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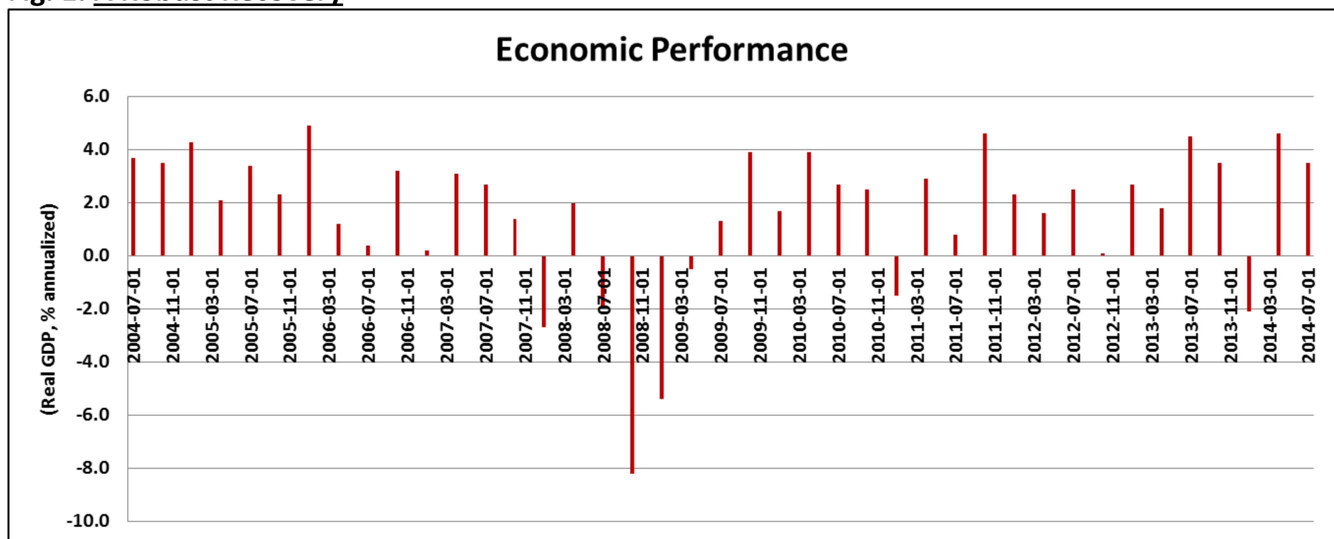
Advocacy Investing®

CLOSE CALL

- **Equity markets swoon in October to a near-correction, but recover to set new records in early November**
- **Data releases underscore a second consecutive quarter of robust growth in 3Q14**
- **A ninth consecutive month of 200,000+ employment gains, unemployment falls to 5.8%**
- **The IMF sounds a cautionary note on global growth**
- **The US mid-term elections produce GOP control over Congress, but the jury is still out on policy**
- **The Fed ends QE-III with little fanfare and impact on markets**

The past few weeks have been an exceptionally busy period, with the equity markets' October swoon, the end of quantitative easing, geopolitical flashpoints and the US mid-term election injecting a high dose of uncertainty in the economic and financial mix.

