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Title: Advocacy Investing® Portfolio Strategies, Issue 60
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Date: August 13, 2014

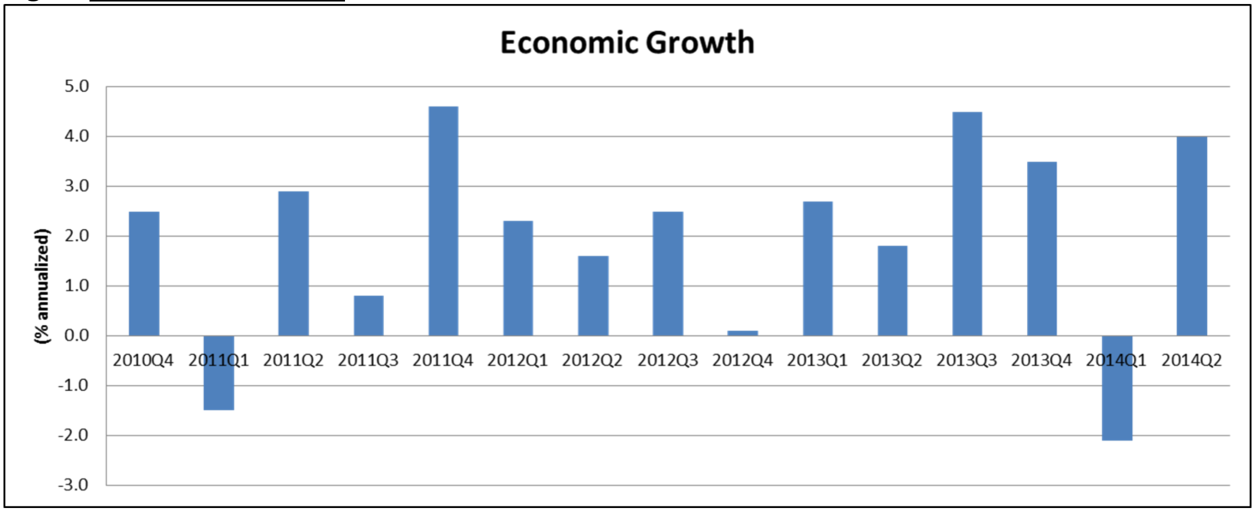
Advocacy Investing®

BETTER BY THE MONTH

- **A strong rebound in 2Q14 from the winter doldrums**
- **Robust payroll numbers point to solid labor market improvements, with unemployment heading down to 5.5% by year-end**
- **Fed policy: "steady-as-she goes", with an eye to a possibly earlier U.S monetary tightening**
- **Economy on path to above-trend growth in the next few quarters**
- **Sharp July month-end correction reflects markets on a knife-edge, spooked by monetary policy uncertainties-goodbye to Goldilocks!**

An Above-expectations Rebound: The economy rebounded sharply in 2Q14, with GDP expanding at an above-expectations rate of 4.0% (quarter-on-quarter, annualized), after shrinking by 2.1% in 1Q14. While the signs of a more vigorous economic recovery abound, the US economy will essentially be flat in 1H14 because of the sharp contraction in 1Q14. The expansion was broad-based: private consumption expenditures rose by 2.5%, gross private investment by17%, exports by 9.5%, imports by 11% and government expenditures by 1.6%. Moreover, the economic contraction in 1Q14 was revised from -2.9% to -2.1%, and the economic growth number for 2013 was revised upwards from 1.9% to 2.2%. However, we should keep in mind that these numbers will be revised twice more before being finalized.

