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Advocacy Investing®

ACCELERATION

- **The economy shrank slightly in 4Q12, but seemed to recover by year-end**
- **Economic data releases point to acceleration**
- **Healing of the housing sector continues**
- **Job creation continues at a steady, but clearly inadequate pace**
- **Some of the global risks have faded, at least temporarily**
- **Equity markets buoyant in January across the board, with key indices nearing record levels**

Fourth Quarter Disappointment: Despite the slight contraction of output experienced in 4Q12 (GDP unexpectedly fell by 0.1% annualized); the economy seems to have been on an accelerating path in the past two months. Equity markets are nearing all-time records, the housing market's recovery shows evidence of being on a more solid footing and manufacturing is rebounding. Meanwhile some of the major global risks that hobbled the economy have faded, at least temporarily. The US economy could be reaching escape velocity, and finally breakout into more rapid growth than the 2-2.5% average of the last three years.

The global economy is on the mend: The IMF, in its latest report, projects 2013 global growth at 3.5% in 2013 from 3.2% in 2012. Emerging markets and the US economy are set to accelerate. In Japan, the new government of Prime Minister Abe is committed to ending two decades of stagnation and deflation through fiscal and monetary stimulus.

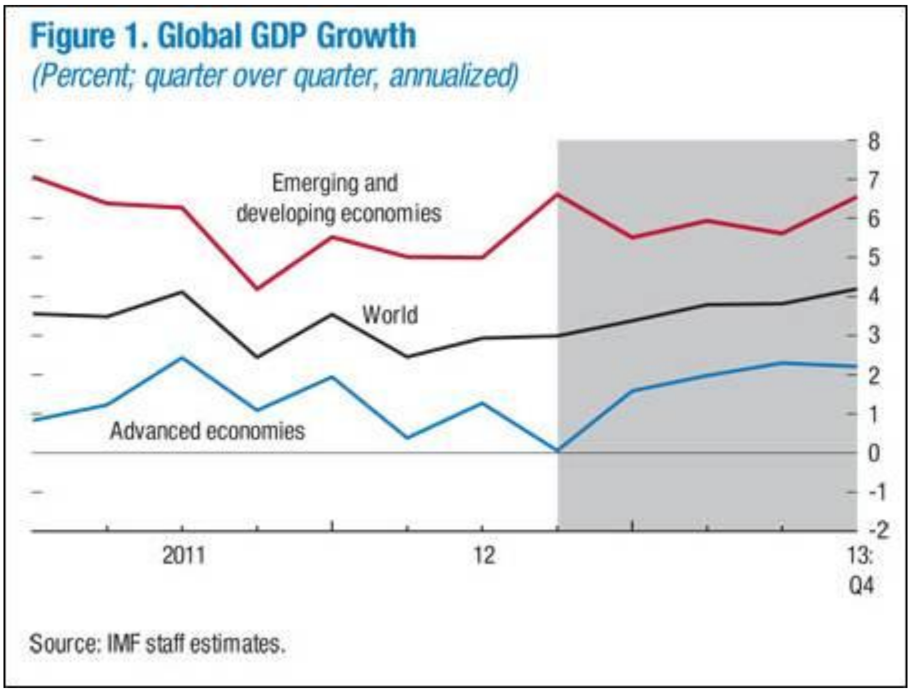
Table 1: <u>IMF Forecasts</u>

GDP Growth (%)	2011	2012	2013	2014
World	3.9	3.2	3.5	4.1
US	1.8	2.3	2.0	3.0
Euro area	1.4	-0.4	-0.2	1.0
Japan	-0.6	2.0	1.2	0.7
Emerging Markets	6.3	5.1	5.5	5.9
China	9.3	7.8	8.2	8.5
World Trade (Volume, %)	*5.9*	*2.8*	*3.8*	*5.5*

Source: IMF, World Economic Outlook, January 2013

World trade is also set to expand at a somewhat faster pace, rising by an expected 3.8% in 2013 after slowing down in 2012. This improvement is reflected in a sharply improved manufacturing performance by China, which saw its Manufacturing PMI rise for the second month in a row in January.

