Market & Economic Commentary

Fall 2014

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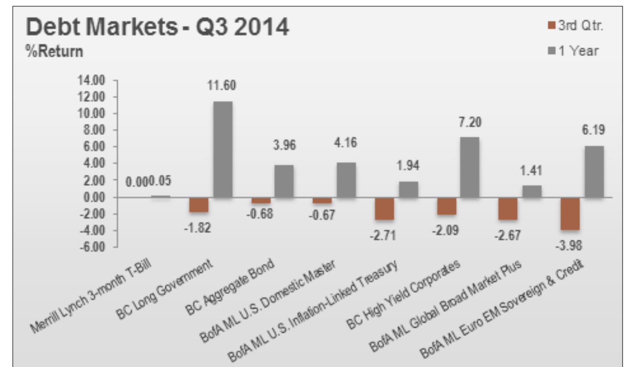
THE NORTH PIER*spective*

Market & Economic | Fall 2014

By: Jim Scheinberg - November 7, 2014

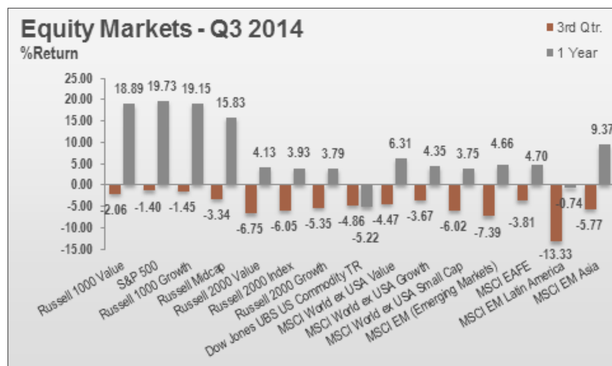
We took an end of summer dip. Turns out the water's still warm.

In our Summer Economic and Market PIER*spective* (July 17, 2014), I warned that the unusually low volatility the markets had been enjoying was not likely to continue for long, regardless of our still bullish expectations for equity markets and the global economy as a whole. Though things remained rather calm through the end of the Third Quarter, a confluence of headlines (ebola, ISIS and Eurozone-cooling) spooked the markets. After hitting an all-time high on September 19th, the U.S. stock market (with most of the globe in tow) began a dramatic selloff that would come just a hair short of an "official" 10% correction. The magnitude of the declines weren't as dramatic as the speed. The S&P 500 sold off the final 7.5% of its 9.5% *correction-ette* during the last 5 days of its near month long swoon. Those lows were reached intraday on October 15th, a day on which the Dow initially declined 460 points before recovering into the market's close. What was even more dramatic was that they yield on the 10-year Treasury declined from 2.25% to 1.89% during that same trading session, which was one of the most volatile moves in fixed income that I remember witnessing in my 25 year career. Over the next two weeks, economic data and earnings calmed emotions and the domestic markets have fully recovered, actually achieving fresh new highs. But as we said in our October 16 *PierAlert*, "Volatility is here, as predicted."



How the Markets Fared

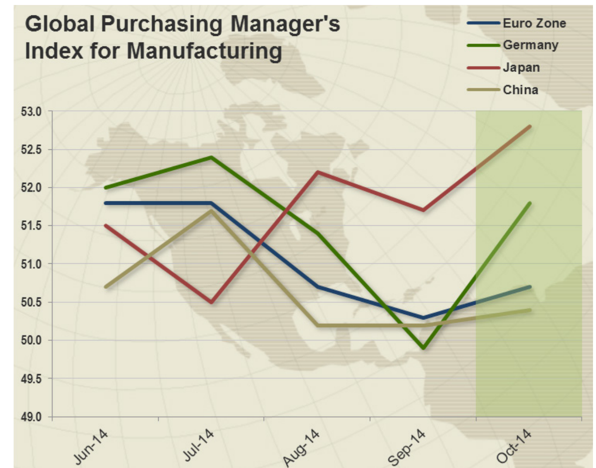
The Yield on the 10-Year Treasury was unchanged during the quarter at 2½%, trading in a very tight range. With very little movement in the Treasury markets, high quality bonds earned little more than their coupons. Credit spreads widened somewhat, reducing returns in credit sensitive areas of fixed income. The BarCap Aggregate Index was virtually unchanged, giving back most of its yield in price declines and high yield bonds lost close to 2% net. Because of an advance in the value of the U.S. Dollar, international and emerging market debt was lower as well when measured back in dollar-terms. Latin American emerging market bonds sank further, due to Argentina's second default in 13 years. It's actually quite remarkable that the decline in emerging market debt globally was isolated solely to the immediate region. In similar times in the past (such as 1994 - Mexico and 1998 - Indonesia) a high profile default like this has widened credit spreads meaningfully for the entire asset class.



