Market & Economic Commentary

Fall 2015

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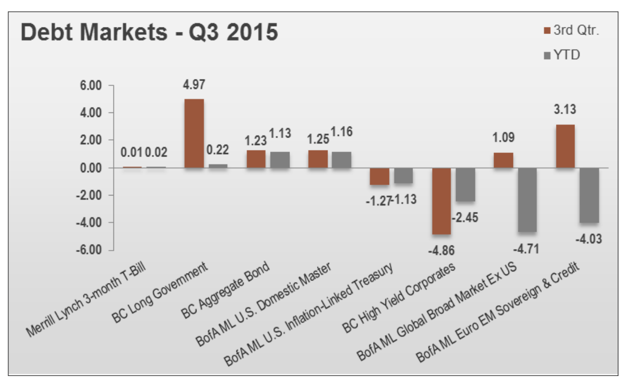
By: Jim Scheinberg - November 11, 2015

Wait and See-Saw

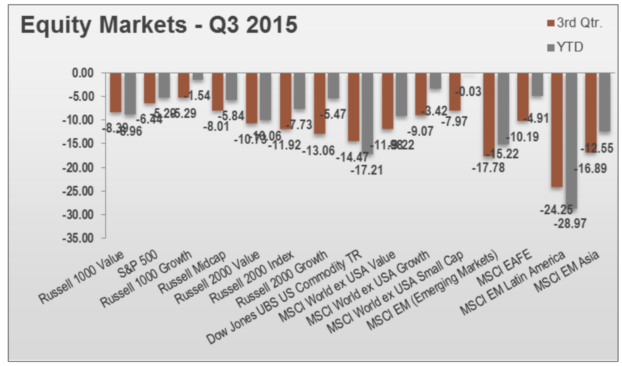
The stock market was rocked by a sharp correction in August, resulting in over an 11% sell-off in just six trading sessions in August. The markets attempted a recovery, but it failed in the final days of September, retesting the August lows. Concerns of a slowing China were the root cause of the decline. Speculation that Chinese slowing was an indicator of global conditions as a whole sent skittish investors to the sidelines. Commodity prices sold off sharply during the quarter as well. Also an indicator that global demand might be waning, investors weren't the only ones that were spooked. The Federal Reserve Bank, which had been largely assumed to be raising the discount-lending rate in the fall, took pause in the face of the sell-off and left interest rates unchanged at near zero. The Fed has increasingly seen its role as the calmer of markets in addition to the primary role of supporting the economy. In the end, equity markets globally erased all of their gains for 2015, and Q3 entered the history books as one of the worst since the financial crisis. As with most emotion-based corrections, calmer heads have prevailed and the markets have almost fully recovered their Q3 losses. Economic data in the U.S. (as well as from a fair portion of the globe) simply did not justify the sell-off, as conditions are seemingly quite stable. But as you will see in our analysis of the data, the market sell-off had an effect on more than just the Fed. Many sectors took pause in August and September. What remains to be seen is whether the effects will be temporary or more long-lasting.

How the Markets Fared



With the Fed on hold and economic fears on the rise, money poured into U.S. Treasuries yet again, pushing interest rates down for government bonds. The yield on the benchmark 10-Year Note declined from 2.33% to 2.06% during the quarter, which helped the Barclays Aggregate index climb 1.23%. Gains in U.S. governments were offset by declines in corporate bonds with deeper credit risk. The most exaggerated declines occurred in the U.S. high yield markets. Not only were they affected by widening credit spreads as economic fears mounted, but the hard hit energy sector, which saw meaningful declines, represented a fair amount of that index. There is concern that sub-$50 oil will lead to meaningful defaults in the energy portion of the high yield market. Commodities resumed their swoon with declines of over 14%. Metals and energy were the hardest hit.

Global equity markets sold off across the board. More cyclically sensitive, value-oriented stocks were most susceptible in the face of fears over a global slowdown. Both domestic and international large cap value indexes underperformed their growth counterparts by approximately three full percentage points. Small caps in the U.S. were harder hit, as they are more sensitive to money flow than larger companies. This trend was oddly reversed in developed international markets where small caps saw smaller declines. However, it was the emerging markets that were the hardest hit with Latin American equities losing nearly a quarter of their value in dollar-terms in just one short quarter. Asian EM equities saw large double-digit declines as well. It deserves note that all of these markets have recovered meaningfully in just the short month since the quarter close.



