THE NORTH PIER*spective*

Market & Economic Commentary

Summer 2014

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By: Jim Scheinberg - July 17, 2014

Steady as She ~~Goes~~ Grows

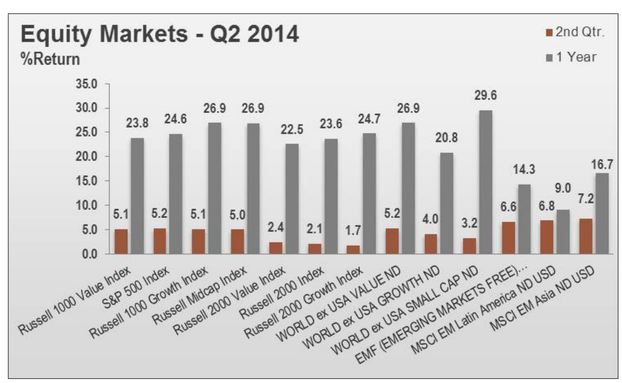
I've been a sailor since the age of 10. And before that, like many of my contemporaries, I logged enough hours watching Popeye to be proficient in numerous nautical clichés. For those of us that need a refresher, the Nautical Dictionary at Seatalk.com defines the command "Steady as She Goes" thusly:

> "A command to the helmsman to observe the compass direction on the present heading, and maintain that course."

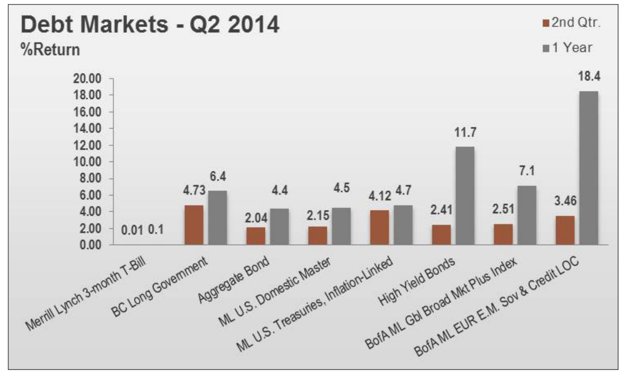
Our North Pier financial translation: *You're heading the right way, keep your eyes on the gauges and don't muck it up.* We believe this to be the command of the day. Since the beginning days of the recovery, we have been projecting a meaningful global economic resurgence. Factors such as rebounding domestic real estate, strengthening labor markets and a massive increase to the global consumer class have been the basis of our theme. In the last several quarters, we have seen strong evidence that that resurgence is finally at hand. At present, all that's required to stay on course is to keep a steady hand on the tiller and a watchful eye on the compass.

How the Markets Fared

In Q2, that's precisely what most global economies and financial markets did. Stocks steadily advanced again, tacking another two to seven percent on top of Q1's similar growth. Global equity markets were led by gains in emerging market equities, which benefited from the surge in commodity prices, which we enthusiastically reported on in Q1. (Or they were driven higher due to increased EM demand, depending on whether you like to bet on the chicken or the egg.) Developed stock markets saw mid-single digit gains, both at home in the U.S. and abroad.



Here, bigger was better, with large-cap stocks beating out smaller capitalization names by a few percentage points. If the global economy is heating up as we have forecasted, it stands to reason that resource and production sensitive EM countries and large multinationals would benefit first. That's precisely what we saw evidenced in Q2.



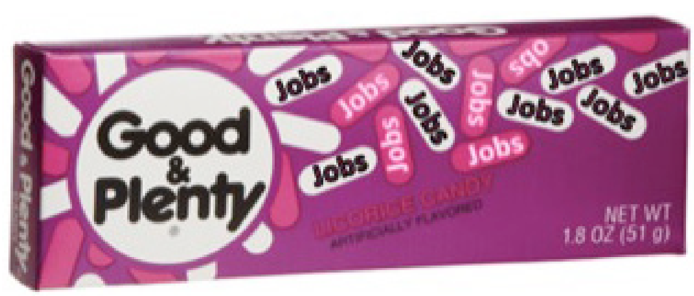
The world's fixed income markets also showed a continuance of the first quarter's strength during Q2. Despite tapering from the Federal Reserve (with a reduction in their purchases of U.S. Government debt and mortgages from the Quantitative Easing program), interest rates continued to pull back from their 2013 run up. This is likely due in part to a surprising contraction in 1st Quarter GDP, which was largely credited (and dismissed as aberrational) due to the unusually cold weather experienced last winter. The 10-year Treasury yield retreated another ¼% to close the quarter near 2½%. This helped long-term U.S. Government bonds gain an additional 4.7%. Now up over 12% YTD. These volatile instruments have now recaptured nearly all of their losses for 2013. [Side note: This move has benefited pension funds who have adopted Liability Driven Investment Strategies (LDI) but could have negative implications for funding levels if these lower rates hold through the end of the year.] Though interest rates have again moved lower, and inflation still appears to be in check, renewed buying in the TIPS markets helped them garner better than 4% gains during the quarter as well. Real yields on TIPS are again negative through 6 year maturities. Emerging market debt also had a strong quarter, continuing their recovery with 3.5% gains. The rest of the intermediate, high quality fixed income sector netted returns around 2% both in government and corporate debt in the U.S as well as developed market debt internationally.

