forced to advance its decision in maintaining its zero interest rate policy. Because interest rates will remain low by historical standards, rising rates may have only a marginal impact on the lease-versus-buy decision. However, the changing rate environment could impact the equipment leasing industry in other ways, for example, through net interest margin compression.

EQUIPMENT & SOFTWARE INVESTMENT OUTLOOK

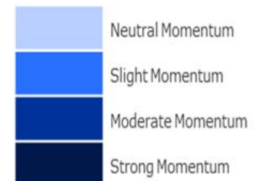
Foundation-Keybridge U.S. Equipment & Software Investment Momentum Monitor

Equipment and software investment grew at an annualized rate of 8.9% in Q4 2013, following modest growth of 2.2% in Q3. It is likely that both the added political certainty from Congress' budget deal in December and the pending expiration of the bonus Section 179 depreciation caused some investment to be "pulled forward" before the year-end. Overall, replacement demand, reduced political uncertainty, rising capacity, and a pickup in underlying economic fundamentals should all drive equipment and software spending in 2014. We expect equipment and software investment to grow 4.2% in 2014 as economic conditions solidify and business confidence continues to recover.

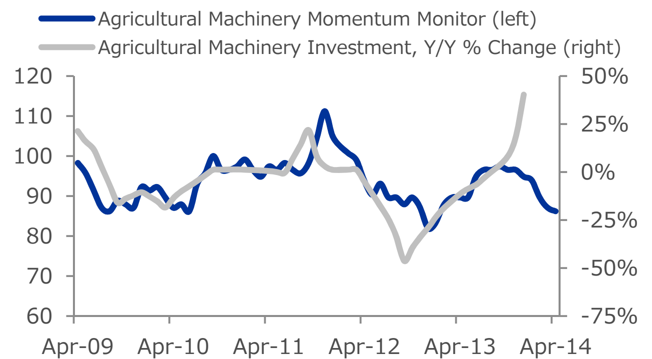
Equipment Vertical Heat Map: 3-Month Outlook



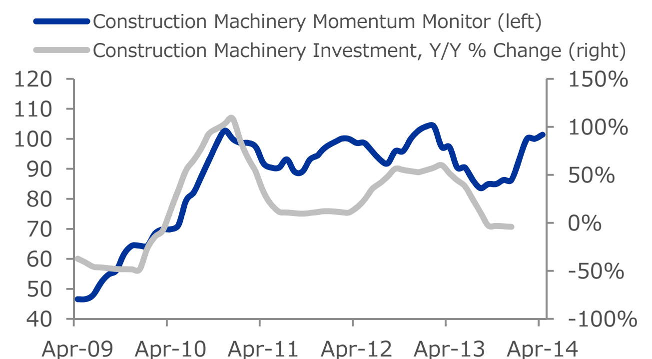
The Equipment Vertical Heat Map summarizes the latest movements in each of the 12 Equipment & Software Investment Momentum Indices. Verticals exhibiting strong recent momentum are shaded darker, while verticals exhibiting weak recent momentum are shaded lighter. The heat map provides a snapshot of the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



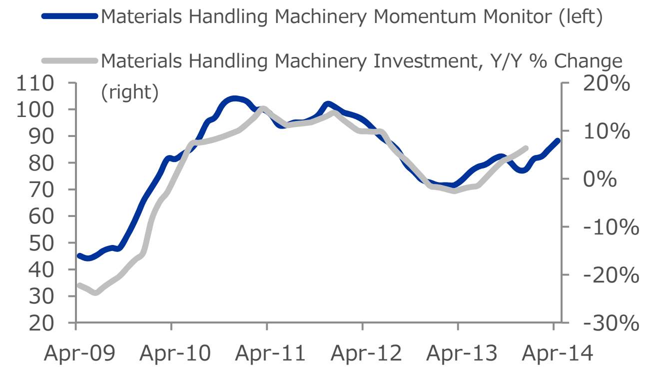
Agricultural Machinery: Investment in Agriculture Machinery increased at an unusually rapid annualized rate of 386.39% in Q4 2013, and due to a low base-year effect is now up 40.3% from Q4 2012. The Agriculture Momentum Index decreased from 87.1 (revised) in March to 86.2 in April, a fourteen-month low. Data remains weak including Agriculture equipment leases, Cattle and Broiler Exports, and Inventories of Farm Machinery equipment. Overall, we continue believe the jump in investment in Q4 will be short-lived, and that there will be slower investment growth in Q1-Q2 2014.



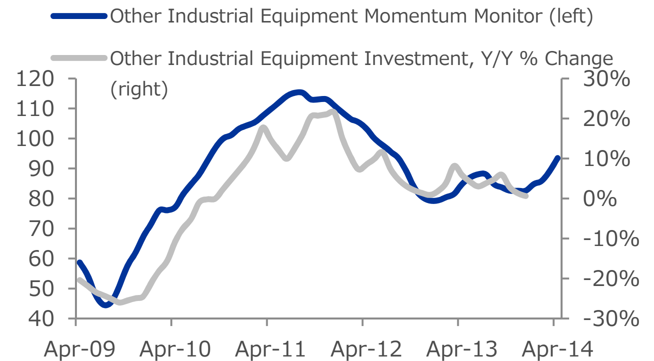
Construction Machinery: Investment in Construction Machinery declined 1.6% at an annualized rate in Q4 2013 and was down 4.2% year-over-year, a second consecutive year-over-year contraction. The Construction Momentum Index increased from 100.0 in March to 101.4 in April, a fourteen-month high. Multifamily housing starts increased at a strong pace in February, and construction employment continues to post monthly gains. Overall, the Index points to a continued contraction in Q1 2014, followed by a rebound in construction equipment investment later in the year.



