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Advocacy Investing®

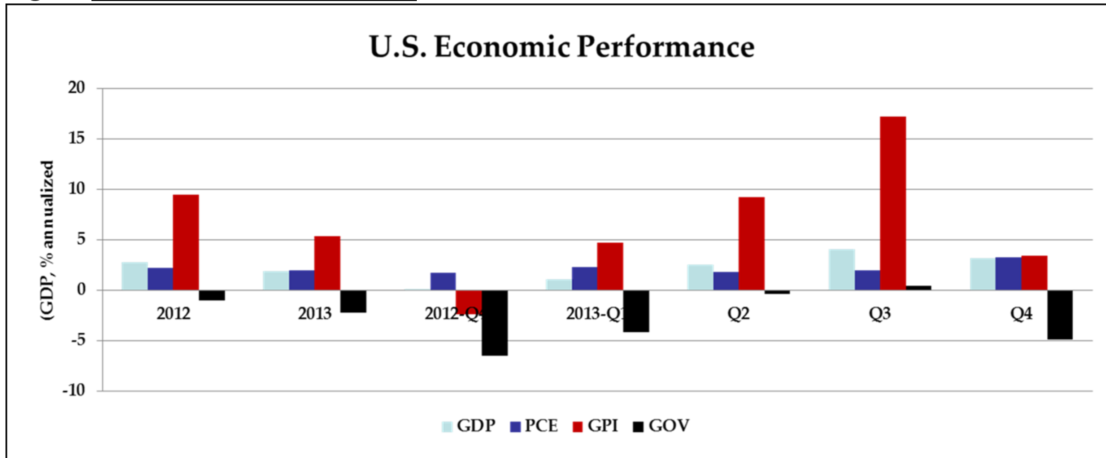
THE YEAR OF THE HORSE

- **The US economy accelerates in 4Q13**
- **As Yellen takes over, the Fed continues to taper**
- **However, the second consecutive disappointing payrolls number in January could lead to taper pause**
- **US economy shows great promise in 2014, but faces high risks**
- **Emerging markets in turmoil roil equity markets**
- **Markets pause, but correction unlikely**

As we mark the start of the Chinese Year of the Horse, the improved U.S. economic performance stands in contrast to the turmoil in the emerging market economies. The question is whether the economic horse will race ahead or will it stumble, as it has so many times in the past few years after a promising start.

Growth Acceleration: Preliminary numbers show that the economy expanded at an annualized pace of 3.2% in 4Q13, from 4.1% in the preceding quarter, the best two-quarter performance since 2H11. Overall, the economy accelerated to 3.5% in 2H13. Growth was driven by positive contributions from personal consumption expenditures (+3.3%), exports (+11.4%), nonresidential fixed investment (+3.8%), private inventory investment, and state and local government spending. This was offset by the drag from federal government spending (minus 12.6%), residential fixed investment and imports. However, the strong 2H13 performance was not enough to offset a weak 1H13 and, overall, GDP rose by only 1.9% in 2013 from 2.8% in 2012.

