# Market & Economic Commentary

## Winter 2013/2014

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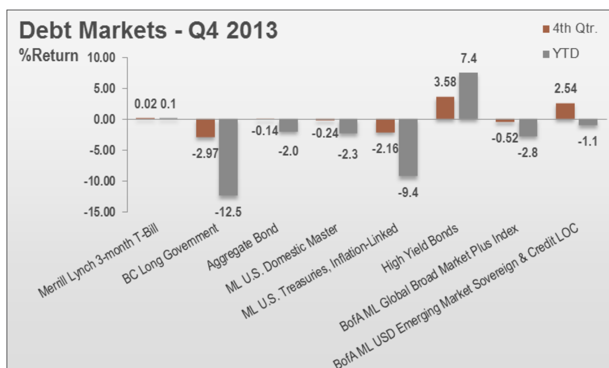
## Market & Economic | Winter 2013/2014

By: Jim Scheinberg - February 1, 2014

**Off to the Races?**

A year ago, I closed my Economic Commentary asking, “Can you imagine what it will look like once the economic engine of the globe is firing on all cylinders?” In 2013, we got a good look at what that engine can do. With this meteoric year for stocks in the books, there can be no doubt that the economies and equity markets of the developed world are all starting to pump strongly. With gains of 20% to nearly 60% for most developed markets around the globe, derived mostly from expansion of multiples (e.g. P/E ratios), investor sentiment has surely grown confident. However, in the emerging markets, which grow more and more impactful on the global stage each year, their cylinder still seems to be sputtering. It appears that we are not quite done with the tune-up that is required in order for the whole engine to perform at peak levels.

Despite the EM’s lag, the global engine put out a ton of horsepower last year. The U.S. had explosive growth in equities. Large caps advanced 33% and were still out-done by their smaller peers, where small caps surged 38%. Though value and growth indexes mirrored each other’s performance in the larger end of the capital spectrum, in small caps growth dominated value by nearly nine percentage points. Small emerging names like Tesla Motors drove these gains. Amazingly, the United States took the Silver Metal in the 2013 Financial Olympics. It was Japan who topped the podium, grabbing gold with an astounding 56.7% return for the Nikkei. The all-in economic poker hand of Japanese Prime Minister Shinzo Abe initially appears to be paying off. In Europe, gains were more modest, ranging from 14% in the UK to 23% in Germany. As with all poker games, there was a big loser at the table in this year of great dispersion. The Asian emerging markets were nearly flat, while Latin American EM’s declined an average of 13%. Slumping currencies, falling commodity prices and declining exports all contributed to their woes.




Emerging Market equities weren’t the only losers in the room. Over at the debt tables, declines in long-term bond prices approached the levels of lose in Latin stocks. With interest rates finally on the rise here in the U.S., the BarCap Long Government Bond Index saw declines of 12.5% for the year. The Bellwether 10-year Treasury saw its yield spike from 1¾% at the start of 2013, to over 3% by year’s end. As shocking as that jump may seem, these new, higher levels represent the average rate of the 10-year during the first few years following the depths of the crisis. Longer-term norms are still 200-400 basis points higher than here. Losses weren’t just isolated to traditional Treasuries. TIPS, which are supposed to be Insulated from interest rate moves, saw declines of nearly 10% for the year as well. The bubble that had bid up prices in these inflation indexed bonds (causing negative real yields) finally began to deflate in Q2, continuing on down through the end of the year. Despite their economic difficulties, EM debt markets only saw modest declines of a few percent. Turns out, the U.S. debt market was

the riskiest place to invest in 2013. Well, except for High Yield bonds that is. Again, junk wasn't so junky, providing investors with over 7% returns for the year. With default rates at record lows, credit risk was the place to be in 2013.

**Thus Begins the Era of Multiple Expansion**

So with these big gains in stocks, many might ask, "Can we go any higher?" If history is any indicator, the answer is, "Absolutely." It is true that the deep discount in valuations we routinely commented on seems to have disappeared, with the S&P 500 now trading near historic norms of 15.4 times earnings. However, this does not indicate that the gains in the indexes or even further expansion in multiples is over, far from it. The 1995-1999 bull market saw 18 consecutive quarters of multiple expansion. Of course that period did end in a valuation bubble. However, whereas that market was dominated by surges in just the tech and telecom sectors, this market is enjoying a more broad-based expansion. Typically, as discounted markets recover, they continue to run well after average valuations have been achieved, with the biggest exceptions being the 1987 and 2002 recoveries. It is important to note that those recoveries were on the heels of emotionally shocking events in the markets (the 1987 crash and the dot com bubble bursting coupled with 9/11). So, it is entirely possible that the recovery following the 2009 financial crisis may have a similarly cautious tone. Either way, the point is that these trends tend to be long lived, both in expansion and contraction, similar to the economic cycles they mirror.