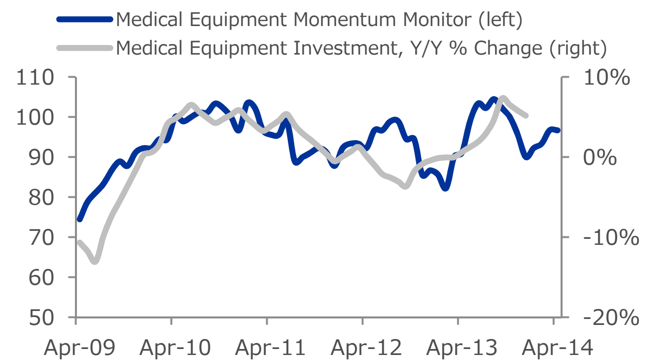
Materials Handling Machinery: Investment in Materials Handling Machinery declined at a 4.3% annualized rate in Q4 2013 yet was up 6.3% year-over-year. The Materials Handling Momentum Index increased from 85.3 (revised) in March to 88.2 in April. Among the key indicators, Imports of Materials Handling Equipment increased 14% on the month, while the S&P Industrials Index reached a new all-time high. Overall, the Index continues to increase at a steady pace, signaling stronger investment over the next three to six months.



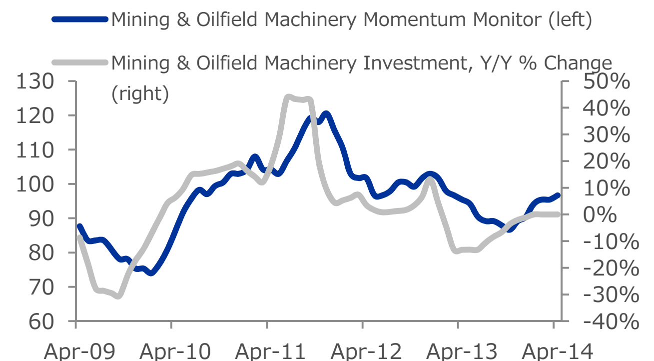
Other Industrial Equipment: Investment in all Other Industrial Equipment declined 7.5% at an annualized rate in Q4 2013 and was now up a modest 0.6% year-over-year. The Other Industrial Equipment Momentum Index jumped from 89.1 (revised) in March to 93.5 in April. Shipments of Industrial Machinery increased 4% over the past month, while the Effective Federal Funds Rate fell 1 basis point. Overall, the Index appears to be on the rebound after several months of sluggish movement, suggesting an uptick in growth by mid-2014.



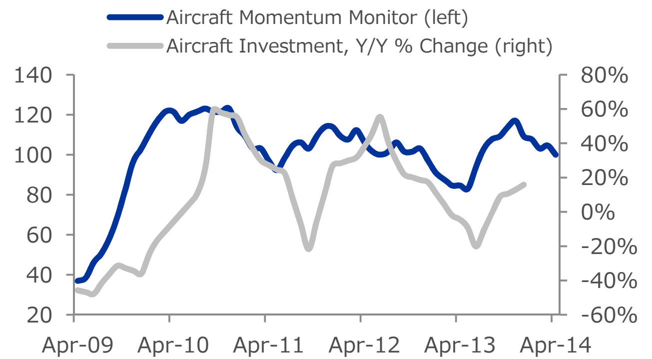
Medical Equipment: Investment in Medical Equipment increased 0.7% at an annualized rate in Q4 2013 and was up 5.2% year-over-year – the second fastest annual growth rate in ten quarters. The Medical Equipment Momentum Index held steady at 96.7 (revised) from March to April. Prices for Physicians Services declined over the past month and made a negative contribution to the Index. This negative contribution, however, was in part offset by strength in Medicaid Receipts. Overall, the Index is pointing towards moderate growth in medical equipment over the next three to six months.



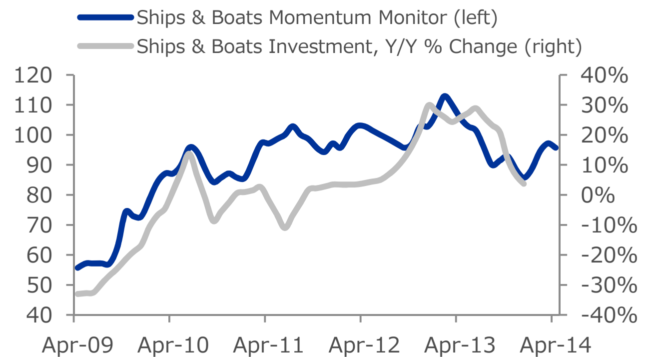
Mining & Oilfield Machinery: Investment in Mining & Oilfield Machinery declined 5.1% at an annualized rate in Q4 2013 and was down 1.1% year-over-year, the fastest growth rate in seven quarters. The Mining & Oilfield Machinery Momentum Index increased from 95.4 (revised) in March to 96.7 in April. Over the past month, New Orders for Mining, Oil Field & Gas Field Machinery increased 26.1%, while the ISM Manufacturing increased 2.1 points from the previous month and made a positive contribution to the Index. Additionally, Imports of Energy-Related Petroleum Products increased over the past month. Overall, the Index is indicating modest growth in investment later in the year.



