Title: Advocacy Investing® Portfolio Strategies, Issue 54
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Date: January 17, 2014

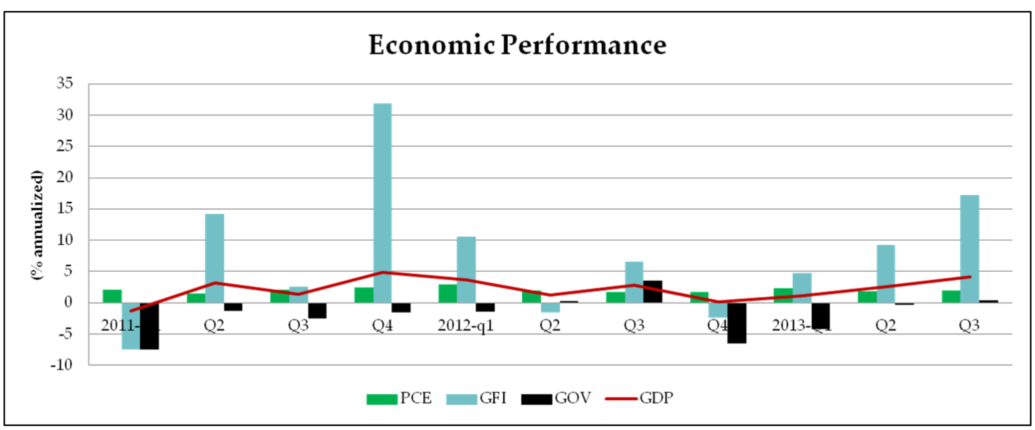
Advocacy Investing®

A STRONG END AND A STRONG (BUT VERY COLD) START

- **Data releases indicate a strong finish for 2013—3Q13 GDP revised upward to 4.1%**
- **An unexpectedly weak December payrolls and very cold weather in early January could result in some volatility in early 2014**
- **Despite the poor jobs report, the economy enters 2014 on a positive note—stronger global growth and less fiscal headwinds**
- **The final FOMC meeting of 2013 decides to begin the taper**
- **The global markets exceptional surge in 2013 may be difficult to duplicate in 2014**

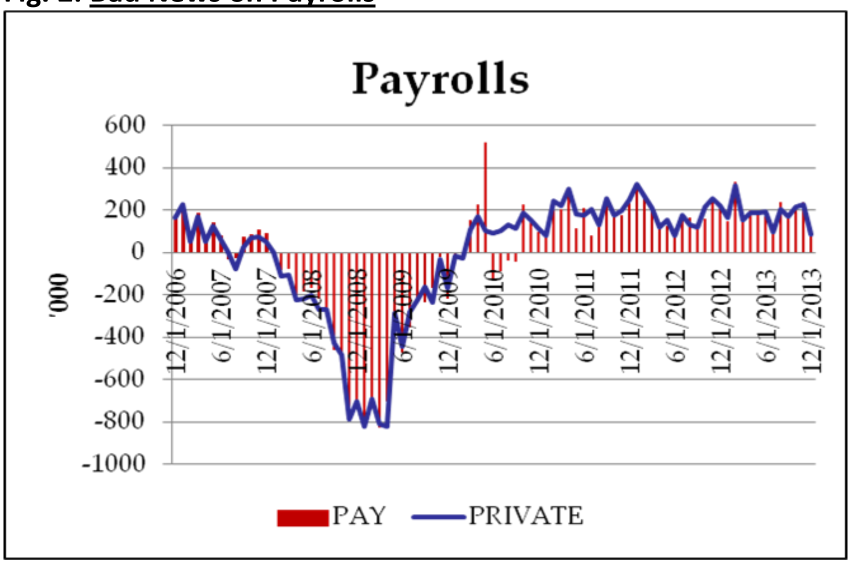
The US economy ended the year on a strong note: The year-end economic momentum is expected to carry into 2014. Economic output growth for 3Q13 was revised upward to 4.1% (annualized) from the earlier estimate of 3.6%—and 2.5% growth in 2Q13—mainly on the strength of a more buoyant final demand. With the exception of the federal government, which remains a drag on growth, all sectors—personal consumption expenditures, residential and non-residential fixed investment, net exports, inventories and local governments—contributed to growth. In particular, personal consumption expenditures and non-residential fixed investment performed better than earlier estimated.

