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Advocacy Investing®

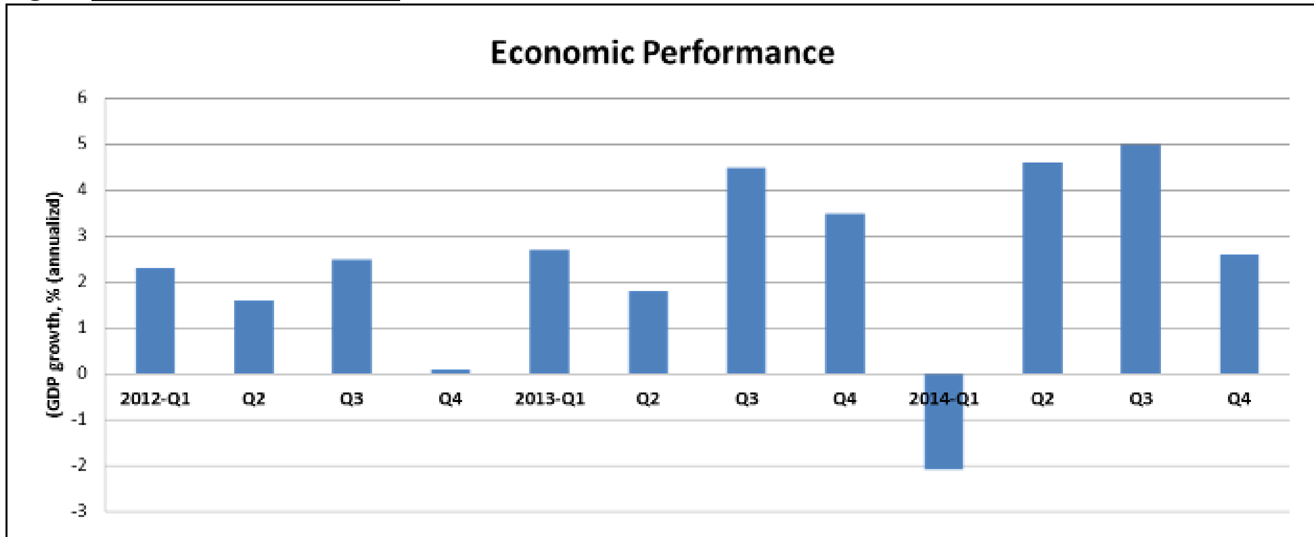
A VOLATILE START TO 2015

- **The US economy continued to grow in 4Q14, albeit at a slower pace**
- **The oil price collapse is a major boost for the US economy; globally, it could mean a transfer of $2.5 trillion from producers to consumers**
- **A very strong payrolls report underscores the economy's strong momentum**
- **The global economy is subject to strong cross-currents; the IMF downgraded its 2014-15 outlook**
- **The Fed remains on neutral; the European Central Bank introduces quantitative easing**
- **A volatile 2015 start for the financial markets**

The US economy ended three quarters of solid growth in 4Q14, but rising risk aversion, market instability and strong cross-currents in the global economy pose new risks to the economic picture.

Growth Acceleration in 2014: The first estimate of output growth in the last quarter of 2014 showed that the US economy grew by 2.6% (annualized) in 4Q14—somewhat below market expectations, but still a solid number. Surging personal consumer expenditures were offset by a slowdown in fixed investment, a widening external gap and a pullback in government spending. This came after two very strong quarters, with the economy accelerating to 4.6% in 2Q14 and 5% in 3Q14 (annualized). For the year as a whole, real GDP rose by 2.4%, and nominal GDP reached $17.7 trillion.