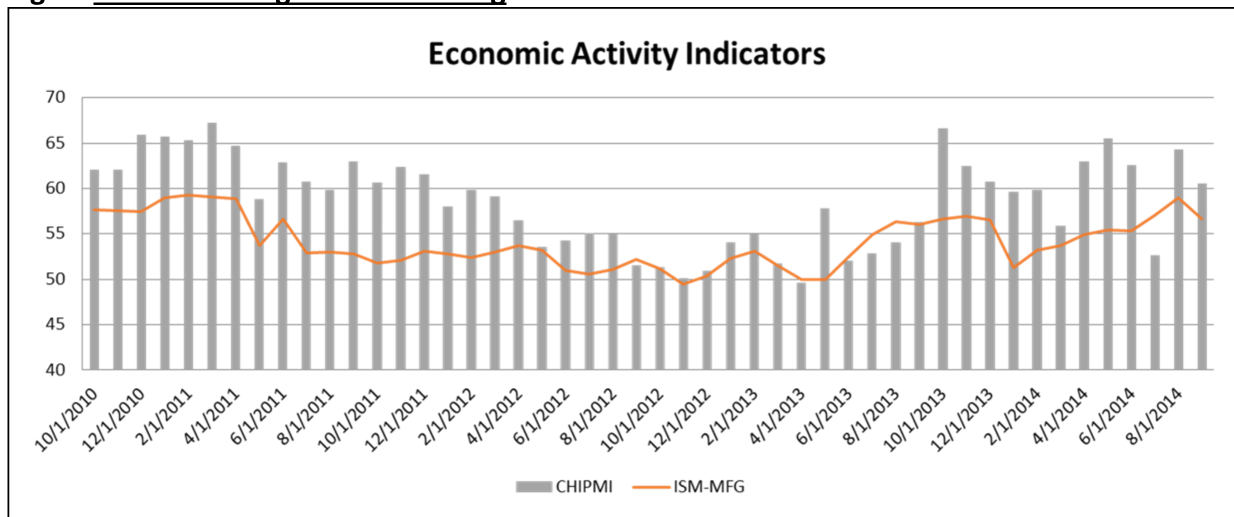
Fig. 1: <u>A Robust Recovery</u>



Robust Recovery: Despite all the sound and the fury, the US economy continued to chug along at a steady pace, and the data releases in October and early November underscored a robust economy gaining momentum. Market analysts were expecting a return to a more sluggish pace after the catch-up in 2Q14, but economic growth in the third quarter of 2014 (3Q14) surprised on the upside and exceeded market expectations. Output rose by 3.5% (annualized), a slowdown relative to the 4.6% registered in 2Q14. The creditable economic performance was broad based, with positive contributions for personal consumption expenditures, fixed investment, net exports and government expenditures. Nevertheless, we need to inject two notes of caution. First, the faster expansion was due in part to an unexpected increase in government expenditures, particularly at the Federal level. Second, the GDP number is only the first of three estimates and is likely to be revised.

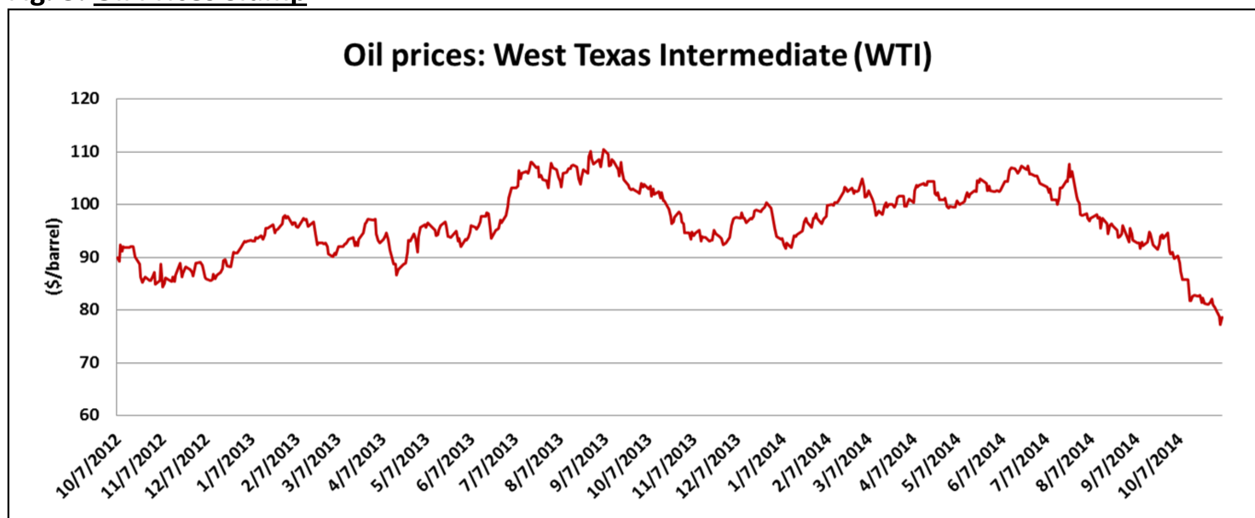
Moreover, the stronger-than-expected economic performance in 3Q14 came on the heels of generally very positive data releases. Industrial and manufacturing output rose by a respective 1.0% and 0.1% (month-on-month m/m) in September, while durable goods fell by 0.2% (m/m). Factory orders slid by 0.6% m/m. Forward-looking survey data also improved during the course of the month. The early-month surveys were mixed, with the Empire State index falling to 6.17 from 27.54 a month earlier; while the Philadelphia Fed index declined from 22.5 to 20.7 over the same time period. However, the late-month surveys showed unexpected strength. The ISM-Manufacturing rose to 59 from 56.6 a month earlier, the broad-based Chicago PMI increased from 60.5 to 66.2 over the same period and the Markit PMI-Manufacturing fell only slightly from 57.5 to 55.9. On the consumer side, consumer confidence indices reached multiyear highs. The University of Michigan-Reuters indicator increased to 86.9 at the end of October from 86.4 in September, while the Conference Board Index rose from 89 to 94 over the same period. However, the September sales data was mixed, with personal income rising by 0.2% m/m, but both retail sales and personal consumption expenditures (PCE) declined by respectively by 0.2% and 0.3% (m/m). (Part of the decline in PCE was good news, as it reflected the sharp fall in gasoline prices, now at their lowest year-to-date level.) The ISM-Non-Manufacturing fell slightly, but remained at a robust 57.1.