Fig. 1: <u>An Economic Acceleration</u>



A Resurgent Economy: The data releases in December, as well as surveys of business and consumers, all point to a resurgent economy. On the industrial side, industrial production and manufacturing jumped by respectively 1.1% (m/m) and 0.6% in November. Durable goods increased by 3.5% m/m and factory orders rose by 1.8%. December surveys also pointed up—the Empire State index returned to positive territory (0.98 from -2.21 the previous month) and the Philadelphia index edged up from 6.5 to 7.0. The ISM-Manufacturing stabilized at 57 and the Chicago PMI (which has broader coverage) declined from spending the two months over 60 to 59.1. On the other hand, the ISM-Non-manufacturing fell slightly to 53 from 53.9 in November. The trade deficit fell sharply in November, as imports rose and oil imports shrank. Consumer confidence also rebounded, with both the University of Michigan –Reuters (at 82.5) and Conference Board indices (at 78) registering strong increases. While disposable income rose by 0.2% (m/m) in November, both retail sales (+0.7%) and personal consumption expenditures (+0.5%) rebounded.

Fig. 2: <u>Bad News on Payrolls</u>



A Nasty Surprise: High frequency data, as well as other labor market surveys, had pointed to further improvement in the labor market. First-time unemployment claims dropped in the last week of 2013 to 330,000, the lowest level in a month. Nevertheless, the December payrolls report came in with disappointing numbers, with total jobs added of only 74,000, significantly less than the market expectation of 200,000, and far lower than the average for the previous four months. The private sector added 87,000 positions. The only positive note was the upward revision by an aggregate of 80,000 for the September-November numbers. The low payrolls number for December brought the three-month average down to 175,000 for 3Q13 from 200,000 in the September-November period. Overall, the economy created about 2.2 million jobs in 2013, about the same level as each of 2011 and

2012. The goods-producing sector dropped by 3,000, private services increased by 90,000 and government employment fell by 13,000. Equally disappointing were the data on earnings. Hourly earnings rose by 0.1%, while weekly hours worked declined by 0.1, to 34.4 hours. The unemployment rate (which is based on a separate household survey) dropped from 7.0% to 6.7% as a result of a sharp drop in the labor participation rate. All in all, this was a disappointing and unexpectedly low outcome, given all the positive signs seen in other economic indicators. Nevertheless, it would be expected that the numbers in coming months will improve. The December number is likely to be an outlier. For one thing, we have seen upward revisions of each of the three previous months' numbers since September, which generally is a sign of strengthening labor markets.

Global economy on the mend: The global economy also enters 2014 on a more buoyant note. Renewed optimism about growth has led the IMF to announce that it would revise upward its projections for 2013 and 2014 after having cut them back last October. Germany, the eurozone's largest economy, is experiencing declining unemployment and faster industrial growth. The eurozone recovery has broadened, with most member countries either out of recession or about to return to growth. Overall, the eurozone growth is expected to accelerate from 1% in 2013 to a projected trend of 1.3-1.5% this year. The UK economy is expected to continue its strong performance, accelerating to 2.5-3.0% in 2014 from about 2.0% in 2013. Markets are rewarding the improved fiscal and economic performance of the eurozone periphery with sharply lower sovereign borrowing costs. Ireland completed a successful sovereign bond issue after three years of painful adjustment, Spain in back in the capital markets, and Portugal is preparing its return. Even Greece, whose bonds offered a 27% return in 2013, is considering a return to capital markets in 1H14. Nevertheless, the markets might be ahead of the macroeconomic indicators, and the eurozone recovery is still on very weak grounds. Draghi, the president of the European Central Bank (ECB) expressed concerns about the slow pace of recovery, as well as the threat of deflation in the eurozone, and reiterated that the ECB stood ready to expand its monetary stimulus. China on the other hand continues to experience a modest easing as the government tries to rein in and reform the financial system, with growth expected to slow to 7.0-7.5% this year from 7.6% in 2013.

Housing Markets: Since mid-2013, the housing market recovery has marked a pause, but falling mortgage rates, the improvement in the households' balance sheets (net worth up by $6 trillion in the first three quarters of 2013) and improved labor markets have fuelled a rebound. Housing starts exceeded 1 million, (annualized) in November, while existing and new home sales remained steady. Construction spending rose by 1.0% m/m. Housing prices also continued their upward trajectory, with the Case-Shiller index gaining 1.0% m/m in October—13.3% year-on-year.