Fig. 1: Solid Economic Growth



Mixed Date Releases: The data releases for December and January were mixed. Industrial production and factory orders fell by respectively 0.1% and 0.7% (month-on-month, m/m) in December, while durable goods fell more sharply by 3.4%. Early-month surveys were mediocre—the Empire State index rose from -1.23 to 9.95, but the Philadelphia Fed survey fell from 24.3 to 6.0—end-month surveys drew a better picture. The broad-based Chicago PMI was stable at 58.9. The ISM-Manufacturing fell slightly to 53.5 from 55.1 the previous month, and the Markit PMI-Manufacturing remained at 53.9. On the consumer side, consumer confidence—as measured by both the University of Michigan-Reuters Index and the Conference Board measure—rose to an 11-year high in January. Personal income rose in December by 0.3% (m/m), while personal consumption expenditures fell by 0.3% (m/m)—however, falling energy expenditures explain most of the fall. Retail sales also fell by 0.9% (m/m) in December. Automobile sales fell by 1.7% in December to 16.3 million vehicles (annualized), still a relatively strong result. Nevertheless, the income and spending data shows that households continue to be very cautious by showing a preference for saving over consumption. A strong dollar, an improving economic picture in the US and weak growth are having a negative impact on external balances. Despite the sharp fall in oil imports, total imports rose and exports fell in December, expanding the trade deficit to $46.6 billion from about $40 billion in the preceding month. The trade gap for the year as a whole expanded to $505 billion from $476 billion in 2013.

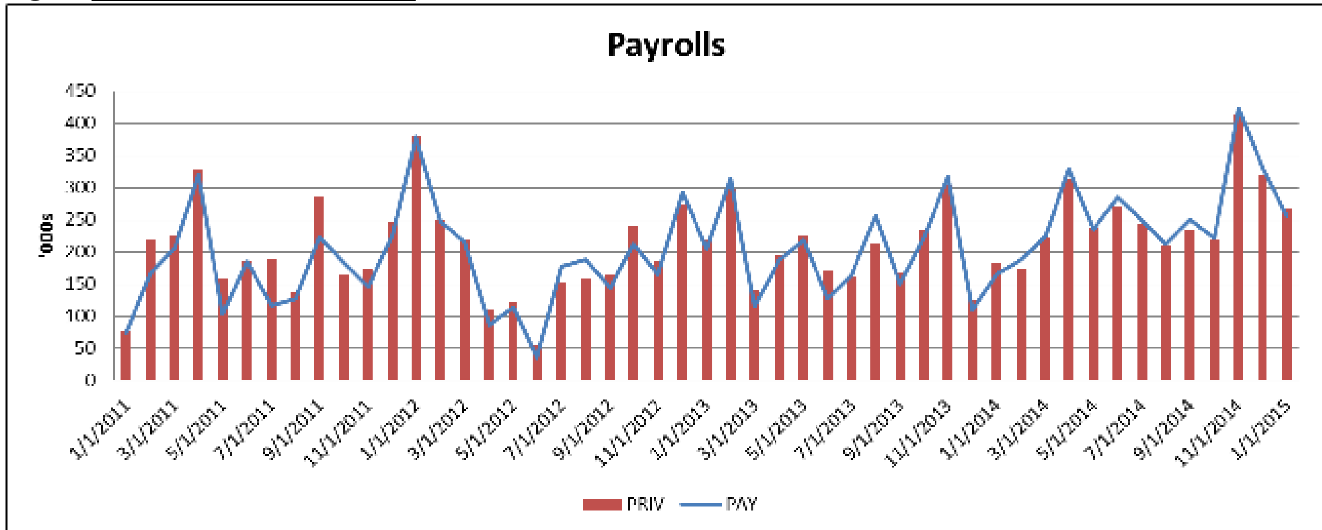
Oil Price Collapse a Boon for US Economy: A big boost to household purchasing power across the globe has come from the collapse in oil prices. It is estimated that the decline in gasoline prices, if sustained, could add $1,250 per year in disposable income to each household in the United States—and more for those northeastern states that depend on fuel oil for home heating. Moreover, developments in the oil markets will have a broader impact globally. Global macroeconomic weakness

and surging non-OPEC supplies contributed to a 55% slide in oil prices from their 2014 high of $100 on 6/25/2014. Oil prices continued to fall in January, with the US benchmark (West Texas Intermediate, WTI) losing another 15% in the month to $45/barrel (bbl). Global demand remains subdued as a result of the Chinese economic slowdown and weak growth in Europe. At the same time, surging US crude production in the past few years and OPEC's policy of defending its market share both have ensured abundant supplies. The royal succession in Saudi Arabia is not expected to change Saudi oil policy, and the impact of lower oil prices on US shale production will take time to have an effect on US production. In any case, there is enough slack in the market to absorb some US production decline. The International Energy Agency (IEA) forecasts that excess supply conditions should continue in 2015, even in the face of a decline in non-OPEC production. Therefore, while oil prices have rebounded in the first week of February, breaking through $50/bbl, analysts do not see this as a sustainable recovery, as current excess supply conditions in the global oil markets are expected to continue in the medium-term, and oil prices (WTI) should remain in the $50-60 range for the foreseeable future.