Fig. 2: Manufacturing Remains Strong



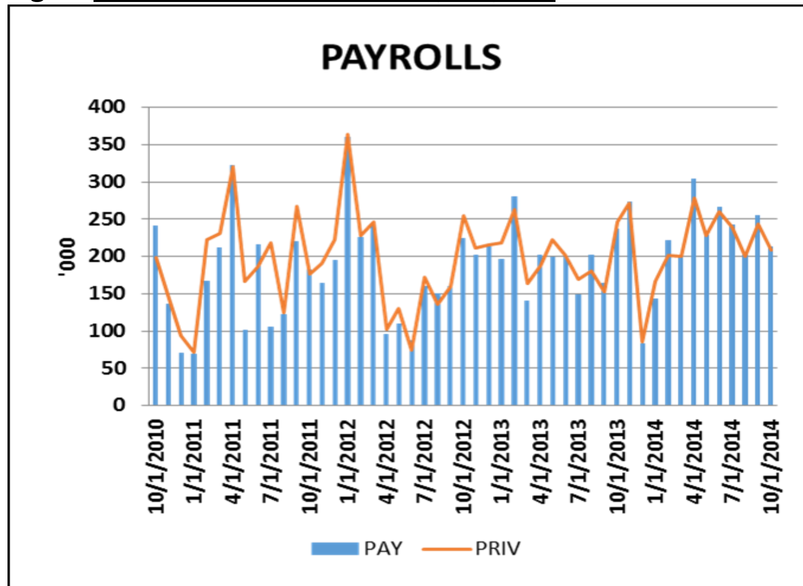
Oil Prices Slump: The oil markets have sharply reversed course and we have seen oil prices drop by almost 25% since mid-year, the third such occurrence of such a magnitude in the past quarter century. Oil prices (West Texas Intermediate, WTI) have fallen by 12% in October—and by over 25% in the past four and a half months—since the year high of $104.50/barrel on July 21st, reaching a 6-year low of $75.84 on November 4th. Ample global oil supplies, record US oil production and weak global demand should continue to undermine oil prices, which are expected to remain around $75/bbl for WTI over the next few months. So far, OPEC has shown little unity, with its leading producer Saudi Arabia cutting its posted prices. However, the oil cartel could react if prices fall under $70/bbl.