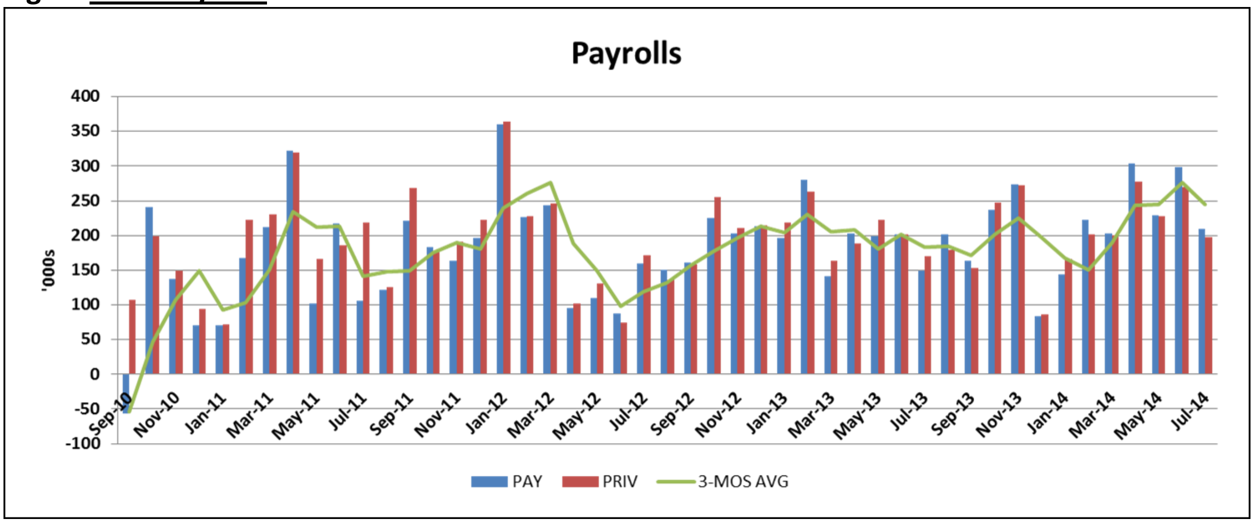
Fig. 1: Economic Rebound



Data Releases Point North: Nevertheless, the strong outcome in quarterly growth is in line with the other data releases over the past two months, which all pointed to a strong recovery from the winter doldrums. On the industrial and manufacturing side, both the actual data and forward-looking surveys showed improvement. Industrial production and manufacturing rose by respectively 0.2% and 0.1% (month-on-month, m/m) in June. Early July surveys also improved, with the Empire State Index rising from 19.28 to 25.6, and the Philadelphia Fed indicator up from 17.8 to 23.9. Late-month indicators show some softening in the still robust pace of manufacturing activity, with the ISM-manufacturing at 57.1 from 55.3 the previous month, and the broad-based Chicago PMI falling to 52.6 from 62.6 at end-June. Motor vehicle sales were up 1.2% m/m in June, to 17 million units (annualized). Consumer confidence remains strong at end of July with the University of Michigan-Reuters at 81.3 down from 83.5 in June and the Conference Board index up sharply to 90.5 from 86.5 in June. Retail sales gained 0.2% in June. Personal income and personal consumption expenditures were up by 0.4% each in July. The service sector also expanded, with the PMI Markit-Services stable at 61. Inflation has also picked up, reaching a year-on-year pace of 1.8% in June. Oil prices (West Texas Intermediate, WTI) fell to below $100/barrel (bbl) for the first time since early February, ending July around $98.20/bbl from a high of $105.37 at end-June.

Mixed Signals: The housing market seems to be marking time after several strong quarters. Housing starts and new home sales were down in June, while existing home sales edged up. Moreover, both new and existing home sales have been declining on a year-on-year basis since the beginning of the year, reflecting tighter mortgage markets and weak income growth. Moreover, "investors" accounted for a large portion of the improvement in the housing market in the past few quarters, and that interest seems to have tapered as the market has healed (foreclosures are down to their pre-crisis levels) and rotated towards more traditional buyers. Furthermore, the Case-Shiller Index showed a decline of 0.3% (m/m), the first since January 2012. On the positive side, we are seeing some easing of mortgage standards, which could help restart the market.

Fig. 2: <u>Solid Payrolls</u>



Solid Employment Growth: The labor market continued to improve in July, as total payrolls rose by 209,000 (the sixth consecutive month in excess of 200,000). The two previous months were revised upwards by an aggregate of 15,000, which brought the 3-month moving average to 245,000 (from 277,000 in 2Q14). Private payrolls rose by 198,000, with all sectors contributing to the increase—the goods producing sector up by 58,000, the private services sector by 140,000 and government by 11,000. However, the strong cyclical improvement in the labor markets has yet to translate to rising wages, as hourly wages and weekly hours worked remained flat. High-frequency data also underscore the improved labor markets, with first time jobless claims around or below the 300,000 benchmark level for the past few weeks. The unemployment rate (derived from a separate household survey) rose from 6.1% to 6.2% as a result of an uptick in the labor participation rate. The broader U-6 measure of unemployment and underemployment increased to 12.2% from 12.1% in June.