Fig. 1: <u>IMA Global Forecast</u>

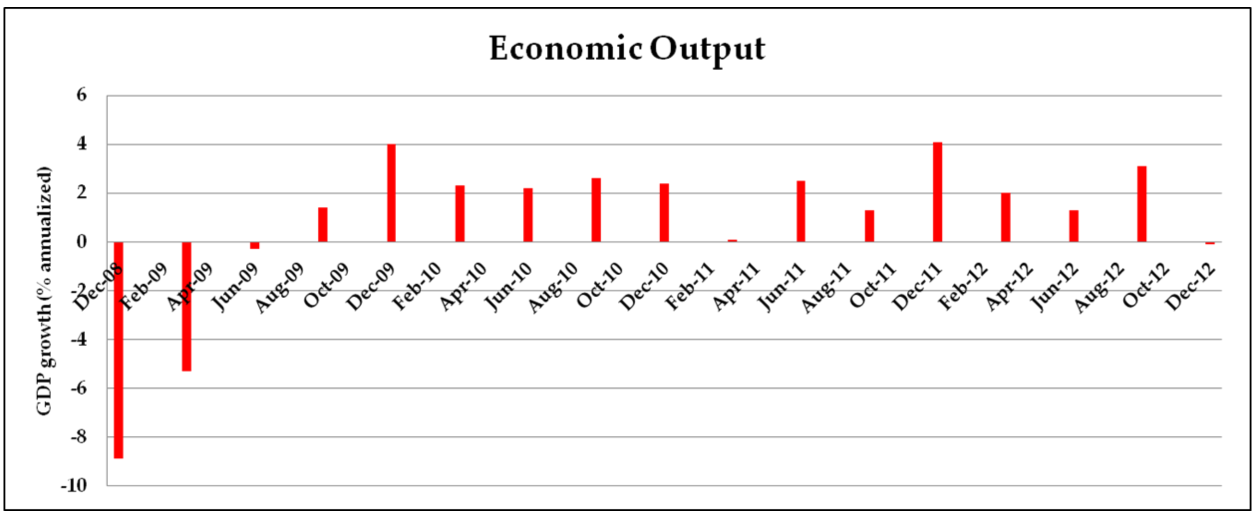


Several months of quiet seem to have boosted investor confidence—perhaps prematurely. Italy and Spain have been issuing 10-year debt at significantly lower yields, while at the same time Portugal was able to return to bond markets. In another sign of renewed investor confidence, private flows to the eurozone periphery were back in the black in 4Q12, when $100 billion flowed back to those economies after three years of outflows. At the same time, in contrast to the United States and other emerging markets, the eurozone recession is spreading from the periphery to the core, and the bloc is expected to remain in recession through mid-2013. Nevertheless, both business and consumer confidence are starting to show signs of recovery in Germany, the largest and healthiest economy in the euro bloc.

However, we need to be wary of concluding that the world economy is out of the woods. First of all, the IMF forecast is anything but rosy, showing only at best a modest improvement. In the words of Christine Lagarde, Executive Director of the IMF: "We have avoided collapse, but we need to guard against any relapse. 2013 will be a make-or-break year." This point is reflected in the fact that only two of the six largest developed economies, the United States and Germany, have returned to pre-crisis output levels. The improvement in Europe may be oversold, and any convergence of core and periphery sovereign bond yields is illusory. At best, the market participants have given some more time for the periphery countries to restructure their economies. The announcement of a UK referendum in 2018 on whether or not to remain in the European Union will introduce additional market uncertainties.

