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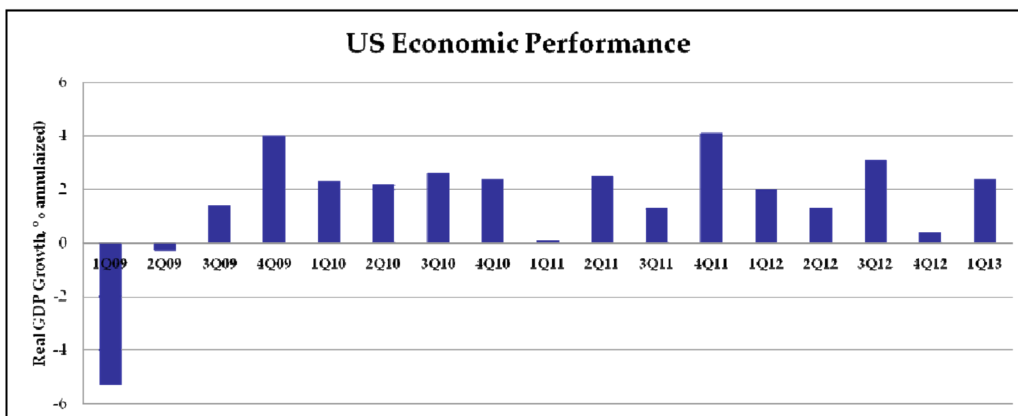
Advocacy Investing®

THE END OF THE BERNANKE PUT?

- **Data releases underscore a 2Q13 slowdown, but…**
- **A reassuring employment report offsets some of the gloom**
- **Improved fiscal outlook pushes fiscal issues to the background**
- **Fiscal and global growth drags could fade in 2H13 after a slow 1H13**
- **Bond markets crash in response to QE-III uncertainty**
- **Equity markets correction likely in the face of higher volatility**

Sluggish Growth: Output growth in 1Q13 was revised slightly downward (in the first of three revisions), from an annualized 2.5% to 2.4%. With the exception of the government sector (which has been shrinking for 10 out of the last 11 quarters) growth was broad based, led by an upturn in private consumption expenditures and inventories. While fixed investment remained positive, non-residential investment has slowed. Residential investment growth, while robust at an annualized 12.1%, slowed from its peak of 17.6% in the previous quarter. Altogether, these numbers are another indication that the US economy still has trouble escaping from its tepid recovery in the context of a generally weak global economy.

