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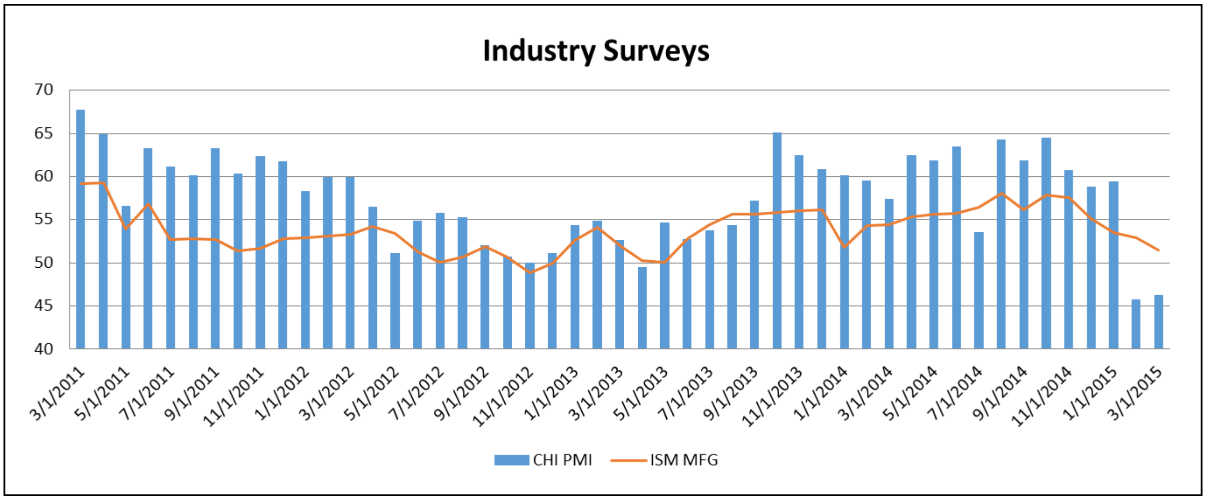
Advocacy Investing®

**A LOSS OF MOMENTUM**

- **The economy experienced a sharp deceleration in 1Q15**
- **March payrolls disappoint**
- **The Fed sends mixed signals, but no rate increase expected until the end of 3Q15**
- **The strong dollar creates havoc, but may have peaked**
- **The S&P500 has difficulty holding to the 2,100 level, may be headed for a mild correction**

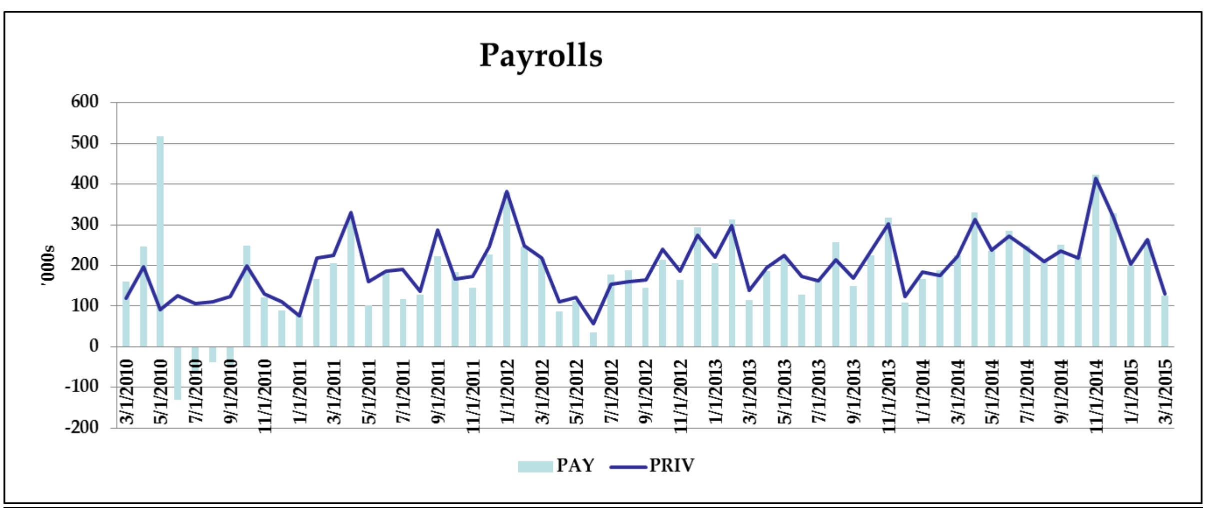
***Soft Data:*** The second revision to 4Q15 economic output numbers left GDP growth unchanged at 2.2% (annualized). However, the data releases for the month of February and March indicate some softening of economic growth. On the industrial side, both actual results and surveys showed a deceleration. Industrial production rose by 0.1% (month-on-month, m/m) in February, while manufacturing output declined by 0.2% (m/m). Factory orders rose by 0.2% (m/m) after declining by 0.7% the previous month; durable goods, (ex-transportation) fell by 0.4% m/m, the second consecutive monthly decline. Early month surveys where stable at low levels—the Empire State and Philadelphia indices were almost unchanged at respectively 6.9 and 5.0. Late month surveys were mixed. The Markit PMI-Manufacturing increased to 55.7 at the end of March from 55.1 a month earlier, while ISM-Manufacturing fell from 52.5 to 51.9 over the same period. The broad-based Chicago PMI rose slightly, but remained under 50 for the second month in a row, indicating a contraction. On the consumer side, we saw strong gains in consumer confidence (with the University of Michigan-Reuters and Conference Board indices at respectively 93.0 and 10.3 at the end of March) and robust gains in personal income (up by 0.4% m/m in February). In contrast, actual consumption remained subdued, with personal consumption expenditures up by only 0.1% m/m, while retails sales fell by 0.6% m/m. The services sector remained stable, with the ISM-NonManufacturing index at 56.5 at the end of March.