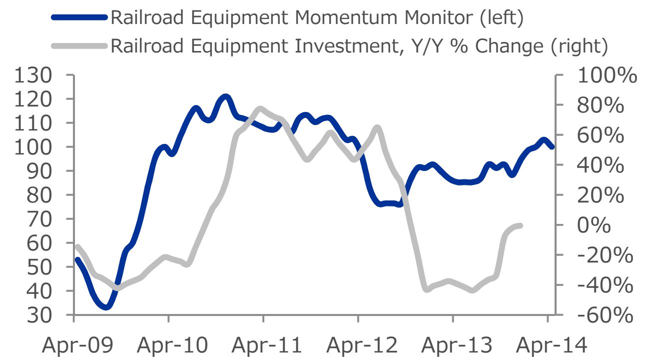
Aircraft: Investment in Aircraft increased 311.1% at an annualized rate in Q4 2013. On a year-over-year basis, investment in Aircraft was up 15.9%. The Aircraft Momentum Index declined from 104.6 (revised) in March to 100.0 in April. Among the key indicators, Shipments of Nondefense Aircraft and Parts declined on the month, while both the Transportation Services Index and Vehicle Miles Traveled made negative contributions to the Index. Overall, the Index's recent movement suggests that there will be a slight downturn in investment over the next three to six months.



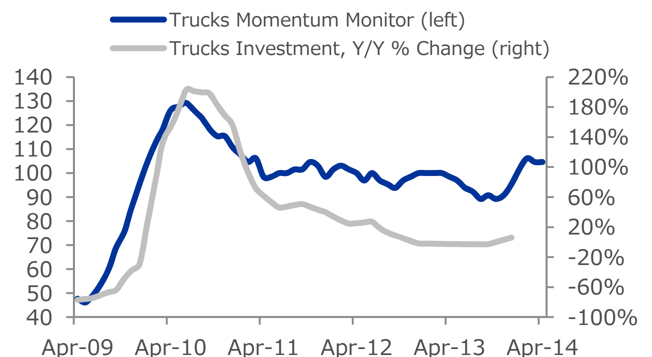
Ships & Boats: Investment in Ships & Boats increased 1.5% at an annualized rate in Q4 2013. Additionally, the investment level is now up 3.7% from one year earlier, a deceleration from double-digit growth in the past five quarters. The Ships & Boats Momentum Index decreased from 97.1 (revised) in March to 95.7 in April. Both Shipments and New Orders of Ships & Boats declined, while the ISM Employment Index was little changed. Overall, the Index declined this month, yet still indicates positive growth over the next three to six months.



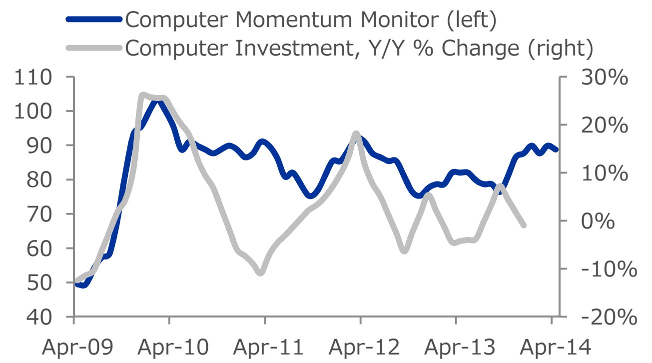
Railroad Equipment: Investment in Railroad Equipment declined 31.2% at an annualized rate in Q4 2013, and was essentially flat (down 0.5%) on a year-over-year basis. The Railroad Equipment Momentum Index eased slightly from 102.9 (revised) in March to 100.0 in April. Both Nonfarm Payroll Growth and the ISM Manufacturing Index contributed positively to the Index, while Coal Production and Machine Tool Orders were a drag on the Index. Overall, the Index is signaling a modest improvement in investment over the next three to six months.



