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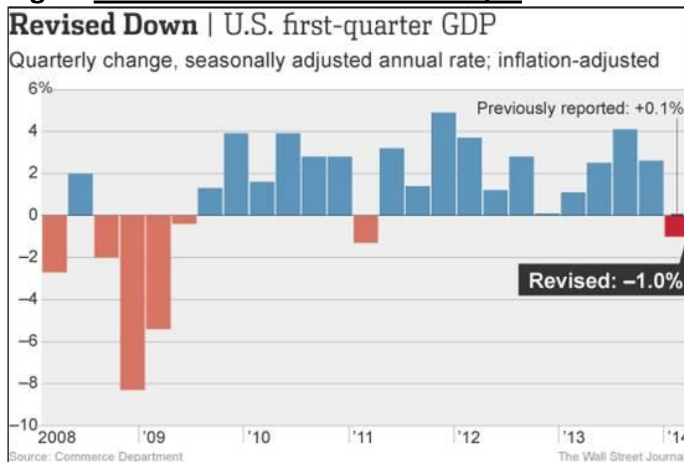
Advocacy Investing®

EXIT STRATEGIES

- **Output contraction in 1Q14 seen as off-trend**
- **The data release stream remains positive, although the consumer lags**
- **A strong May payrolls report revives hopes of a growth acceleration**
- **Deflation fears in the eurozone lead to aggressive easing—including negative benchmark rates**
- **Growth prospect risks are increasingly on the upside**
- **Record breaking equity markets defy gravity—and fundamentals**

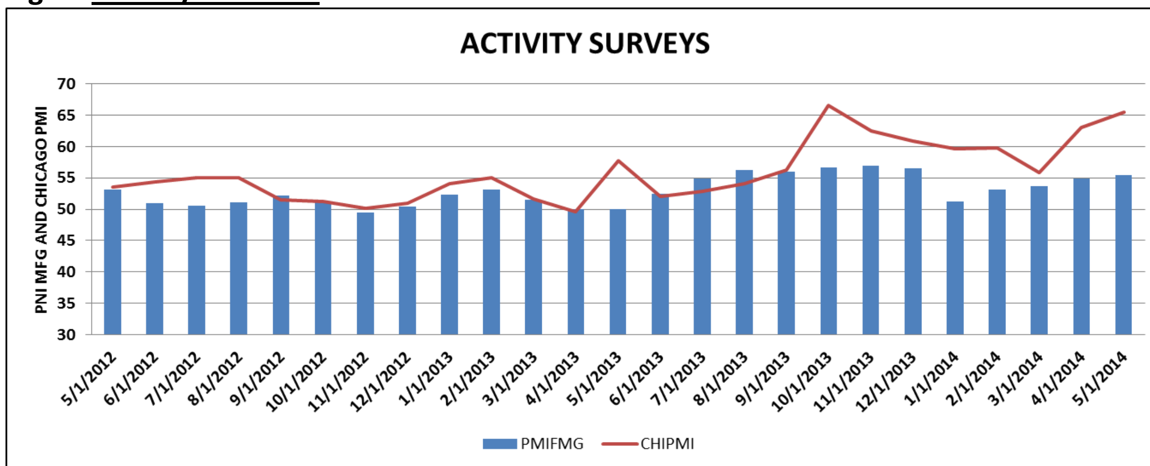
Bad News, Good News: The bad news was that the US economy shrank in 1Q14 for the first time in three years. The good news is that the contraction was largely the result of severe weather, and all indications are that the economy has rebounded strongly since the end of February. Real output fell by 1% (annualized), more than the market expectation of a 0.5% drop. Sharply falling fixed investment (both residential and business capital expenditures), a contraction in business inventories and a rise in the current account deficit were only partly offset by a boost in consumer demand. Government spending fell slightly.