Soft Oil Prices: Oil prices (West Texas Intermediate, WTI) declined in 4Q13 to an average of $97.50/barrel (bbl) from an average of $105.8/bbl in 3Q13. They dropped further since the end of the year, losing 5.4% in the first 6 days of the year to their lowest level in 8 months. The latest agreement reached with Iran on implementing the November deal pushed oil prices further down.

Table 1: **Fed Economic Projections-Dec 2013**

Fed Projections	2013	2014	2015
GDP (% p.a)	2.2-2.3	2.8-3.2	3.0-3.4
Unemployment (%)	7.0-7.1	6.3-6.6	5.8-6.1

Behold the Taper! The Federal Open Market Committee (FOMC) ended the suspense at its Dec 17-18 meeting and voted to begin tapering the Fed's bond purchases by January (from $85 to $75 billion a month), with the objective of ending the program by the end of 2014. The FOMC statement, while remaining very cautious, was clearly more optimistic, citing "more balanced risks". The Fed upped its output growth forecasts for each of 2013 and 2014 by 0.2% relative to its earlier (September) projections, and improved its unemployment rate forecasts by 0.1% in each year. This means that the Fed expects the unemployment rate to fall to its target rate of 6.5% sometime in the third quarter, which could then signal to the market a return to a tighter monetary policy and possible an acceleration of the taper pace. However, the Fed has pledged to keep the benchmark Fed funds rate low for a considerable period of time as insurance against another economic dip. Bond yields rose in response, with the 10-year breaking the 3.0% level for the first time since July 2009. Furthermore, the yield curve steepened, with the 2-10 year spread increasing by 30 basis points since the end of September, to 2.62%.

The Senate finally approved Janet Yellen as the new chair of the Federal Reserve System, albeit by a smaller-than usual margin (56-26). The new Fed leader will take office on February 1st, and will inherit a $4.1 trillion balance sheet. Yellen's first task will be to begin an orderly retreat from quantitative easing without spooking the markets. Easing unemployment should allow the Fed to accelerate the taper pace—currently set at a $10 billion reduction after each of the remaining seven FOMC meetings—and stabilize its balance sheet by 3Q14. On the other hand, unexpected shocks (such as the low December payrolls report) could derail the process and force the Fed to delay, or even reverse the process. Furthermore, if the U.S. returns to a more dynamic growth path, pressure to increase short-term interest rates will increase. (According to the Taylor rule, interest rates should be at 1.0-1.5% today, rising to 1.5-2.0% by 3Q14, and 4.0% once we reach full employment.)

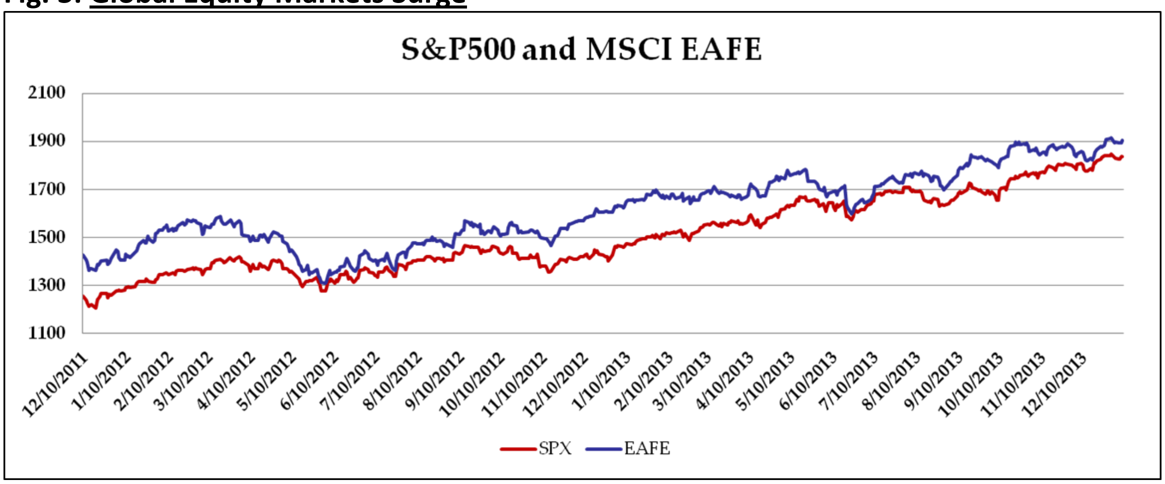
Economic Momentum: The economic prospects for 2014 have improved, but uncertainties remain. The US economy is starting the year with strong momentum from 4Q13, a fading fiscal drag, a housing recovery regaining steam, and rapidly improving labor markets. At the same time, business capital expenditures remain anemic. Furthermore, households, which have benefited from lower unemployment and large positive wealth effects, are also suffering from meager wage gains. The deep freeze of early January should have only a temporary negative impact—typically, weather-related disruptions get compensated over time.

