MARC J. LANE | WEALTH GROUP®

PROTECTING TODAY'S WEALTH. BUILDING TOMORROW'S.®

Title: Advocacy Investing® Portfolio Strategies, Issue 57
By: Karim Pakravan, Ph.D.
Copyright: Marc J. Lane Investment Management, Inc.
Date: April 17, 2014

Advocacy Investing®

THE FED SHIFTS GUIDANCE

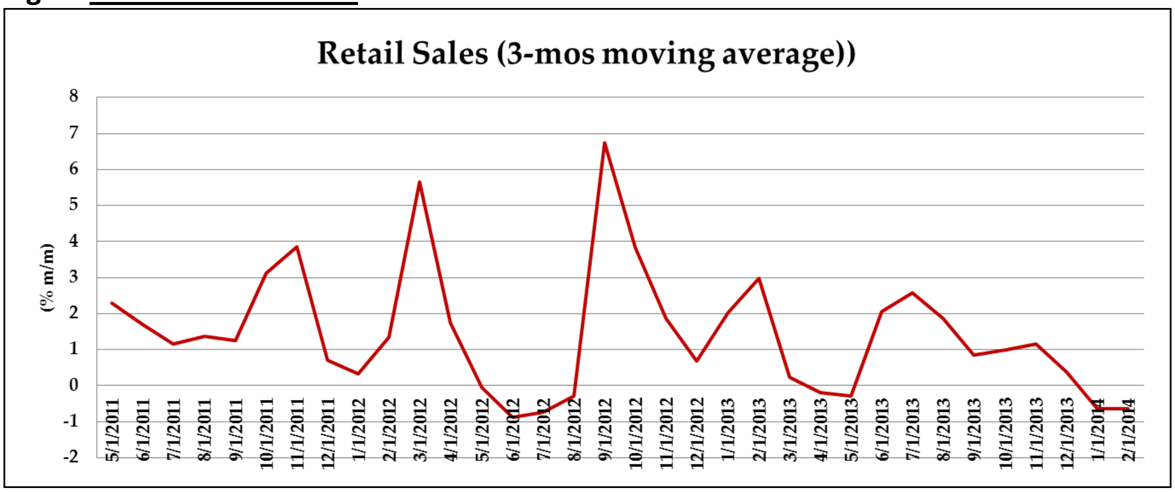
- **Data releases and a strong payrolls report signal the end of mid-winter doldrums**
- **The Fed shifts guidance under its new chair, Janet Yellen…**
- **…but monetary policy is not expected to change for the foreseeable future**
- **The global economy is challenging, clouding medium-term prospects for the US economy**
- **A 2Q14 rebound will be difficult to maintain unless final demand strengthens**
- **Equity markets continue to surprise, but market dynamic is questionable**

The second revision of 4Q13 economic activity resulted in a small upward revision of the estimate of GDP growth from 2.4% to 2.6% (annualized). The composition of growth did not change much. On one hand, personal consumption expenditures, non-residential fixed investment and net exports provided a boost while on the other, residential fixed investment and federal spending remained a drag.

Positive Momentum: The stream of data releases and surveys for February and March provided a more optimistic picture of an economy that seems to have shaken its mid- winter severe weather doldrums. Industrial production and manufacturing rebounded by respectively 0.6% and 0.8% (m/m) in February, while the forward looking surveys all showed improvements. The Empire State index rose from 4.48 to 5.61, while the Philadelphia Fed index increased from minus 6.3 to minus 1.0. The Markit PMI-Manufacturing fell slightly from 57.1 to 55.5, while the ISM-Manufacturing rose from 53.2 to 53.7. The broader Chicago PMI declined to 55.0 from 59.8 a month earlier—overall, all three indices remain comfortably over 50. However, export and import growth have slowed down as a result of a weak global economy and lagging domestic demand in the United States: exports dropped by 1.1% (m/m) and imports rose by 0.4% (m/m) in February. On the consumer side, personal income and personal consumption expenditures each increased by 0.3% m/m in February, while the consumer confidence indices remained stable—the University of Michigan-Reuters indicator rose from 79.9 at the end of February to 80 at the end of March, while the Conference Board index increased from 78.3 to 82.3 over the same period. The services sector also recovered, with the ISM-NonManufacturing rising to 53.1 at the beginning of April from 51.6 a month earlier. Oil prices (West Texas Intermediate, $/barrel) remained stable in March around the $100 level.