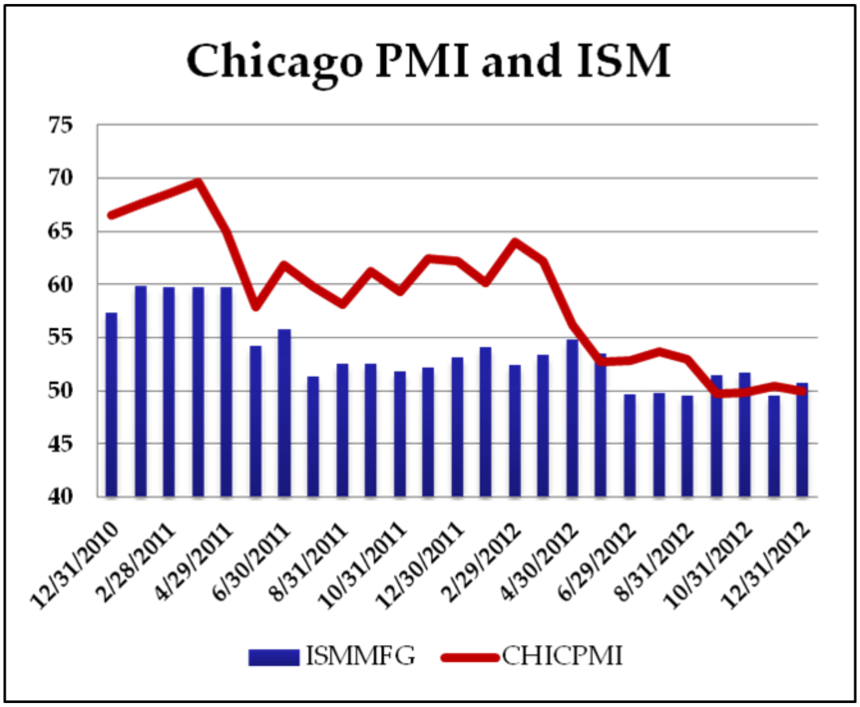
GDP Shrinks Unexpectedly: The final revision of 4Q2012 GDP showed a contraction of 0.1%, below market expectations of about 1% growth. Yet, the number should not be too alarming, since it reflected a 3.9% drop in government spending (mostly defense) and a decline in the pace of inventory accumulation. In contrast, private demand (consumer spending and investment) rose at a healthy pace. Additional factors affecting the weakness in the economy were both Hurricane Sandy, as well as the uncertainties caused by the looming fiscal cliff.

Fig. 2: US Economic Output



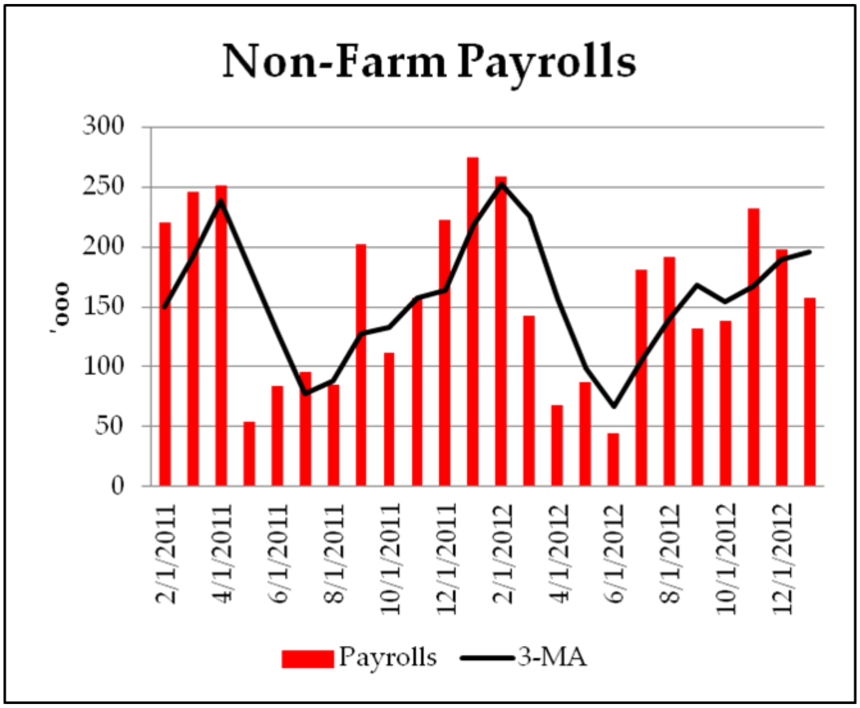
The disappointing GDP report was offset by a continued positive stream of economic data releases, which have been consistently pointing upwards in the past two months. On the consumer side, the University of Michigan Consumer Confidence index rose, offsetting somewhat the fall in the earlier reported Conference Board measure. Personal income jumped by 2.6% (m/m)—mostly as a result of large dividend distributions ahead of the 2013 tax increases--and personal consumption expenditures rose by 0.3% m/m. Retail sales rose by 0.5% month-on-month (m/m) in December. Manufacturing also shows signs of a stronger recovery. Industrial and Manufacturing production were up respectively 0.3% and 0.5% m/m. Forward-looking indicators also showed signs of strength: the Markit PMI-Manufacturing rose to 56.1 in January, while durable goods orders rise by 4.6% m/m (1.3% extransportation). The Chicago PMI and the ISM-manufacturing index both registered strong increases. The two earlier surveys—Philadelphia and the Empire State indices—which were published earlier in the month—stayed in negative territory, most likely because of lingering effects from the October Sandy super-storm. The ISM Non-Manufacturing (services) shrank slightly from 55.5 to 55.2.