## Fig. 1: Soft Surveys




Oil prices were unable to hold at the $50/barrel level in March in the face of abundant supplies and inventories, and WTI fell to a low of under $44/barrel in mid-March, slowly recovering to above $50 in early April. The nuclear deal with Iran has had a mildly bearish impact on oil prices, with WTI falling at the margin after it was announced on Thursday April 2. In the medium-term, the deal could add 1 million barrels per day (mbd) of Iranian crude to global oil supplies, keeping the bearish pressure on oil prices over the medium term. However, any prospective increase in Iranian oil supplies will be very gradual.

## Fig. 2: Payrolls

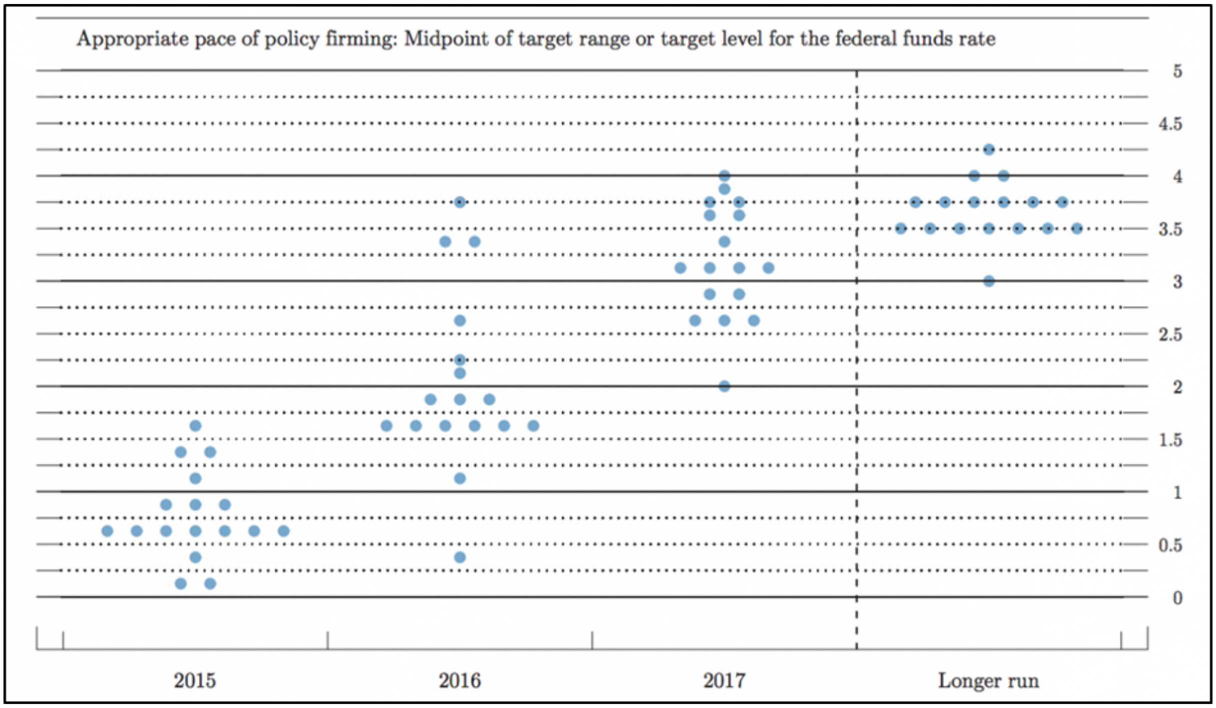


***Major Disappointment:*** The March payrolls report was certainly disappointing. Total employment increased by 126,000, (private payrolls increased by 129,000), about half market expectations. In addition, the previous two months' numbers were revised downward by an aggregate of 69,000. This brought the three-months moving average down to 197,000, from 280,000 in February. All of the gains were in private business services, while employment in manufacturing and construction remained flat. The mining sector (mostly oil and gas) experienced continued job losses.

The unemployment number (derived from a separate household survey) remained constant at 5.5%, but the labor supply showed continued weakness, with the participation rate falling marginally to 62.7% (it stood at 63.2% one year ago). Long-term unemployment fell by 0.1%, to 10.9%, down 3% in the past two years. While average weekly hours fell by 0.1 to 34.5 hours, average hourly earnings rose by a robust 0.3%, the only good news in an otherwise disappointing jobs market situation. In consequence, labor earnings proxy (annualized) rose by 2.8%. High-frequency data stood in contrast to the payrolls and continued to improve as first-time jobless claims fell further to 268,000 in the last week of March.