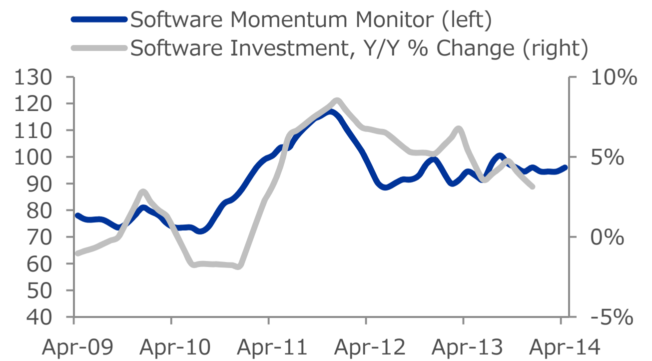
Trucks: Investment in Trucks increased 7.8% at an annualized rate in Q4 2013 and was up 6.0% year-over-year, after declining on an annual basis for four consecutive quarters. The Trucks Momentum Index held steady at 104.6 from March to April. Housing Starts increased 2.3% over the past month, while the ISM Manufacturing Index rebounded in February after falling sharply in January. Despite the pause in the upward momentum of the Index, trends in underlying data point to increased investment due to replacement demand over the next three to six months.



Computers: Investment in Computers increased jumped 31.6% at an annualized rate in Q4 2013, yet was still down 1.0% on a yearly basis. The Computers Momentum Index declined from 89.9 (revised) in March to 88.8 in April. Monthly increases in the Tech Pulse Index and the Morgan Stanley High-Tech 36 Index were offset by sharp declines in Retail Sales at Appliance, Television, and Camera Stores and Shipments of Communication Equipment. Overall, recent movement of the Index indicates muted investment in Computers over the next three to six months.



Software: Investment in Software increased 2.8% at an annualized rate in Q4 2013 and was up 3.1% year-over-year. This marks a slight deceleration from faster annual growth in the previous quarter. The Software Momentum Index increased from 94.5 in March to 96.0 in April. Positive contributions from the ISM Nonmanufacturing Employment Index and Producer Prices for Information Software Publishers made positive contributions to the Index. Overall, the Index is pointing towards no change in momentum over the next three to six months.



Equipment & Software Investment Growth Forecast

Year/Year % Growth Rates

Sector	10-Year Average	Last Quarter	Next 12 Months
Agricultural Machinery	0.6%	40.3%	5.0%
Construction Machinery	14.1%	-4.2%	-4.0%
Materials Handling Equipment	1.8%	6.3%	3.0%
Other Industrial Equipment	1.6%	0.6%	1.0%
Medical Equipment	4.7%	5.2%	4.5%
Mining & Oilfield Equipment	13.9%	-1.1%	4.0%
Aircraft	5.7%	15.9%	6.0%
Ships & Boats	5.3%	3.7%	2.0%
Railroad Equipment	8.7%	-0.5%	2.0%
Trucks	18.7%	6.0%	7.0%
Computers	8.2%	-1.0%	3.0%
Software	4.8%	3.1%	3.0%

Source: Macrobond Financial, Keybridge (forecasts)

U.S. CAPITAL INVESTMENT AND CREDIT MARKETS

Review of Recent Trends

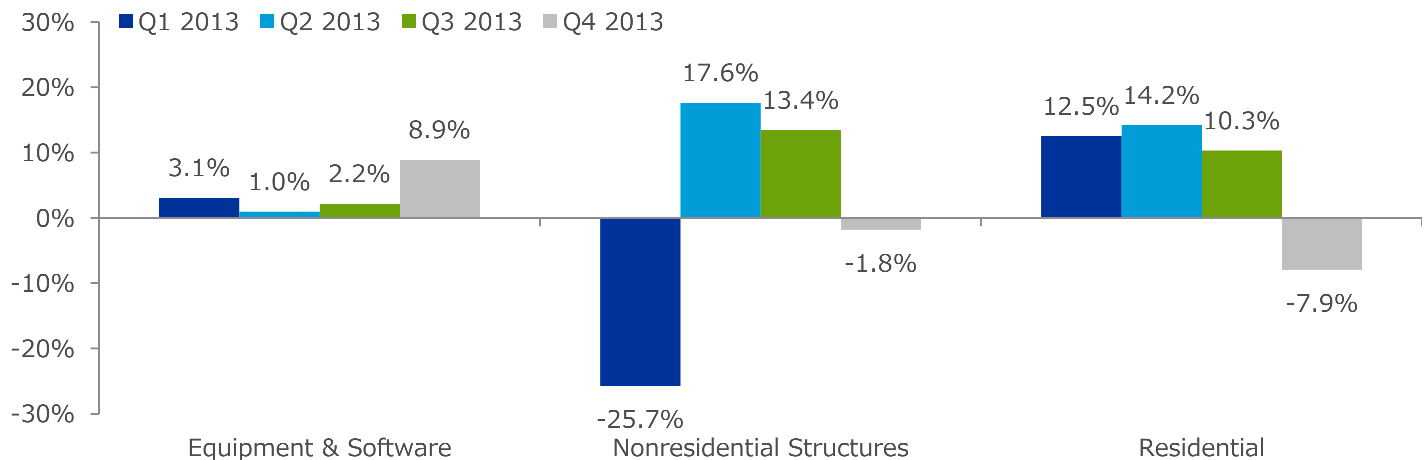
Equipment and Software Investment grew at an 8.9% annualized rate in Q4, a substantial pick up from 2.2% growth in Q3 2013. Residential investment contracted at a 7.9% annualized rate, a sign that the cold weather prevented residential home building over the winter months. Investment in Nonresidential Structures was also weak, contracting at a 1.8% annualized rate.