So, if further gains generally seem to be more related to the state of the economy than they are to valuations, where is the economy heading?

**Taper-Worm**

If fear of getting a tapeworm is that it will steal nutrition from a healthy host thus stunting its growth, then the same could be said about fears of what a *Fed Taper-Worm* will do to the health of the U.S. and subsequently, the global economy. In December, the Fed announced that it would alas begin the process of unwinding its monetary stimulus program of Quantitative Easing by reducing the amount of Mortgage-backed Securities and Treasuries it purchases each month from $85 billion to $75 billion. Then again, they announced a further reduction of $10 billion. The assumption of many is that this will eventually lead to increases in interest rates from our current, historic low-levels. However, there are a meaningful amount of naysayers on Wall St. and Capitol Hill that believe that these higher rates will rob the economy of its hard fought momentum as the cost of capital increases. This speculation has recently been expanded to include fears that higher interest rates here in the U.S. will attract money away from investment in the emerging markets economies, adding to last year's downside volatility.

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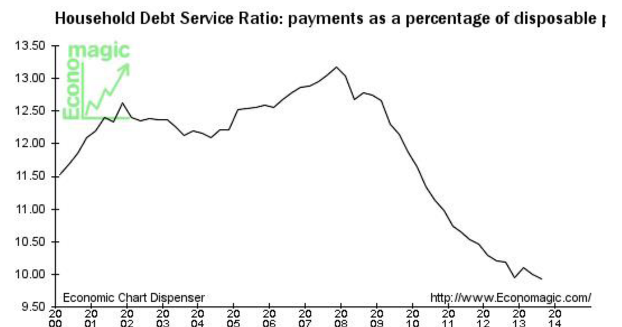
Are these concerns well placed? "Don't fight the Fed" used to be a Wall St. mantra, suggesting that you shouldn't invest in stocks when rates were on the rise. The implication was that rising rates would eventually cool the economy (and corporate profits along with it). Further, the feeling was that rising rates for U.S. Government debt would attract investment dollars away from other risk assets, such as stock. This tracks along with the fears expressed about emerging market debt investment. However, a rising interest rate environment is generally very favorable for stocks when rates are lifting from such extreme lows. It is not until rates get high that this phenomenon represents a headwind. In fact, a recent study from JPMorgan found that "when yields are below 5%, rising rates are generally associated with rising stock prices." Our review of the data found that when yields on the 10-year Treasury were on the rise, but

still below 4.5%, the market had never gone down in over 50 years! Clearly the point of where interest rates start to represent a headwind is likely much higher than where we stand today. As long as the economy is recovering, and rates continue to rise, then stocks should perform well through this initial phase of rising interest rates.

**So Where Are We Economically?**

Domestically, things appear to be quite good. Instead of delving too deep into the numbers this quarter, it's best just to summarize the key areas of our focus.

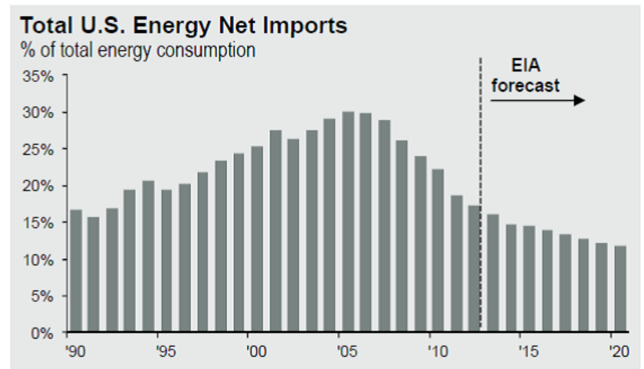
- Real GDP for the U.S. was revised to up a robust 4.1% in Q3, 2013. The World Bank predicts that our GDP will advance from 1.8% in 2013 to 2.8% in 2014. Further, they expect global GDP to increase 0.5% to 3.2%, with developing economies increasing at a rate of 5.3% and developed nations up to 2.2% from 4.8% and 1.7% respectively.
- Household balance sheets are at all-time highs. The average American is wealthier than they have ever been and their debt is more manageable then at any point in modern history. Debt service ratios are at all-time lows. No wonder consumer confidence is near 5 year highs at 80.7.