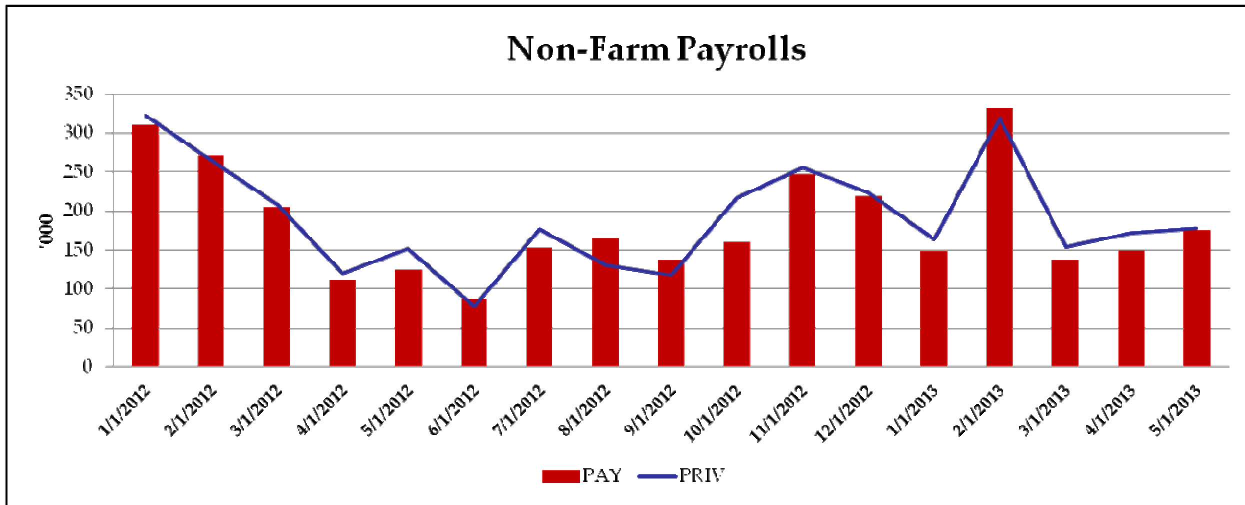
Fig. 1: Economy stuck in slow growth



Pointing Down: Data releases in May have confirmed a slowdown in 2Q13. The deceleration was driven by poor industry and manufacturing numbers. Forward-looking survey numbers were mostly negative. Both the Empire State and Philadelphia Fed surveys slipped into negative territory (respectively at -1.43 and -5.2) and the ISM-Manufacturing fell to 49.0 in June from 50.7 the previous month. Surprisingly, the Chicago PMI (which reflects a broader range of economic activity) jumped to 58. Industrial production was down 0.5% month-on-month (m/m) in April after a 0.4% increase in March. Both indices of consumer confidence rose to sharply (Reuters-University of Michigan to 84.5, the highest in 14 months, the Conference Board to 76.5). Nevertheless, the consumer remained cautious in the face of flat personal income, cutting personal consumption expenditures by 0.2% m/m. In a positive development, aggregate households' net worth jumped by $3 trillion in 1Q13 to $70.1 trillion, exceeding for the first time in six years its pre-crisis level. The trade deficit widened in March, largely as a result of a jump in non-energy imports, but this trend is actually a positive one, since it reflects a strong underlying consumer demand in the United States.

A Solid Payrolls Report: The May non-farm employment report provided proof of the resilience of the economy, while at the same time highlighting areas of concern. Payrolls rose by an above-expectation 175,000 in May, with an aggregate downward revision of 12,000 for the previous two months. The three-months moving average fell to 154,000 from 206,000 for the February-April period. Overall private payrolls increased by 178,000, and government employment shrank by 3,000. The employment data confirms a slowdown in the goods producing sector, with construction up only 8,000 and manufacturing continuing to shrink for the third month in a row (down 1000). Services provided most of the lift, while the Federal government payrolls fell by 14,000. The unemployment rate, which is based on a separate household survey, edged up from 7.5% to 7.6% as a result of a rise in the labor force—in itself positive news. However, the improved employment picture did not translate into strong earnings gains. Weekly hours worked edged up by 0.1 hours to 34.5 hours and hourly wages remained flat. In combination, this led to an earnings proxy rising by 3.5% on an annualized basis. High frequency data also pointed to a steady improvement in labor markets, with first-time jobless claims falling by 11,000 in the last week of May, to 341,000.

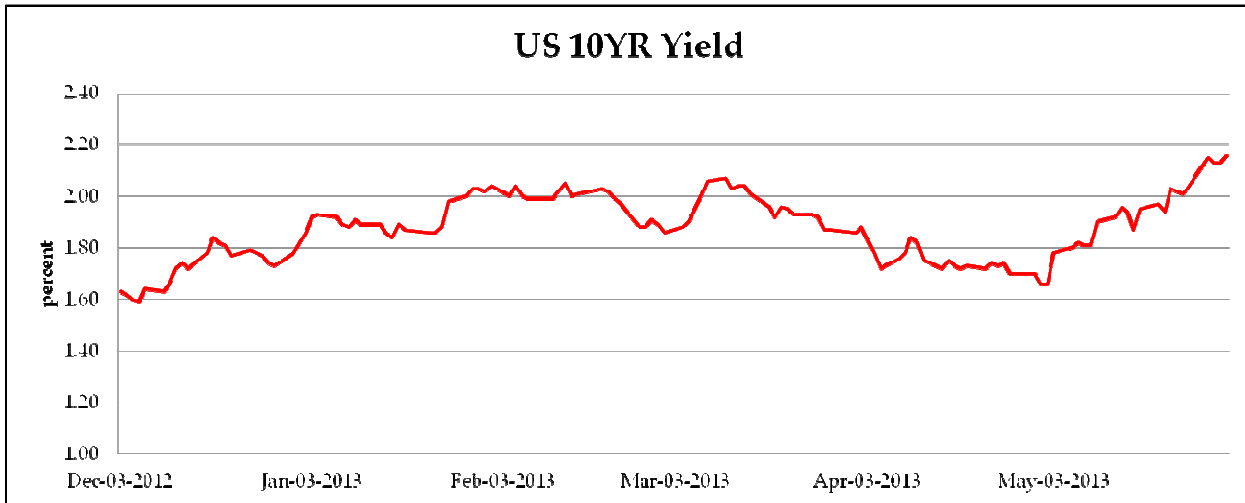
Fig. 2: Labor Markets Steady Improvement