Fig. 3: Oil Prices Slump



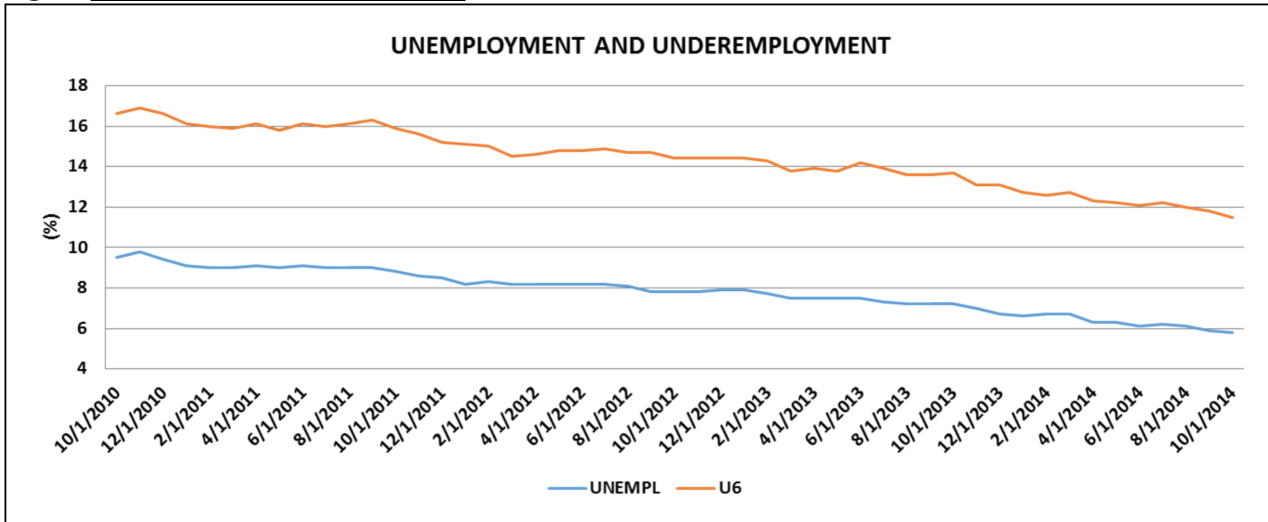
Housing Market Signs of Life: The housing market shows signs of stabilization. New and existing home sales, as well as housing starts, increased in September. However, the Shiller-Case 20 city price index fell by 0.4% (m/m) in August, its fourth monthly consecutive decline.

Fig. 4: <u>Ninth-month of 200,000+ job gains</u>



Payrolls Optimism: High-frequency data releases continue to underscore the improvement in the labor markets. Weekly first time jobless claims fell to 278,000 at the end of October. This is the eighth consecutive week this indicator has been under the key 300,000 level. The October payrolls number essentially delivered the same message as in the previous few months: a steadily improving labor market, but no upward pressure on wages. Non-farm payrolls increased by 214,000 (private payrolls up 203,000), with an aggregate upward revision of 37,000 for the two previous months. This is the 9th consecutive month of job gains exceeding 200,000. The three-month average also remained above 200,000. The improvement was felt across the board: goods-producing sectors gained 28,000 jobs, private services increased by 181,000 and government by 11,000. The separate household survey showed the unemployment rate falling to 5.8% from 5.9% at the end of September. Since labor force participation inched up to 62.8% (up by over 400,000), the improvement in the unemployment rate was due entirely to the new hiring. The broader U-6 index (which also measures underemployment) fell to 11.5% from 11.8% at the end of September and from 13.8% a year ago. The gains in employment have yet to lead to stronger wage inflation. Average weekly hours worked remained at 34.6% and average hourly wages crept up by 0.1% over the previous month.

Fig. 5: Elevated Underemployment



Global Jitters: The global economic situation remains challenging. So far this year, global growth has been running at an annualized 2.75%, compared to an annual average of 4% in the 2011-2013. The US's two main trading partners, China and the European Union are both experiencing weakening economic performance. The Eurozone barely avoided its third recession in six years. However, the European Commission slashed its economic projections for 2014 from 1.2% to 0.8% and for 2015 from 1.7% to 1.1%. The fact that the slowdown has been focused in the core economies, particularly Germany and France, the two largest economies in the eurozone, is a cause for concern. In response, Mario Draghi, the President of the European Central Bank, has committed to expanding the ECB's quantitative easing program to $1 trillion euros. In China, weak manufacturing output and a slippage in exports has led economic growth to slow down to 7.3% (annualized) in 3Q14, the weakest performance in five years. Faced with continued economic doldrums, the Bank of Japan announced a quantitative easing program that could reach $600 billion. Despite these central bank moves, little improvement is expected over the medium term.

A Farewell to QE: The Federal Open Market Committee concluded its October 28-29 meeting by officially ending QE-III. In the words of the FOMC: "…The Committee judges that there has been a substantial improvement in the outlook for the labor market since the inception of its current asset purchase program. Moreover, the Committee continues to see sufficient underlying strength in the broader economy to support ongoing progress toward maximum employment in a context of price stability. Accordingly, the Committee decided to conclude its asset purchase program this month."