Stocks saw a similar tale of two cities in Q3. Large Cap U.S. Equities were as quiet as the Treasury markets during the quarter, setting modest new highs before beginning their selloff in the last days of September. Smaller companies, however, had a rough go of it with big losses in July and September. International equities also lost ground as fears of a European and Asian slowdown reversed all of Q2's comeback. Growth

stocks edged out more cyclically sensitive value sectors both domestically as well as in developed international markets. Commodities dramatically reversed their rally from the first half of the year, losing 12½% in Q3. As fears of a global slowdown mounted in October, commodity prices continued to decline nearly another 6%.

Halloween's over, should we still be scared?



Since the *correctionette* was largely caused by fears of a global slowdown, let's start there first. The European Commission just released its Autumn Forecast for the EU revising GDP growth expectations down to 1.3% in 2014 and 1.5% and 2.0% for 2015 and 2016 respectively. Both the World Bank and the IMF expect slightly lower, but steady growth for China between 7%-7½% for over the coming year. Historically, these forecasts have proved volatile, based on current snapshots of economic activity. Though we at North Pier are seeing these same signs of malaise, especially in the Eurozone, we don't see the trend accelerating lower into meaningful recession. Rather, we theorize that Europe is likely experiencing the fits and starts recovery the U.S. experienced just a few years ago. Though far too early to call an end to the cooling trend that was evidenced in the final months of the summer, we are seeing initial signs of an upward turn in our forward looking indicators for Europe, China and Japan. While Germany, Ireland and Spain all improved, weakness in Italy and France is slowing growth in the EU.

Surging and Firming

The ISM Report on Business for Manufacturing (ROB) surged to 59 in October (up from 56.6 in September) nearing the highest levels since 2007. New orders, reported at 65.8, suggest that there is more good news to come. The services ROB retreated to a still strong 57.1 vs. 58.6 last month. The readings forecast GDP improvement for the U.S. of 4%-5% for the coming year. With the International ISM data mentioned previously showing at least a base for Europe and China (just above 50) and a positive turn for Japan, we believe conditions are ripe for the U.S. strength to lead global business activity forward.

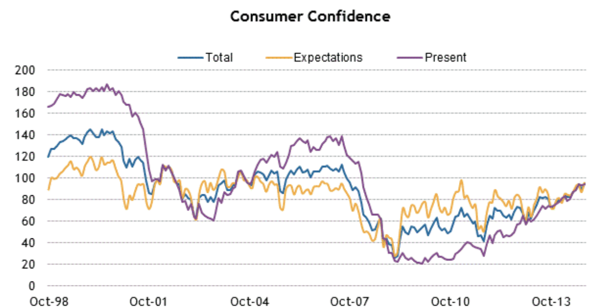
North Pier Weather Forecasts for a Warm Winter… Maybe Even Hot.

Initial Jobless Claims are now at a 20 year low, indicating more strength ahead in the labor markets. Non-farm payrolls continue to add around 250,000 jobs a month, a very healthy level. Gains in the labor market now have a well entrenched momentum that will likely carry the unemployment rate (presently 5.9%) continually lower into the coming year. We should see 5% or lower unemployment in the U.S. by the end of 2015.