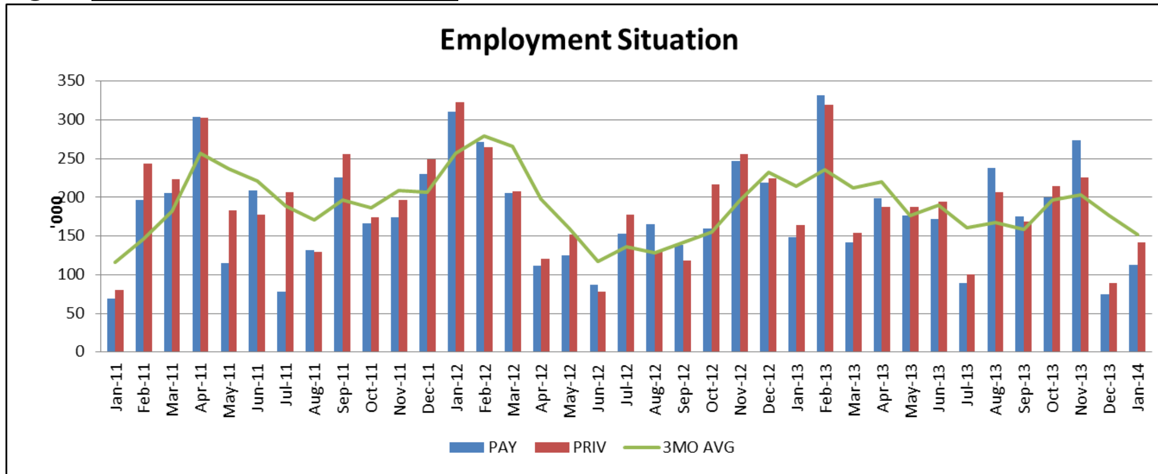
Fig. 1: US Economy Accelerates



Mixed Signals: The economic data releases have been uneven. Industrial production edged up in December by 0.3% month-on-month (m/m), with manufacturing increasing by 0.4% m/m). However, forward-looking surveys were mixed. Both the Empire State and Philadelphia Fed surveys of manufacturing, now in positive territory for the second consecutive month, showed increases. In contrast, the Markit PMI-Manufacturing Index fell from 55.0 to 53.7 and the ISM-Manufacturing fell from 53.0 to 51.3. The Chicago PMI (which covers a broader swath of economic activity) declined slightly, from 60.8 in December to 59.6 at the end of January. Personal income remained stagnant in December, but personal consumption expenditures (+0.4% m/m) and retail sales (+0.2% m/m) rose. Confidence measures improved further in January. The University of Michigan-Reuters consumer confidence index rose to 81.4 at the end of January from 80.4 in the previous month, and the Conference Board benchmark increased from 77.5 to 80.7 over the same period. The services sector expanded as well, with the ISM-Non Manufacturing Index rising to 54 from 53 in December.

Bad News, Good News: The payroll numbers for January delivered another mediocre result. Total payrolls expanded by only 113,000, significantly below the market expectation of 181,000. Private payrolls rose by 142,000. While upward revisions for 4Q13 raised the total, the three-month average fell to 152,000 from 176,000 in December. Goods producing sectors saw a big jump in jobs, (+76,000), while services' job growth slowed somewhat (+ 66,000). The government sector registered a third-month decline (minus 29,000). Average hours worked remained static at 34.4, and hourly earnings increased by 0.2%. The good news was that the unemployment rate (which is derived from a separate household survey) fell from 6.7% to 6.6%, while at the same time the labor participation rate increased from 62.8% to 63.0%.

Fig. 2: January Payrolls Disappoint



The January employment data was likely distorted by the severe weather. Nevertheless, we have had two consecutive months of below-trend payroll numbers, and if we get a similar report for February, we should be concerned about a negative trend. Offsetting this is the fact that high-frequency data continues to improve, with first-time weekly unemployment claims falling at the end of January by 20,000, to 335,000.

Global Turmoil: Almost on cue with the release of more optimistic projections for 2014 by the IMF (which upgraded its global economic growth forecast for 2014 from 3.6% to 3.7%), emerging markets plunged into crisis. A run on the Argentine peso (which forced the government to sharply devalue the peso) morphed into broader turmoil in emerging markets, in particular the so-called "Fragile Five": Turkey, South Africa, Indonesia, Russia and Brazil. While these economies account for only 14.3% of global GDP, their problems have impacted global equity markets and sharply increased risk aversion and volatility. At the same time, the Chinese economy seems to be in the midst of a sharper-than-expected slowdown—as reflected in a decline in the Chinese PMI-Manufacturing.

Taking the Punch Bowl Away: William McChesney Martin, a past Fed chairman, famously stated that it was the Fed's job to take the punch bowl away as the party got going. Today, the Fed is doing so when the party has barely started. In the Federal Open Market Committee (FOMC) meeting on January 28-29 (Bernanke's last FOMC meeting before his replacement by Janet Yellen), the Fed stated that starting February, it would reduce its bond purchases by a further $10 billion, to $65 billion/month—and continue to reduce it by an additional $10 billion each month until quantitative easing stops. The Fed based its decision on a more positive view of the economy. The FOMC statement reads: *"growth in economic activity picked up in recent quarters. ….. Inflation has been running below the Committee's longer-run objective, but longer-term inflation expectations have remained stable. …The Committee expects that, with appropriate policy accommodation, economic activity will expand at a moderate*