The housing market is stable, with all major indicators (housing starts, new home and existing home sales) showing slight increases in December. Home prices continue to increase, albeit at a slower pace—the Case-Shiller 20-city index was up 0.7% (m/m) in November, for a total of 4.3% on a (year-on-year, y/y) basis.

Good News across the Board: the January payrolls report delivered positive indications across the board. Total payrolls increased above market expectations by 257,000 (private payrolls rose by 267,000), and the previous two months were revised upward by an aggregate 147,000. These results raised the three-month average to 335,000 in January, from a 267,000 average for 2014 as a whole. In other words, the economy has created one million jobs since November. With the exception of the government sector (minus 10,000), the payroll gains were broad-based: goods producing sectors gained 58,000, and private business services were up by 209,000. Weekly hours worked where unchanged at 34.6, but average hourly earnings rose by 0.5%. In combination, this led to a 6% (yearly) increase in the labor income proxy. Both the unemployment and U6 (unemployment/underemployment) rates rise by a tick, to respectively 5.7% and 11.3%. However, this increase reflected a 700,000 rose in the labor force and an increase in the labor participation rate to 62.9% from 62.7% at the end of 2014. High frequency data supports these positive trends, with initial jobless claims registering under 300,000 for 18 of the past 21 months.

Fig. 2: A Strong Payrolls Report



Global Ill-winds: The global economy is subject to strong cross-currents, and is essentially running on 1.5 engines out of four. A robust US economic performance is offset by weakness in the eurozone and Japan, as well as a sharp economic slowdown in China. Both the IMF and the World Bank have downgraded their global growth prospects for 2015.

Table 1: IMF Growth Forecasts

	2013	2014	2015	2016
World	3.3%	3.3%	3.5%	3.7%
USA	2.2%	2.4%	3.6%	3.3%
Eurozone	-0.5%	0.8%	1.2%	1.4%
UK	1.7%	2.6%	2.3%	2.1%
Japan	1.6%	0.1%	0.6%	0.8%
Emerging Markets	4.7%	4.4%	4.3%	4.7%
China	7.8%	7.4%	6.8%	6.3%

While lower oil prices are on net a boon to the global economy, their positive impact is partly offset by deflationary/recessionary pressures in the eurozone, the potential for another Greek sovereign debt crisis and higher volatility in global financial markets.

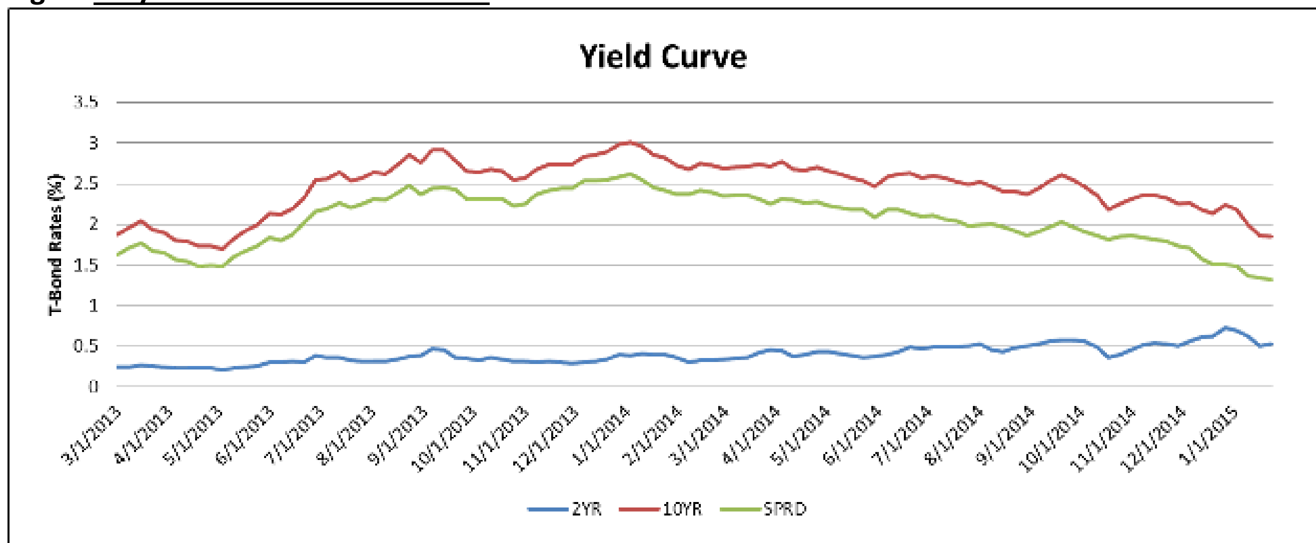
The situation in the eurozone is particularly critical. Faced with the twin challenges of recession and deflation, the European Central Bank (ECB) finally unveiled its long-awaited quantitative easing program at its January 22nd meeting. The program will involve a €60 billion per month purchases of 2-

