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Advocacy Investing®

JACKSON HOLE: THE VIEW FROM THE CENTRAL BANKING PEAKS

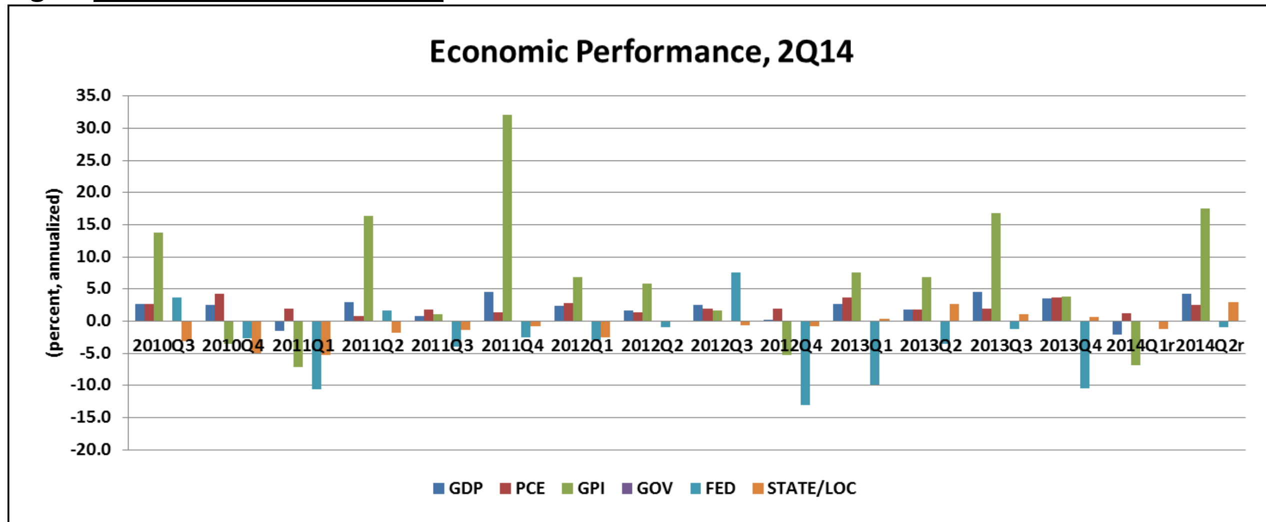
- **The Jackson Hole meeting of central banks confirmed diverging monetary policy paths**
- **European Central Bank ready to counter slowdown and deflation by adopting a quantitative easing program**
- **US 2Q14 economic growth revised upward**
- **Data releases remain positive, although the consumer remains cautious**
- **August payrolls were disappointing, but still strong**
- **The short-term economic outlook is sunny, but headwinds from the eurozone remain a challenge**
- **The S&P500 breaches 2,000 after a strong August, but doubts remain about the sustainability of the rally**

The View from the Grand Tetons—Unsettled: As the world's top central bankers and monetary policy specialists gathered under the majestic peaks of the Grand Teton range for their annual meeting at Jackson Hole, the view in the valley was mixed. The US economy continues to mend; the UK economy is growing, but the eurozone is faltering. The Eurozone PMI –Manufacturing fell to 50.7 in August from 51.8 the previous month. The index was at a multi-month low from France, Italy and even Germany, where the economy shrank by 0.2% in 2Q14. Overall, the ECB has cut its forecast growth for 2015 from 1% to 0.9%. The Japanese economy also took a turn for the worse, unexpectedly contracting in 2Q14. The diverging economic fortunes of the main economic powers were also reflected in the different paths for monetary policy; while the American and the British central banks are moving towards gradually reversing course from the ultra-easy monetary policies, the European Central Bank (ECB) and the Bank of Japan are titling towards quantitative easing.

The ECB in the Limelight: Mario Draghi, the President of the ECB, raised expectations of a major shift in economic policy. Draghi was clearly critical of the continued austerity policies followed by the major European countries and indicated that the ECB, which had been accused of incrementalism, had reached the limits of conventional monetary policies. Citing increased downside risks and the threat of a return to a third recession in less than 7 years, the ECB cut its benchmark rate on September 2nd by 0.1% to 0.05%, very close to zero. Furthermore Draghi announced the start of a quantitative easing-light (QE-light) program.