pace and the unemployment rate will gradually decline toward levels the Committee judges consistent with its dual mandate." Despite the expansion of the tapering, Treasury yields fell by 34 basis points from their year-end high 3.0% to 2.67% in the beginning of February. However, this is seen as a reaction to the global financial turmoil, but higher interest rates are likely as monetary easing ends and the economic recovery accelerates. While markets might be hoping that the Fed will relent on tapering faster, Janet Yellen might hesitate to reverse policy unless we see a sharp deterioration in the economic outlook.

Holding its Ground: The housing market seemed to be holding its ground in December. Both existing home sales and housing starts registered a slight increase, while new home sales declined. Prices continued to rise in November, with the Case-Shiller 20 cities index up by 0.9% m/m (13.7% y/y). Mortgage rates have also dropped slightly, further supporting the housing market.

Oil prices increased in January to $97.49/barrel (West Texas Intermediate, WTI), but remained below their end-of-year level (and 12% lower than the 2013 high of $110 in mid-September. Price levels of $95-100 are likely over the next few months.

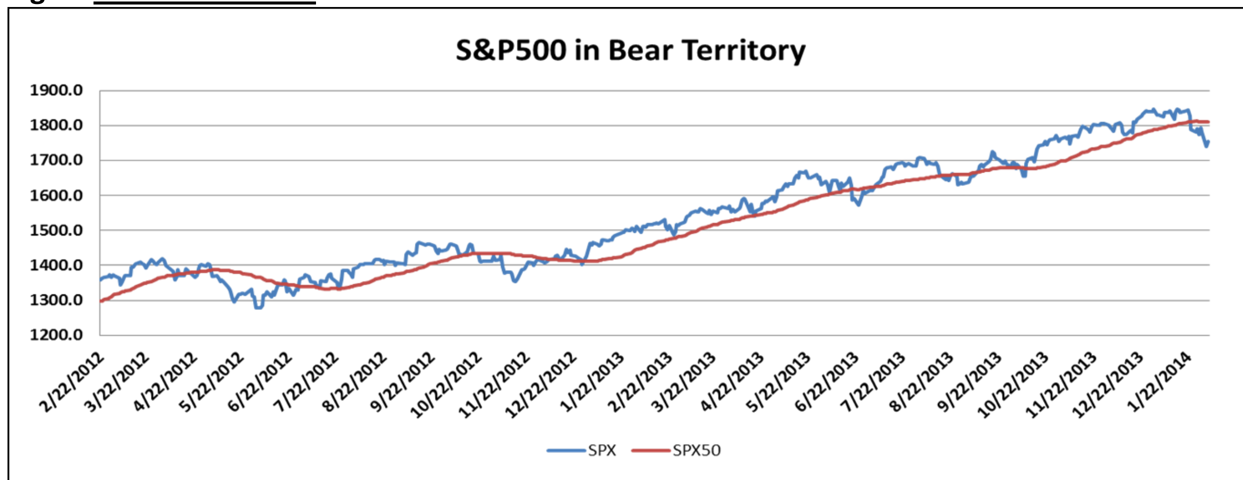
Fiscal truce: The recent non-partisan Congressional Budget Office report indicates that the fiscal deficit will fall to below 3% of GDP in FY2013 (ending September 30, 2014) for the first time since FY2005, and is set to decline further in 2015. At the same time, with the no-drama extension of the debt ceiling for one year by Congress, the threat of another government shut-down has faded.

Greater Promise: The U.S economy shows great promise as we enter 2014, while at the same time facing significant risks. The macroeconomic fundamentals are the most positive since 2008. The recent data releases in the United States point to a more robust economy. Additionally, the truce between the White House and Congressional Republicans and the recent budget deal will result in a fading of the fiscal drag in the next two or three years. However, there has been some loss of momentum and severe weather conditions in the United States (east of the Rockies), combined with the record drought conditions in California will impact growth in 1Q14. The main driver of growth in 2014 will be domestic demand, as net exports could suffer from a weaker global economy. While the US consumer is showing signs of revival, business capital expenditures remain a question mark.