Fig. 1: <u>US Economic Performance 1Q14</u>



Semi-Solid data Releases: Data releases for the month of May show continued strength in industry and manufacturing, but a somewhat wobbly household sector. Both early- and late-month surveys indicate a robust industrial and manufacturing expansion. The Empire State benchmark rose from 1.9 to 19.10, the Philadelphia Fed survey was stable around 15.4. In the more recent survey, the ISM–Manufacturing and Markit Manufacturing PMI, both registered gains, reaching respectively 55.4 and 56.4 in early June. The broad-based Chicago PMI surged to 65.5 from 63 a month earlier. Actual April production numbers were weaker: Industrial production and manufacturing decreased by respectively 0.6% and 0.4% month-on-month (m/m), while durable goods increased by 0.8% m/m. Factory orders also increased by 0.7% m/m, registering a third consecutive monthly increase. Auto sales remained strong in April at an annualized 16 million vehicles pace. Personal income increased by 0.3% m/m in April, but personal consumption expenditures fell by 0.1% m/m. Retail sales rose by 0.1% m/m. The main consumer confidence indices held steady. The ISM Non-manufacturing rose to 57.5 from 55.2 a month earlier. The trade deficit widened sharply in April to $47.2 billion from $44.2 billion in the previous month as a result of higher imports and lower exports, which could be a drag on output growth in 2Q14. Oil prices (West Texas Intermediate, WTI) topped $100/barrel on February 9th and have remained in the $102-105 range since.

Fig. 2: <u>Activity Rebound</u>



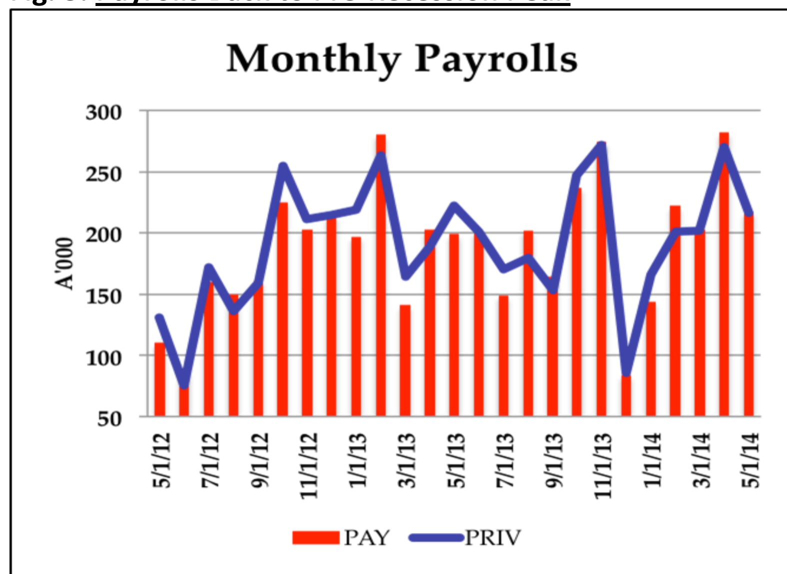
News on housing is mixed. All housing market activity indicators—new and existing home sales and housing starts—were up in April. However, they remain below their high levels reached in 2H13. Housing prices also rose, with the Case-Shiller 20-city index up by 1.2% m/m (12.8% year-on-year, y/y) in March. However, the apparent improvement is still fragile. Despite sharply lower mortgage rates—the 30-year fixed rate dropped to 4.31% in the last week of May, the lowest in a year—mortgage volumes are down 48% y/y. The major cause of this decline is the sharp drop in refinancings, down 80% y/y—the refis now account for 52% of total origination, down from 80% a year ago. Cash sales also

remain at a record high (33% of total), especially at the high end of the market. Moreover, the recovery in the housing market has so far mostly benefitted a handful of cities and high-end properties.

There is a silver lining in the drop of housing activity, since it represents in large part a sharp decline in the sale of real-estate-owned (REOs) by banks. These represent properties that were foreclosed or transferred to banks without foreclosures. Furthermore, while banks still sell more houses than builders, the gap is narrowing.

Labor Market Momentum: The May payrolls report was strong across the board. Total payrolls increased by 217,000, the fourth consecutive month of 200,000+ gains—a first since 2000. Private sector jobs increased by 216,000. The goods producing sectors added 18,000 jobs (construction +6,000, manufacturing +10,000. Private services jobs increased by 198,000 and government positions by 1,000. The participation rate was unchanged at 62.8% (down 0.6% since the beginning of the year).