Within the major equipment and software verticals, investment in Agriculture machinery expanded at the fastest pace, growing 386.4% at an annualized rate. This growth, however, is largely due to end-of-year tax considerations and changing farm conditions and is primed for a correction in the coming quarters. The vertical with the fastest deceleration was Railroad Equipment, which decreased at an annualized rate of 31.2%. Other key movements included a 311.1% ramp up in Aircraft and a 31.6% increase in Computers.

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

Investment Growth Rates

Quarter-Quarter, Seasonally Adjusted Annualized Growth Rate



Source: Macrobond Financial

February's Equipment Leasing & Finance Association's Monthly Leasing and Financing Index (MLFI-25) reported new business volume of $5.0 billion – down 10% from January's reading but 14.9% year-over-year. Particularly noteworthy, however, was December's reading of $10.7 billion – a twelve month high. Year-end volumes are traditionally high, yet this reading was likely lifted by the positive confidence among businesses from Congress passing budgets for fiscal years 2014 and 2015 in mid-December. Along with the resolution of raising the debt ceiling through March 2015, reduced political risk should help support new business volume in 2014, which cumulatively for the first two months of 2014 are up 7.5% year-over-year. Losses as a percentage of net receivables ticked up to 0.4%, while the credit approval ratio dropped to 75.3% - the lowest reading since January 2011. The Equipment Leasing & Finance Foundation's Monthly Confidence Index for the Equipment Finance Industry (MCI-EFI) increased in March to 65.1 from 63.3 in February. The index is at its highest level in two years, indicating elevated confidence among survey respondents.

In its mid-March meeting, the FOMC announced that it would continue tapering its "quantitative easing" program, electing to trim monthly asset purchases by another $10 billion. The FOMC has stated clearly that tapering is not on a pre-determined

course and could change given changes in economic conditions. More hawkish members of the FOMC, however, are continuing to call for acceleration in tapering, as they no longer believe that the economic benefits outweigh the potential costs. They believe that financial market imbalances – such as large issuances of "covenant-lite" and junk bonds – are signs of excessive risk-taking in financial markets. After a few tumultuous months in financial markets due to emerging market instability and "Taper Talk", markets have since calmed. The 10-year Treasury has come back down comfortably below 3%.

Our credit outlook continues to hinge on three primary factors that will continue to result in upward pressure on long-term interest rates:

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

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

(3) The Fed will remain accommodative in its unconventional monetary policy – short-term interest rates will remain near zero in 2014, and QE tapering will be carried out in a well-telegraphed and methodical manner. The expected rise in long-term interest rates will likely not be rapid enough to negatively affect business investment decisions in a material way. In fact, tapering may be a signal of stronger growth expectations and induce business to invest more. While the market anticipates a hike in short-term rates in mid-2015, we believe it could happen sooner.

Data suggests that the propensity to finance equipment may have declined slightly in 2013. In part, rental companies gained market share as they benefited from heightened uncertainty. Businesses now have more clarity about capital investment and financing decisions, as policy uncertainty has abated. On net, we believe that more dependable economic growth will spur investment spending that will result in financing activity. Additionally, slowly rising interest rates will likely induce companies to lock in lower rates while still available, making the first half of 2014 a promising environment for the equipment finance industry.

Summary of Credit Conditions

Factor	Conditions Compared With Last Quarter
Supply	Moderate Improvement
Demand	Strong Improvement
Financial Stress	Slight Decline

- **Credit Supply & Pricing:** Credit supply continues to ease in the corporate sector. The Q1 Federal Reserve survey of banks' senior lending officers showed a loosening of standards on large and medium commercial & industry ("C&I") loans from the previous quarter. The benchmark 10-year Treasury rate has hovered around 2.75% as of late; and, due to the Fed's loose monetary policy and the continued international demand for U.S. treasuries, capital is likely to remain inexpensive for the foreseeable future.

- **Credit Demand:** On the demand side, there are improving trends in the credit market – including for small businesses that have, until recently, been skittish to make capital investments. The latest Fed survey showed an uptick in demand for C&I loans for all sizes of businesses, and C&I loans are now about 1.0% above their pre-crisis high. Specifically for small businesses, the Thomson Reuters/PayNet Small Business Lending Index was up 4.0% in January, and a recent survey from BMO Harris Bank found that 42 percent of business owners/executives said they would upgrade or purchase new equipment in 2014. It is evident that more clarity on fiscal policy and stronger economic growth are helping boost credit demand.

- **Financial Stress:** Improving economic conditions, cleaner balance sheets, and continuous U.S. and internationally accommodative monetary policy have helped financial stress indicators remain subdued. For households, the financial obligation ratio ticked up in Q4 2013, yet remains at historically low. For businesses, the lease delinquency rate ticked up 3 basis points to 0.9%. As more marginal credits enter back into the market after being priced out, it is likely that there could be an upward drift of delinquencies in 2014. Nonfinancial sector debt as a percentage of GDP continues to increase steadily and is a sign that after the lengthy deleveraging cycle, businesses are more comfortable taking on debt given stronger economic fundamentals. Corporate bond yields are continuing to decline so far in 2014, and the spread between corporate grade and treasuries has remained relatively narrow.