30 year sovereign bonds for a period ending in September 2016—for a total of €1.1 trillion. However, at the insistence of Germany, national central banks will be responsible for any losses incurred as a result of the QE program.

Meanwhile, the decisive victory of the left-wing, anti-austerity Syriza Party in Greece on January 25th threatens to open another chapter of the eurozone financial crisis. The only saving grace so far for the region has been the sharp depreciation of the euro, which has lost 7% in January against the US dollar and could be reaching parity in the near-future.

China continues to struggle with a deceleration of growth, which is now falling below 7%. Industrial production is also faltering, with the Manufacturing PMI falling below 50. The era of double-digit growth is clearly past, and medium-term output growth is expected to be in the 6.5-7.0% range at best.

Fig. 3: <u>10-year Yields at Record Lows</u>



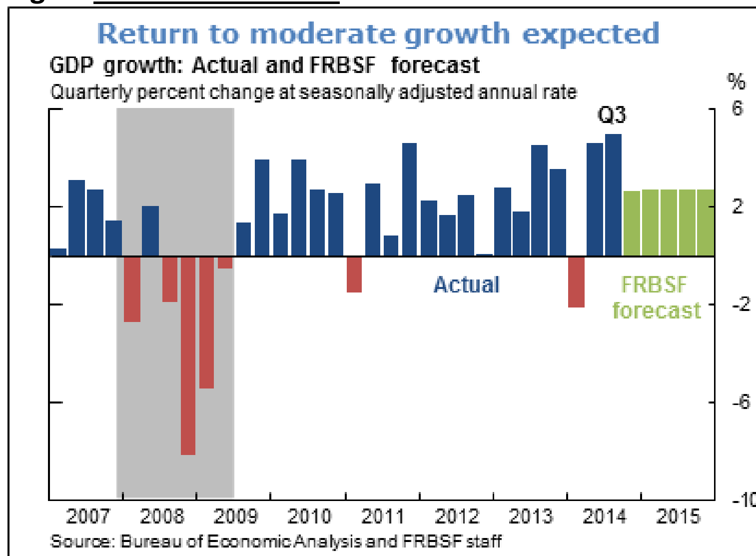
The Fed in Neutral for the Time Being: The Federal Open Market Committee (FOMC) met on January 27-28. The FOMC statement reflected a more bullish view of the economy. According to the FOMC, faster economic growth is taking hold, and the economy is expanding at a "strong" pace (vs "a "moderate" pace in previous statements. Furthermore, the Fed believes that labor market gains are "strong" (vs "solid" in the previous statement). Nevertheless, the Fed remains "patient" in normalizing monetary policy, especially in the face of falling inflation. The Fed also has shifted the calibration of its policy stance from just the unemployment rate (now at 5.6%) to a "wide range of information"—which include labor indicators, inflation expectations and financial markets. Also, for the first time, the Fed statement added global conditions to its indicators. In a recent speech, Bullard, the president of the St

Louis Fed, reiterated his belief that the markets were more dovish than the Fed, and that a mid-year rate increase was highly likely. Overall, the FOMC statement language and Bullard's comment have prompted market expectations of no rate increase until the end of 2Q15 at the earliest. Meanwhile, the 10-year yields have dropped by another .53% in January, to a record-low of 1.67%, and the yield curve has remained flat. The strong payrolls report also impacted the bond markets, with the 10-year yield back to 1.94% by the end of the first week in February.