BOX-THE IMF'S GLOOMY FORECAST

The IMF revised its best-case 2014 global growth projections downward from 3.7%, to 3.3%. ***(World Economic Outlook (WEO) "World Economic Outlook: Legacies, Clouds and Uncertainties", October 2014***). The major reasons for this pessimistic outlook were:

Lower-than-expected US growth, dragged down by a dismal first quarter

A stagnant eurozone dangerously flirting with deflation

A sharp slowdown of growth in China

Weakening growth in emerging markets

In addition, the IMF cited falling potential output growth (or secular stagnation) as a major medium-term macroeconomic risk. Furthermore, while rising geopolitical risks have so far been confined to their regions (witness the sharp drop in oil prices despite unprecedented tensions in the Middle East and Russia, two major oil producing regions); they could eventually have spillover effects in the broader macroeconomy. In conclusion, the IMF recommended a large dose of economic stimulus. In particular, it came out strongly (in its own diplomatic way) against excessive fiscal austerity in the major countries and recommended a major expansion of infrastructure spending in developed countries, both as short-term stimulus and a long-term productivity boosting measures.

QE-III started in mid-September 2013 with $85 billion monthly purchases of long-term securities, with the taper starting at the end of 2013. During QE-III, the Fed balance sheet expanded by 60%, to approximately $4.5 trillion. Over this period of time, the central bank accumulated $790 billion in Treasuries and $813 billion in mortgage-backed securities. The FOMC also stated that it will not begin shrinking the Fed balance sheet and the proceeds of the maturing MBS and Treasury securities will be reinvested.

Labor market conditions are the key driver of monetary policy of the Yellen Fed, and the FOMC continued to indicate that interest rates will be kept close to zero for a "considerable period of time." The latest payroll report is unlikely to change the Fed's stance and the markets continue to expect the first (modest) tightening in mid-2015. Nevertheless, it did leave the door open to an earlier Fed move if conditions in the labor markets improve faster, with significant and steady labor income gains.

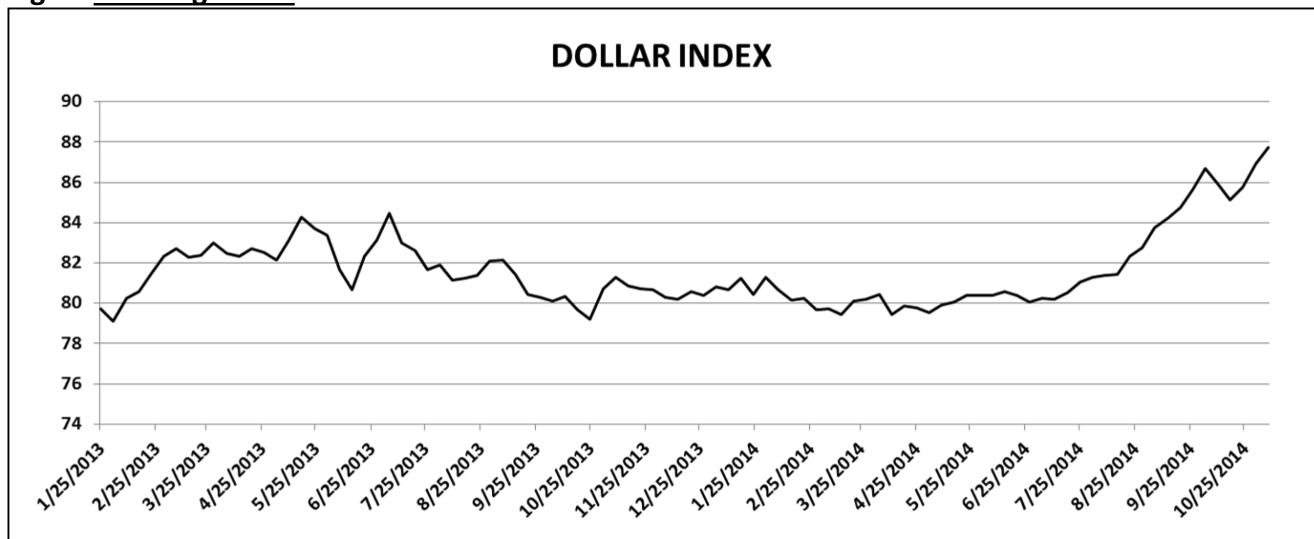
Interest rates dropped sharply in tandem with the markets, with the 10-year bond yield falling by 42 bp to a low of 2.19% on October 10th. Since then, rates have recovered somewhat, ending the first week of November at 2.37%. The yield curve also flattened, with the 2-10 year spread falling by 21bp between September 19th and October 10th.