Overview of the U.S. Economy

Despite the deceleration in Q4 2013, the U.S. economy still expanded 3.4% in the second half of 2013, relative to 1.8% in the first, suggesting that economic fundamentals are solidifying. In particular, consumer spending and exports were strong in Q4. Looking forward, a budget agreement and reduced policy uncertainty from Washington could help the economy to break out from its "start-stop" growth pattern.

A severely cold winter slowed a variety of economic indicators from home sales to nonfarm payroll growth, and may trim 1.0% off GDP growth in the first quarter. However, positive cyclical forces continue to shift towards the pro-growth direction. The sustainable housing market recovery, low natural gas prices, robust auto sales, record high household wealth, steadily improving credit availability, and employment gains all point to a year stronger growth and the possibility of "break out" growth close to 3.0%. However, downside risks from adverse weather in Q1 2014, high oil prices, soft patches in international growth, and political wild cards during an election year remain potential headwinds.

The March average of the Economist Poll of Forecasters for 2014 GDP growth declined slightly to 2.8% from 2.9% in February, while the Federal Reserve's most recent "central tendency" forecast for growth is in the range of 2.8% to 3.0% – a slight decrease from the Fed's December 2013 forecast. This forecast implicitly assumes that 2014 will not see the same fiscal consolidation that detracted from growth in 2013.

Overall, Keybridge's macro outlook is in-line with consensus forecasts – we expect growth of 2.8% in 2014.

Indicator	Recent Activity
Consumption	Consumer spending grew at its fastest pace in twelve quarters.
Equipment & Software Investment	Equipment & Software Investment increased at an 8.9% annualized rate in Q4. This marks the fastest rate of growth in eight quarters.
Residential Investment	Residential Investment declined in Q4, a sign that the weather interrupted the housing market's recovery.
Government Expenditures	As expected, Government Expenditures declined 5.2% in Q4, making the effects of the October government shutdown clear. State and local spending was flat.
Net Exports	Q4 Exports grew at their fastest pace in three years.

Headline CPI inflation will likely remain subdued – slightly below 2% – in 2014. Given the geo-political environment, oil price shocks are a concern as conditions in the Ukraine and Crimean peninsula have been unstable. If oil price increases flow through to gasoline prices, it could take a substantial bite out of household income and consumption in the first half of 2014. However, rising domestic energy production will otherwise continue to temper prices and help tame inflationary pressures. Additionally, limited real wage growth, and flat food prices are likely to continue for much of 2014. On the upside, housing prices will begin to work into inflation, adding between 0.1 to 0.3 percentage points to headline inflation.

The central themes affecting our outlook in the near-term are the effects of the cold weather and business inventory accumulation, while for the rest of 2014, the absence of fiscal consolidation and the course of monetary policies will be the dominant themes.

There is a general consensus among economists that the cold weather slowed economic activity in Q4 2013 and into Q1 2014. Cold weather causes consumers to delay large-ticket purchases, housing starts to be postponed, and hiring to slow as well. Of the 52 "high impact" snow storms in the Northeast over the past 50 years, five have occurred this past winter – an indication of the severity of this past winter. Monthly data in retail sales and industrial production, however, is already indicating that a Spring "thaw" will boost economic activity. Economists estimate that the bad weather will likely cut a full percentage point out of GDP growth in Q1. However, Q2 will likely see a rebound of about the same magnitude.

Also in the near-term, there will likely be subtraction from GDP growth from businesses inventories drawing down. Inventory accumulation has made positive contributions to GDP growth in each of the past four quarters, making a drawdown and a net negative to top-line GDP growth likely – especially as the cold weather over the past few quarters put a pause on much private sector demand.

One central theme through the rest of 2014 is the increased certainty about fiscal policy. Congress' budget deal in mid-December, and the subsequent Fiscal Year 2014 budget approved in mid-January, undoes much of the so-called budget sequester and imposes no new taxes for 2014. The Treasury Department predicts that total FY2014 outlays will be 9% greater than FY2013 outlays. Additionally, Congress voted in February to lift the debt ceiling until March 2015. These agreements will prevent a significant amount of political risk and have the potential to buoy consumer and business confidence in 2014. After a fiscal drag on GDP growth of about 1.75 percentage points in 2013 due to the "Fiscal Cliff" resolution, government spending will likely have a neutral effect on GDP in 2014.

The course of monetary policy is the other central theme of 2014. After its first meeting with Janet Yellen as Chair, as expected, the FOMC announced a further $10 billion reduction in the monthly rate of large-scale asset purchases, or "quantitative easing". Unless there is a material shift in economic conditions, we expect the Fed to remain apace with its tapering and for the program to end in late 2014.

Two aspects of monetary policy have changed in material ways since the latest outlook and are key factors to watch in 2014. First, the FOMC has evolved its language of forward guidance on short-term rates. With the unemployment rate bordering 6.5%, it raises the question of how long the Fed will maintain its zero interest rate policy. Through repeated statements, the Fed has suggested that short-term rates will remain pat until late 2015; however, in its latest monetary policy statement, the FOMC has moved towards employing more "qualitative" measures to assess the proper path for monetary policy. This is likely to include close observation of a combination of economic data, including monthly payroll growth, the long-term unemployment rate, developments with industrial production, and real monthly incomes.