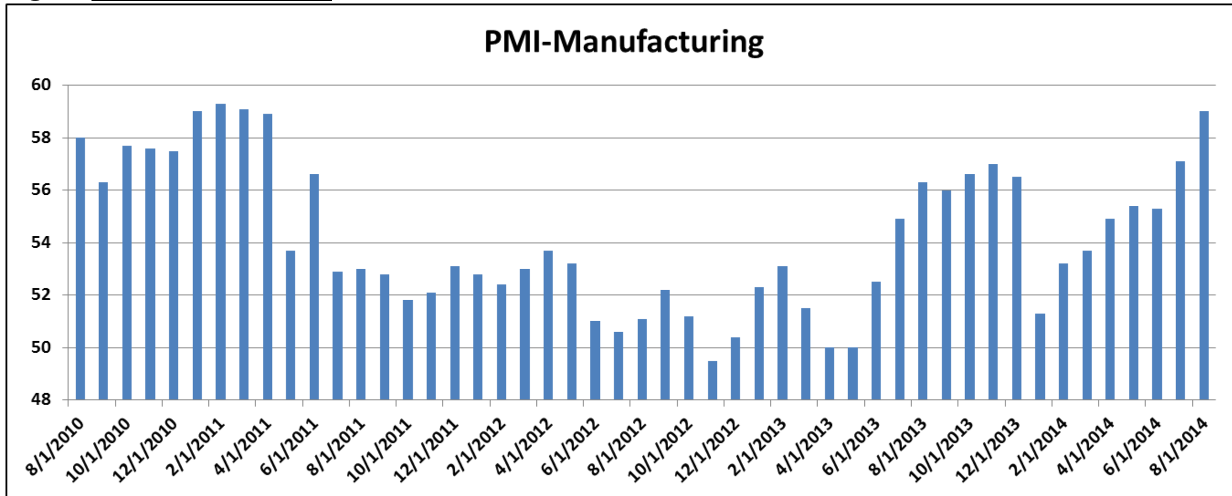
Upward Revision: In their first revision 2Q14 economic growth numbers were upped from 4% to 4.2% (annualized.) Growth was broad-based, with personal consumer expenditures, both residential and non-residential capital expenditures, exports and state and local governments contributing to growth.

Fig. 1: US Economic Performance



The latest data releases for the United States remain positive, although the household and consumer sector are showing a pullback. Personal income was up by 0.2% (month-on-month, m/m) in July and both major indicators of consumer confidence were up at the end of August—the University of Michigan-Reuters index rose to 82.5 from 79.2 the previous month and the Conference Board indicator increased from 90.3 to 92.5 over the same period. Nevertheless, July personal consumer expenditures fell by 0.1% m/m, their first decline in six months, and retail sales were flat. Industrial production and manufacturing increased by respectively 0.4% and 1.0% m/m in July; while durable good sales (boosted by strong demand for aircraft) increased 22.6%. Forward-looking survey data also underline robust industrial and manufacturing growth. In early August, the Empire State indicator fell to 14.69 from 25.6 the previous month, and the Philadelphia Fed index jumped from 23.9 to 28.0. Late-month surveys were also strong, with the Chicago PMI jumping to 64.3 from 52.6, the ISM-Manufacturing to 59 from 56.1 and the Markit PMI-Manufacturing increasing from 55.8 to 57.9. The PMI-Services remained firm at 59.5. Oil prices (West Texas Intermediate, WTI) are down, having fallen by 5% in August to $95.32/barrel—and 12.4 % in the past year. Finally, the Fed's Beige Book (which surveys regional conditions) reported that the economy strengthened in all 12 Federal Reserve Districts in July and August.