An End to Winter Doldrums: The March payrolls numbers, which were close to market expectations, showed a rebound from the severe weather impact in the preceding months. Total payrolls increased by 192,000 (private payrolls were also up by 192,000), while upward revisions added an aggregate 37,000 to the January-February results. The strong March result and the upward revisions boosted the 1Q14 average to 178,000 per month from 138,000 in February (and 195,000 in 4Q13).

Fig. 1: <u>Retail Sales Weaken</u>

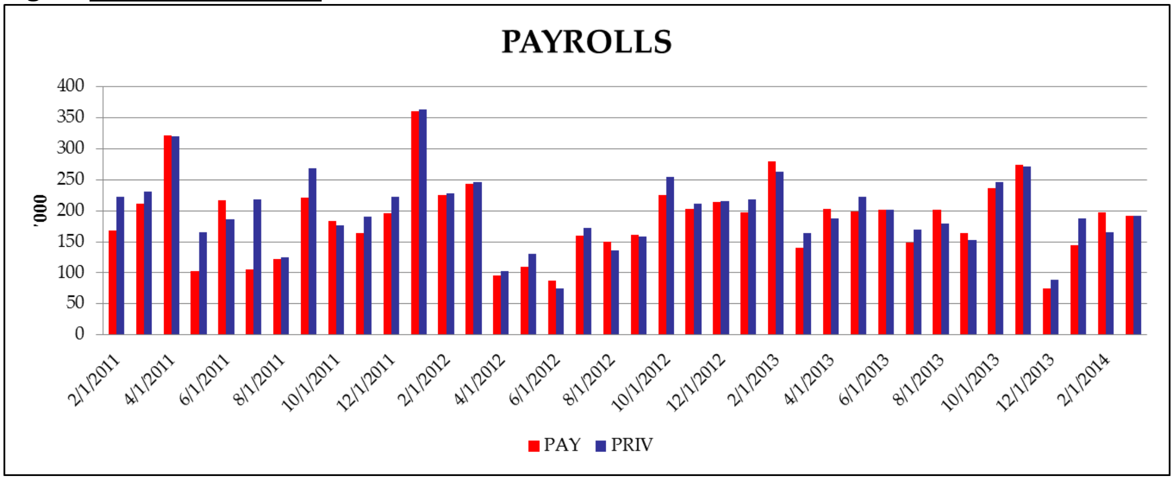


The goods producing and private services sectors increased by respectively 25,000 and 167,000, and government employment remained stable. Within the goods sector, manufacturing employment fell by 1000 and construction increased by 19,000. Weekly hours worked increased from 34.3 to 34.5 hours, underscoring the fact that the weather played an important role in the mid-winter labor market weakness. Hourly wages remained stable, giving us a labor income proxy growth of 4% (annualized). The unemployment rate (based on a separate household survey) remained at 6.7%, with the participation rate also unchanged at 63.2% (which reflects a rise in the actual number of people in the labor force). The U6 unemployment rate[1] remained stable at 12.7%, down from 13.8% a year earlier. High frequency data also support the improvement in labor markets, with weekly first-time jobless claims hovering around 320,000 in March and falling to 300,000 in the first week of April.

Overall, an important benchmark was reached in March, as private payrolls reached their pre-recession level of 116 million. Relative to January 2008, the big gainers have been mining and logging (+21%), Education and Health (+13.0%), and Business Services (+5.42%). The losers have been Manufacturing (-12.0%) and Construction (-20.4%).

[1] The U6 unemployment rate counts not only people without work seeking full-time employment, but also counts "marginally attached workers and those working part-time for economic reasons