Secondly, the schism between the "Doves" and the "New Hawks" will continue to be a story in 2014 and is part of pressure building up at the Fed. Although inflation remains under target, more "hawkish" FOMC members continue to cite financial market imbalances as a reason for tightening conditions sooner. If economic data show an accelerating trend over the course of 2014, it is very possible that the Fed could be forced to advance its decision in maintaining its zero interest rate policy. Overall, we expect a moderate steepening of the yield curve to continue in 2014, as short-term rates remain low and long-term rates rise in tandem with tapering and improved economic growth.

Additional Factors to Watch

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

Healed Financial Sector: The wealth effect from rising home prices and equity values has left households feeling more comfortable about borrowing. Household debt increased by $241 billion in Q4 2013, the largest increase in more than six years. Of this $241 billion, nearly two-thirds was mortgage debt. This data signals that after multiple years of deleveraging and tight credit conditions, households are now borrowing again – particularly for new homes.

Energy Renaissance: Recent data from the Energy Information Administration revealed that total U.S. crude oil production averaged 7.5 million bbl/d in 2013. This led to an overall increase of 15% in total production relative to 2012, the largest annual percentage change since 1940.

Exports: Real Exports of Goods & Services grew 9.5% at an annualized rate in Q4, the fastest rate of growth in four years. And the increased domestic production of oil is having a notable impact on overall U.S. imports, helping to push the current account deficit to the smallest percentage of GDP since 1998.

Mixed Global Growth: Although Europe's GDP has posted positive gains in the past three quarters, downside risks to the recovery remain. Business investment is muted, and long-term unemployment is still perilously high. The IMF has recently prescribed that the ECB should commit to boosting inflation in order to give an upward nudge to aggregate demand. Elsewhere, recent data out of China showed that industrial production, fixed asset investment, and retail sales all slowed, all but confirming a slowdown in the world's second-largest economy.

Projections for Key Economic Indicators

Indicator	2012	2013	2014e	2014 Quarterly Estimates			
				Q1e	Q2e	Q3e	Q4e
Real GDP (SAAR %)	2.8%	1.9%	2.8%	1.9%	3.3%	3.0%	3.0%
Real Investment in Equipment & Software (SAAR %)	7.2%	3.5%	4.2%	2.3%	4.5%	4.0%	4.5%
Inflation (annualized rate)	2.1%	1.5%	1.6%	1.3%	1.5%	1.7%	1.9%
Federal funds (effective, end of period)	0.15%	0.15%	0.15%	0.15%	0.15%	0.15%	0.15%
10-year Treasury Rate (end of period)	1.80%	2.90%	3.3%	2.8%	3.0%	3.2%	3.3%
Total Payrolls (in thousands)	+2,236	+2,331	+2,704	+504	+700	+750	+750

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

QUARTERLY DATA

Indicator	2011	2012				2013			
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Real Gross Domestic Product (SAAR %)									
GDP	4.9%	3.7%	1.2%	2.8%	0.1%	1.1%	2.5%	4.1%	2.6%
Consumer Spending	2.4%	2.9%	1.9%	1.7%	1.7%	2.3%	1.8%	2.0%	3.3%
Gross Private Fixed Investment	31.9%	10.5%	-1.6%	6.5%	-2.4%	4.7%	9.2%	17.2%	2.5%
Inv: Equipment & Software	10.1%	6.7%	5.5%	-2.1%	9.0%	3.1%	1.0%	2.2%	8.9%
Inv: Agricultural Machinery	-52.5%	-5.9%	-52.4%	-60.8%	45.2%	93.2%	-30.9%	-40.4%	386.4%
Inv: Construction Machinery	17.9%	9.5%	85.6%	149.3%	7.6%	31.8%	2.8%	-38.7%	1.6%
Inv: Materials Handling Equipment	15.7%	4.7%	2.4%	-6.4%	-6.2%	0.2%	7.4%	14.0%	4.3%
Inv: All Other Industrial Equipment	23.8%	-23.8%	14.9%	4.2%	13.6%	0.6%	-5.4%	16.4%	-7.5%
Inv: Medical Equipment	-4.4%	8.9%	-8.5%	-9.6%	9.1%	10.7%	-1.4%	11.2%	0.7%
Inv: Mining & Oilfield Machinery	-50.7%	58.1%	25.9%	9.3%	-24.4%	-45.6%	26.6%	46.3%	-5.1%
Inv: Aircraft	272.5%	1.3%	78.5%	-67.3%	218.7%	-50.6%	-21.1%	12.5%	311.1%
Inv: Ships & Boats	4.8%	18.8%	-23.5%	66.2%	87.5%	0.1%	-11.6%	28.8%	1.5%
Inv: Railroad Equipment	227.7%	10.5%	13.9%	-38.0%	-86.0%	54.8%	-25.4%	23.2%	-31.2%
Inv: Trucks	15.4%	4.1%	22.0%	-4.7%	-23.4%	2.2%	19.5%	-4.2%	7.8%
Inv: Computers	12.6%	24.4%	-17.5%	-33.6%	80.7%	-15.9%	-15.0%	2.3%	31.3%
Inv: Software	9.7%	1.6%	6.3%	3.7%	9.4%	7.7%	-5.9%	8.6%	2.8%
Credit Conditions									
Nonfinancial Sector Debt (% of SAAR GDP)	75.7%	75.4%	75.8%	76.1%	77.6%	78.0%	78.9%	79.2%	79.8%
Loan Delinquency Rate	1.6%	1.5%	1.4%	1.2%	1.2%	1.1%	1.0%	1.0%	0.9%
Lease Delinquency Rate	0.9%	0.9%	0.8%	0.8%	0.8%	0.8%	0.9%	0.9%	0.9%
Net Tightening of C&I Loan Standards	-5.9%	5.4%	-6.9%	-9.5%	-7.6%	-7.4%	-19.1%	-18.1%	-8.3%