- Real Estate, both residentially and commercially, continues to show strong improvements. The Case Shiller Index of 20 cities rose nearly 14% year-over-year. Inventories remain near record lows and purchases are at post 2008-crisis highs. Even with the recent rise in both prices and mortgage rates, affordability remains near its most attractive levels in history, suggesting that there is still plenty of room for housing to contribute to a continuing economic resurgence.
- The strength in real estate has led to housing starts and commercial construction surging to post 2008-crisis highs as well. This has led to over 500,000 construction jobs being regained in the last year. We are still nearly 2 million below the peak 2007 levels, however.
- The employment situation as a whole continues to improve with the jobless rate finishing the year at 6.7%, down from 7.9% in December 2012. In addition to the previously commented on recovery in construction jobs, the services sector is well above 2008 levels. Other areas that are booming include the energy sector where mining and extraction jobs are at their highest levels in history.

**The Energy Payoff: Oil Imports Heading to New Lows**

The topic of the U.S. energy industry deserves more focus. The domestic oil and gas boom is doing more than adding jobs. It is starting to heal our massive trade imbalance. In the Jan-Nov period in 2012, we imported $384 billion of petroleum products and exported $112 billion. In the Jan-Nov of last year, exports rose nearly 8% to $124 billion, while we imported far less, just $340 billion (according to the BEA 1/7/14 Report on Trade). This boom in our energy industry has helped narrow our trade gap to a 10 year low of $34 billion in November. And the trend suggests further narrowing is likely.




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

Now globally, prices will still heavily influence prices at home. This is because the U.S. chooses to export a large portion of its processed petroleum (in the form of things like gasoline). So from an economic and national security perspective, increased domestic production and decreased reliance on foreign oil is good. But as for an impact of energy prices on our cost of living and production, the story is more globally-dependent. Translation, despite domestic advances in the energy industry, global demand will likely determine how much you pay at the pump.

**PIER*ing* Ahead**

As our regular readers know, in the 5+ year history of North Pier, we have looked to no greater crystal ball to predict future economic conditions here in the U.S. than the Institute of Supply Management (ISM) Report on Business (ROB). The most recent ROB shows the manufacturing side of the economy will continue to excel. December's reading of 57 showed robust new orders which are replacing dwindling backlogs and shrinking inventories. If this phenomenon holds, we could see price pressures start to creep into the cost of goods. Good for top-line growth in earnings but potentially challenging for consumers. The Non-manufacturing ROB is showing general health in the services side of the business economy, with a reading of 53… still showing moderate expansion. However, new orders and backlogs dropped meaningfully in December as prices and labor costs continued to rise. This could mean that the U.S. economy may not yet have the appetite to absorb higher prices. Time will tell. (See the update on the following page for additional data an commentary.)

Seeing as the purchasing manager data has been so accurate in predicting the strength of the U.S. recovery over the last several years, we thought now would be good time to check in on what these numbers are telling us globally. Here, the data is encouraging. We see continued strength in the stronger areas of performance in 2013, such as Germany and Japan. Further we see evidence of heat emerging from the rest of the EU, with the exception of France. This even includes beleaguered Greece. In Latin America, Mexico is also strengthening. And Brazil, where much recent concern has been focused, is actually showing remarkable stability (suggesting that worries may be overblown). Generally, with the exception of Australia who remains dependent on resource prices, the globe looks poised for a solid year in 2014… including much of the EM. My PIERspective for 2014 is that if this ISM data is correct, which supports the World Bank's predictions for improving growth, then the last cylinders of the global engine will finally be precision-tuned… and we'll be off to the races.

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Managing Partner

## Market & Economic | February 24, 2014 Update

The ISM Report on Business for January  showed a sharp decline in the manufacturing data, coming in at 51.3 vs. 56.5 for the month prior. The non-manufacturing reading showed a slight increase. The release of the manufacturing data reeled markets, which reacted in fear of a looming slow down. Our intuition told us that this was solely as a direct result of the brutal weather experienced during the month (some saying the worst since 1977). A check of the Markit Global PMI data (below) supports our suspicion, with only Canada showing a logically similar retreat. Eurozone and Asian economies seemed to strengthen during January, as they were not affected by atypical weather. North Pier anticipates that as U.S. temperatures heat up, so will the Purchasing Manager data.