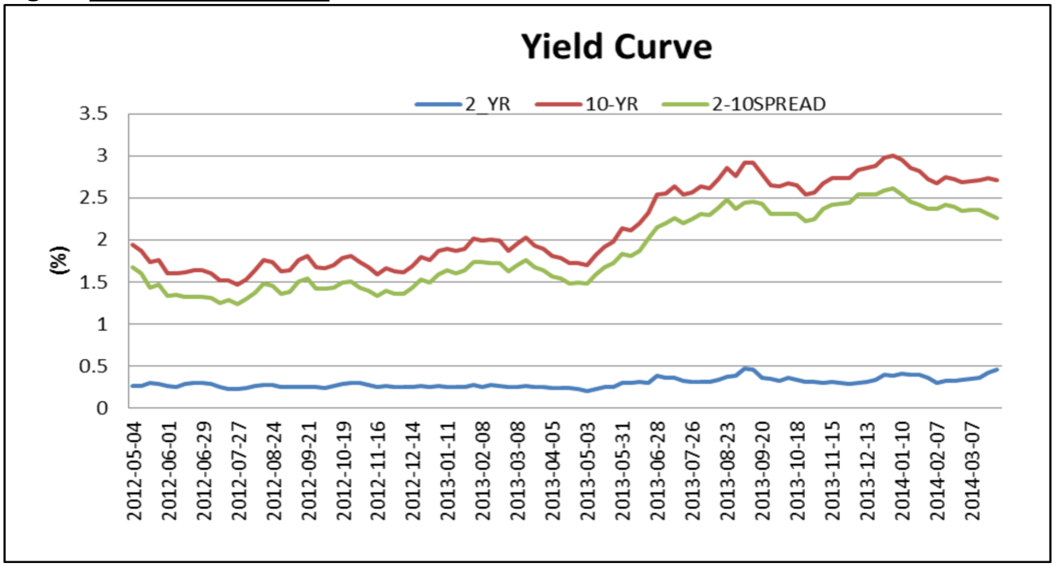
Fig. 2: Payrolls Rebound



The housing market remained calm. Housing starts (907,000), new home sales (440,000) and existing home sales (4.6 million, all February data annualized) were broadly unchanged from January. House prices continued to rise, with the Case-Shiller 20-city index up by 0.8% m/m (13.4% y/y) in January.

The Yellen Era Begins: Janet Yellen, the new chairperson of the Board of Governors of the Federal Reserve Bank (Fed), lost no time in making her imprint. The statement issued by the first meeting of the Federal Open Market Committee (FOMC) under her leadership (March 18-19) reflected a major shift in guidance. The language of the FOMC statement on the economy remained the same, citing "the cumulative progress toward maximum employment and the improvement in the outlook for the labor market conditions" as the rationale for a further $10 billion reduction in Fed asset purchases to $65 billion per month in April. However, the FOMC dropped the reference to the 6.5% unemployment rate as a policy benchmark, instead stating that it will replace this quantitative benchmark by a broader array of indicators. Moreover, the FOMC statement reiterated that the Fed funds rate will be maintained at its current rate of 0-0.25% for a "considerable time after the asset purchases program ends". Nevertheless, Yellen caused a stir when she mentioned a relatively short timetable in her press conference (potentially sometime in 2H15) for a normalization of interest rates. In a later speech, Yellen took a more dovish stance, noting that the employment situation was far from satisfactory, hence the need for continued easy monetary conditions. In her own words, "extraordinary support is still needed and will be for some time".

Fig. 3: Stable Yield Curve



The Fed also issued its economic projections, with a small revision relative to the December 2014 numbers.

Table 1: Fed Economic Forecasts

(percent)	2014	2015	2016
GDP (%)	2.8-3.0	3.0-3.2	2.5-3.0
Unemployment (%)	6.1-6.3	5.6-5.9	5.2-5.6
PCE Inflation (%)	1.5-1.6	1.5-2.0	1.7-2.0

BOX: Yellen's Labor Market Analysis

In a recent speech, Janet Yellen spelled out the labor market analysis underlying her monetary policy views. From Yellen's point of view, while the unemployment rate has dropped to 6.7%, the situation in labor markets is far from satisfactory. Yellen cited four pieces of evidence to underscore her conclusions. First, there is a very large contingent (7 million) of part-time workers who would prefer to work full-time, but cannot find full-time jobs. Second, the decline in unemployment has not led to a tightening of labor markets and a rise in compensation—in fact, the wage growth since the recession has been around 2% per year, significantly lower than in past recoveries. Third, the number of long-term unemployed is unusually high. Finally, the participation rate has fallen from 66% prior to the recession to around 63% today, the lowest since 1978. The latest payroll report supports Yellen's views on continued slack in the economy, which in turn reflects a Fed commitment to easy money for the next three or four quarters.