Overall, we have the picture of a solid pace of jobs creation, which should lead to a steady decline in the unemployment rate to around 5.5% by the end of 2014, with a rising labor market participation rate.

Another piece of encouraging news has been the decline in long-term unemployment over 1H14, as the proportion of the long-term unemployed (six months or more) has declined from a high of 45% of the total number unemployed at the peak of the recession to 33% by the end of June. At the same time, the data indicates that the ability to find a job for the long-term unemployed has improved significantly. Nevertheless, long-term unemployment and underemployment remains significantly higher than in the aftermath of previous recessions, which is one factor keeping wages stagnant despite the continued improvement in the labor markets.

Goodbye to Goldilocks: The Federal Open Market Committee (FOMC) held its fifth scheduled meeting of the year on July 29-30. There were no surprises in the FOMC statement, which reiterated its view that while the economy is growing at a moderate pace, there is evidence of "significant underutilization of labor resources." At the same time, the Fed does not see a threat of deflation. In fact, the latest inflation number (CPI up by 1.8% y/y), is close to the Fed target of 2%. As expected, the FOMC felt confident enough about the economic recovery to announce another $10 billion cut in its bond purchasing program, now running at $25 billion per month. Furthermore, the FOMC Statement underscored that short-term rates are expected to remain within the 0-1/4 per cent range for the foreseeable future (probably until early to mid-2015), and should remain below what would be considered in line with the macroeconomic situation (somewhere around 2.5-3.5% for Fed fund rates) once monetary policy returns to a more normal stance.

The FOMC statement and Fed Chairperson Yellen's recent semi-annual testimony to Congress underscore the fact that Janet Yellen remains very cautious, while at the same time maintaining her focus on the labor markets as a key policy guide. In her testimony, Yellen stated that the economic recovery is not yet complete, citing three headwinds: diminished household expectations about their future financial health, tighter mortgage credit and low productivity growth.

Nevertheless, this cautious stand hides the fact that we are probably at the end of the "Goldilocks era": just-right economic growth sufficient to keep a steady pace of improvement, but not high enough to get the Fed off its easy monetary policy cycle. In fact, the faster-than-expected decline in unemployment could lead the Fed to tighten monetary policy earlier than the currently expected mid-2015. (This stance is already reflected in rising dissent on the FOMC and among regional Fed presidents). The 10-year Treasury yield fell to a 13-month low of 2.49% at the end of July. However, it is expected that Treasury yields will rise and the yield curve will steepen in the next few months as a result of the faster economic recovery.

IMF Downgrades Global Growth: The IMF in its latest revised outlook has downgraded slightly its 2014 global output growth forecasts (lower by 0.3% from its April forecast). The global economy is now expected to expand at 3.4%, with US output rising by a meager 1.7% and the eurozone finally out of recession. However, the data for the year is distorted by very poor first half global performance, which was dragged down by the first quarter U.S. contraction as well as the weak Chinese economy, but there are clear indications that global growth is accelerating as we move past the mid-year point.

Table 1: IMF Forecast

Year	2012	2013	2014	2015
World	3.5	3.2	3.4	4.0
US	2.8	1.9	1.7	3.0
eurozone	-0.7	-0.4	1.1	1.5
Japan	1.4	1.5	1.6	1.1
Em Mkts	5.7	4.7	4.6	5.0
China	7.7	7.4	7.4	7.1