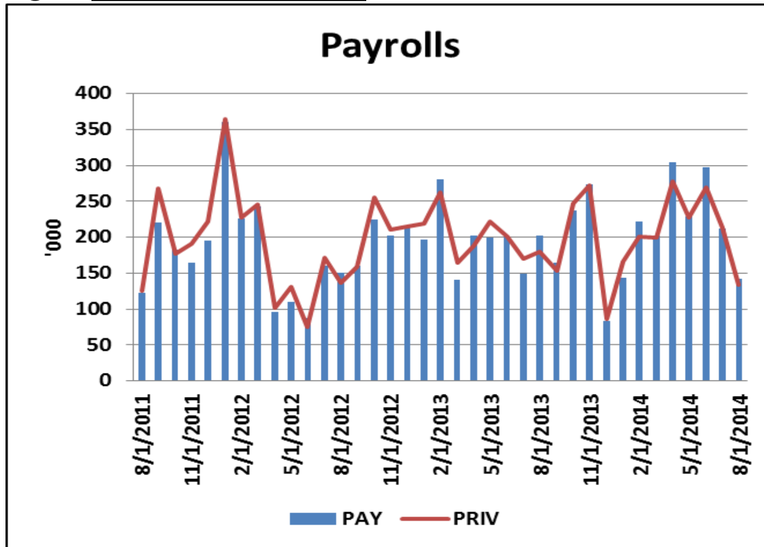
Fig. 2: US Manufacturing



The housing market results were mixed. Housing starts and existing home sales rose slightly in July, while new home sales were about flat. Home prices (as reflected in the Case-Shiller 20 city index) fell for the second month in a row in June, down 0.2% m/m. Construction spending recovered, rising by 1.8% m/m in July after a 0.9% contraction the previous month.

Monetary Policy Shift in Sight: With the quantitative easing taper expected to be complete by the October Fed meeting, there are clear indications of an upcoming shift in monetary policy. Minutes of the July Federal Open Market Committee (FOMC), as well as Fed chief Yellen's speech at Jackson Hole seem to indicate that the gap between doves and hawks is narrowing. Yellen's policy focus over the first months of her Fed leadership has been on the labor markets, arguing for a continuation of the ultra-easy monetary policy in the face of continued underlying weakness in the employment situation. However, she took a more optimistic view of the improvements in the labor markets in her Jackson Hole speech, stating that "...US labor markets are more balanced than had previously been seen." In combination with positions taken by the well-known hawks and doves at the Fed, all indications are that the era of zero short-term interest rates should be over sometime in 2Q15. Moreover, a gradual tightening of monetary policy is likely to be accompanied by steps designed to shrink the $4 trillion Fed balance sheet. Furthermore, the economy should continue to create 150,000-200,000 jobs a month over the next few months, adding 1.5-2.4 million new jobs and bringing the unemployment rate down to about 5% by the end of 2015—the level commonly known as NAIRU (non-accelerating inflation rate of unemployment), which could trigger an even faster tightening beyond 2015.