Generally speaking, investors of all types in most places continued to be rewarded as much during the second three months of 2014 as they were in the first.

The 68.9%

We were all bombarded with a rash of new "percentages" over the last few years: the Top One-Percent, Occupy movement's 99%, and Mitt Romney will likely never forget his fated "47%." For our purposes today, we are focused on "The 68.9%." In JP Morgan's last report, 68.9% of the U.S. economy is based on consumption. Plain and simple, consumer behavior drives the economy. And that behavior is comprised of a few simple and related components: means and sentiment. *Sentiment* is related to consumers' mood. Are they willing to spend the money they have? *Means* include employment, earnings and personal wealth. And as you can imagine, the more means you have, the more positive your sentiment is likely to be. So let's look at the state of that 68.9% today.

Good and Plenty

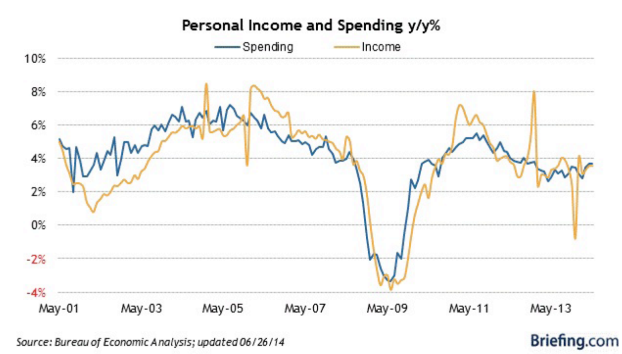


The labor markets continued their trend of steady improvement, adding an additional 816,000 jobs in the 2nd quarter. This was by far the best single quarterly advance since the 2008 financial crisis. The unemployment rate declined to 6.1% last month, when we finally saw the replacement of total-jobs-lost during the crisis. Though far from *full employment,* the labor markets have moved from Condition-Orange to Condition-Yellow. Of concern, beneath the assuring progress of the recent employment data, is the way in which we are getting there. North Pier has observed that of the 400,000+ newly employed workers in the June report, 275,000 reported only being able to find part time work, even though they were seeking full time positions. This hints to a foreboding theme emerging: many companies are likely seeking to hire (and even reclassify) workers into part-time status to avoid being subject to Obamacare. This is not simply conjecture, North Pier has observed this directly in several cases. Nonetheless, more jobs of any kind are better than less. As labor markets tighten further, competition in hiring will hopefully improve the quality of those opportunities, resulting in more full-time positions and higher wages. In fact, we are already seeing some evidence of that, with average hourly earnings growing at better than a 2% annualized rate; their best levels in nearly three years.

We're In the Money, We're In the Money…

Family wealth continues to improve. JP Morgan reports that consumers' balance sheets now stand 15% richer than their former peak, reached in 2007. This is due in part to the stellar performance of the stock market during the recovery. Fidelity recently released findings that as of the end of the First Quarter, the average 401(k) was worth $88,600, up from $46,200 just five years earlier. On the residential real estate front, homes continue to gain value after an amazing 2013, albeit at a more realistic pace. The pace of ascent "slowed" to a year over year gain of 10.8%, still robust by most measures. Month-over-move gains from March to April averaged over 1% for the 20-City Case Shiller Index. It appears that the quick spike off of the market bottom appears to be over, but with inventories still low at a 5.6 month supply, further advances in values are likely to continue for some time. This has a big impact, as home equity represents nearly a quarter of all family-assets.