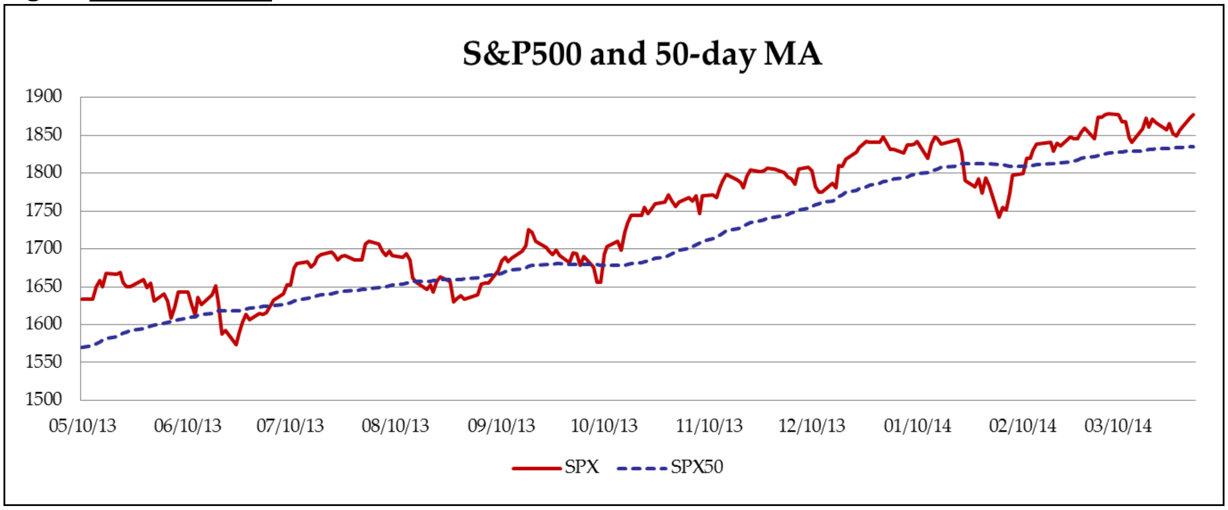
The tone of Yellen's remarks, the Fed forecasts and the latest payroll numbers give us some confidence that the taper will continue as planned and quantitative easing will come to an end by the beginning of 3Q14. However, as the economy continues to mend, the gap between the actual short-term policy rate (0-.25%) and the Taylor rule norm (1.5% in 2014, 2.5% in 2015 and 3.5-4.0% in 2016) should gradually narrow, with at least some rate increases as early as mid-2015.

A Hopeful Spring? The first quarter should be considered a write-off, with a more robust March performance not sufficient to offset the weak economic results of the previous two months. Consequently, economic growth is not expected to exceed 1% (annualized) in the quarter. While recent data point to a stronger recovery in 2Q14, boosted in part by the realization of pent-up demand from 1Q14, we still are struggling to separate the weather-related noise from the underlying trends, and the question is whether this dynamic will be sustained in 2H14.

- The global economic picture is mixed. The Chinese economy continues to slow down—the HSBC PMI-Manufacturing remains under 50—and its growth rate could drop to 5% in 1Q14, struggling to reach 7% for the year. The eurozone recovery is uneven. Furthermore, a clear threat of deflation is leading the European Central Bank to consider adopting quantitative easing policies.
- The weaker global economy is dragging down US exports.
- Final demand remains weak despite the high levels of consumer confidence. Personal consumption expenditures are up, but much of the increase is due to higher health care expenditures (the Affordable Care Act is kicking in) and higher utility bills. Ex-health care and utilities, personal consumption is actually falling.
- Business capital expenditures are also lagging, as corporations have shown an unwillingness to invest their mountain of cash.
- On the positive side, we do not expect a fiscal drag this year.
- Oil prices should remain stable or even decline in the medium term.

Overall, I would expect that these considerations will keep economic growth within 2.5-3.0% in 2014.