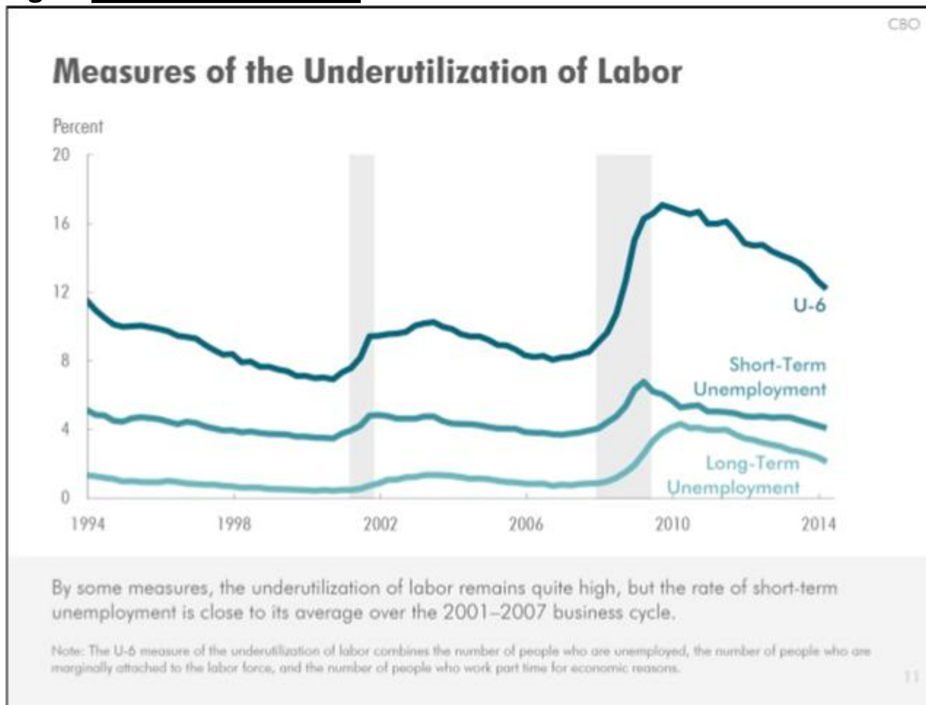
Fig. 3: A Downside Surprise



Disappointing, but Still Strong: After experiencing several months of 200,000-plus monthly additions, the August payroll report came in significantly below market expectations of 200,000 new jobs. The economy added only 142,000 new jobs (134,000 private sector jobs) in August, and the previous two month numbers were revised downward by 28,000. This brought the three-month average down to 202,000 from 234,000 in July and 266,000 in 2Q14. Private business services added 47,000 positions, while manufacturing was flat. Within these categories, retail was flat and employment in auto manufacturing fell by 5,000. The labor participation rate remained at 62.8% (unchanged since April), unemployment fell from 6.2% to 6.1% and weekly hours worked stayed at 34.5. There was some good news: the proportion of long-term unemployed and part-time workers fell, bringing down the broader unemployment and underemployment rate (U6) down from 12.1% to 12.0%. Hourly wages were up 0.2% m/m, which translated into a labor income proxy growth of 4.5% (annualized). High-frequency indicators also remained positive, with first-time jobless claims at or below the 300,000 benchmark for the past 9 weeks.

While the labor markets are on the mend and labor market slack is rapidly fading, employment has yet to recover from the Great Recession. All measures of labor force utilization have improved from their deep recession levels, but remain significantly higher than their pre-recession historic averages. In particular, the proportion of long-term unemployed remains high and the U-6 unemployment/underemployment rate, at about 12%, is at about 1.5 times its pre-recession average. Furthermore, the labor markets are suffering from a number of structural factors: increased polarization, with a smaller proportion of mid-level jobs; a stubbornly high proportion of part-time jobs and a declining participation rate.

Fig. 4: Underutilizing Labor



Short-term Outlook: The upward revision of 2Q14 GDP shows that the economy is on a solid footing, but faces challenges.

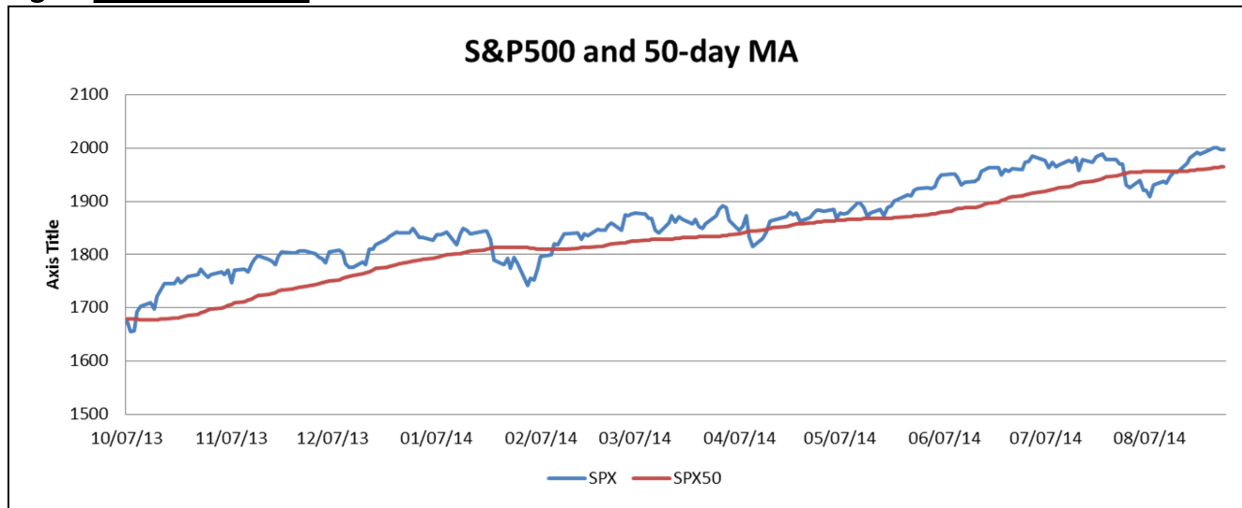
- We have seen a strengthening of the positive drivers of growth in the past few months, with exports, business expenditures and manufacturing on an expansion path.
- The fiscal drag has faded and the fiscal situation has improved significantly. According to the Congressional Budget Office (CBO), the deficit for the current fiscal year (ending September 30, 2014) is projected at $504 billion, or 2.9% of GDP, from 4.1% in FY2013.
- Monetary policy remains supportive and energy prices have declined.

However, challenges remain:

- The consumer continues to lag, and the improvements in consumer confidence have yet to translate in a more durable recovery in personal consumption expenditures.
- The economy faces stronger headwinds than earlier in the year from the fading of the eurozone recovery which could cut into prospective growth rates.

