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Advocacy Investing®

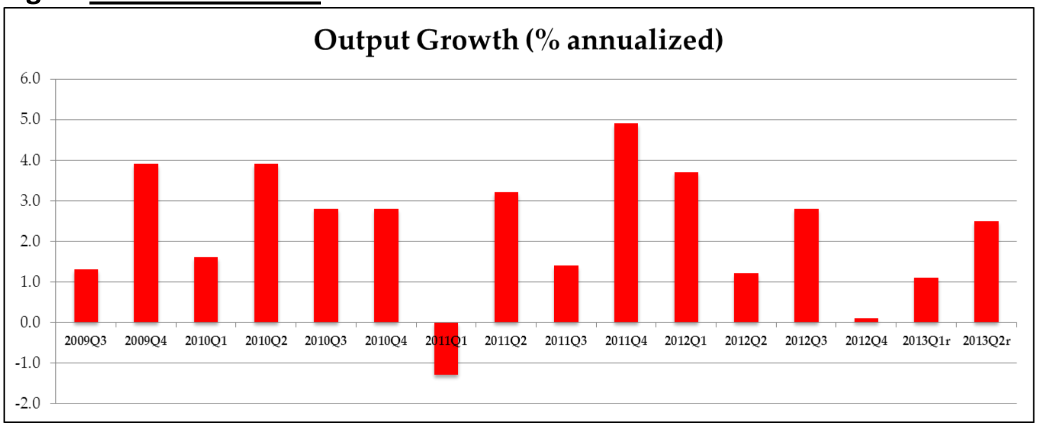
NO AUGUST BREAK

- **An eventful August heralds a volatile September**
- **2Q13 GDP numbers revised upwards and US data releases point to a manufacturing revival**
- **Disappointing August payroll numbers underscore mediocre growth and performance**
- **Normalizing interest rates reflect in part market expectations of Fed tapering**
- **Heightened geopolitical risks spook markets**
- **Strong global PMIs point to a global manufacturing bounceback**

The month of August has been particularly eventful, with rising geopolitical risks in the Middle East, surging oil prices, stressed emerging markets and troubled equity markets. September is also busy: a G20 summit (September 6th), Federal Open Market Committee (FOMC, September 18th), German elections (September 22nd), and potentially, a Congressional vote of authorization for military action in Syria. However, with the exception of the Syrian vote, no surprises are expected. In October, we expect a long-drawn confrontation between the Administration and the GOP in Congress over the FY2014 and raising the debt ceiling.

Upward Revision: US economic growth in 2Q13 was upgraded to 2.5% (all numbers annualized) from 1.7% in the first revision of that indicator. The revision showed that the economic expansion was broad with consumer spending, fixed investment, inventories, and net exports all contributing to growth. Final sales rose by 1.3% from a 0.2% in 1Q13 non-residential fixed investment and exports registered the strongest growth. Government spending continues to fall, albeit at a slower pace.