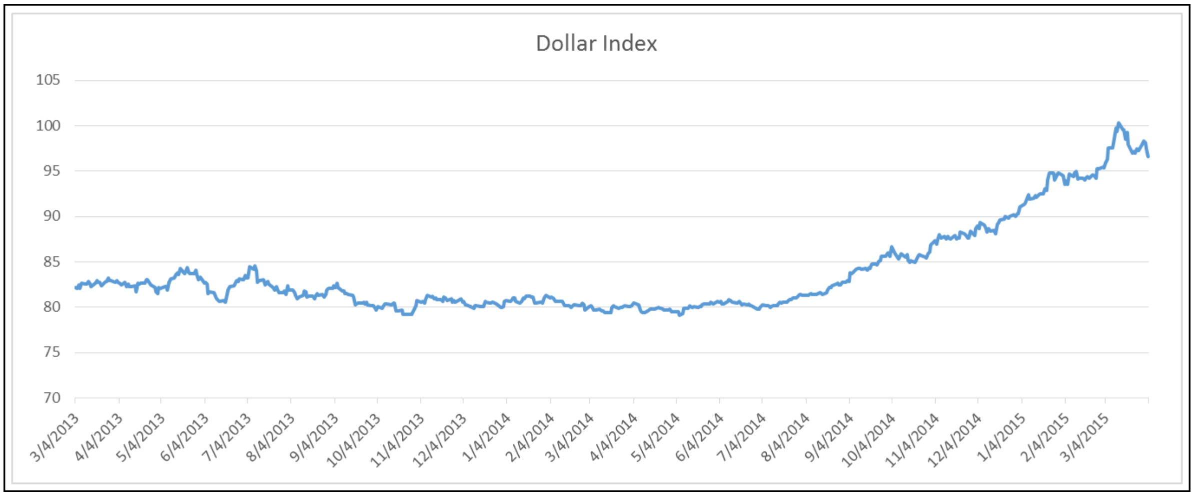
***Moonwalking:*** The March 17-18 meeting of the Federal Open Market Committee (FOMC) has been compared by some analysts to Michael Jackson's "moonwalking"—going in one direction while seeming to go in another. In effect, the FOMC dropped the word "patient" from its statement, while at the same time indicating that its first rate increase was not imminent. On one hand, the end of Fed "patience" means that we are back to a more conventional monetary policy. On the other, the Fed recognized some moderating of economic growth and revised its 2015 growth forecast range down to 2.3%-2.6% from 2.6%-2.9%. At the same time, the Fed remains frustrated by the slow pace of wage growth, and continues to be concerned by the potential impact of monetary tightening on an already supercharged dollar. Furthermore, with inflation remaining close to zero, we are far from the 2.0% target set by the Fed as a threshold for faster tightening. In any case, several of the regional Fed presidents, as well as Fed Vice Chairman Stanley Fischer, had indicated that the "conversation" on monetary tightening should begin. This position is supported by the so-called "dot-graph," which follows the evolving views of the FOMC members over successive meetings. Nevertheless, the soft jobs number for March has put a damper on tightening talks, and any move in this regard could be postponed to the end of 3Q15. Most recently, New York Fed president Dudley stated that the pace of increases would be "shallow." Overall, market expectations and the Fed "dots" diagram point to Fed Fund rates at 0.75%-1.00% by the end of the year. Bond markets also reacted to the jobs data, and the ten-year T-Note yield fell once again to under 2% — ending the first week of April at 1.83%.