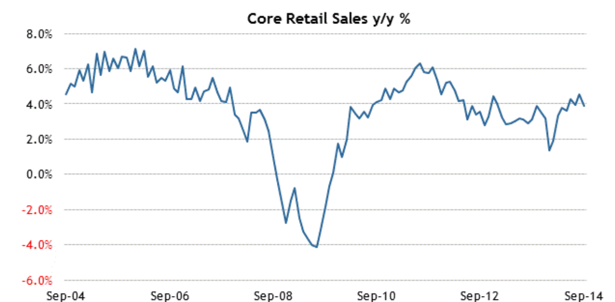
With the tightening in the labor markets, we are finally seeing some consistency in wage growth, which was previously an area of criticism in the recovery. Hourly earnings have been rising in a range of 2¼% - 2½% year-over-year of late. The average work week also ticked up a hair last month to 34.6 hours worked (a post-crisis high).

THE NORTH PIER*spective*

Spending Gener*U.S.*ly



Strength in jobs and increasing pay would logically bode well for the U.S. consumer; and it has. The Conference Board's Consumer Confidence Index rose to a post financial crisis high of 94.5 in October from an originally reported 86.0 in September (since upwardly revised to 89). The Michigan Sentiment reading is equally showing post-crisis highs.



Retail Sales have been strong showing a 4.5% improvement from Q3 2013. If upbeat sentiment holds, this Christmas is likely to be a boom for retailers and the economy as a whole. We are also seeing evidence of this confidence in spending for big-ticket items. Durable Goods Orders are running 5% better than last year and new orders are showing a 7.6% increase since October 2013. This is great news for the U.S. auto industry where light vehicle sales have finally reclaimed their long-term normal, pre-crisis levels of 16-18 million sales a year.

Sanity Checks and Balances

On November 4th, the country returned the Senate majority to the GOP. With the Republicans in control of both houses of Congress, they will set the legislative agenda in Washington for at least the next two years. With mixed control of the Executive and Legislative branches of government, we are unlikely to see any major policy initiatives that would undermine our current path to prosperity. However, President Obama may increase his already aggressive use of Executive Order, which could throw a wildcard into our prediction, and potentially draw the country into a Constitutional crisis.

PIER*ing* Ahead

Adding up the data of the last quarter, we see little reason to revise our macro-level expectations. The underpinnings of the global recovery remain in place, with the U.S. continuing to lead the world into a new era of prosperity. Yes, Eurozone debt and unemployment continues to be a drag on global progress, but strength here in the U.S. as well as the continuing emergence of the consumer class in Asia is likely strong enough to further drive the globe forward. Eventually, this growth should pull Europe out of its anemic economic state. The dread of a reversal in the global economic recovery that rose its spooky little head in the weeks leading up to Halloween was not completely misplaced. But scary things are not uncommon in October as well as the other 11 months of the year. The reality is that Europe's trajectory is quite similar to our very own fits-and-starts recovery of 2009-2012. During that era, we had a few *scary,* but minor decelerations along the way. Most were event driven: the BP Gulf oil spill, the Japanese earthquake and a couple of European Debt crises. However, the strong underpinnings of a U.S. recovery supported these dips and they proved to be short-lived.

The maco-level conditions of the globe should similarly support any short-term ebb in this era of economic tail-winds. In the coming years, we foresee that a rising tide truly will lift all ships, regardless if some presently have a few leaks. We will be watching commodity prices closely in the coming quarters for confirmation or contradiction of our theories. If the recent improvement in the global purchasing manager reports hold, then material prices should soon firm alongside them. If so, we expect that the recently downward revisions to European and Asian growth expectations will prove to have been an overreaction. We will update our network with a *PierAlert* if our monitored indicators show otherwise. In absence of that, however, you can still assume that we aPIER to be on course.

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