Fig. 1: GDP Acceleration



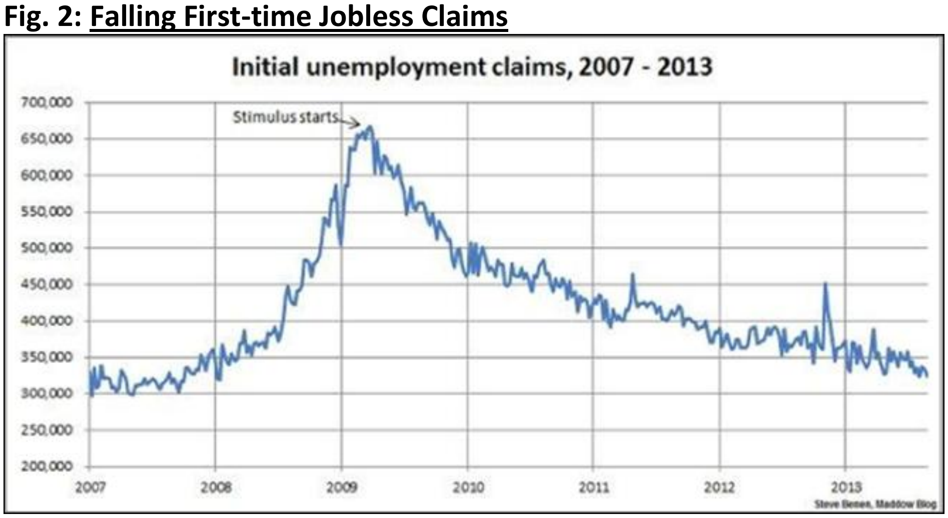
European Hopes, Falling BRICs: The eurozone emerged from recession, with 2Q13 output rising by 0.3%, with Germany and France leading the pack with respectively 0.7% and 0.5% growth. The UK economy also emerged from recession. Survey data shows that both business and consumer confidence continue to improve, although unemployment remains high. The European recovery is led by the manufacturing sector, with the eurozone PMI-Manufacturing up to a 26-month high. On the other hand, emerging markets are in the midst of a vicious circle of falling commodity prices, capital outflows and depreciating currencies—$94 billion has been withdrawn from emerging market funds since May. China has stabilized, with the official Manufacturing PMI rising to a 16-month high, but other large emerging markets—India, Brazil and Indonesia—have experienced sharply lower growth in 2Q13. After years of complaining about the impact of G-7 quantitative easing, which had resulted in massive capital inflows to emerging markets and a sharp appreciation of their currencies, emerging markets are now seeing equally large capital outflows and depreciating currencies, forcing countries like Indonesia, India and Brazil to raise interest rates.

A Manufacturing Revival: Economic data releases were mixed, although they improved at the end of the August. On one hand, lagged data for industrial and manufacturing production was unimpressive. On the other, survey data suggests that the sector is back into an expansionary mode. Industrial production was flat in July, manufacturing declined by 0.1% (month-on-month m/m) and durable goods fell sharply. Both the Empire State and the Philadelphia Fed surveys remained in positive territory, albeit slightly lower. The Chicago PMI (which reflects broad economic activity) increased to 53 from 52.3. The ISM-manufacturing index beat market expectations, rising to 55.8 in August from 55.4 a month earlier. The Markit PMI-Manufacturing index fell slightly. Inventories are down, which should be reflected in stronger output in the near future. On the household/consumer side, the data was also mixed. While both the University of Michigan/Reuters and the Conference Board consumer confidence surveys showed an increase in August, July data for personal income (+0.1% m/m) and personal consumption expenditures (+0.1%) disappointed and retail sales rose by only 0.1% (m/m). The services sector also expanded, with ISM-Non-manufacturing rising to 58.6 at the end of August from 56.0 a month earlier.

Better Data: The housing market saw somewhat better results in July. Housing starts and existing home sales rose, but new home sales fell sharply. Construction spending was up by 0.6% m/m in July, after a flat June number. Case-Shiller data showed that house prices continue to rise, up by 0.8% (m/m) (12.1% year-on-year, y/y) in June. However, mortgage rates are climbing, increasing by 100 basis points since May. This increase may push potential buyers to move faster in anticipation of further increases, thus boosting short-term data. In the longer term, however, the impact of higher mortgage rates is likely to slow the real estate recovery.

Payrolls Disappoint….Again: The disappointing payroll numbers for August were unexpected, since both high frequency data and earlier surveys had pointed to much higher numbers. First-time jobless claims have been on a steadily declining path, falling to a 5-year low of 322,000—very close to the 300,000 key benchmark level. Yet, overall payrolls rose by only 169,000, below the 175,000 market expectations and private payrolls expanded by 152,000. Furthermore, there was an unusually sharp downward aggregate revision of 70,000 to the June-July numbers—the July number alone was cut by 58,000 to 104,000. Good-producing sectors increased payrolls by 18,000 (manufacturing expanded by 14,000), services by 134,000. The government sector's increase of 17,000 seems to be more of a seasonal adjustment than actual growth in numbers. The 3-month, monthly average jobs creation number fell from 172,000 in the March-April period to 148,000 in the June-August one (176,000 to 152,000 for the private sector). At the same time, the unemployment rate, which is derived from a separate household survey, fell from 7.4% to 7.3%, but mostly for the wrong reasons, since it resulted primarily from a second monthly decline in labor force participation. On the income side, the data was somewhat better, with hourly wages rising by 0.2% and hours worked by 0.1 to 34.5 hours.