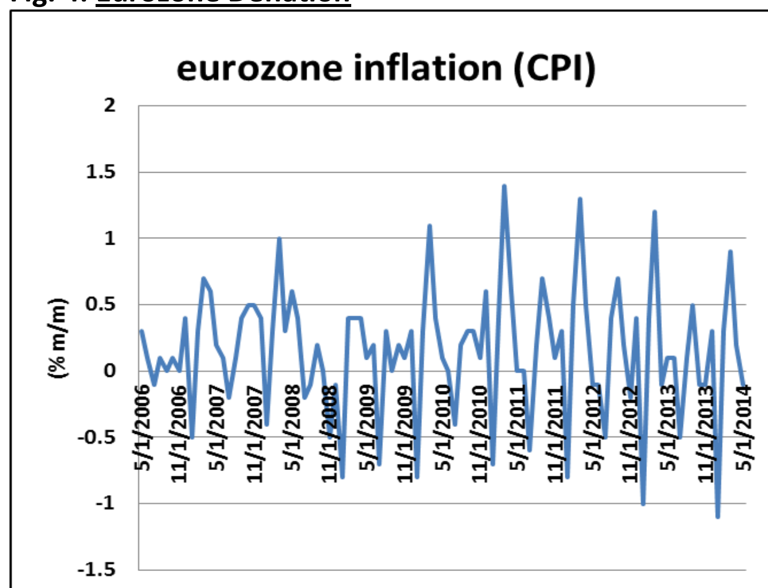
Fig. 3: Payrolls Back to Pre-Recession Peak



The unemployment rate, which is derived from a separate survey, stayed constant at 6.3%. The U-6 unemployment and underemployment rate fell to 12.2%, the lowest level since October 2008. Hourly wages rose 0.2% and weekly hours worked were unchanged at 34.5 hrs. High frequency data continue to improve. First-time jobless claims fell to 312,000 in the last week of May, and the four-week average was at its lowest point in seven years. The economy has created an average of 217,000 jobs per month in the first five months of the year. The May result pushed total US employment to 138.5 million, past the pre-recession peak of 138.4 million reached in 2008. Nevertheless, there is still considerable slack

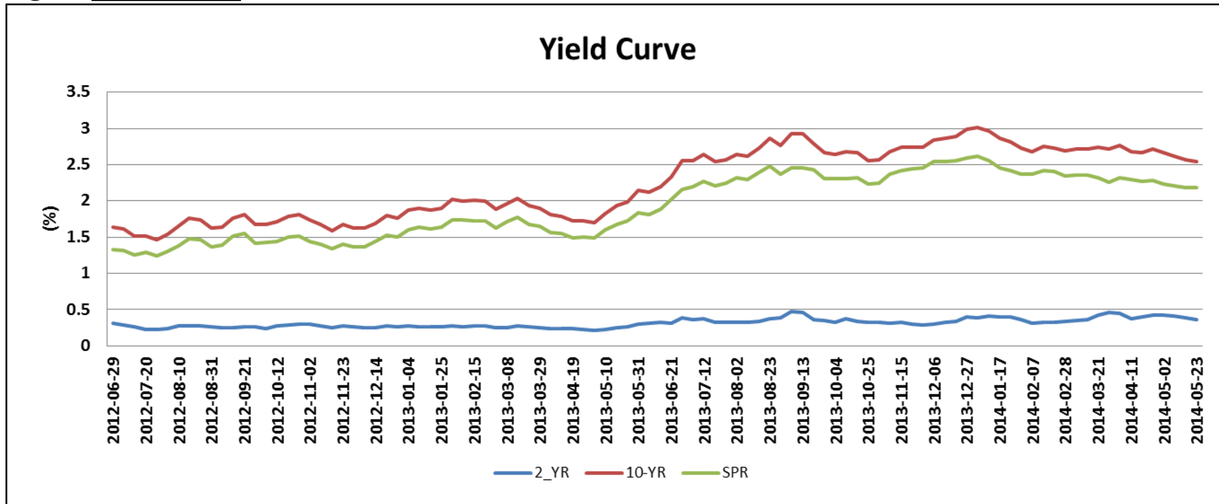
in the labor markets: given the growth in the labor force, we are still short of almost 7 million jobs before we can say that we are at full employment. This slack explains the fact that wages and labor income overall continue to stagnate—while at the same time, we are seeing labor shortages and sharp wage increases in certain categories such as construction jobs.