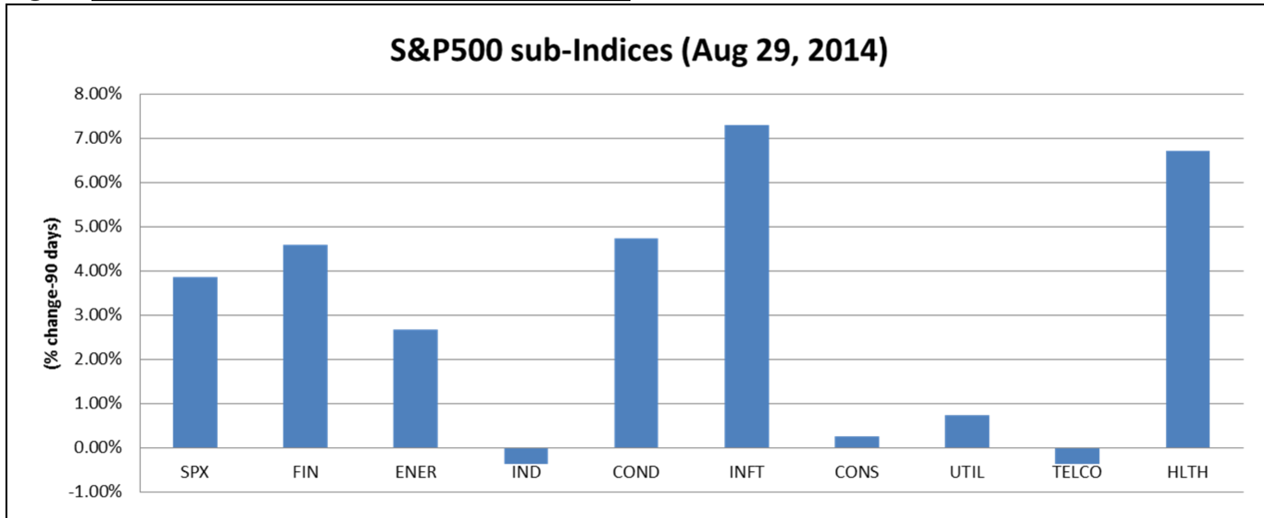
Nevertheless, the economy could expand at a steady and above-trend 3% over the next two to three quarters.

Fig. 5: The Bull Persists



Breaching 2000: The S&P500 breached the 2,000 level on August 25th, closing the month at a record level of 2,003. Overall, the market index had its best August performance in 14 years, gaining 3.7% over the course of the month—and 8.1% year-to-date (ytd). Moreover, 9 out of 10 index component shares gained. At the same time, these gains happened at record low trading volumes, as retail investors remained on the sidelines. A eurozone growth slowdown and rising tensions in Ukraine are increasing the global markets' choppiness. The MSCI-EAFE barely moved in August, gaining only 1.1% ytd, while the MSCI-EM (emerging markets) has gained 9.8% ytd and 3.3% in August. While all sectors gained on a 90-day basis, cyclical sectors performed better in August. The August payrolls report put a damper on the market; nevertheless, the S&P500 ended the first week of September at a new record of 2,007.

Fig. 6: S&P500 Sub-indices 90-day Performance



While the markets are reaching new records, valuations remain within range (The S&P500 forward-looking P/E ratio reached 15.1 at the end of August from 13.6 at the end of 2013—significantly below the 21 peak reached in the dot.com bubble in 2000. However, the main market drivers remain the same: steady profits growth and a strengthening economic recovery. Furthermore, buybacks, which were a major factor in the upward market momentum, are fading as companies find their own stocks becoming more expensive. Nevertheless, markets are overpriced in a broader sense, as the strong performance in August is not in line with basically unchanged, albeit positive fundamentals. If anything, uncertainty over US monetary policy and weaker economic growth should be pulling the markets back. The softer August payroll report should take the edge off a potentially more hawkish Fed and provide some market support in the next few weeks. Nevertheless, the Fed medium-term message is clear—tightening by mid-2015—and markets also seem to have discounted the expectation of higher interest rates. In addition, markets tend to react positively to mid-tem elections, which could be another sustaining factor in the short run.

While a mild correction is likely, the S&P500 should trade with 1,950-2,300 range at year-end. Our projection is based on a lower-bound growth equal to nominal GDP growth (5.5- 6%) and an upper-bound based on a P/E of 18.