Fig. 4: A Bull Market



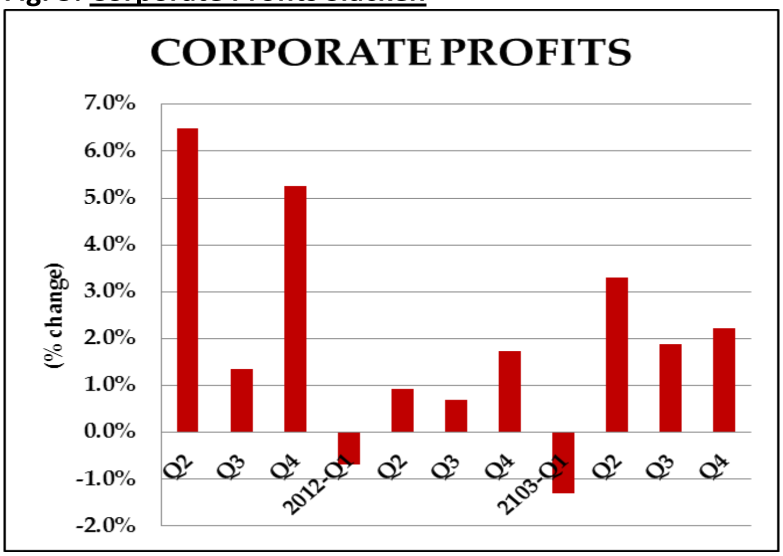
Betting on Growth: The equity markets are recovering from a weak start of the year. By the end of February, the S&P500 had erased its early 2014 losses. Nevertheless, the S&P500 had its weakest quarter since 2009, gaining only 1.3% in 1Q14. The directionless market reflects a degree of befuddlement by the investors about economic prospects. That is not surprising. On one hand, the extended bull market continues to signal a stronger economic recovery, while the low bond yields reflect a degree of pessimism regarding medium-term growth. The rebound continued in the first week of April. The S&P500 hit an all-time high of 1,890 on April 2nd, and the March payroll numbers briefly boosted the S&P500 to an all-time high of 1895 in early session on Friday April 4th. Global indices were more mixed. The MSCI EAFE (covering the major industrial countries outside of North America) declined by 1% over the quarter, while the MSCI-EM (emerging markets) remained flat. However, most markets heated up at the end of the quarter, with the MSCI –EAFE rising by 2.9% in March, the FTSE-All World at near-record levels and the MSCI-EM finally starting to recover.

Table 2: *S&P500, 1Q14*

Period	S&P500
January	-3.6%
February	4.3%
March	0.7%
1Q14	1.3%

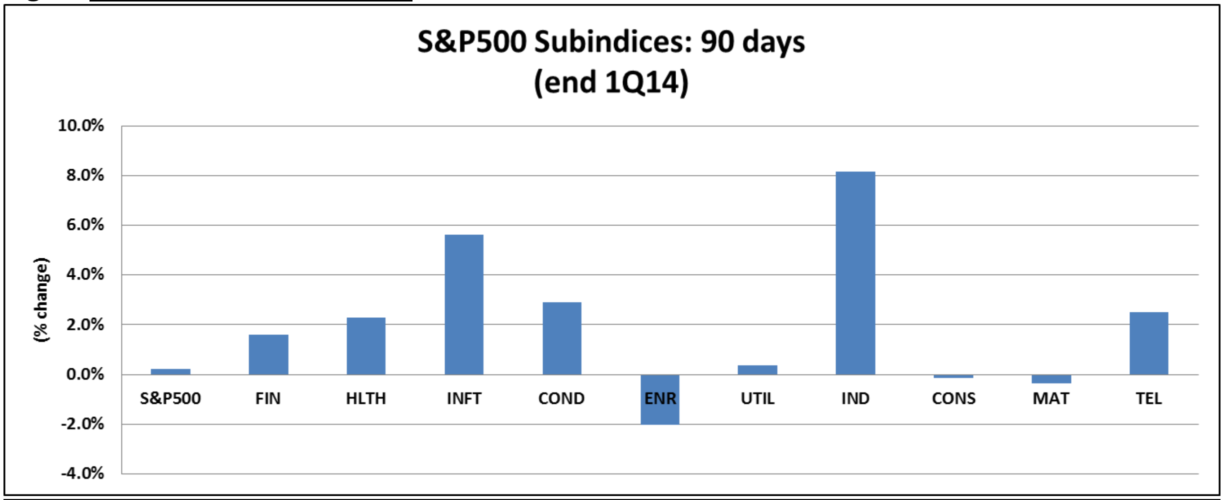
Geopolitical risks have faded, at least in the short term. Valuations remain high. The S&P500 continues to be expensive, trading at 17.5 P/E at the end of 1Q14—higher than its 15.6 average over the previous five year—and 15.3 P/E computed on a 12-months forward earnings base (relative to its 13.8 ten-year average). The sectoral picture is mixed, with Health Care and Information Technology leading the market in March—Energy remains the only negative sector, both over March and 1Q14 as a whole. Profits remain weak, rising by less than 2% (quarter on quarter) in each of the last two quarters of 2013. As the 1Q14 profits start to come in, analysts expect a slight decline (-0.4%) in S&P500 profits over the quarter despite top-line growth. Overall, S&P500 profits increased 12.8% in 2013, but the apparently strong earnings performance conceals a much weaker picture for operating earnings and cash flows.