Fig. 4: Eurozone Deflation



The ECB Strikes: Globally, the eurozone and China continue to dominate the news. With the threat of deflation looming, the European Central Bank cut a key rate to minus 0.10—a central bank first—at its meeting on June 5th, hoping to send a strong message to the markets. However, the central bank held off on introducing quantitative easing for the time being. The strong showing of extreme right-wing populist parties in the recent elections to the European parliament has undermined the ability of the European governments to coordinate economic policy, and this could lead to a shift in economic policy towards more growth-oriented measures. In China, the HSBC PMI Manufacturing has shown its strongest performance in four months, but remains under the 50 level, which indicates a continuing contraction. Exports also increased, another sign of economic acceleration. While the Chinese government continues on its path of economic reform, it also has introduced some modest stimulus measures to prevent growth from falling below 7.5%.

Fig. 5: Yield Curve



Glide Path: While the minutes of the April 18-19 Federal Open Market Committee (FOMC) confirmed that the Fed is in no hurry to raise short-term rates, they also underscored a growing debate within the Fed about the exit from ultra-easy monetary policy followed since the advent of the Great Recession. The Fed is not concerned about inflation (which has been below the Fed target of 2% for the past 27 months). The focus is on the impact of monetary normalization on the financial markets—unknown territory. Over the past six years, the Fed's balance sheet has expanded five-fold, to $4.2 trillion at the end of May. At the same time, the central bank cut short-term interest rates to zero and embarked on three rounds of quantitative easing (QEI, II, and III). Furthermore, it has become a major factor in the mortgage markets by reinvesting the proceeds from maturing mortgage-backed securities (MBS) in new MBS. The Fed started the exit from QE-III in December 2013, and will have completed its tapering by the end of 3Q14. The latest payrolls report should not influence the taper's pace one way or another.

The Fed is now looking at an exit from it zero-interest rate policy, most likely sometime in the second or third quarter of 2015, raising short-term rates gradually to their historical averages of around 4%. At the same time, the Fed needs to shrink its balance sheet and reduce bank reserves (which have ballooned to $3 trillion over their historic pre-crisis levels). In order to achieve this goal, the Fed is looking at new instruments, such as the use of repurchase (repo) or deposit facilities.

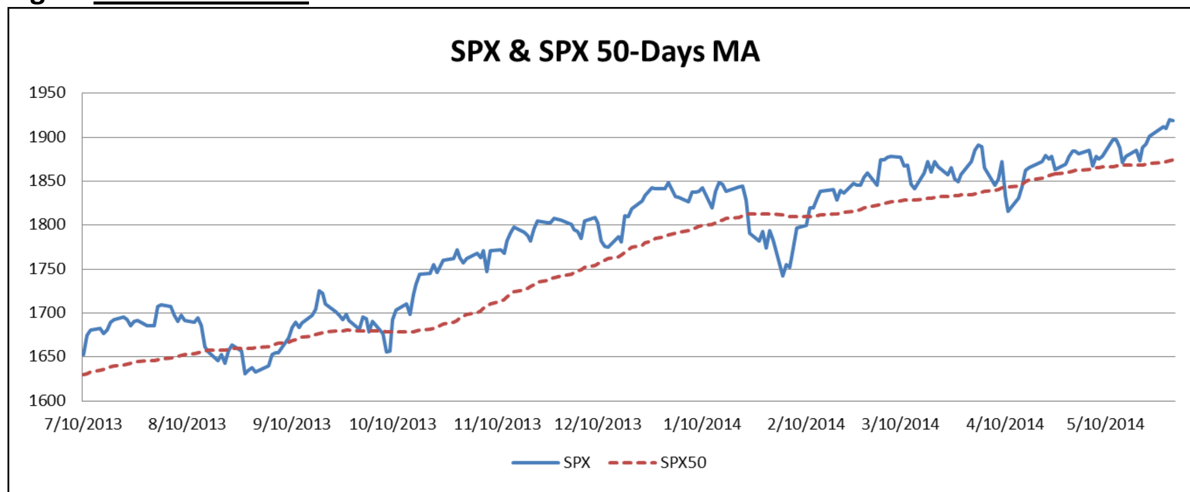
Ideally, the Fed could achieve a glide path to monetary normalization without major market disruptions. The markets have already discounted the tapering without significant negative impact and it is likely that news of impending gradual increases in short-term rates will be absorbed without major problems. Nevertheless, the Fed will likely face some short-term volatility as it weans markets away from the exceptional monetary measures of the past few years.