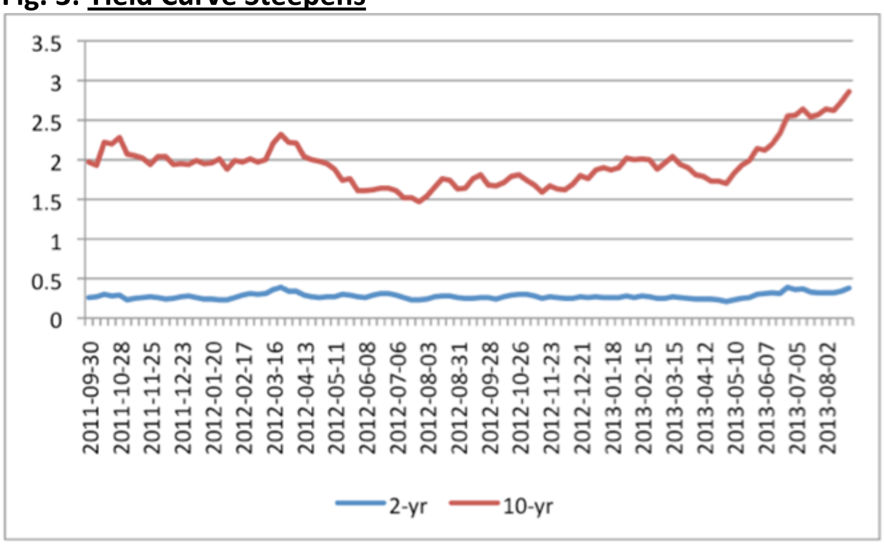
Fig. 2: <u>Falling First-time Jobless Claims</u>



Fed Tapering Lite?: Fed tapering is an old story already. It is no longer a question of "if," but "when" and "how much?" Despite the weak payrolls data, we continue to expect September to mark the beginning of the end of the Fed experiment with the so-called "unconventional monetary policy." These policies almost certainly avoided a second recession, but in the absence of a constructive fiscal policy, failed to help the economy achieve escape velocity. With the stream of data releases indicating a slow but steady recovery, the Fed will probably move to formally announce its intention to cut back on bond purchases at its September FOMC meeting, while keeping the option of a reversal if the situation deteriorates once again. Moreover, the tapering will likely be very gradual, with the Fed testing the waters, and the focus will probably be on cutting back the Treasury's purchases first in order to avoid roiling the mortgage markets. It could be even more gradual (the so-called "tapering lite") if downside risks to the economy emerge from the soft job report and any military action in Syria.

In the meantime, markets have already priced in the tapering. Yields on 10-year Treasury note briefly broke through 3% in early September before falling back to 2.93% at the end of the week after the payroll report—yields are up 100 basis points year-to-date. The yield curve has also steepened significantly with the 10-year-2-year spread widening by almost 100 basis points (to 245 basis points) between April and September. While Fed tapering has played a role in the rate's climb, this trend also reflects the underlying strength of economic growth.

Fig. 3: <u>Yield Curve Steepens</u>



Higher Oil Prices: Oil markets were stressed by the escalation of the Syrian crisis. Oil prices (West Texas Intermediate, WTI) rose to a two-year high of $110.52/barrel (bbl) at the end of the first week of September, up 19% year-to-date. While Syria itself is not a major oil producer, markets fear retaliation against other oil producers of the region in the event of a US airstrike against that country. However, it is likely that the oil markets are over-reacting, as they have in past episodes of Middle East turmoil. Even if such an event occurs, it is unclear if it will have a lasting impact, as the key players in the region have no incentive to escalate the crisis.

Political Risks: President Obama has taken a gamble by asking for Congressional approval of a strike on Syria. He faces opposition from both sides of the aisle by anti-war Democrats and isolationist Republicans. Moreover, his GOP foes might want to use the opportunity to undermine his presidency by voting against a strike. Given the level of political opposition to any new military action, both in public opinion and in Congress, a "no" vote is likely. However despite the dire predictions of pundits about the President putting his presidency at risk, a defeat for Obama, however stinging in the short term, is unlikely spill over in other areas of policy-making.