The Fed faces a difficult balancing act. The latest payroll report strengthens the case for a June monetary tightening. At the same time, the Fed is well aware of the lack of inflationary pressures. Falling oil prices and the strong dollar have pushed prices in negative territory, and we expect deflation (both headline and core) to prevail in the next few months. Larry Summers, the former Treasury Secretary under President Clinton, has warned about the dire consequences of a too soon/too fast tightening of monetary policy, as such an action could kill the recovery. Nevertheless, the Fed can point to the minimal impact of ending QE on financial and economic conditions to defend a gradual and modest tightening.

President Obama sent a $4 trillion (22% of GDP) spending plan for FY2016, calling for a 6.4% increase in spending over the previous year and a deficit equal to 2.5% of GDP. This budget proposal comes at a time of significant improvement in the fiscal situation, with deficits falling to 2.8% and 3.2% respectively in FY2014 and 2015. Nevertheless, the administration's spending plan is likely to face strong opposition from the new Republican-dominated Congress. In the meantime, President Obama and the Republicans are facing a number of budgetary battles in the next few months, but any government shutdown is unlikely.

Fig. 4: <u>A Positive Outlook</u>



A Turnaround year for the US Economy: While 4Q14 economic performance was below-expectations, economic growth remains above the average of 2.3% for the previous 21 quarters of the recovery. Conditions for an acceleration of the economic expansion have improved significantly:

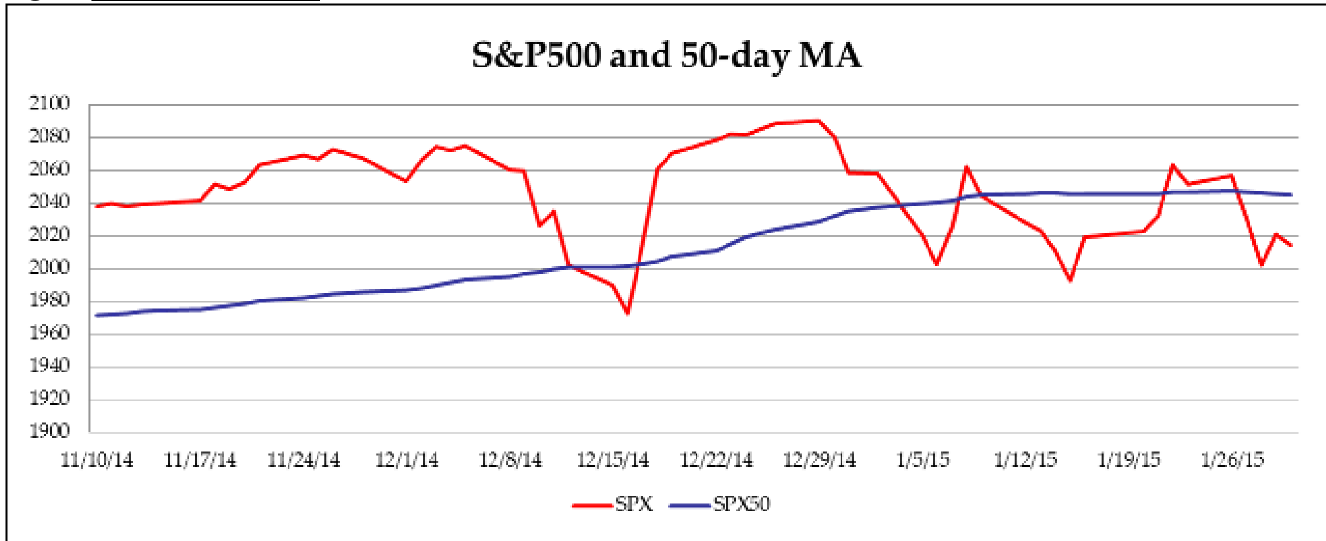
- Strong gains in employment should be reflected in improved wage and income gains. The households could be back in action, as consumer confidence is back at levels consistent with higher spending. The latest GDP data show that personal consumption expenditures increased by 4.3% in 4Q14, almost twice the average pace of the previous 11 quarters
- In contrast with the household sectors, we expect businesses to hold back and capital expenditures to remain relatively weak, particularly as we see large cutbacks in the oil-related businesses
- While low oil prices have a negative impact on both oil companies and the oil patch states, the overall impact on the economy is very positive
- The fiscal drag of the past few years has waned and the government sector (federal and state combined) should have a positive contribution to GDP
- There are faint signs of an improved economic picture in both Japan and the eurozone, which could limit downside global risks
- The US economy is relatively closed (exports account for only 16% of GDP), and as such could be partially insulated from a global slowdown. Nevertheless, the strong dollar and the widening trade gap will have a negative impact on the growth number.