Long-term interest rates have dropped further as a result of several factors: a shift of investors from stocks to bonds, strong demand by boomers rebalancing their portfolios, and a decline in the supply of government securities. The 10-year Treasury's yield declined to a one-year low of 2.46% at the end of May, down .5% from the end of 2013, before recovering to around 2.60 % in early June.

Growth Risks on the Upside: Theoretically, the sharp decline in bond yields should be a predictor of an economic slowdown or recession. However, with several structural and cyclical factors at play, this does not seem to be the case, and the recent string of robust data releases makes the opposite case. The main drags on the US economy (sluggish middle class income growth, low business capital expenditures and subpar global growth) remain in place. However, risks seem to be on the upside. In particular, the strong jobs report could pave the way for an economic rebound over the next two quarters. In fact, this year could be a record one in terms of job creation. This could be the onset of a virtuous cycle, leading to growth accelerating beyond the 2.0-2.5% of the past few quarters.

Defying Gravity: The equity markets continue to surprise, with the S&P500 registering a strong performance in May, breaking new records. The index broke through the 1,900 level on May 23rd, resulting in a 2.2% increase for the month of May (4.4% YTD). Most sub-indices are now at their 52-week highs. The S&P500 jumped by a further 1.2% in the first week of June to a new record of 1,947.

Fig. 6: The Bull Revives

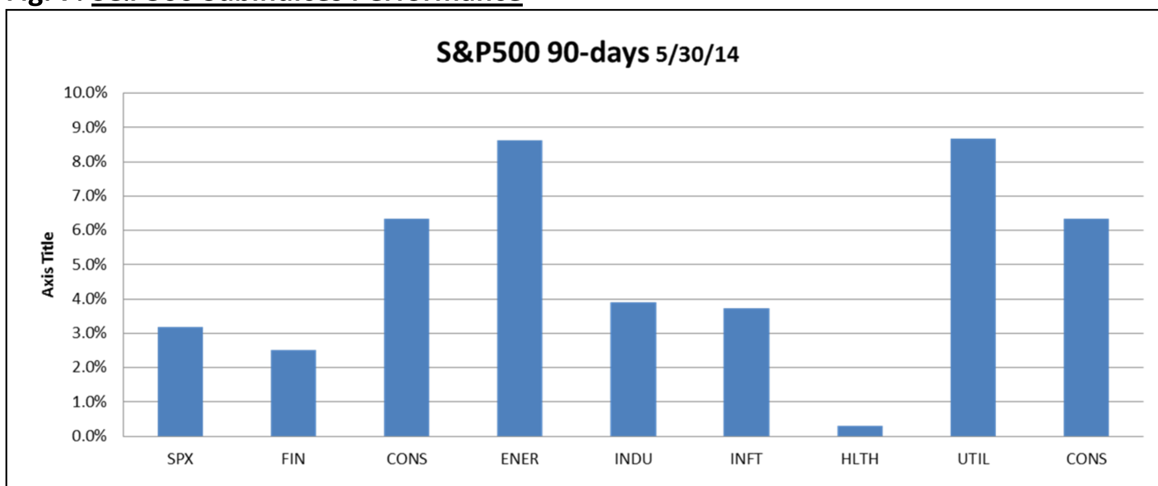


The strong market momentum continues to be divorced from the real economy:

- Defensive sectors are leading the rally since early May on a 30-day basis, while no pattern has emerged on a 90-day basis.