Housing Recovery Takes Root: Housing remains robust despite a pause in housing starts (which fell to an annualized 853,000 in April from over 1 million in March). Both new home and existing home sales were steady, and house prices continued their sharp increase, with the Case-Shiller Index rising by 1.1% m/m (10.9% year-on-year, y/y). Nevertheless, despite 12 months of continuous price increases, the average index remains 28% below its pre-crisis level). The continued supply-demand imbalance supports rising prices. On one hand, inventory is tight in part because of 44% of homeowners are still underwater and will not bring their homes to market until prices rise further. On the other, low mortgage rates, new household formation, pent-up demand by households and investor interest feed into strong demand. Investors have accounted nationally for 20-25% of all residential purchases in the past year—and close to 1/3 in markets like Florida. These investors now include institutional investors with significant amounts of idle cash, such as private equity funds. For example, the private equity group Blackstone's real estate arm has accumulated a portfolio of 26,000 residential units. While these investors account for a small fraction of total housing market activity, their investments are concentrated in the worst-hit markets, and have had a more significant impact at the margin.

The real estate market recovery is expected to continue, and prices should continue to rise. However, improved inventory and higher mortgage rates could lead to a dampening of price increases by the end of the year.

Fig. 3: Interest Rates Surge

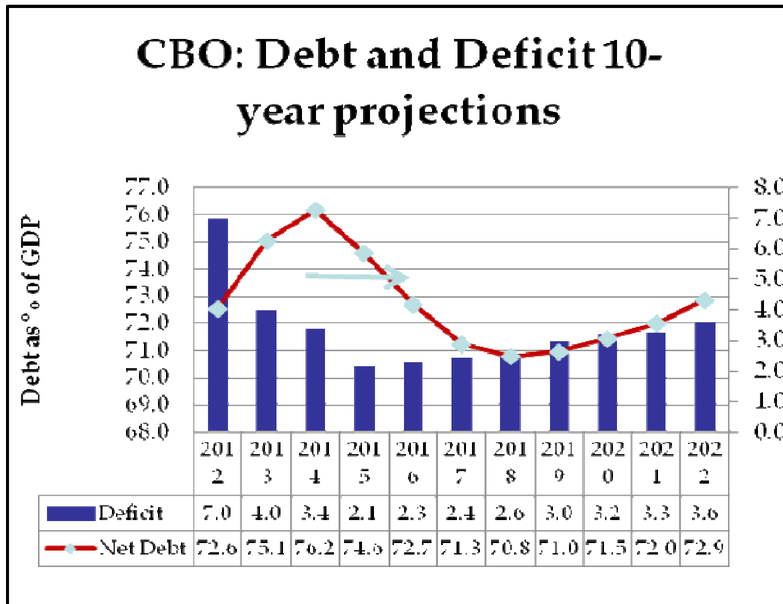


A Wobbly Bernanke Put: In the past month, financial markets have been roiled by uncertainty over monetary policy. In his semi-annual testimony to Congress, Federal Reserve Chairman Bernanke clearly stated that the Fed has no intention of killing the recovery by a premature tightening of monetary policy, while at the same time hinting that we have reached the end of the road as far as Quantitative Easing (QE) is concerned. Once again, Bernanke linked a slowing down of the pace of asset purchases to the pace of improvement in the economy, in particular the labor markets. Nevertheless, the Minutes of the April 30th Federal Open Market Committee (FOMC) meeting show that several influential regional Fed presidents are pushing for an early (and gradual) exit from Quantitative Easing—as early as this summer.

The anticipated curtailing of the "extraordinary measures" by the Fed, combined with a steady, albeit unspectacular, pace of economic growth and falling unemployment led to a sharp increase in global yields from their end-April low. The benchmark 10-year rate rose by 50 basis points in May to 2.1%. This resulted in a bond market rout, with all of the most popular bond funds losing an average of 1.8% in May.

The bond markets might have gotten ahead of themselves, and the sell-off might have been premature. The May jobs report was "just right" as far as the markets are concerned—the economy is healing, but we are still far from the Fed's target 6.5% unemployment rate, and the economy is still showing signs of weakness. These trends should strengthen the hand of the FOMC "doves" led by Bernanke and push back the timing of a QE-III curtailment to the end of 3Q13 at the earliest. Nevertheless, there is considerable evidence that the period of low interest rates and tight credit spreads is ending globally.