Fig. 3: Industry on the Mend



Good News, Bad News: The employment situation continues to move sideways. On one hand, we are getting consistent jobs growth. On the other, the growth in employment is plainly not sufficient to dent the high unemployment rate. The January nonfarm payrolls report showed a 157,000 rise in employment (168,000 for the private sector), with a 127,000 total upward revision for November and December—which brings the 3-months average close to 200,000. Services payrolls rose by 130,000, and the goods producing sector employment increased by 36,000 (with the construction accounting for almost 80% of the increase). Government employment fell by 9,000. Moreover, the government issued its annual benchmark upgrade, revising upwards the number of jobs created in the April 2011-March 2012 period by 424,000. This brought the total number of jobs created since the end of the recession to 5.51 million jobs (or 63% of the total job loss of 8.74 million). Weekly hours worked remained unchanged, but hourly wages rose by 0.2% (m/m).

Fig. 4: <u>Non-Farm Payrolls</u>



The separate household survey showed a rise in the unemployment rate to 7.9% as a result of a rise in labor force participation. High frequency date also show uneven improvement. Weekly first time jobless claims fell to a low of 330,000 in mid-January, rising to 368,000 at the end of the month. (This number needs to fall to the low 300,000 in order to signal a stronger recovery.)

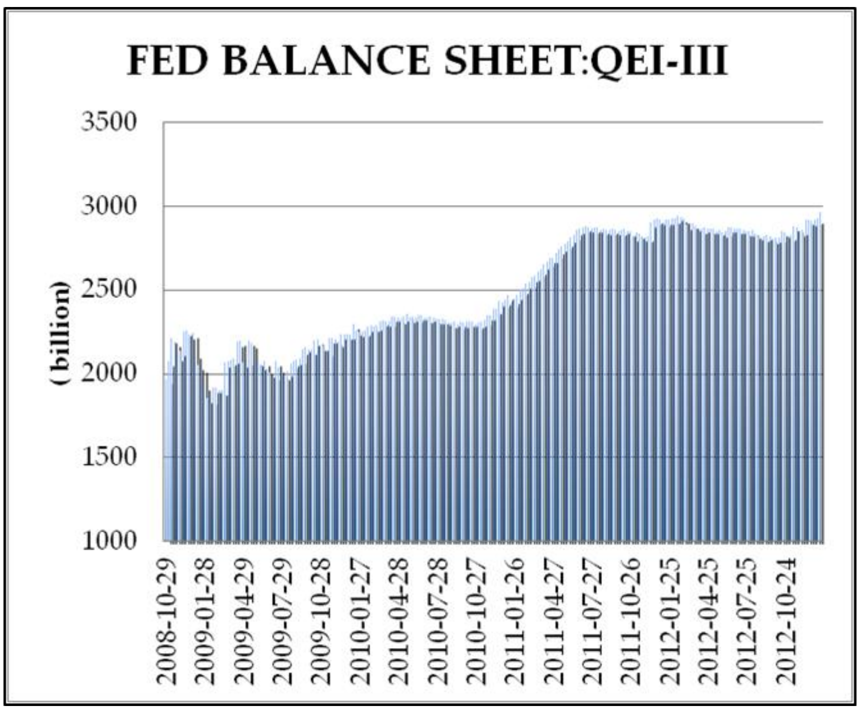
Housing on Solid Ground: The housing recovery seems to be gathering steam. The Case-Shiller 20-city index rose by 0.6% m/m in November, the 10th consecutive monthly increase, while the year-on-year price rise accelerated to 5.5%, the highest in two and a half years. Furthermore, the Corelogic survey shows that house prices rose by 7.5% in 2012 and are expected to increase by a further 6% in 2013. The factors underlying this substantial improvement are as follows:

- We are seeing fewer distressed sales, as the expected flood of foreclosed properties sales did not materialize. On the other hand, short sales have increased
- The supply of houses for sale has dropped to 1.82 million in December (representing an inventory of 4.8 months, less than the normal 6 months)
- This trend is due in part to the fact that homeowners are withholding properties from the market, either because they are still under water, or they expect prices to rise further

- The hardest hit markets are seeing the largest jumps in prices
- Both new and existing home sales have risen in the past few months
- Housing starts are getting close to the 1 million mark

Latest FOMC Meeting Offers no Surprises: The Federal Reserve Open Market Committee (FOMC) meeting on January 30th did not offer any surprises. The economic forecast was unchanged since its last meeting (December 12, 2012), with the Fed reiterating the weakness of the economy. If anything, the GDP numbers for 4Q12 reinforced the Fed's view that the economic recovery is far from being on solid ground. The Fed will continue quantitative easing by expanding its balance sheet through purchase of both mortgage-backed securities and longer-term Treasuries to the tune of $85 billion per month. Since beginning quantitative easing in November 2008, the Fed has grown its balance sheet by about $1 trillion, to close to $3 trillion.

Figure 5: <u>Fed Balance Sheet</u>



The bond markets are also showing signs of responding to the improved economic environment. Yields on the 10-year Treasuries rose above 2% in the last week of January.

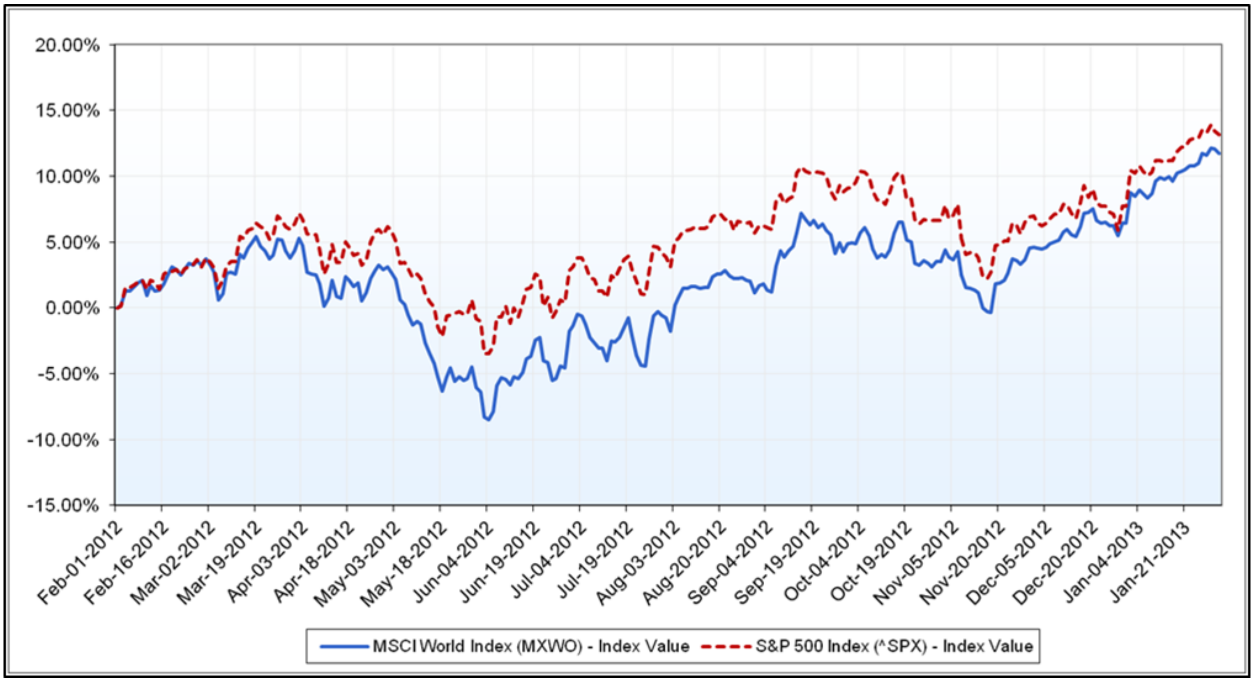
Oil prices have reacted to the improved economic news coming from the United States and China in the past few weeks as well. The benchmark West Texas Intermediate (WTI) rose to almost $98/barrel ($/bbl) at the end of January, up 7.5% for the month (and 15% from its 4Q12 low.