Uncertainty remains on several key factors. First, business capital spending has not recovered from the recession (in the first three quarters of 2013, it grew at an anemic 1.7%). Second, the Chinese economic reforms could put the economy on a stronger footing, but have also increased the risks of financial problems. Third, we could face another debilitating political standoff on the debt ceiling in 2Q14. Finally, strong consumer confidence has yet to lead to more robust household spending.

Despite these uncertainties, we could see an acceleration of growth to 3% in 2014, and a decline of unemployment to 6% by year-end.

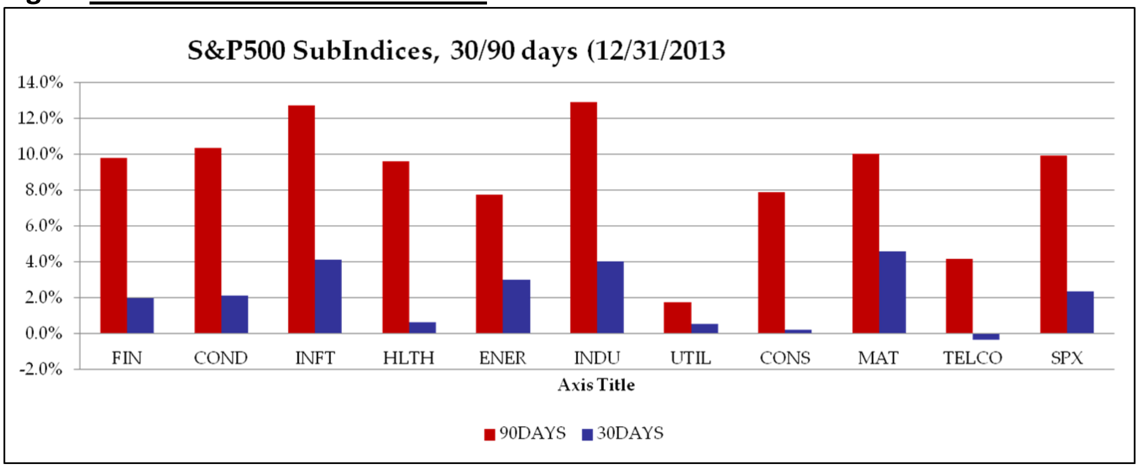
Happy Days Are Here Again: The financial markets ended 2013 with one of its best performances in several decades. The S&P500 was up by almost 30%, and the MSCI-EAFE (which includes the major developed countries ex North America) rose by about 18%. The S&P500 broke through the 1,800 level in mid-December, and has stayed comfortably above, indicating 1,800 as the new support level for the index. The performance of the market sub-indices has been roughly in line with the economic cycle, with the cyclical sectors generally outperforming the defensive ones.

Fig. 3: <u>Global Equity Markets Surge</u>



Markets took a breather in early January, but the disappointing December payrolls had little impact, and the S&P500 dropped by about 1% in the first ten days of the year.

Fig. 4: S&P500 Sectoral Performance



The market's exceptional performance in 2013 could be difficult to duplicate. The S&P500 has risen for two years in a row. Moreover, the market has been in the black for all of the past two years—meaning that it never fell below its beginning-of-year level. This trend has occurred only once in history (1975-76). The trailing P/E ratio rose from 14.54 to 18.01 during 2013, up 23%—which means that the rise in valuation accounted for three quarters of the total market rise. Considering that the average trailing P/E is 15.3, the market started undervalued and ended overvalued.