Fig. 4: Fiscal Position Improves



Grand Bargain Unlikely: The latest fiscal projections by the non-partisan Congressional Budget Office (CBO) paint a much improved medium-term fiscal picture. Fiscal deficits are projected to stabilize around a manageable 3-4% of GDP while net debt held by the public should peak at about 76% of GDP.

Table 1: CBO Projections

CBO's Baseline Budget Projections

	Actual, 2012	2013	2014	Total 2014-2018	2014-2023
Revenues	15.8	17.5	18.3	18.9	18.9
Expenditures	22.7	21.5	21.6	21.5	21.9
Deficit (-) or Surplus	-7.0	-4.0	-3.4	-2.5	-3.0
Debt Held by the Public	72.6	75.1	76.2	n.a.	n.a.

The downside of the favorable recent fiscal trends is that they have pushed the much-needed reform of the tax system to the background. This would have been difficult to achieve, anyway, given the deadlock between the White House and the GOP, but the prospects of any “grand bargain” have dissipated further with the latest fiscal developments.

Independently of the CBO study, Standard& Poors’ which had downgraded US government debt from AAA to AA+ (negative outlook) in July 2011, upgraded the outlook to “stable,” citing a medium-term easing of the fiscal situation and the stabilization of the debt to around 84% of GDP over the next few years.

Global Drag: In a clear indication that the eurozone leadership is moving away from its insistence on austerity, the European Commission gave three of the largest European economies (France, Spain and the Netherlands) extra time to meet the 3% of GDP fiscal deficit target, while freeing Italy from its intensive fiscal monitoring by Brussels. Nevertheless, the global environment remains challenging. The Organization of Economic Cooperation and Development (which groups the 26 major industrial and emerging market economies) issued its semi-annual economic forecast for the world economy. In this report, the OECD warned that the continued recession in the eurozone (now in its 6th quarter) could threaten the global recovery. In addition, there are further signs of slowdown in the pace of economic growth in China, where the latest Manufacturing PMI numbers show a contraction. Commodity prices have been adversely affected by the slowdown in China, which in turn has created a negative impact feedback loop between lower commodity prices and slower growth for commodity exporters, all the way from Australia to the emerging markets of Latin America.

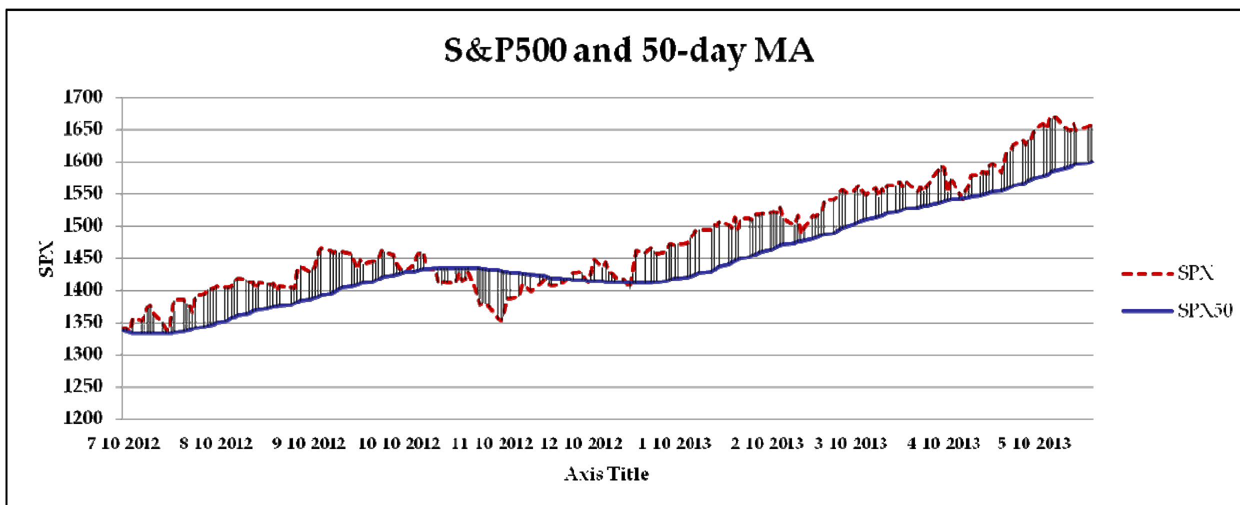
Unsteady as She Goes: The overall picture for the US economy is relatively robust, with steady employment growth. The services and housing sectors (which are driven by domestic factors) have offset somewhat the headwinds from a lagging manufacturing sector and the fiscal drag.