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

MONTHLY DATA

Indicator	2013 Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	2014 Jan	Feb
Employment													
Change in Total Payrolls (thousands)	280	141	203	199	201	149	202	164	237	274	84	129	175
Change in Private Payrolls (thousands)	263	164	188	222	201	170	180	153	247	272	86	145	162
Unemployment Rate	7.7%	7.5%	7.5%	7.5%	7.5%	7.3%	7.2%	7.2%	7.2%	7.0%	6.7%	6.6%	6.7%
Business Activity													
Industrial Production	98.8	99.1	98.8	99.0	99.2	99.0	99.6	100.2	100.4	101.2	101.2	101.0	101.6
Capacity Utilization	78.1%	78.2%	77.9%	77.9%	77.9%	77.7%	78.0%	78.4%	78.4%	78.9%	78.8%	78.5%	78.8%
PMI Composite Index	53.1	51.5	50.0	50.0	52.5	54.9	56.3	56.0	56.6	57.0	56.5	51.3	53.2
NFIB Small Business Optimism Index	90.8	89.5	92.1	94.4	93.5	94.1	94.1	93.9	91.6	92.5	93.9	94.1	91.4
Consumer Activity													
Consumer Confidence	68.0	61.9	69.0	74.3	82.1	81.0	81.8	80.2	72.4	72.0	77.5	79.4	78.3
Personal Consumption (M/M % Chg)	0.3%	0.3%	0.0%	0.1%	0.2%	0.1%	0.2%	0.2%	0.2%	0.4%	-0.1%	0.1%	0.2%
Retail Sales (M/M % Chg)	0.9%	-0.8%	0.1%	0.6%	0.8%	0.4%	0.2%	0.0%	0.4%	0.2%	-0.2%	-0.6%	0.3%
Lending Activity													
C&I Loans (M/M % Chg)	0.5%	0.8%	0.6%	0.2%	0.9%	0.9%	0.0%	0.3%	0.8%	0.1%	1.1%	0.7%	2.4%
MLFI-25 New Business Volume (Bil. $)	4.7	6.8	7.5	7.5	8.6	7.2	6.4	7.7	7.6	6.6	10.7	6.0	5.4
MLFI-25 Avg Losses as a % of Net Rec.	0.40	0.30	0.30	0.30	0.30	0.30	0.40	0.40	0.40	0.30	0.30	0.30	0.40
MLFI-25 Credit Approval Ratio	77.4	78.4	77.2	78.8	78.5	78.6	79.1	77.3	77.6	76.5	78.3	76.9	75.3
Interest Rates (% end of period)													
Fed Funds Target Rate (Lower Bound)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
1-Year Treasury Rate	0.16	0.15	0.12	0.12	0.14	0.12	0.13	0.12	0.12	0.12	0.13	0.12	0.12
3-Year Treasury Rate	0.40	0.39	0.34	0.40	0.58	0.64	0.70	0.78	0.63	0.58	0.69	0.78	0.69
10-Year Treasury Rate	1.98	1.96	1.76	1.93	2.30	2.58	2.74	2.81	2.62	2.72	2.90	2.86	2.71
30-Year Treasury Rate	3.17	3.16	2.93	3.11	3.40	3.61	3.76	3.79	3.68	3.80	3.89	3.77	3.66
AAA Corporate Bond Yield	3.90	3.93	3.73	3.89	4.27	4.34	4.54	4.64	4.53	4.63	4.62	4.49	4.45
BAA Corporate Bond Yield	4.85	4.85	4.59	4.73	5.19	5.32	5.42	5.47	5.31	5.38	5.38	5.19	5.10
Prices													
Headline Inflation (Y/Y % Chg)	2.0%	1.5%	1.1%	1.4%	1.8%	2.0%	1.5%	1.1%	0.9%	1.2%	1.5%	1.6%	1.1%
Core Inflation (Y/Y % Chg)	2.0%	1.9%	1.7%	1.7%	1.6%	1.7%	1.8%	1.7%	1.7%	1.7%	1.7%	1.6%	1.6%
Oil Price (West Texas Int., $/barrel)	92.03	97.24	93.22	91.93	96.36	105.10	107.98	102.36	96.29	92.55	98.17	97.55	102.88

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