The Recovery Consolidates: Are we out of the storm or is this merely a lull? While the answer to that question is important in the longer-term, the truth is, the longer the lull, the less likely the storm will return. Forces that have been building over the past few months are now bearing fruit, resulting in the confluence of several factors: a fading of global recessionary fears, a risk-off environment in global equity markets and a reduction of the risk of another deadlock in the US debt ceiling problem. The consumer confidence indicators seem to indicate that improved employment prospects and the positive wealth effect have largely offset the negative impact of the January tax increases. Furthermore, there is a strong pent-up demand for business spending, which had been deferred in the second half of 2012 as a result of continued policy and political uncertainties. Finally, we expect a resurgence of exports as the global economy picks up.

At the same time, we must inject a note of caution and avoid excessive optimism. The adverse impact of the sharp defense cuts on economic growth in 4Q12 clearly indicates that the economy is not yet ready to absorb another round of fiscal austerity. Moreover, the fiscal wars are by no means over. The economy has to overcome two near-term hurdles: the so-called budget sequester, which would cut spending by $110 billion (approximately 0.7% of GDP), and an increase in the debt ceiling, which Congress has suspended until May 18th, pending the presentation of a budget for FY 2013. Finally, significant risks remain in Europe.

Overall, my forecast for the US economy is for trend growth of 2.0-2.5% in the first half of 2013, accelerating to 3.0-3.5% by the second half of the year.

Fig. 6: Global Bulls

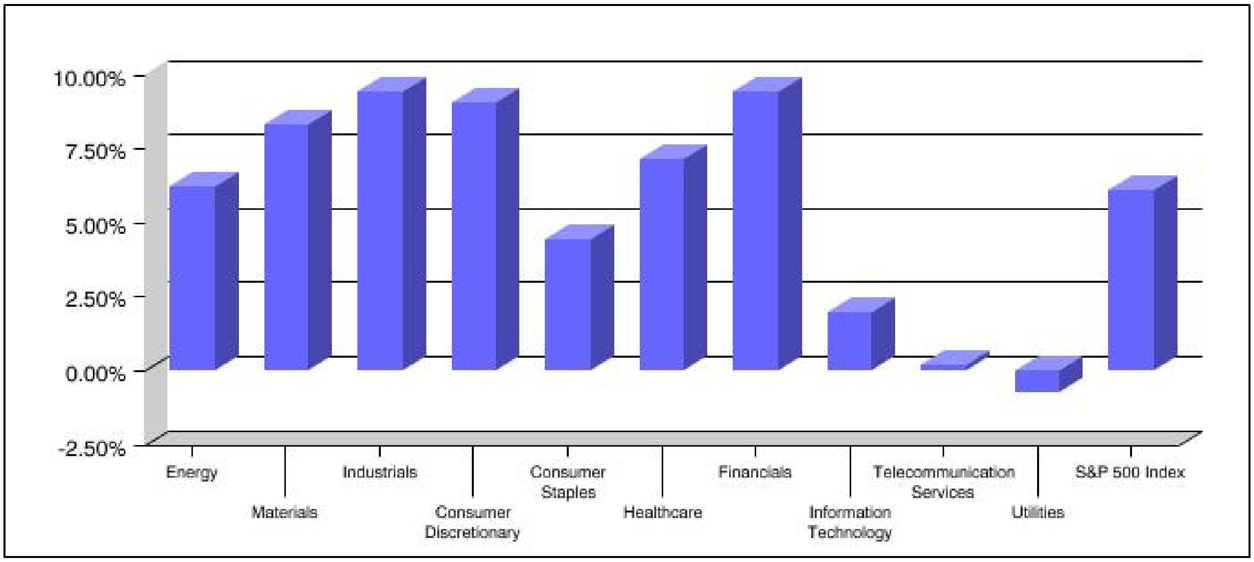


Fearless on Wall Street? In the past few weeks, market participants seem to have banished fear, with the VIX index at a five-year low. Global equity markets are up, European sovereign bond yields in the troubled periphery countries are down, and the euro is up 13% from its 2010 low point. After a three month lull, the equity markets have surged in January. The S&P500 broke through the 1,500 level on January 26, and is within 4% of its all-time high of 1,565 reached on October 9, 2007. The S&P500 has been above its 50-day average since December 7th. The Dow is on a similar path, breaking through 14,000 on February 1st. The strong market performance was led by cyclical sectors: financials, materials, consumer discretionary and energy.