**Fig. 3: Fed Dots**




***Damned if you do, damned if you don't:*** Not long ago, the rest of the world was complaining about the weak dollar, and how the US was gaining an unfair competitive advantage as a result. However, this is no longer the case. The strong dollar is creating havoc both in the US corporate world and overseas. The greenback has gained 25% between mid-July 2014 and mid-March of this year. Two factors explain the strength of the dollar. First, it reflects the relative strength of the US economy in an unsteady global economic environment. Second, the divergences in monetary policy have changed market expectations. On one hand, the Fed is on the verge of tightening. On the other, the European Central Bank (ECB) and other major monetary institutions in both developed and emerging market economies have moved to jumpstart growth by supersizing easy monetary policies. For the eurozone, dollar strength (reflected in the sharply weakening euro) is a boon, since it enhances the competitiveness of European exports. However, emerging markets, already battered by the fall of commodity prices, are experiencing massive capital outflows.

Fig. 4: <u>Supercharged Dollar</u>



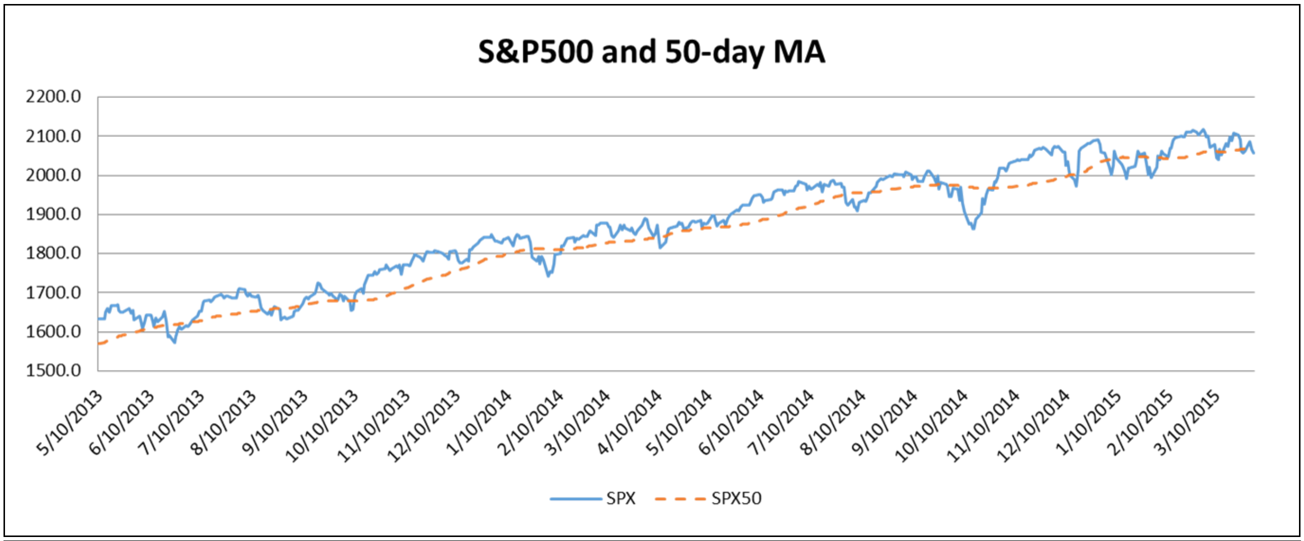

Economic news from the eurozone has improved. The March eurozone PMI-Manufacturing index rose to 52.2 at the end of March from 51.0 the previous month, reflecting continued expansion. Looking at the core economies, we see German growth accelerating further, but the French expansion moderating somewhat. The Greek problem is in abeyance, but has been relegated to the margins for the time being. China's PMI-Manufacturing index recovered to over 50 in March after two months of contraction.

***A Slow Start to the Year:*** The downshift experienced by the economy since 4Q14 accelerated in the first months of 2015, with manufacturing, durable goods, exports, construction and retail sales all moving into contraction mode. Part of the slowdown can be attributed to the extreme weather experienced in large parts of the country, but the strong dollar and falling oil prices were also important factors. The strong dollar (which has gained about 15% in the past 12 months) has hurt exports—which have declined by 3.7% from their peak of almost $200 billion in November of last year. In addition, it has put major pressure on corporate margins.