While the US has outperformed the eurozone and other major economies, it has not been able yet to escape the trap of mediocre growth since it emerged from the 2008-09 recession, with output expanding at 2.5% or less over the past 15 quarters. Unemployment has come down significantly, but incomes have stagnated. Manufacturing is suffering from the weakness in Europe and major emerging markets, (as well as from a strong dollar) and soft capital expenditures. Moreover fiscal policy has been contractionary and credit has yet to expand in a significant manner. At the same time, it seems that QE-III has reached a point of diminishing returns in terms of its impact on the real economy. Globally, emerging markets are on a softening of growth trend, with lower growth in the BRICs and weakening commodity prices.

Overall, with no clear engine of growth, these trends point to a weaker 2Q13, with growth estimated at 1.5-1.6% (annualized). The offset is that some of the fiscal and global drags on growth should fade over 2H13 and 1H14, leading potentially to growth of 2.5-3.0% over this period.

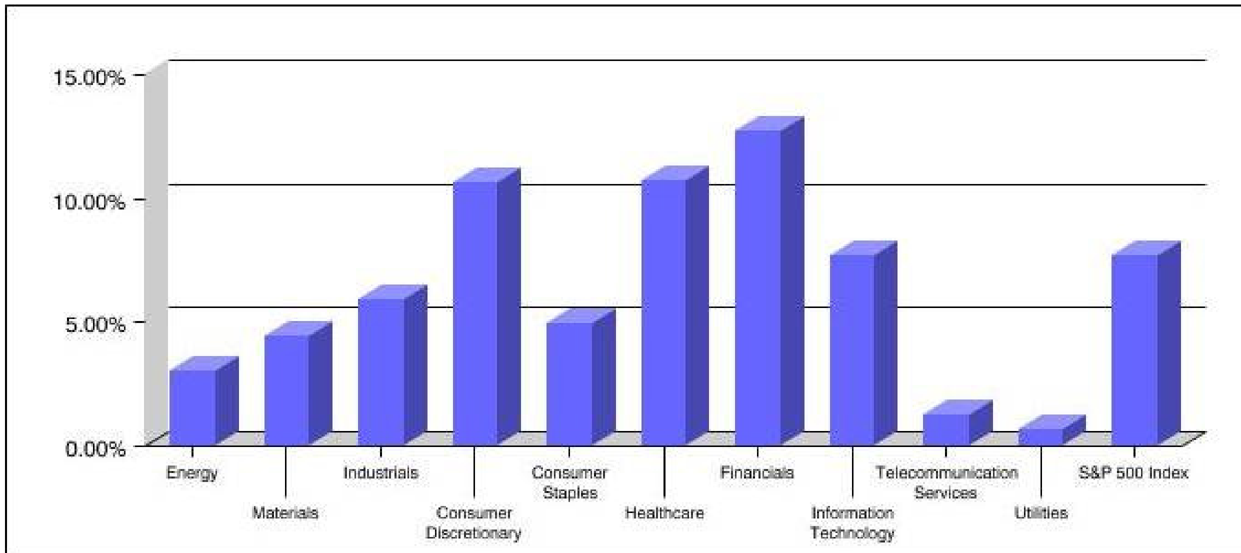
Markets on a Cusp: Investor sentiment shifted from greed to fear in mid-May and equity markets suffered a sharp drop in the first week of June after a very strong first four months of the year. The S&P500 fell from a peak of 1,669 on May 17 to 1,608 on June 5, and then recovered by the end of the first week of June to 1,639 on the stronger-than-expected payroll report. The markets have witnessed a sharp increase in volatility and risk since mid-May; the VIX fell from its April 18th high of 17.56 to a 2Q13 low of 12.45 on May 17th (when the S&P500 peaked at 1,669), but it has since jumped to 16.28 in the first week of June. While the S&P500 has remained above its 50-day moving average since early December 2012—a clear bullish signal—it has dropped from its peak. International markets also remain volatile, with the Nikkei peaking on May 22nd at 15,627 (a 70% rise since the then new government of Prime Minister Abe introduced an aggressive monetary expansion policy last December) before dropping by 17% since. Weakness in emerging market equities, turmoil in Turkey and the regional escalation in the Syrian civil war also contributed to rising volatility.

Fig. 5: <u>The Bull Runs out of Room</u>



There was no playbook for the Fed as it tried to stave off a recession, and there is none as we contemplate the normalization of monetary policy. The interplay between the easy monetary policy and macroeconomic fundamentals has become more complicated as investors ponder the timing of the Fed's next move and its impact on markets. The Fed has been severely criticized by a number of major market players, including PIMCO's Bill Gross, who believes that the serious distortions brought about by the Fed's quantitative easing have had a negative impact on growth. JP Morgan's James Dimon has also been quoted as saying that markets will be "scary" as interest rates return to normal.