Box

The CBO Report: Medium and Long-term Economic Prospects: The non-partisan Congressional Budget Office (CBO) presented its medium and long-term forecast for the US economy in its August 27th report. The CBO projects an acceleration of growth over 2014-2016. Over the next few quarters, the CBO expects the economy to rebound and grow at a pace over 3% as a result of more robust consumer and business spending and a waning of the slack in the labor markets. However, the CBO is less optimistic in the long term and projects a tapering-off to around 2% per year by the 2020s. While economic output is expected to return to its potential level by 2017-18, longer-term potential output growth is likely to be capped at about 2% by low productivity growth and a further decline in labor force participation.

CBO	*GDP (%)*	*Deficit (%GDP)*	*Debt (% of GDP*
2013	3.1	4.1	72.044
2014	1.5	2.9	74.415
2015	3.4	2.6	74.02
2016	3.4	2.9	73.595
2017	2.7	2.7	73.013
2018	2.3	2.7	72.805
2019	2.3	3.0	73.086
2020-24 avg	2.1	3.6	77.206 (end-24)

The longer-term fiscal situation is less promising, as sharp increases in social security, healthcare and interest payment outlays should result in persistent deficits and a slight increase in the debt to GDP ratio over the next decade. Nevertheless, the main fiscal indicators are expected to remain in the sustainable zone, with deficits around 3% of GDP and stable debt ratios.

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August Data Releases

Economic Data Releases-Aug 2014	*Prior*	*Consensus*	*Actual*	*Min*	*Max*
Macroeconomy					
GDP (2Q14, % Annualized) First estimate	4.00%	4.0%	4.2%	3.7%	4.1%
CPI (m/m) Jul	0.3%	0.1%	0.1%	0.1%	0.2%
Core CPI (% m/m) Jul	0.1%	0.2%	0.1%	0.1%	0.3%
Balance of Payments					
Exports (% m/m) Jul	0.0%		0.9%		
Imports (% m/m) Jul	-1.1%		0.7%		
Trade Deficit $ billion) Jul	$40.8	$42.3	$40.5	$40.0	$40.5
Current Account Deficit ($ billion) (4Q13)					
Oil Prices (WTI, $/bbl, eom) Aug	$100.70		$95.32		
Corporate Profits (y/y) 2Q14	2.4%		4.5%		
Industrial & Manufacturing					
Empire State (Aug)	25.6	20.00	14.69	15.00	26.00
Philadelphia Fed (Aug)	23.9	20.00	28	17.00	21.00
ISM-Mfg Aug	57.1	56.9	59	55.5	58.0
Chicago PMI (Aug)	52.6	56.4	64.3	54.0	60.0
Markit PMI Mfg Aug	55.8	57.8	57.9	55.5	58.0
Industrial Production (% m/m) Jul	0.4%	0.3%	0.4%	0.0%	0.6%
Manufacturing (% m/m) Jul	0.3%	0.5%	1.0%	0.3%	0.8%
Durable Goods (m/m) Jul	2.7%	5.1%	22.6%	-1.0%	24.5%
Durable Goods, ex transp (m/m)	3.0%	0.4%	-0.8%	-0.5%	1.3%
Factory Orders (m/m) Jul	1.5%	10.9%	10.50%	9.6%	11.6%
Services					
PMI Services (August)	60.8	58.5	59.5	58.3	61.5
Consumer Spending					
Retail Sales (% m/m) Jul	0.2%	0.2%	0.0%	0%	0.4%
UMich Consumer Sentiment (end-Aug	79.2	80.5	82.5	79.6	82.0
ConfBd Consumer Confidence (end-Aug)	90.3	89.5	92.4	85.0	94.0
Personal Income (m/m) Jul	0.5%	0.3%	0.2%	0.1%	0.5%
Personal Consumption Expenditures (m/m) Jul	0.4%	0.2%	-0.1%	0.0%	0.3%
Housing Market					
Housing Starts ('000) Jul	945	963	1093	950	1025
New Home Sale ('000) Jul	422	430	412	415	455
Existing Home Sales (MM) Jul	5.03	5.00	5.15	4.90	5.15
Construction Spending (m/m) Jul	-0.9%	0.9%	1.8%	0.6%	2.0%
Case Shiller-20 (m/m) Jun	-0.3%	0.1%	-0.2%	-0.5%	0.2%
Case Shiller-20(y/y) Jun	9.3%		8.1%		
Employment					
First Time Claims ('000) (Last week Aug)	298	300	302	290	310
Non-Farm Payroll Aug	212,000	230,000	142,000	195,000	270,000
o/w Private Sector	213,000	220,000	134,000	187,000	270,000

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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