At the same time, we should recognize that strong headwinds could undo some of the progress. The most significant one is the on-going structural weakness in aggregate demand in two out of the three most important economic players (eurozone and Japan), and a weakening of growth in the third (China). Furthermore, another Greece-induced debt crisis in the eurozone would have a major negative impact on markets and confidence if it isn't resolved swiftly.

Nevertheless, 2015 could be the turnaround year we have been waiting for, and these trends should in combination result in output growth of 3.0-3.5%.

In the long-term, policy makers in major countries need to continue to address structural problems that negatively impact global economic prospects: excessive leverage and indebtedness of governments, chronic excess supply and deflationary pressures, and the need to implement structural reforms.

Fig. 5: The Bears Return



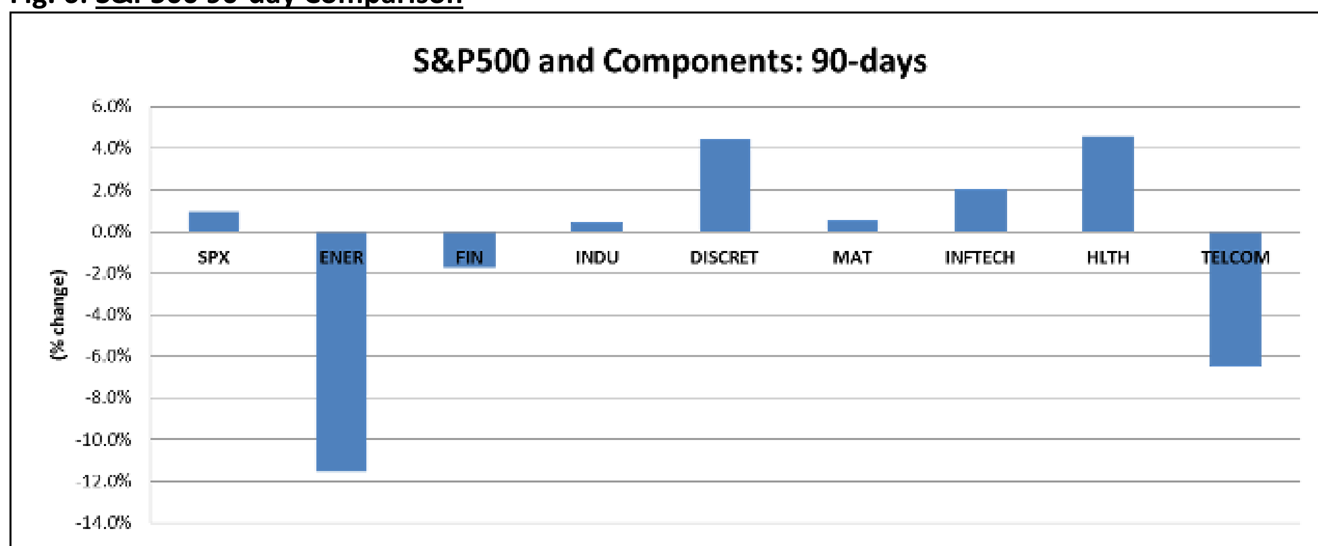
A Narrative-driven Market: In a month dominated by event risk (eurozone deflation, yet another potential Greek financial crisis and "Grexit", soft oil prices and heightened geopolitical risks), it is no great surprise that the markets remained moody and volatile. The S&P500 had been bouncing between 2,000 and 2,060 for most of January, falling below 2000 on the last trading day of January, down by 3% for the month. Nevertheless, the index remains 11.1% over its level one year ago. With the index below its 50-day moving average, the market was in bear territory for most of the month of January. All of the nine S&P500 sectors lost ground in January, with a mixed picture for the 90-days performance—although defensive stocks outperformed cyclical issues. The markets recovered in the first week of February, with the S&P500 having its best week since year-end, gaining 2.9% to 2,055.