The major factors affecting market performance have been:

- Improved macroeconomic picture
- Continued quantitative easing by the Fed and other major central banks
- Better-than-expected earnings, with 72% of the S&P500 firms reporting 4Q12 earnings beating the estimates
- Fading event risks: euro breakdown and fiscal cliff/debt ceiling impasse
- Renewed interest of retail investors, as evidenced by large January inflows into stock mutual funds

Fig. 7: S&P500 90-day Performance (1/31/2013)



Since hitting a low in March 2009, the equity markets have followed a cyclical pattern—with upswings followed by correction, consolidation, followed by another upswing—leading each time to a higher level in a quasi-step function. The latest bull run started on December 7, 2012 and is now in its eighth week, with the price-earnings (P/E) reaching a 19-month high of 17.8 on January 31st. In the short-term, we have to determine whether the market can defend the 1,500 level. In the longer run, assuming that the ratio reaches its pre-crisis average of 20, the S&P500 could be on track to reach approximately 1,700 by mid-year 2013. However, the market faces several hurdles. Firstly, we would need an acceleration of growth to justify such a level. Secondly, as mentioned earlier, we have to overcome policy hurdles. Thirdly, we need to test whether the market can wean itself from easy money if, as expected, the Fed starts reversing course by the end of 3Q13.

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January 2013 Economic Data

ECONOMIC DATA RELEASES					
January 2013	Prior	Consensus	Actual	Min	Max
Macroeconomy					
GDP (3Q12, % Annualized) Final revision	3.1%			2.6%	3.0%
CPI (m/m) Dec	-0.3%	0.0%	0.0%	-0.1%	0.3%
Core CPI (% m/m) Dec	0.1%	0.1%	0.1%	0.1%	0.2%
Balance of Payments					
Exports (% m/m) (Oct)	-3.6%				
Imports (% m/m) (Oct)	-2.1%				
Trade Deficit $ billion (Oct)	$42.2				
Current Account Deficit ($ billion) (3Q12)	$107.5				
Industrial Production					
Empire State (Jan)	-8.1	0.0	-7.8	-5.0	9.5
Philadelphia Fed (Dec)	8.1	6.0	-5.8	2.0	14.5
ISM-Mfg Jan	54	55.5	55.8	52	56.1
Chicago PMI (Jan)	50.0	50.5	55.6	46.7	52.5
Markit PMI Mfg Jan	54.2	54	56.1	52	55.3
Industrial Production (% m/m) Dec	1.0%	0.2%	0.3%	-0.1%	0.3%
Manufacturing (m/m) Dec	1.3%	0.4%	0.8%	0.3%	0.6%
Durable Goods (m/m) Dec	0.7%	1.6%	4.6%	-0.5%	3.5%
Durable Goods, ex transp (m/m)	1.2%	0.4%	1.3%	-2.5%	2.4%
Factory Orders (m/m) Dec	0.0%				
Services					
ISM non-mfg Dec	56.1				
Consumer Spending					
Retail Sales (% m/m) Dec	0.4%	0.3%	0.5%	0.0%	0.8%
UMich Consumer Sentiment (2d half Jan)	71.3	71.5	73.5	70.7	75.9
ConfBd Consumer Confidence (Jan)	66.7	65.1	58.6	61.6	70.0
Personal Income (m/m) Dec	1.0%	0.7%	2.6%	0.4%	1.5%
Consumer Spending (m/m) Dec	0.4%	0.3%	0.3%	0.1%	0.5%
Housing Market					
Housing Starts ('000) Dec	851	887	954	865	920
New Home Sale ('000) Dec	398	388	369	375	406
Existing Home Sales (MM) Dec	4.99	5.10	4.94	4.95	5.20
Housing Index Dec	47	48	47	46	50
Case Shiller-20 (m/m) SA Nov	0.7%	0.7%	0.6%	0.5%	0.9%
Case Shiller-20(y/y) Nov	4.3%	5.8%	0.055	4.8%	6.4%
Employment					
First Time Claims ('000) (last week Jan)	330	350	368	340	370
Non-Farm Payroll (Jan)	196,000	185,000	157000	131,000	157,000
o/w Private Sector (Jan)	202,000	185,000	166000	138,000	210,000

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.