More of the Same, Higher Risks: The medium-term economic action has moved from emerging markets to the G3, but the overall macroeconomic picture is mixed. The economic recovery is being led by the G-3, with the US plodding along, Europe recovering and Japan on an accelerating growth path. The medium-term prospects will be colored by the following issues:

- President Obama faces a protracted confrontation with the GOP House majority over the FY 2014 budget and raising the debt ceiling
- Higher oil prices will hit the consumer's wallet and delay a faster recovery in consumer spending
- The pace of job creation in the US economy remains subpar
- While Europe is out of recession, the eurozone recovery is fragile
- Emerging markets will continue to be a drag on the global economy
- Middle East turmoil, uncertainty over the pace and/or the impact of Fed tapering will translate into higher market volatility
- No matter what the market impact of a potential Fed pull back, interest rates are normalizing

On the positive side of the ledger, global business confidence and manufacturing are improving, as indicated by the general improvement in global PMIs. However, we do not see any reason to believe that the pace of economic recovery will accelerate. In combination, these factors point to a continuation of a 2-2.5% pace of economic growth, with significant downside risks.

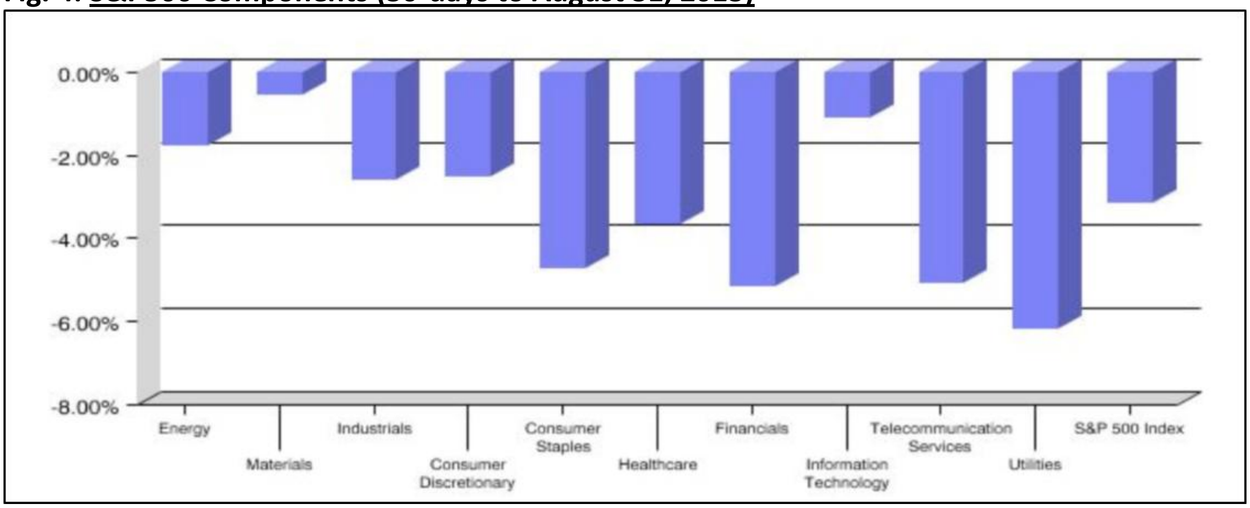
Fear and Loathing: September has been historically the worst month for equity markets. This year, a particularly busy August portends an equally volatile September. Equity markets were roiled in August, with the S&P500 reversing its July gains, dropping 4.5% from its August 2nd high of 1,709. Overall, the index lost 4.5% in the month to a six-week low of 1,632. Global equities were also hit, with the MSCI EAFE (covering developed countries outside North America) falling by 5% from its 2013 peak of May 22. The MSCI-Emerging markets lost 10% over the same period. All of the S&P500 sectors lost ground, with the defensive sectors (utilities and consumer staples) being hit the worst. The VIX index rose 42%

in August, to 19, but remains significantly below its September 2011 high. After a difficult early September period, markets have recovered somewhat, ending the first week of the month higher, with the S&P500 at 1,655, and up to 1,671 on the first day of the second week (September 9th).

In the short-term, markets have been strengthened by the postponement of US strikes on Syria, as well as by the spate of megadeals: the sale by Vodafone of its Verizon stake and the purchase of Nokia's mobile phone business by Microsoft.