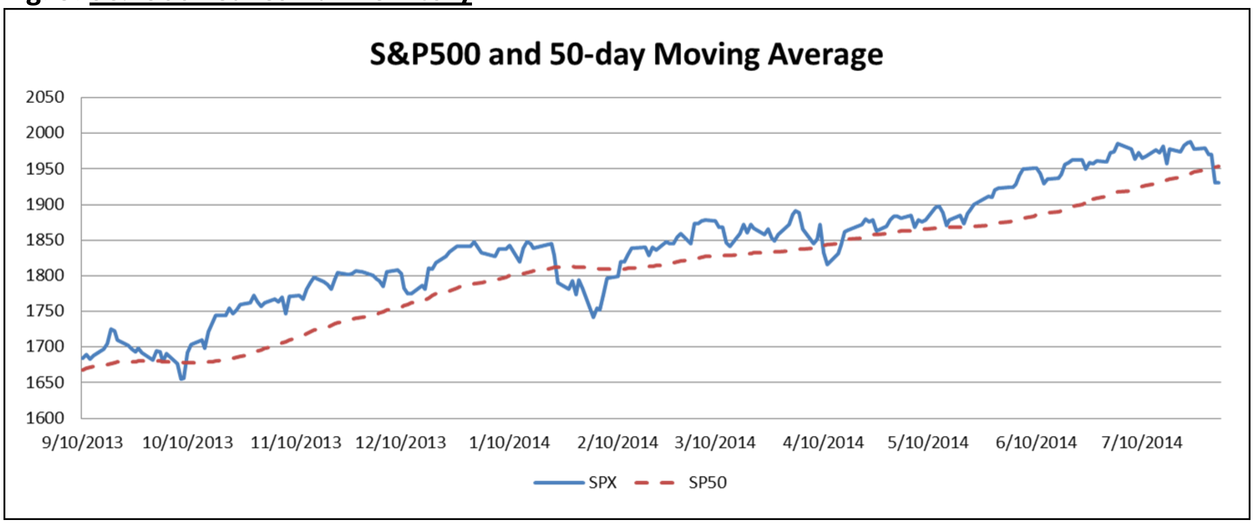
The IMF forecast is supported by recent data releases. The eurozone has shown unexpected strength in both manufacturing and services. However, economic prospects are mixed, with Germany growing at close to 1%, while France (the second largest economy) is still flat and Italy (the third largest one) continues to shrink. The UK recovery seems to be on a strong footing and the Japanese economy is emerging from a slow period. Chinese data shows improvement. The latest HSBC-Markit PMI Manufacturing rose to 52 in July, reaching its highest level in 18 months. Furthermore, 2Q14 GDP registered a 7.5% growth rate. However, we should recognize that while China's economy is recovering, it is unlikely to be able to break out of the 7.0-7.5% growth pace it has experienced in the past few quarters, which will have long-term implications both for the United States and commodity exporters.

Improving Prospects, but Downside Risks Remain: The strong rebound of the economy in 2Q14 was good news. While some of the improvement is due to a recovery from a dismal first quarter, there is increasing evidence that we have been pivoting to an above-trend pace of growth in the past few months, and this acceleration in growth could continue for the balance of this year and possibly into 2015. While consumption expenditures (which account for 70% of the economy) still remain disappointing, there are signs that households might be ready to loosen their purse strings: consumer confidence remains high and the rapid drop in unemployment should lead to faster wage gains. Furthermore, manufacturing and exports continue to expand at a relatively rapid pace, and the global economic scene is healthy.

Downside risks remain. In the short term, the major risk to the recovery is a stingy consumer. Since 2010, we have had a pattern of inventory-driven mini-cycles, with two strong quarters followed by slow ones. Given the sustained improvement in the underlying data, we will probably escape this pattern, but a low-growth scenario cannot be ruled out. A worsening of the Ukraine crisis, a possible Russian military intervention and a new round of US-European Union sanctions could also have a dampening impact of global growth.

Overall, we can expect the economy to expand at a pace exceeding 3% over the balance of the year. In the longer-term, however, economic growth will be constrained at its potential pace of about 2.5%, down from 3-3.5% in the 1990s and early 2000s.

Fig. 3: <u>S&P500 Leaves Bull Territory</u>



Markets' Whiplash: In the past few weeks, the equity markets seemed to be impervious to the on-going and seemingly endless series of geo-political shocks: Ukraine, Syria, Iraq and now the latest round of hostilities between Israel and Hamas in the Gaza Strip. In fact, the market has shown remarkable resilience to downside shocks. Prior to the end-July dip, the average S&P500 decline lasted 1.4 days in 2014, with no dips lasting more than 3 days (compared to an average of 9 since 2009). Moreover, we have had no market correction in 33 months, (compared to a historic average of one every 18 months). The S&P500 is now trading at 18 times earnings, the highest since 2010.