Fig. 6: 90-day Sectoral Performance (end-May 2013)



At this stage, a return to fundamentals seems to be in order. First, corporate profits have tapered off, falling by 2% in 1Q13. Second, price-earning ratios have increased in line with the markets, rising from 14.5 at the end of 2012 to 18.5-19.0—close to their historic highs—at the end of May. Third, macroeconomic indicators continue to move in the right direction, albeit at a less than satisfactory rate. Fourth, nominal GDP is unlikely to grow faster than 4-5% this year and next. At the same time, of all the major markets (bonds, equities, commodities and currency), equities still seem to offer relatively low risk as there is still a great deal of cash on the sidelines—recent interest rate increases reflect in part the normalization of the economic situation. With a relatively flat E (earnings), any gains in the S&P500 must come from P/E expansion, which will be harder to achieve. All in all, these factors point to a pause in the equity markets, with a potential for a correction. At the same time, the 90-day sectoral performance has tended to favor cyclical stocks, which reflects market optimism about the economy—and a floor under the S&P500 at around 1,600.

May 2013 Economic Data

ECONOMIC DATA RELEASES May 2013	Prior	Consensus	Actual	Min	Max
Macroeconomy					
GDP (1Q13, % Annualized)1st revision	2.5%	2.5%	2.4%	2.2%	2.9%
CPI (m/m) Apr	-0.2%	-0.3%	-0.4%	-0.4%	0.1%
Core CPI (% m/m) Apr	0.1%	0.2%	0.1%	-0.1%	0.2%
Balance of Payments	0.1%			0.1%	0.2%
Exports (% m/m) (Mar)	-0.9%		1.2%		
Imports (% m/m) (Mar)	0.3%		2.4%		
Trade Deficit ($ billion) (Mar)	$37.1	$42.1	40.3	$37.0	$43.5
Current Account Deficit ($ billion) (4Q12)					
Oil Prices (WTI, $/bbl, eom) May	$104.87		$91.97		
Industrial Production					
Empire State (May)	3.05	3.75	-1.43	0.00	8.50
Philadelphia Fed (May)	1.3	2.2	-5.2	0.0	6.5
ISM-Mfg Jun	50.7	51	49	49	52.5
Chicago PMI (May)	49.0	50.0	58.7	47.5	53.0
Markit PMI Mfg Jun	52.1	52.1	53.2	51.5	52.5
Industrial Production (% m/m) Apr	0.4%	0.3%	-0.5%	-0.5%	0.3%
Durable Goods (m/m) Apr	-5.9%	1.1%	3.3%	-2.2%	4.2%
Durable Goods, ex transp (m/m)	-1.7%	0.4%	1.3%	-0.7%	1.8%
Factory Orders (m/m) Mar	4.7%	1.4%	1.0%	0.5%	3.9%
Services					
ISM non-mfg Mar	53.1	53.8	53.7	52.5	55
Consumer Spending					
Retail Sales (% m/m) Apr					
UMich Consumer Sentiment (2d half May)	83.7	83.7	84.5	82.0	84.5
ConfBd Consumer Confidence (May)	69	71.5	76.2	69.0	74.0
Personal Income (m/m) Apr	0.3%	0.1%	0.0%	-0.2%	0.3%
Consumer Spending (m/m) Apr	0.1%	0.0%	-0.2%	-0.3%	0.6%
Housing Market					
Housing Starts ('000) Apr	1021	965	853	930	1000
New Home Sale ('000) Apr	444	425	454	406	440
Existing Home Sales (MM) Apr	4.94	5.00	4.97	4.91	5.00
Construction Spending (m/m) Apr	-1.7%	1.0%	0.4%	-5.1%	1.7%
Construction Spending (y/y) Apr	4.8%		4.3%		
Case Shiller-20 (m/m) SA Mar	1.3%	0.1%	1.1%	0.6%	1.5%
Case Shiller-20(y/y) Mar	9.4%	10.2%	10.9%	9.5%	10.6%
Employment					
First Time Claims ('000) (Last week May)	357	345	346	335	350
Non-Farm Payroll (May)	149000	167,000	175000	147,000	210,000
o/w Private Sector (May)	172000	178,000	178000	154,000	220,000

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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