Volatility has come back. The VIX indicator, which averaged about 12 for the first ten months of 2014 jumped in December and January, reaching 20.67 at the end of the month. Moreover, the Dow Jones registered 100+ point movements in 75% of the January trading days. Why the surge in volatility?

- Divergence in economic performance and economic policies among the major countries has led to significant currency volatility
- Adverse contagion from the collapse in oil prices, which are affecting the oil majors—lower earnings and capital expenditures—as well as upping the pressure on the weakest oil producing countries such as Russia and Venezuela
- Large foreign-exchange losses for corporates un- (or insufficiently) hedged against the dollar surge.

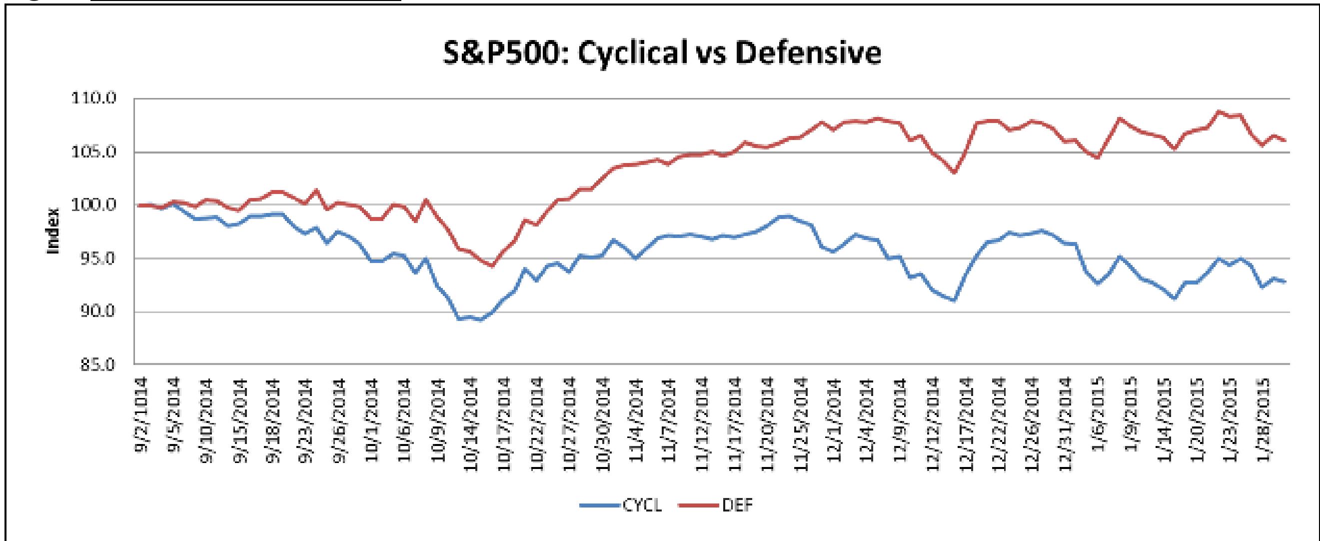
US multinationals are facing a weakening global economic picture as well as a strong dollar. The corporate picture is mixed—although 70% of the S&P500 names exceeded expectations—and there are no clear trends in winners and losers—except for oil companies. On one hand, Apple announced the highest quarterly profit ever for any corporation ($18 billion) in 4Q14. On the other, oil company revenues and earnings took a major hit in 4Q14, and the trend is expected to continue in 1Q2015. Nevertheless, non-oil S&P500 corporates had a strong quarter, with earnings up by 8.6% in 4Q14.