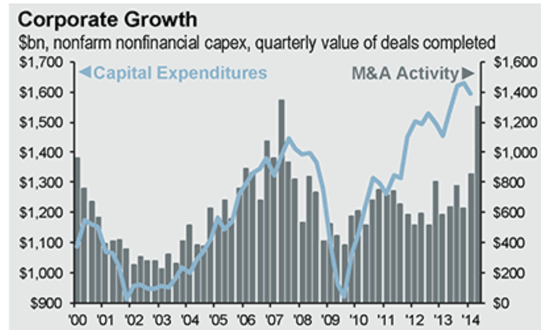
In the Mood



Stronger demand in the labor market and improved personal finances have logically led to continued increases in consumer sentiment. The Conference Board's Consumer Confidence Index rose to 85.2 in June, to its highest level since the recession began in January 2008. This was led by strong gains in the present situation component, which now interestingly stands at the same level as the future expectation data. Confidence is spilling into spending behavior, with discretionary spending nearing 4% gains year-over-year through May. Increased spending isn't just coming from gains in income. Americans are willing to add more debt to their balance sheets for purchases now, as well. Consumer credit has increased by nearly $20 billion per month thus far in 2014, an increase of nearly 6.5% from last year.

ROBust Business to Business Conditions

This optimism from consumers has clearly spilled into America businesses, which continued to show strength in the Second Quarter. The June Manufacturing ISM® Report On Business® PMI® (ROB) was virtually unchanged from May's reading at 55.3. (Reminder: readings over 50 indicate expansion.) That follows steady improvement from January's 51.3. Still more encouraging in June's data was that new orders jumped two full points to 58.9 from 56.9 in May, their highest levels of the year. On the services side of the economy, the news is just as encouraging. The June Non-Manufacturing ROB was down a hair to a still healthy 56.0. Here too we saw an increase in new orders to 61.2 from 60.5 in May. The purchasing manager's office is not the only place we find confidence. American CEOs are still feeling rather chipper. The Conference Board Measure of CEO Confidence™, remained highly optimistic in the July 9th report with a reading of 62, down only slightly from last quarter's 63. (Again, readings over 50 indicate optimism.) This general enthusiasm has not only resulted in more business amongst companies, but also in companies investing back into themselves (and their peers). Capital expenditures continue to set all-time records, M&A activity has been at its most active levels since the 2008 crisis, as is the appetite for companies buying back their own shares.



Source: J.P.Morgan Guide to the Markets; via jpmorganfunds.com

Let's not get too big of a head

After such a long period of low-economic-self-esteem, we are starting to see the signs that our optimism might not just be returning, but actually starting to get a bit ahead of itself. Of late, analysts, under the guidance of company management, have proven to be a bit too enthusiastic with their projections for earnings growth. The latest recap of the earnings situation on Wall Street from Factset shows some interesting data:

- *The estimated earnings growth rate for Q2 2014 is 5.5% (as of 7/18/14 earnings releases).*
- *On 3/31, the estimated earnings growth rate for Q2 2014 was 6.8%.*
- *Seven of the ten sectors have lower growth rates [as of 7/11/14] (compared to March 31) due to downward revisions to earnings estimates.*
- *For Q2 2014, 86 companies have issued negative EPS guidance and 27 companies have issued positive EPS guidance [as of 7/11/14].*

-Factset (7/11/14 & 7/18/14 reports)

Though some of the revisions are likely to have come from fallout after our extraordinarily cold winter, these downward revisions to growth cannot be casually dismissed. It may just be that corporate America has painted a bit too rosy of a picture of itself, to itself. With valuations no longer a bargain with everything from P/E and P/B ratios to Price to Earnings Growth (PEG) ratios and Dividend Yield all now inline with 25 year norms, there is not much room for letdowns.

PIER*ing* Ahead

The skies above up are blue, the wind is still up, and the seas are relatively calm. For now, it appears to be smooth sailing ahead. Equities are likely to enjoy continued earnings growth in the second half of 2014, benefited by further firming in the global economy. (Our analysis of global PMI data suggests a broad-based acceleration is underway.) If history repeats itself, as it's prone to do, multiples will continue to expand as earnings grow, leading to added gains

in most markets. But as we know all too well, the weather can change on a dime. The horizon is dotted with scattered grey clouds such as renewed unrest in the Middle East, a recent unanticipated drop in the University of Michigan Consumer Sentiment reading and uncertainty around Fed monetary policy implications. If a storm were to develop, the seas could get rough very quickly. Further, if the winds of growth die down, we may simply drift for a while. The calm conditions that we've enjoyed recently are not likely to continue for long in any case. Our markets have been unusually devoid of volatility for quite some time. Even if we continue to pilot a generally bullish course ahead (which we forecast we will) we are likely to experience heavier seas along the way. If so, keep a firm hand on the helm and watch your gauges… *Steady as She Goes.*

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