At the same time, the gains to consumers from lower oil prices have failed to offset the loss in employment and capital expenditure cutbacks in the energy industry. In fact, the data indicate that investors continue to save most of the gains realized from the recent oil price decline. While we do not expect a repeat of last year's first quarter contraction, growth in 1Q15 is projected at only around 1%.

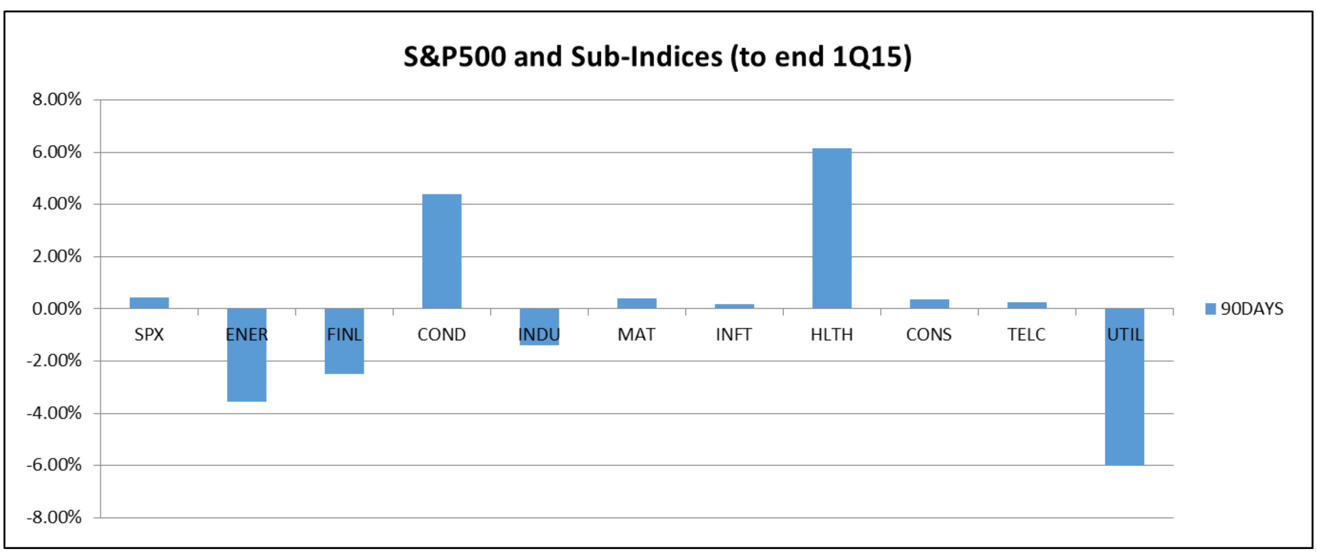
The economy is expected to rebound in the second and third quarters. Some of the weather-related weakness should fade away, while the dollar seems to have reached a ceiling—it has already declined by about 2% since hitting a high in mid-March. However, the slow start of the year will make it more difficult for economic growth to break through the 3% level for the year as a whole.

**Fig. 5: Bearish**




***Mild Correction:*** The S&P500 has not been able to hold on to the 2,100 level in the past few weeks. The S&P500 lost 2.2% in the month of March, erasing earlier gains in the year and ending unchanged over 1Q15. There was no clear pattern to the losses: utilities and energy shares were the biggest losers, while healthcare and consumer discretionary share showed strong gains.

**Fig. 6: S&P500 90-day Performance**



In the absence of strong improvements in the economic fundamentals, the global equity markets have been somewhat sustained by a surge in M&A activity ($811 billion) in 1Q15, half of it in the United States. The European Central Bank's quantitative easing has provided a boost to European markets, while US markets still follow every shade of Fed guidance. Emerging markets' equity markets generally remain in the doldrums.

Market indicators point to what could be at best a pause or a mild market correction in the United States. The S&P500 is expensive, trading at 18 times earnings—the highest since 2010—and 1.8 times sales—the highest since 2001. In addition, the earnings picture does not look promising. Corporate profits declined in 1Q15, and analysts expect at least three quarter of declining earnings in 2015. Investors have been withdrawing funds from ETFs ($4.7 billion in March) and put options on the S&P500 outnumber call options by the highest amount since October 2008. Overall, it would seem that the index will have trouble breaking through the 2,100 level.