The Mid-Term Election: While the midterms handed the Republican Party control of the Senate, it is not likely to be a game-changer in terms of economic policy. Post-election, both parties made

conciliatory noises and made promises to work together, but the reality is that beyond a reform of the corporate tax regime, infrastructure spending and new free trade agreements, President Obama/Democrats and the GOP have deep differences on most issues.

Moreover, talk of compromise might not last long in the face of a determined effort by the more radical factions of the GOP to undo President Obama's key policy agenda items. The sharp drop in the fiscal deficit (now estimated at 2.8% of GDP for FY 2013) means that spending battles are not on the agenda, but there is a heightened risk of political battles escalating into threats of or actual government shutdowns or technical defaults, anyone of which would be damaging to confidence and markets.

Fig. 6: A Strong Dollar



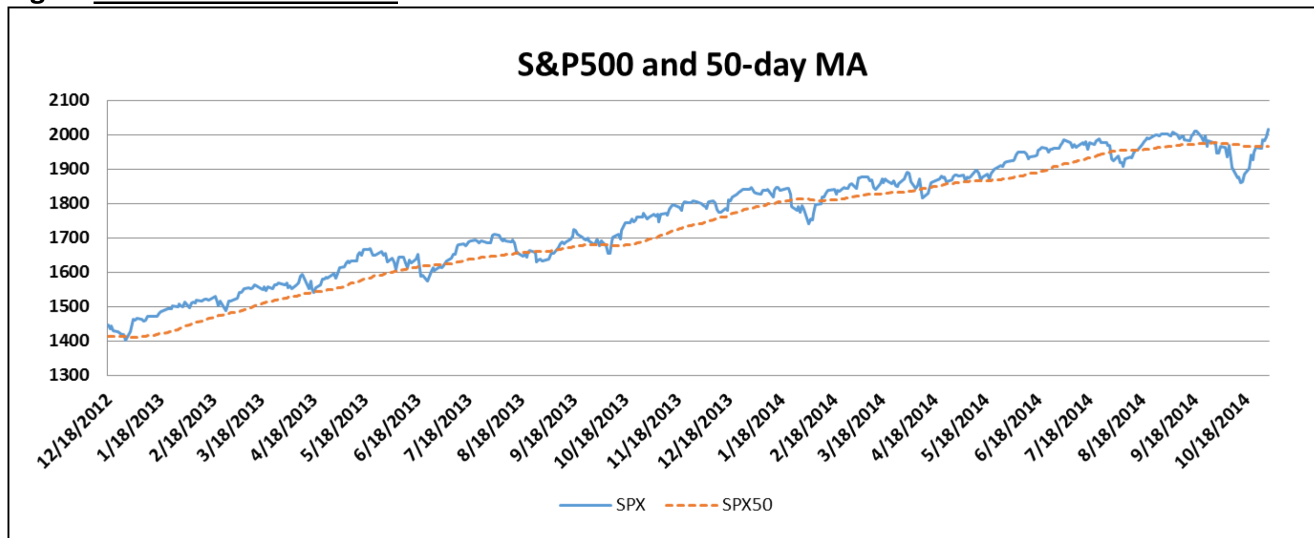
Economic Prospects Look Good, But… Several months of positive data releases have underscored that the US economic recovery is continuing at a solid, if unspectacular pace, with domestic demand gradually picking up speed and labor markets healing at a steady pace. However, the economy, which just competed two quarters of above-trend growth, faces a number of diverging factors in the short and medium term.

- Strong dollar: the trade-weighted dollar has gained almost 10% since the beginning of the year, crimping US competitiveness and widening the trade deficit. However, this is partly offset by the impact on the profitability of US multinationals, as the strong dollar boosts the value of foreign currency earnings

- Oil prices: the 25% drop in oil prices is a clear plus for the US economy, more than offsetting the negative impact of the strong dollar. A 20% drop in oil prices will add $70 billion to the US households' personal income over one year
- Global economy: the weak global economy remains the biggest headwind facing the US economy
- Domestic demand: domestic demand remains weak, despite the strength of both consumer and business confidence

On balance, assuming that the global economy holds, these factors should offset each other and the economy could continue to expand at a 2.5-3.0% pace. In the longer term, political agreements between the two parties should boost potential growth. A reform of the corporate tax rate could allow the repatriation of hundreds of billion dollars of corporate earnings parked overseas. Infrastructure spending and trade agreements would also have a positive effect.