Fig. 6: S&P500 90-day Comparison



The surging dollar also had a significant dampening effect on corporate earnings. Overseas operations account for more than 40% of the S&P500 earnings, with the number as high as 50% for tech companies. The dollar index (DXY, a weighted average of the US currency against its major trading partners) has risen to a 25-year high, gaining 17.7% in the past 12 months (and up by 29% over its 2003 low). The current earnings per share of the S&P500 stand at about $120, and it is estimated that each 10% rise in the dollar will cut $3 from this number.

Fig. 7: Defensives Outperform



Overall, earning prospects for 2015 are mixed, and depend on the ability of the US economy to sustain the economic expansion. S&P500 corporations, which saw their profits rise by about 6.4% y/y in 4Q14, should experience a 3% drop in their results in 1Q15, and a meager 2.7% increase for the year as a whole. Non-oil corporations should be doing better, with an expected 8% rise in their earnings in 1Q15.

January Data Releases

Economic Data Releases-January 2015	Prior	Consensus	Actual	Min	Max
Macroeconomy					
GDP (4Q14, % Annualized) First estimate	5.0%	3.2%	2.6%	2.2%	3.5%
CPI (m/m) Dec	-0.3%	-0.4%	-0.4%	-0.6%	-0.2%
Core CPI (% m/m) Dec	0.1%	0.1%	0.0%	0.0%	0.2%
Balance of Payments					
Exports (% m/m) Nov	1.6%		-1.0%		
Imports (% m/m) Nov	0.9%		-2.2%		
Trade Deficit $ billion) Nov	$39.8	$37.9	$46.6	$37.5	$40.0
Current Account Deficit ($ billion) (3Q2014)	$98.2		$100.3		
Oil Prices (WTI, $/bbl, eom) Jan	$53.27		$45.19		
Corporate Profits (y/y) 3Q14					
Industrial & Manufacturing					
Empire State (Jan)	-1.23	5.00	9.95	0.00	8.00
Philadelphia Fed (Jan)	24.3	20.00	6.00	16.00	25.30
ISM-Mfg Jan	55.1	54.1	53.5	5.0	55.4
Chicago PMI Jan	58.8	58.8	58.9	54.5	58.8
Markit PMI Mfg Jan	53.9	54.1	53.9	53.7	54.1
Industrial Production (% m/m) Dec	1.3%	-0.1%	-0.1%	-1.5%	1.3%
Manufacturing (% m/m) Dec					
Durable Goods (m/m) Dec	-2.1%	0.7%	-3.4%	-1.3%	2.9%
Durable Goods, ex transp (m/m)	-1.3%	0.8%	-0.8%	0.3%	2.4%
Factory Orders (m/m) Dec	-0.7%	-0.7%	-0.7%	-1.4%	1.8%
Services					
ISM Non-MFG (Jan)	56.5	56.5	56.7	54.5	57.5
Consumer Spending					
Retail Sales (% m/m) Dec	0.4%	-0.1%	-0.9%	-0.4%	0.4%
UMich Consumer Sentiment (end-Jan)	98.2	98.1	98.1	97.7	100.0
ConfBd Consumer Confidence (end-Jan)	93.1	96.0	102.9	93.5	100.0
Personal Income (m/m) Dec	0.3%	0.3%	0.3%	0.1%	0.5%
Personal Consumption Expenditures (m/m) Dec	0.5%	-0.2%	-0.3%	0.1%	0.5%
Housing Market					
Housing Starts ('000) Dec	1043	1041	1089	950	1082
New Home Sale ('000) Dec	431	452	481	444	470
Existing Home Sales (MM) Dec	4.92	5.05	5.04	4.93	5.12
Construction Spending (m/m) Nov	-0.2%	0.6%	0.4%	0.5%	1.5%
Case Shiller-20 (m/m) Nov	0.7%	0.6%	0.7%	0.3%	0.9%
Case Shiller-20(y/y)	4.5%	4.3%	4.3%	4.2%	4.7%
Employment					
First Time Claims ('000) (Last week Jan)	267	290	278	280	310
Non-Farm Payroll	329,000	230,000	257,000	215,000	275,000
o/w Private Sector	320,000	22,900	267,000	215,000	268,000

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.

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