## Data Releases

| *Economic Data Releases-January 2015* | Prior | *Consensus* | *Actual* | *Min* | *Max* |
|---|---|---|---|---|---|
| **Employment** | | | | | |
| First Time Claims ('000) (Last week Mar) | 288 | 285 | *268* | 275 | 295 |
| Non-Farm Payroll Mar | 264,000 | 247,000 | *126,000* | 200,000 | 271,000 |
| o/w Private Sector | 264,000 | 240,000 | *129,000* | 207,000 | 260,000 |

| *Economic Data Releases-March 2015* | *Prior* | *Consensus* | *Actual* | *Min* | *Max* |
|---|---|---|---|---|---|
| **Macroeconomy** | | | | | |
| GDP (4Q14, % Annualized) Second revision | 2.6% | 2.1% | *2.2%* | 1.7% | 2.4% |
| CPI (m/m) Feb | -0.7% | 0.2% | *0.2%* | 0.0% | 0.2% |
| Core CPI (% m/m) Feb | 0.2% | 0.1% | *0.2%* | 0.0% | 0.2% |
| **Balance of Payments** | | | | | |
| Exports (% m/m) Jan | -0.3% | | *-1.6%* | | |
| Imports (% m/m) Jan | -3.6% | | *-4.4%* | | |
| Trade Deficit $ billion) Jan | $42.7 | $41.5 | *35.4* | $39.5 | $46.0 |
| Current Account Deficit ($ billion) (4Q2014) | $98.9 | $105.0 | *113.0* | $100.0 | $112.0 |
| Oil Prices (WTI, $/bbl, eom) Feb | 49.76 | | *47.6* | | |
| Corporate Profits (y/y) 4Q14 | 5.1% | | *2.9%* | | |
| **Industrial & Manufacturing** | | | | | |
| Empire State (Mar) | 7.78 | 7.00 | *6.9* | 0.00 | 10.00 |
| Philadelphia Fed (Mar) | 5.20 | 7.00 | *5.0* | 2.00 | 12.00 |
| ISM-Mfg Mar | 52.9 | 52.5 | *51.5* | 50.9 | 54.1 |
| Chicago PMI Mar | 45.8 | 50.2 | *46.5* | 49.5 | 53.5 |
| Markit PMI Mfg Mar | 55.1 | 55.3 | *55.7* | 54.1 | 55.6 |
| Industrial Production (% m/m) Feb | -0.3% | 0.3% | *0.1%* | -0.1% | 0.5% |
| Manufacturing (% m/m) Feb | -0.3% | 0.1% | *-0.2%* | -0.3% | 0.5% |
| Durable Goods (m/m) Feb | 2.0% | 0.7% | *-1.4%* | -2.0% | 2.0% |
| Durable Goods, ex transp (m/m) | -0.7% | 0.3% | *-0.4%* | -0.8% | 0.8% |
| Factory Orders (m/m) Feb | -0.7% | 0.0% | *0.2%* | -1.3% | 1.0% |
| **Services** | | | | | |
| ISM Non-MFG (Feb)) | 56.9 | 56.7 | *56.5* | 46.5 | 58.5 |
| **Consumer Spending** | | | | | |
| Retail Sales (% m/m) Feb | -0.8% | 0.3% | *-0.6%* | -0.1% | 0.5% |
| UMich Consumer Sentiment (end-Mar) | 91.2 | 92.1 | *93.0* | 91.0 | 95.0 |
| ConfBd Consumer Confidence (end-Mar) | 12.3 | 95.5 | *101.3* | 93.0 | 98.2 |
| Personal Income (m/m) Feb | 0.4% | 0.3% | *0.4%* | 0.2% | 0.4% |
| Personal Consumption Expenditures (m/m) Feb | -0.2% | 0.2% | *0.1%* | -0.3% | 0.6% |
| **Housing Market** | | | | | |
| Housing Starts ('000) Feb | 1081 | 1048 | *987.0* | 987 | 1076 |
| New Home Sale ('000) Dec | 482 | | | 440 | 495 |
| Existing Home Sales (MM) Feb | 4.82 | 4.91 | *4.9* | 4.65 | 5.05 |
| Construction Spending (m/m) Feb | -1.7% | 0.2% | *-0.1%* | -0.8% | 1.0% |
| Case Shiller-20 (m/m) Jan | 0.9% | 0.9% | *0.9%* | 0.5% | 1.1% |
| Case Shiller-20(y/y) | 4.4% | 4.6% | *4.6%* | 4.2% | 5.0% |

*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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