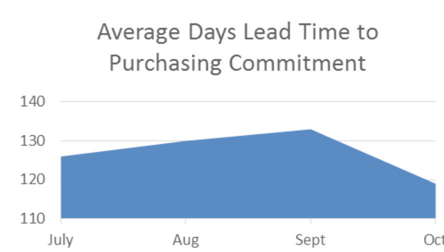
As previously projected by North Pier, GDP growth slowed in Q3 to 1.5%. Earlier in the year, the markets were expecting a strong second half. We contended (and continue to contend) that the manufacturing economy will continue to face tough year-over-year comparisons until the full effects of the massive rise in the U.S. Dollar vs. the Euro and other currencies (which occurred Aug 2014-March 2015) are absorbed. This should be somewhere are around spring 2016. Again, the U.S. economy appears very strong through a global lens, but looks far more muted when measured in terms of the newly appreciated.

September Businesses were ROBed!

The latest Report on Business (ROB) out of the Institute of Supply Management for November confirms our continuing views. The Manufacturing ROB came in at 50.1. Though this indicator is holding steady at anemic growth levels, forward-looking conditions in the report are improving a bit. New orders reversed their downward trend, and inventories are reportedly shrinking. Exports, which have been contracting, are doing so at a slightly slower rate. The most notable improvements are coming from wood products and furniture manufacturing. Perhaps the currency winds that have been flying in the face of the U.S. manufacturing sector are starting to abate.

On the services side, things continue to look much brighter. The ROB-NMI (Non-Manufacturing Index) surged to 59.1 in October, its second-highest reading since 2005! The highest reading was 60.3 in July, which was registered before the summer stock market correction. New NMI orders are soaring to robust levels. Growth was led by transportation & warehousing, health care & social assistance, and professional, scientific & technical services.

I found one piece of data in the recent quarter that exemplifies what I theorize is happing in the economy. Due to the sharp decline in the stock markets in August, we believe that purchasing managers took a wait-and-see approach on planned expenditures. I noted in a small subcomponent of the ISM report that capital expenditures (an indication of future business investment) dramatically reversed an uptrend in the amount of time that purchasing managers were taking to make a decision. That number, which had grown as high as 133 days in September, abruptly dropped to 119 in October. It appears as if much of the U.S. took a pause to see whether the summer correction was going to turn into a summer collapse. Once the markets calmed, it was back to business.



You're… *wait for it…* hired!

Initial unemployment claims remain at a 40 year low and continuing claims are approaching their lowest levels since the over-employed years of the of the late 90's. October's job growth rebounded smartly with nonfarm payrolls increasing by 271,000. This supports our suspicion that new hires, like new purchases, were put on hold in the wake of the summer pullback in stocks. September's new job report was revised even lower from 142,000 down to 137,000, well below the 200,000+ monthly average of the last two years. Again, most of the gains were in the services side of the economy. However, manufacturing, which actually saw a reduction of 24,000 jobs in Q3, saw its first real gains in over a year, adding 27,000 jobs. (Again, the worst may be over for the manufacturing sectors). Average work week hours and total compensation also rebounded from September's fractional declines. Average hourly earnings grew 0.4% month-over-month, now a full 2.5% higher than they were last year, the strongest increase since the financial crisis. We are starting to really see some wage improvements. The next question is, will this lead to upward pressure on prices?

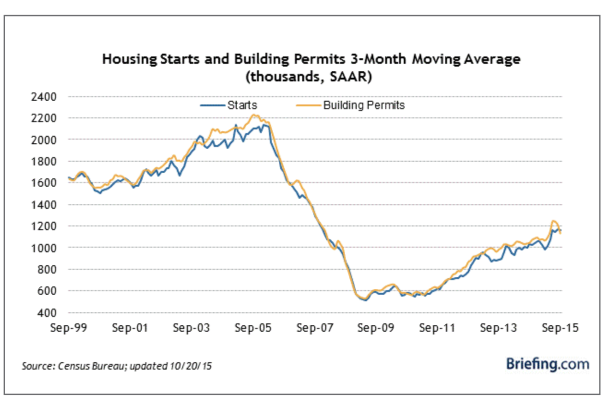
Our Prices Are So Low…

So far, the answer is "no." The Producer Price Index actually declined 0.3% net in the third quarter, led by a drop in material costs. Every measure shows that inflation is still in check. Year-over-year, prices for consumers (measured by CPI) increased just 1.9% through September. This is still well below the Fed's CPI target of 2.5%. This is one likely reason that the Fed has felt they have room to be measured in raising interest rates. The strength of the U.S. dollar, making foreign goods services and materials less expensive has continued to help keep prices in check.

Peeping at People

Now that we've looked at the business environment in the United States, it's time to check in with the main driver (over two-thirds) of the U.S. economy: the consumer. Here the news continues to be relatively good. Although Americans did exhibit the same cautionary pause that we saw in the business sector after the summer swoon in stocks, things appear to heading for a rebound this fall.