Fig. 7: The Return of the Bulls

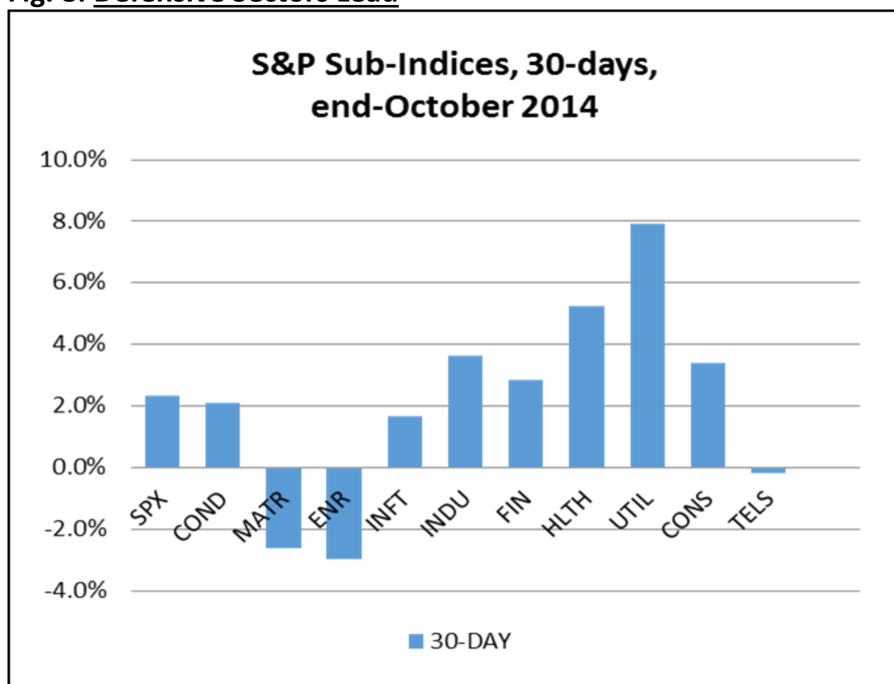


A Close Call amid Rising Noise: The equity markets' complacency was shattered in the first weeks of October, when a surge of risk aversion caused the major US and global indices to dip sharply, bringing the markets down dangerously close to a "correction" (i.e. a 10% or more drop). Global risk aversion surged and investors rushed for the exits, and the S&P500 dropped by 9.3% from its peak of 2,011 of September 18th to its trough of 1,862 on October 15th. Other markets followed suit, with the MSCI-EAFE (covering developed markets outside North America) and the MSCI-EM (emerging markets) falling by respectively 8.1% and 10% over the same period. The proximate cause of the market reversal was a pessimistic World Economic Outlook (WEO) IMF report, with the ominous title "World Economic

Outlook: Legacies, Clouds and Uncertainties." The gloomy IMF assessment was aggravated by the Ebola scare and the further unraveling of the Middle East hot spots (Iraq and Syria).

The equity markets, which have had an almost uninterrupted 66-month bull run which led to a 200% increase in the S&P500 index between March 9, 2009 and September 18, 2014, were definitely overdue for at the very least a minor correction—the last correction occurred between July and September 2011, when the market index fell by 14%. Nevertheless, the correction was short-lived. Having apparently overreacted, the markets recovered in the second half of October, at least temporarily, buoyed by positive US data releases and hints of further monetary easing. The S&P broke new records in the first week of November, reaching 2,030 on November 6th.

Fig. 8: Defensive Sectors Lead



So far, the markets have been bouncing around the 2,000 level for the S&P500. Whether they can break away from this level remains to be seen. At this stage, the potential for a mild correction remains.

It remains to be seen if the markets can sustain the 2,000 level or even exceed it. As of November 7th, the S&P500 has risen by 10.3% (year-to-date). On the positive side, we have two factors at play. First, in the short-term, the stream of positive economic data indicating potentially accelerating economic growth should be a positive for the market. Second, earnings in 3Q14 have been good, but

unspectacular, with 81% of the S&P500 companies beating market expectations. Third, the GOP's overwhelming victory in the midterm elections could lead to business-friendly economic reforms if President Obama and the GOP can overcome their deep differences—the jury is still out on this one. On the negative side, much of the boost in the market has come from defensive sectors (utilities, healthcare and consumer staples), with the cyclical sectors lagging. Furthermore, top line growth is lagging—S&P500 sales are expected to rise by 3.4% from 5.7% in 2012 and 4% in 2013. The positive impact of the mid-term elections could evaporate fast if we return to gridlock-as-usual in Washington, Furthermore, the strong dollar will constrain sales and earnings of the US multinationals.