- The record level of the S&P500 was accompanied by record low trading volumes and a continued shift of funds from equities to bonds. There was a $1.2 billion outflow from mutual and ETF funds that buy US equities in 1Q14, while bond funds gained $34 billion over the same period.
- Corporate profits were up 5.3% y/y in 1Q14, but declined slightly on a quarter-to-quarter basis.

Fig. 7: S&P500 Subindices Performance



A case for further market gains on fundamentals is a difficult one to make. However, unless the pace of economic growth and labor market improvements accelerate, the likelihood of a correction down the road—the last one was in August 2011—has increased significantly.

May Data Releases

Economic Data Releases-May 2014	*Prior*	*Consensus*	*Actual*	*Min*	*Max*
Macroeconomy					
GDP (1Q14, % Annualized) Second estimate	3%	-0.5%	-1.0%	-0.8%	0.2%
CPI (m/m) Apr	0.2%	0.3%	0.3%	0.2%	0.4%
Core CPI (% m/m) Apr	0.2%	0.1%	0.2%	0.1%	0.2%
Balance of Payments					
Exports (% m/m) Apr	2.1%		-0.2%		
Imports (% m/m) Apr	3.1%		1.2%		
Trade Deficit $ billion) Apr	$44.2	$41.0	$47.20	$38.6	$43.0
Current Account Deficit ($ billion) (4Q13)					
Oil Prices (WTI, $/bbl, eom) Mar	$99.74		$102.67		
Corporate Profits (y/y) 1Q14	6.0%		5.3%		
Industrial & Manufacturing					
Empire State (May)	1.90	5.00	19.10	3.00	8.50
Philadelphia Fed (May)	16.6	14.30	15.40	8.00	22.00
ISM-Mfg May	54.9	55.5	55.4	54.6	56.6
Chicago PMI (May)	63.0	63.0	65.5	59.9	64.5
Markit PMI Mfg May	55.4	56.2	56.4	55.6	56.5
Industrial Production (% m/m) Apr	0.9%	0.0%	-0.6%	-0.3%	0.3%
Manufacturing (% m/m) Apr	0.7%	0.4%	-0.4%	0.0%	0.4%
Durable Goods (m/m) Apr	3.6%	-0.8%	0.8%	-3.0%	0.5%
Durable Goods, ex transp (m/m)	2.9%	-0.1%	0.1%	-0.6%	1.0%
Factory Orders (m/m) Apr	1.5%	0.5%	0.7%	-0.2%	0.9%
Services					
ISM non-mfg May	55.2	55.3	56.3%	54.5	57.5
Consumer Spending					
Retail Sales (% m/m) Apr	1.5%	0.4%	0.1%	-0.1%	0.8%
UMich Consumer Sentiment (end-May)	81.9	82.5	81.9	81.0	84.0
ConfBd Consumer Confidence (end-May)	81.7	83.0	83	71.5	85.6
Personal Income (m/m) Mar	0.5%	0.4%	0.3%	0.2%	0.6%
Personal Consumption Expenditures (m/m) Feb	1.0%	0.2%	-0.1%	0.0%	0.5%
Housing Market					
Housing Starts ('000) Apr	947	980	1072	940	1050
New Home Sale ('000) Apr	407	420	433	396	460
Existing Home Sales (MM) Apr	4.59	4.69	4.65	4.60	4.90
Construction Spending (m/m) Apr	0.6%	0.7%	0.002	0.4%	1.2%
Case Shiller-20 (m/m) Mar	0.8%	0.7%	1.2%	0.2%	1.1%
Case Shiller-20(y/y) Mar	12.9%	11.9%	12.4%	11.6%	12.9%
Employment					
First Time Claims ('000) (Last week May)	204	310	312	300	319
Non-Farm Payroll Mar	282,000	213,000	217,000	110,000	240,000
o/w Private Sector	273,000	215,000	216,000	177,000	225,000

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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