With the market impact of the taper seeming to fade, investors are focusing on the beginning of the 4Q13 earnings releases and the macro data. With the P/E having probably run its course, the onus will be in earnings. Analyst projections indicate that S&P500 profits could increase by about 5% in 4Q13. Analysts are expecting a stronger year for corporate profits, expected to grow at about 9.5% for the year, about twice their 2013 pace. However, this may be optimistic, and 5-7% (in line with nominal GDP) might be more likely.

Therefore, we could expect the S&P500 to rise to 1900-2000 by year-end. Moreover, with the market no longer attractively priced and interest rates on the rise, we should expect a relatively high degree of volatility.

December Data Releases

December 2013	Prior	Consensus	Actual	Min	Max
Macroeconomy					
GDP (3Q13, % Annualized) final	3.6%	3.6%	4.1%	2.4%	3.6%
CPI (m/m) Nov	-0.1%	0.0%	0.0%	0.0%	0.0%
Core CPI (% m/m) Nov	0.1%	0.1%	0.1%	0.1%	0.2%
Balance of Payments					
Exports (% m/m) Sep	1.8%		1.9%		
Imports (% m/m) Sep	0.4%		-1.4%		
Trade Deficit $ billion) Sep	$39.3	$39.9	34.3	$38.9	$42.5
Current Account Deficit ($ billion) (3Q13)	$96.6		$94.8		
Oil Prices (WTI, $/bbl, eom) Dec	$92.72		$98.17		
Industrial & Manufacturing					
Empire State (Dec)	-2.21	4.50	0.98	0.00	8.00
Philadelphia Fed (Dec)	6.5	10.0	7.0	5.0	20.0
ISM-Mfg Dec	57.3	57	57	55.4	58
Chicago PMI (Dec)	63	61.3	59.1	58.0	65.0
Markit PMI Mfg Dec	54.5	54.5	55	54.5	54.6
Industrial Production (% m/m) Nov	0.1%	0.6%	1.1%	0.3%	1.0%
Manufacturing (% m/m) Oct	0.5%	0.5%	0.6%	0.3%	0.6%
Durable Goods (m/m) Nov	-0.7%	1.5%	3.5%	-0.5%	4.0%
Durable Goods, ex transp (m/m)	-0.1%			-1.1%	0.2%
Factory Orders (m/m) Nov	-0.5%	1.6%	1.8%	1.3%	2.0%
Services					
ISM non-mfg Mar Jan 2014	53.9	54.8	53	53.9	55.1
Consumer Spending					
Retail Sales (% m/m) Nov	0.006	0.6%	0.7%	0.3%	1.4%
UMich Consumer Sentiment (End Dec)	82.5	83.5	82.5	82.5	85.0
ConfBd Consumer Confidence (Dec))	72	76.8	78	72.0	81.2
Personal Income (m/m) Nov	-0.1%	0.5%	0.2%	0.3%	0.6%
Consumer Spending (m/m) Nov	0.3%	0.5%	0.5%	0.0%	0.3%
Housing Market					
Housing Starts ('000) Nov	889	952	1021	925	1000
New Home Sale ('000) Oct	474	450	464	400	475
Existing Home Sales (MM) Nov	5.20	5.02	4.90	4.95	5.20
Construction Spending (m/m) Nov	0.9%	1.0%	1.0%	0.2%	4.0%
Construction Spending (y/y) Oct	5.3%				
Case Shiller-20 (m/m) Oct	1.0%	1.0%	1.0%	0.3%	1.4%
Case Shiller-20(y/y) Oct	13.3%		13.60%		
Employment					
First Time Claims ('000) (Last week Dec)	345	331	330	305	355
Non-Farm Payroll Dec	241,000	200,000	74000	120,000	225,000
o/w Private Sector	226,000	189,000	87000	120,000	220,000

Dr. Pakravan has been a senior economic strategist in global financial markets for 25 years. Dr. Pakravan is a recognized specialist in leading-edge applied macroeconomic and financial research on currencies and emerging markets, country risk assessment and modeling in an enterprise-wide risk management context, as well as international financial architecture. Dr. Pakravan has a Ph.D. in Economics, University of Chicago, a M.Sc. in Econometrics and Mathematical Economies, London School of Economics, and a B.A. in Mathematical Economics, University of Geneva. He is the author of numerous publications and is an Associate Professor of Finance at the Kellstadt Graduate School of Management at DePaul University.