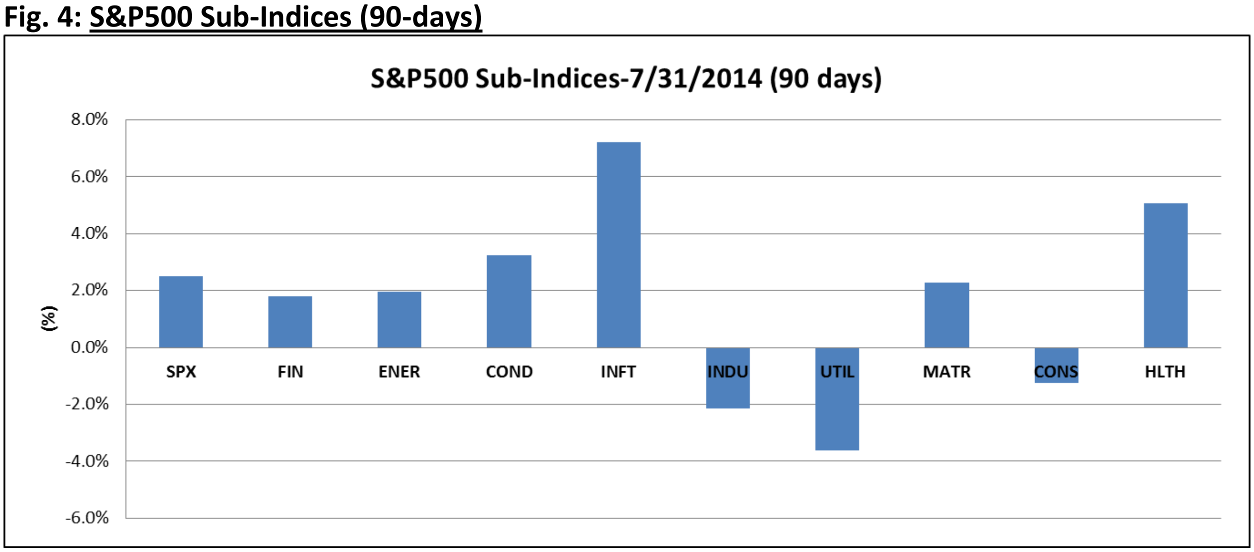
The equity markets have also been supported by high levels of stock buybacks ($153 billion in 1Q14), which boosts prices. The S&P500 corporations are sitting on approximately $1.2 trillion in cash, and strategically-timed stock buy-backs offer a cheap way of boosting stock prices without improving earnings.

However, the market sentiment turned at the end of July. Despite the strong 2Q14 growth numbers released on July 30, the markets got whacked the next day, with the S&P500 dropping by 2% to 1,930 on July 31st. Overall, the index fell by 1.5% in July, its first monthly drop since January 2014. The market index briefly hit an all-time high of 1,987.98 on 7/24, but fell by almost 3% in the last week of the month. All of the sub-indices, with the exception of information technology and health care, ended July in the red. However, the cyclical sectors outperformed the defensive ones on a 90-day basis.

Paradoxically, the strong showing of the economy in 2Q14 spilled over into rising market concerns about an earlier tightening of monetary policy by the Federal Reserve Bank. These concerns were amplified by earnings weakness in European markets and the fear of a backlash on European businesses after the imposition of tough European and American sanctions on Russia over Ukraine. In combination, these factors led to profit taking and a more global market swoon. The VIX jumped by 19%, to its highest level in 4-months.