Besides the continued improvements in the job environment, real estate conditions are the second greatest factor to consumer spending the United States. Existing home sales rose above the five and a half million unit mark last month, and are again near the 2007 highs. Tight inventories of just a 4.8 months' supply of houses on the market helped propel median existing home price increases of 6.1% year-over-year in September. The Case Schiller Index shows similar 5% year over year gains through August. Gains are beginning to become more regionalized with more service and IP- focused economies (such as San Francisco, Denver and Seattle) supporting their local real estate prices, while manufacturing-based markets (such as Chicago, Detroit, Cleveland) are seeing less strength. This tracks the trends we are presently seeing in the bifurcation of the services and manufacturing economies of the U.S.



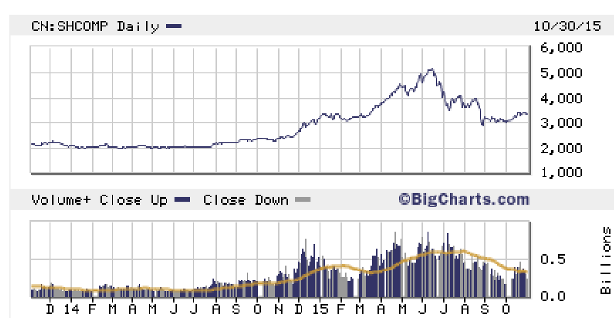
Generally, home owners are feeling confident, as you will see later in our report. However, here too, we saw the pause-pattern appear in late summer. New home sales declined 11.5% in September to 468,000 down from a downwardly revised 529,000 for August. We believe that slowing in this indicator too, will be short lived. Forward-looking gages, such as Housing Starts, continue to improve to their highest levels since the housing bubble burst in 2008. This is further confirmed by a continued increase in construction spending, which is up nearly 15% year over year. North Pier expects to see a sharp rebound in new home sales, and strengthening homes sales in general, as the fall unfolds.

With real estate and jobs in the plus category, American shoppers should be in a rather good mood. It appears that they are: The Consumer Sentiment Index (U. of Michigan) stands at 90.0 for October, rebounding from 87.2 in September. Similarly, the Consumer Confidence Index (from the Conference Board) stands at a strong 97.6 for October, though retreating a bit from 102.6 the month prior. Though still down slightly from the highs of the late spring, the consumer remains solid, hovering near the post financial crisis sentiment highs. The recent pullbacks were likely influenced by the fears stoked by the stock market correction and not based on actual changes in personal conditions. With labor markets strong, low energy costs, and a rebound in stock prices, we would expect to see the consumer grow even more confident into the end of the year.

Put You Money Where Your Mouth Is.

Sentiment is one thing, but how are the American people actually acting? Personal income is up over 4% year-over-year, which has led to personal spending increases of over 3%. Yet households continue to save at vigorous pace, nearing 5% a year. This appears to be a healthy balance. More recently, we have seen the same hesitation for major purchases that we have seen elsewhere. Big-ticket, durable goods orders declined 1.2% in September, which would have been worse if not offset by automobile sales which stand at their best levels in 20 years. Excluding autos, retail sales declined 0.3% in September after declining 0.1% in August. Cheap gas did contribute to the lower sales figures; however, we would ideally would have liked to see consumers spend some of their savings instead of pocketing them. Despite all the declines, consumer credit increased by $28.9 billion in September, its biggest increase since 2011. This, coupled with the strong auto sales data, indicates that buyers may have reined in spending in some areas in late summer, but they didn't put off big planned purchases and had no qualms with taking dipping into credit to do so. This is a very positive sign that consumption should remain somewhat strong into the holiday season.

PIER*ing* Ahead



It's too early to know for sure, but we at North Pier suspect that the market decline of the summer was an overreaction to the stories coming out of China. Even the Chinese stock market has recovered nearly 10% since the close of the quarter. It deserves note that the crash in the Chinese market that started the global selloff wasn't really as much of a crash as it was the popping of a big bubble. The Chinese stocks soared over 50% in just three months this spring. We are simply back at the levels the Shanghai Index began 2015, and a full 50% higher than where it started 2014. But that shock didn't just cause a correction in the broader global stock markets; it caused a pause. Our theory is that large capital expenditures were delayed, but not abandoned. As evidence, we are seeing new orders growing and purchase lead times shrinking.

We will get a better sense as economic data for the next month or two rolls in. If our predictions are accurate, global conditions will improve modestly into the end of the year. Domestically, we believe that the U.S. manufacturing sector will continue to face challenges due to the elevated value of the dollar. Year over year comparisons should start to get better as we enter the second quarter of 2016, leading to a strong 2016 for global equity markets. Until then, the services side of the economy should continue to support U.S. GDP. Our outlook for the coming few months is unclear, as there are competing factors at bay. A difficult earnings environment for U.S. multinationals should be offset by strong labor markets, appreciating real estate values, and a healthy consumer. Like a see-saw, we may see some more ups and downs until we can get through Q1 earnings reports in April. That's our PIER*spective*.

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