The global picture is more problematic. As mentioned earlier, the IMF has upgraded its projections for 2014, principally on the perceived acceleration of growth in the G-7. Nevertheless, the emerging markets turmoil and the slowdown in Chinese growth have rattled the global economy and financial markets. It remains to be seen how much global growth has been dented by the emerging markets and China problems, but any worsening of these problems would negatively impact US economic prospects. With these factors in mind, we can expect a slower start of the year, with 1H14 growth of about 2.5%, accelerating to 3.5% in 2H13.

However, the acceleration of the cyclical upswing belies longer-term structural problems in the US economy. Firstly, despite 16 consecutive quarters of growth, the US economy is still below its potential level, and is not expected to return to that point before 2018. Second, a sharp secular decline in the share of labor income in national income—worsened by the 2008 Great Recession—translates into permanently weaker consumer demand. Third, the so-called U-6 rate, which combines unemployment with underemployment, remains elevated. Finally, the aging of the population and the long-term damage caused by the recession is leading to a decline in the labor participation rate. Unless addressed through long-term policies, these factors could delay the recovery and weaken the underlying economy, leading to long-term below trend growth and higher unemployment.

Fig. 3: <u>The Bear Market</u>

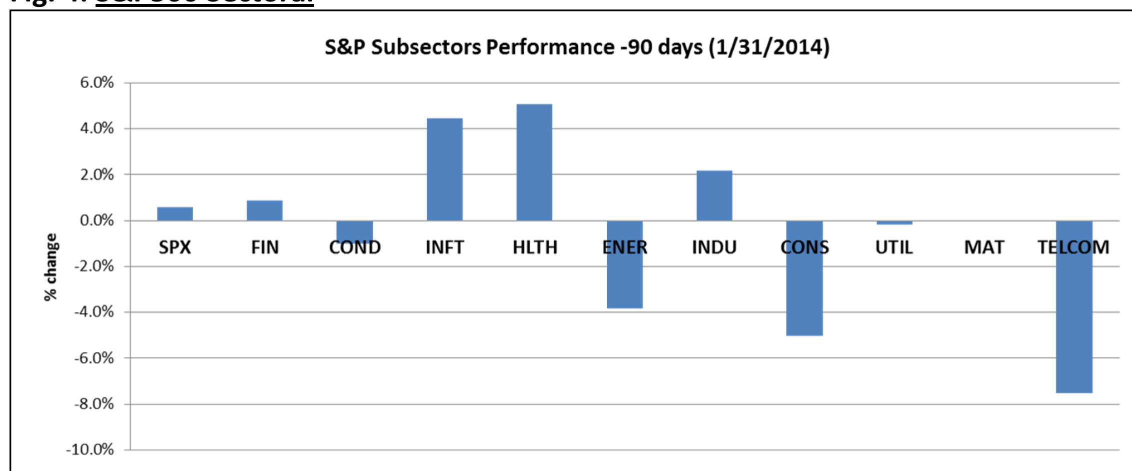


Fear Wins: Global equity markets sentiment since the beginning of the year has been driven by the emerging markets turmoil. The major EM equity indices have been on a declining path since reaching a high point in early May 2013. Since then, the MSCI-Emerging Markets has lost about 12%. However, even prior to that point, the economic and market trends in the emerging markets pointed to a crisis waiting to happen. Capital flows to emerging markets, which sustained much of their buoyancy since 2008, reversed themselves since mid-2013. By the beginning of 2014, the start of the Fed taper, the tightening of global liquidity and concerns over slower Chinese growth fed into increased risk aversion, hitting the emerging markets hard. Between December 31st and the end of the first week of February, the MSCI emerging markets had dropped by 8.5%. The global markets have been on a roller coaster, with cascading drops in major markets across time zones.

The S&P500 is back in bear territory, with the index being under its 50-day moving average since the end of January. The index had its worst start of the year since 2009. Since reaching a high of 1,848 on January 15th, it then declined by 5.3% by the beginning of February. This is the 19th drop of 5% or

more since March 2009. In this period, each 5% drop has been followed by a recovery. Since January month-end, it has recovered somewhat, ending the first week of February, at 1,792, slightly in the black for the month. The index rose during the second week of February, reaching 1,829 on February 13th.