The markets face a set of major challenges and events in the coming weeks. Markets are global, and the emerging markets' swoon has heightened market volatility. While Middle East geopolitical risks and the showdown over the debt ceiling grab headlines, the FOMC September 18th meeting, and the expected decision to gradually reverse quantitative easing, dominate market sentiment. The markets have already discounted the expected Fed decision, but uncertainties remain about how the markets will react. We expected that the markets would initially overreact, but the question is whether or not there would be a more drawn-out withdrawal from bond and/or equity markets.

Fig. 4: <u>S&P500 Components (30-days to August 31, 2013)</u>



As the Fed tapering sets in place, markets will return to fundamentals. The market is facing a resistance level of 1,700 and is unlikely to break through that level with the current global macroeconomic environment. On balance, the risks are tilted to the downside in short and the medium term.

August 2013 Economic Data

ECONOMIC DATA RELEASES Aug 2013					
August 2013	*Prior*	*Consensus*	*Actual*	*Min*	*Max*
Macroeconomy					
GDP (2Q13, % Annualized)1st revision	1.7%	2.2%	**2.5%**	2.0%	2.5%
CPI (m/m) July	0.5%	0.2%	**0.2%**	0.2%	0.6%
Core CPI (% m/m) July	0.2%	0.2%	**0.2%**	0.1%	0.3%
Balance of Payments					
Exports (% m/m) (May)	2.2%		**-0.6%**		
Imports (% m/m) (May)	-2.2%		**0.6%**		
Trade Deficit $ billion) (May)	$34.5	$39.0	**$39.1**	$35.0	$42.5
Current Account Deficit ($ billion) (1Q13)					
Oil Prices (WTI, $/bbl, eom) August	$105.10		**107.98**		
Industrial & Manufacturing					
Empire State (Aug)	9.46	10.00	**8.24**	1.00	12.00
Philadelphia Fed (Aug)	19.8	15.0	**9.3**	7.5	22.7
ISM-Mfg Jun	55.4	53.8	**55.8**	52.1	55.8
Chicago PMI (Aug)	52.3	53.0	**53**	52.0	54.0
Markit PMI Mfg Aug	53.7	53.9	**53.1**	53.5	54.5
Industrial Production (% m/m) Jul	0.2%	0.3%	**0.0%**	0.0%	0.9%
Manufacturing (% m/m) Jul	0.2%	0.3%	**-0.1%**	0.1%	0.7%
Durable Goods (m/m) Jul	3.9%	-4.0%	**-7.3%**	-7.2%	1.4%
Durable Goods, ex transp (m/m)	0.1%	0.3%	**-0.6%**	-0.5%	1.5%
Factory Orders (m/m) Jul	1.6%	-3.4%	**-2.4%**	-4.5%	0.6%
Services					
ISM non-mfg Mar	56.0	55.0	**58.6**	54.0	57.5
Consumer Spending					
Retail Sales (% m/m) Jul	0.6%	0.3%	**0.2%**	0.1%	1.0%
UMich Consumer Sentiment (end-Aug)	80	80.0	**82.1**	79.0	82.0
ConfBd Consumer Confidence (Aug)	81	78.0	**81.5**	74.8	87.0
Personal Income (m/m) Jul	0.3%	0.2%	**0.1%**	-0.1%	0.3%
Consumer Spending (m/m) Jul	0.6%	0.3%	**0.1%**	0.0%	0.5%
Housing Market					
Housing Starts ('000) Jul	846	900	**896**	829	945
New Home Sale ('000) Jul	455	487	**394**	450	505
Existing Home Sales (MM) Jul	5.06	5.15	**5.39**	5.00	5.30
Construction Spending (m/m) Jul	0.0%	0.3%	**0.6%**	0.6%	1.0%
Construction Spending (y/y) May					
Case Shiller-20 (m/m) SA Jun	1.0%	0.1%	**0.8%**	0.6%	1.4%
Case Shiller-20(y/y) Jun	12.2%	11.2%	**12.1%**	11.3%	12.3%
Employment					
First Time Claims ('000) (Last week Aug)	332	330	**323**	325	335
Non-Farm Payroll Aug	104,000	175,000	**169,000**	150,000	234,000
o/w Private Sector (Aug)	127,000	178,000	**152,000**	150,000	230,000

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.