Fig. 5: <u>Corporate Profits Slacken</u>



The continued bull market can be explained in part by two factors: a surge in IPOs and record high share buybacks fueled by surging corporate cash holdings. The first quarter of the year saw 65 IPOs, which raised $10.6 billion. Most of these IPOs were in the hi-tech area, leading to some fears of a repeat of the dot.com bubble of the late 1990s. Buy-backs reached $214 billion in 4Q13, the highest level in 6 years.

Fig. 6: Subsectors Performance



The markets have already fully discounted the Fed tapering, so the forces that should drive them in the medium-term should be earnings, valuations and the macroeconomy. We have consistently underestimated the market's ability to beat or expectations, and the momentum could drive the S&P500 to 2,000. Nevertheless, there are warning signs, and such a level would be difficult to maintain.

March Data Releases

Economic Data Releases-Mar 2014	*Prior*	*Consensus*	*Actual*	*Min*	*Max*
Macroeconomy					
GDP (4Q13, % Annualized) second revision	3.2%	2.6%	2.6%	2.2%	3.0%
CPI (m/m) Feb	0.1%	0.1%	0.1%	0.0%	0.4%
Core CPI (% m/m) Feb	0.1%	0.1%	0.1%	0.0%	0.4%
Balance of Payments					
Exports (% m/m) Feb	0.1%		-1.1%		
Imports (% m/m) Feb	0.5%		0.4%		
Trade Deficit $ billion) Feb	$39.3	$38.3	$42.3	$35.0	$41.0
Current Account Deficit ($ billion) (4Q13)	$96.40	$88.10	$81.10	$81.20	$91.50
Oil Prices (WTI, $/bbl, eom) Mar	$102.59		$101.88		
Industrial & Manufacturing					
Empire State (Mar)	4.48	6.50	5.61	0.00	8.50
Philadelphia Fed (Mar)	-6.3	3.0	-1.0	-2.0	5.0
ISM-Mfg Mar	53.2	54	53.7	51.5	54.7
Chicago PMI (Mar)	59.8	59.0	55.0	57.2	60.6
Markit PMI Mfg Mar	57.1	56.8	55.5	56.2	57.6
Industrial Production (% m/m) Feb	-0.2%	0.3%	0.6%	0.0%	0.5%
Manufacturing (% m/m) Feb	-0.9%	0.3%	0.8%	0.2%	0.5%
Durable Goods (m/m) Feb	-1.3%	1.0%	2.2%	-1.5%	2.5%
Durable Goods, ex transp (m/m)	0.9%	0.3%	0.2%	-1.7%	1.5%
Factory Orders (m/m) Feb	-1.0%	1.2%	1.6%	0.6%	1.5%
Services					
ISM non-mfg Mar Jan	51.6	53.3	53.1	52.0	55.0
Consumer Spending					
Retail Sales (% m/m) Feb	-0.6%	0.2%	0.3%	-0.1%	0.4%
UMich Consumer Sentiment (end-Mar)	79.9	80.5	80	79.9	83.0
ConfBd Consumer Confidence (Mar)	78.3	78.4	82.3	75.0	80.2
Personal Income (m/m) Feb	0.3%	0.2%	0.3%	0.1%	0.5%
Personal Consumption Expenditures (m/m) Feb	0.2%	0.3%	0.3%	0.1%	0.5%
Housing Market					
Housing Starts ('000) Feb	909	910	907	792	835
New Home Sale ('000) Feb	455	440	440	411	466
Existing Home Sales (MM) Feb	4.62	4.60	4.60	4.50	4.75
Construction Spending (m/m) Feb	-0.2%	0.1%	0.1%	-0.5%	0.9%
Case Shiller-20 (m/m) Jan	0.8%	0.7%	0.8%	0.4%	1.1%
Case Shiller-20(y/y) Jan	13.4%	13.2%	13.2%	11.2%	13.8%
Employment					
First Time Claims ('000) (Last week Mar)	310	320	326	315	325
Non-Farm Payroll Mar	197,000	206,000	192000	175,000	275,000
o/w Private Sector	188,000	215000	192000	175,000	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.