The end of QE-III has had little impact on the markets, but the jury is still out on the final outcome as we begin the transition to a more normal monetary policy in the United States, and historically, tightening US monetary policies have been accompanied by global market instability and turmoil. Quantitative easing (QE) is almost over, and it may have seemed that the markets had taken it in stride (apart from the so-called QE tantrum in May 2013, when Bernanke announced the incipient end to the program). And ceteris paribus, the transition could have continued on a relatively smooth path. However, everything was not equal, and the combination of geopolitical crises and political uncertainty in the United States can create a high degree of volatility.

October Data Releases

Economic Data Releases-October 2014	*Prior*	*Consensus*	*Actual*	*Min*	*Max*
Macroeconomy					
GDP (1Q14, % Annualized) First estimate	4.6%	3.0%	3.5%	3.0%	3.5%
CPI (m/m) Sep	-0.2%	0.0%	0.1%	-0.3%	0.1%
Core CPI (% m/m) Sep	0.0%	0.1%	0.1%	0.1%	0.3%
Balance of Payments					
Exports (% m/m) Sep	0.3%		-1.5%		
Imports (% m/m) Sep	0.1%		0.0%		
Trade Deficit $ billion) Sep	$40.0	$40.7	43.0%	$38.6	$42.0
Current Account Deficit ($ billion) (2Q2014)	$98.5				
Oil Prices (WTI, $/bbl, eom) Aug	$91.16		$80.54		
Corporate Profits (y/y) 2Q14	0.5%				
Industrial & Manufacturing					
Empire State (Oct)	27.54	20.50	6.17	12.00	29.20
Philadelphia Fed (Oct)	22.5	24.00	20.70	12.00	29.90
ISM-Mfg Sep	56.6	56.0	59.0	55.2	57.2
Chicago PMI Oct	60.5	60.50	66.20	58.00	61.50
Markit PMI Mfg Oct	57.5	56.10	55.9	56.0	57.8
Industrial Production (% m/m) Sep	-0.1%	0.4%	1.0%	0.3%	0.5%
Manufacturing (% m/m) Aug	-0.5%	0.4%	0.1%	0.2%	0.5%
Durable Goods (m/m) Oct	-18.3%	0.9%	-1.3%	-0.5%	3.4%
Durable Goods, ex transp (m/m)	0.7%	0.5%	-0.2%	0.2%	1.1%
Factory Orders (m/m) Sep	-10.0%	-0.7%	-0.6%	-1.2%	2.7%
Services					
ISM Non-MFG (Nov)	58.6	58.0	57.1	56.0	59.5
Consumer Spending					
Retail Sales (% m/m) Sep	0.6%	-0.1%	-0.3%	-0.5%	0.3%
UMich Consumer Sentiment (end-Oct)	86.4	86.4	86.9	86.0	87.0
ConfBd Consumer Confidence (end-Oct	89.0	86.8	94.0	80.0	90.0
Personal Income (m/m) Sep	0.3%	0.3%	0.2%	0.1%	0.3%
Personal Consumption Expenditures (m/m) Sep	0.3%	0.5%	-0.2%	0.2%	0.5%
Housing Market					
Housing Starts ('000) Sep	957	1010	1017	955	1120
New Home Sale ('000) Sep	466	460	467	445	495
Existing Home Sales (MM) Sep	5.05	5.10	5.17	5.00	5.20
Construction Spending (m/m) Sep	0.5%	0.6%	-0.4%	0.3%	1.0%
Case Shiller-20 city (m/m) Aug	-0.5%	0.1%	-0.1%	-0.3%	0.4%
Case Shiller-20(y/y)	6.7%	5.8%	5.7%	5.3%	12.4%
Employment					
First Time Claims ('000) (Last week Oct)	288	283	278	280	290
Non-Farm Payroll October	256,000	240,000	214,000	200,000	282,000
o/w Private Sector	244,000	235,000	209,000	205,000	277,000

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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