Fig. 4: S&P500 Sectoral



Furthermore, the market has not had a correction (a drop of 10% or more) since March 2009, so technically, one is long overdue. Market volatility has also increased, with the VIX index hitting 21.44 on February 3, the highest level in one year. The decline has not spared any sector, with Utilities and Health Care the only S&P500 sectors registering any increase in both the past 30 and 90 days periods.

One could argue that beyond the emerging market-induced decline, the market is adjusting after having gotten ahead of the fundamentals. However, neither the macroeconomic data nor the earnings justify market panic. The 4Q13 earnings reporting season is not over, but so far 77% of the S&P500 reporting companies have exceeded expectations. These factors point to a market moving sideways at best in the short-term, with event-driven high volatility. I would expect that confirmation of improved prospects would allow the market to return to growth, albeit at a more modest pace.

January Data Releases

Economic Data Releases-January 2014	*Prior*	*Consensus*	*Actual*	*Min*	*Max*
Macroeconomy					
GDP (4Q13, % Annualized) First estimate	4.1%	3.0%	3.2%	2.2%	4.2%
CPI (m/m) Dec	0.0%	0.3%	0.3%	0.1%	0.4%
Core CPI (% m/m) Dec	0.2%	0.1%	0.1%	0.0%	0.2%
Balance of Payments					
Exports (% m/m) Dec	0.8%		-1.8%		
Imports (% m/m) Dec	-1.3%		0.3%		
Trade Deficit $ billion) Dec	$34.6	$36.0	$38.7	$34.0	$42.5
Current Account Deficit ($ billion) (3Q13)	$96.6				
Oil Prices (WTI, $/bbl, eom) Jan	$98.42		97.49		
Industrial & Manufacturing					
Empire State (Jan)	2.22	3.30	12.51	-1.00	7.00
Philadelphia Fed (Jan)	6.4	8.7	9.4	2.3	10.0
ISM-Mfg Jan	53	53.9	51.3	55	55.8
Chicago PMI (Jan)	60.8	59.5	59.6	56.0	61.2
Markit PMI Mfg Jan	55	53.9	53.7	53.2	54.3
Industrial Production (% m/m) Dec	1.0%	0.3%	0.3%	-0.1%	0.8%
Manufacturing (% m/m) Dec	0.6%	0.3%	0.4%	-0.3%	0.4%
Durable Goods (m/m) Dec	2.6%	1.6%	-4.3%	-2.0%	3.5%
Durable Goods, ex transp (m/m)	0.1%	0.7%	-1.6%	0.2%	1.5%
Factory Orders (m/m) Dec	1.5%	1.8%	-1.5%	-2.4%	0.1%
Services					
ISM non-mfg Mar Jan	53	53.9	54	52.0	55.0
Consumer Spending					
Retail Sales (% m/m) Dec	0.4%	0.0%	0.2%	0.5%	0.7%
UMich Consumer Sentiment (End Jan)	80.4	81.0	81.2	79.4	84.0
ConfBd Consumer Confidence (Jan)	77.5	79.0	80.7	75.5	81.0
Personal Income (m/m) Dec	0.2%	0.2%	0.0%	0.0%	0.4%
Consumer Spending (m/m) Dec	0.6%	0.2%	0.4%	0.1%	0.4%
Housing Market					
Housing Starts ('000) Nov	1107	985	999	915	1050
New Home Sale ('000) Dec	445	450	414	420	471
Existing Home Sales (MM) Nov	4.82	4.90	4.87	4.80	5.20
Construction Spending (m/m) Dec	0.8%	0.0%	0.1%	-0.2%	0.1%
Case Shiller-20 (m/m) Nov	1.0%	0.8%	0.9%	0.4%	0.1%
Case Shiller-20(y/y) Nov	13.60%	13.7%	13.7%	12.1%	14.1%
Employment					
First Time Claims ('000) (Last week Jan)	351	337	331	335	350
Non-Farm Payroll Jan	75000	181,000	113000	125,000	270,000
o/w Private Sector	89000	182,000	142000	115,000	280,000

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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