The market behavior over the past few months raises two apparently contradictory questions. First, is the market in a bubble? And second, are we at the beginning of a market correction? The high valuations naturally bring up the question of whether or not the market is in a bubble. In her testimony to Congress, Yellen reiterated her view that the social media and biotech sectors exhibited a high degree of froth, warning about overvaluations in very volatile sectors. Furthermore, we see high premia paid for growth stocks, a situation that might be difficult to sustain given the relatively weak earnings performance in those sectors. However, overall, the S&P500 earned $108 per share in 2013. Assuming that it can increase that number to $110, the market index could potentially reach 2,200 at a multiple of 20, still below the 22-25 multiples associated with a market peak. At the same time, the underlying strength in the economy increases the likelihood that a correction will be short-lived. In fact, the markets recovered on Monday after the sharp two-day drop at the end of July, continuing the previously noted trends. Nevertheless, the markets cannot continue to rely on multiple expansion (which accounted for 75% of the improvement in 2013) or Fed monetary support to sustain the upward trend. The era of Goldilocks is over, and the market will need to focus on earnings to validate future performance.

Fig. 4: <u>S&P500 Sub-Indices (90-days)</u>



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July Data Releases

Economic Data Releases-July 2014	*Prior*	*Consensus*	*Actual*	*Min*	*Max*
Macroeconomy					
GDP (2Q14, % Annualized) First estimate	-2.1%	3.1%	4.00%	2.3%	4.0%
CPI (m/m) Jun	0.4%	0.3%	0.30%	0.2%	0.6%
Core CPI (% m/m) Jun	0.3%	0.2%	0.10%	0.1%	0.3%
Balance of Payments					
Exports (% m/m) May	-0.1%		1.0%		
Imports (% m/m) May	1.1%		-0.3%		
Trade Deficit $ billion) May	$47.00	$45.1	$44.40	$42.1	$46.5
Current Account Deficit ($ billion) (4Q13)					
Oil Prices (WTI, $/bbl, eom) July	$105.37		$97.38		
Corporate Profits (y/y) 2Q14	5.3%		6.8%		
Industrial & Manufacturing					
Empire State (Jul)	19.28	17.80	25.6	12.00	20.50
Philadelphia Fed (Jul)	17.80	16.90	23.9	12.00	21.00
ISM-Mfg-Jul	55.3	56.0	57.1	55.0	56.8
Chicago PMI (Jul)	62.6	63.2	52.6	61.0	65.0
Markit PMI Mfg July	57.5	57.6	56.3	57.5	59.0
Industrial Production (% m/m) Jun	0.5%	0.4%	0.2%	0.1%	0.3%
Manufacturing (% m/m) Jun	0.4%	0.4%	0.1%	0.2%	0.5%
Durable Goods (m/m) Jun	0.8%	0.4%	-1.0%	-1.7%	-1.0%
Durable Goods, ex transp (m/m)	0.4%	0.3%	-0.1%	0.1%	0.7%
Factory Orders (m/m) Jun	-0.6%	0.6%	1.1%	0.0%	0.8%
Services					
PMI Services Flash (Jul)	61.2	60.0	61.0	59.0	61.4
Consumer Spending					
Retail Sales (% m/m) Jun	0.5%	0.6%	0.2%	0.5%	1.3%
UMich Consumer Sentiment (end-Jul)	82.5	83.0	81.3	82.0	93.0
ConfBd Consumer Confidence (end-Jul)	86.4	85.5	90.9	83.5	88.5
Personal Income (m/m) Jun	0.4%	0.4%	0.4%	0.3%	0.5%
Personal Consumption Expenditures (m/m) Jul	0.3%	0.4%	0.4%	0.3%	0.6%
Housing Market					
Housing Starts ('000) Jun	985	1026	893	985	1085
New Home Sale ('000) Jun	442	475	406	459	510
Existing Home Sales (MM) Jun	4.91	4.99	5.01	4.90	5.06
Construction Spending (m/m) Jun	0.8%	0.5%	-1.8%	0.0%	0.5%
Case Shiller-20 (m/m) May	0.1%	0.4%	-0.3%	-0.5%	1.8%
Case Shiller-20(y/y) May	10.8%	9.9%	9.3%	9.2%	10.3%
Economic Data Releases-April 2014	*Prior*	*Consensus*	*Actual*	*Min*	*Max*
Employment					
First Time Claims ('000) (Last week July)	279	305	302	295	320
Non-Farm Payroll Jul	298,000	233,000	209,000	200,000	280,000
o/w Private Sector	270,000	237,000	198,000	200,000	275,000

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.