### Global Purchasing Manager's Index for Manufacturing

| | 2012 | | | | | | 2013 | | | | | | | | | | | | 2014 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Jul | Aug | Sep | Oct | Nov | Dec | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Dec | Jan |
| Global | 48.8 | 48.7 | 48.7 | 48.9 | 49.6 | 50.0 | 51.5 | 50.9 | 51.2 | 50.4 | 50.6 | 50.6 | 50.8 | 51.6 | 51.8 | 52.1 | 53.1 | 53.0 | 52.9 |
| U.S. | 51.4 | 51.5 | 51.1 | 51.0 | 52.8 | 54.0 | 55.8 | 54.3 | 54.6 | 52.1 | 52.3 | 51.9 | 53.7 | 53.1 | 52.8 | 51.8 | 54.7 | 55.0 | 53.7 |
| Canada | 53.0 | 53.0 | 52.4 | 51.4 | 50.4 | 50.4 | 50.5 | 51.7 | 49.3 | 50.1 | 53.2 | 52.4 | 52.0 | 52.1 | 54.2 | 55.6 | 55.3 | 53.5 | 51.7 |
| U.K. | 45.5 | 49.1 | 48.2 | 48.0 | 48.4 | 50.7 | 50.9 | 48.2 | 49.3 | 50.6 | 52.1 | 53.0 | 54.7 | 57.3 | 56.7 | 56.5 | 58.1 | 57.3 | 56.7 |
| Euro Zone | 44.0 | 45.1 | 46.1 | 45.4 | 46.2 | 46.1 | 47.9 | 47.9 | 46.8 | 46.7 | 48.3 | 48.8 | 50.3 | 51.4 | 51.1 | 51.3 | 51.6 | 52.7 | 54.0 |
| Germany | 43.0 | 44.7 | 47.4 | 46.0 | 46.8 | 46.0 | 49.8 | 50.3 | 49.0 | 48.1 | 49.4 | 48.6 | 50.7 | 51.8 | 51.1 | 51.7 | 52.7 | 54.3 | 56.5 |
| France | 43.4 | 46.0 | 42.7 | 43.7 | 44.5 | 44.6 | 42.9 | 43.9 | 44.0 | 44.4 | 46.4 | 48.4 | 49.7 | 49.7 | 49.8 | 49.1 | 48.4 | 47.0 | 48.8 |
| Italy | 44.3 | 43.6 | 45.7 | 45.5 | 45.1 | 46.7 | 47.8 | 45.8 | 44.5 | 45.5 | 47.3 | 49.1 | 50.4 | 51.3 | 50.8 | 50.7 | 51.4 | 53.3 | 53.1 |
| Spain | 42.3 | 44.0 | 44.5 | 43.5 | 45.3 | 44.6 | 46.1 | 46.8 | 44.2 | 44.7 | 48.1 | 50.0 | 49.8 | 51.1 | 50.7 | 50.9 | 48.6 | 50.8 | 52.2 |
| Greece | 41.9 | 42.1 | 42.2 | 41.0 | 41.8 | 41.4 | 41.7 | 43.0 | 42.1 | 45.0 | 45.3 | 45.4 | 47.0 | 48.7 | 47.5 | 47.3 | 49.2 | 49.6 | 51.2 |
| Ireland | 53.9 | 50.9 | 51.8 | 52.1 | 52.4 | 51.4 | 50.3 | 51.5 | 48.6 | 48.0 | 49.7 | 50.3 | 51.0 | 52.0 | 52.7 | 54.9 | 52.4 | 53.5 | 52.8 |
| Australia | 40.3 | 45.3 | 43.0 | 42.8 | 44.3 | 44.3 | 40.2 | 45.6 | 44.4 | 36.7 | 43.8 | 49.6 | 42.0 | 46.4 | 51.7 | 53.2 | 47.7 | 47.6 | 46.7 |
| Japan | 47.9 | 47.7 | 48.0 | 46.9 | 46.5 | 45.0 | 47.7 | 48.5 | 50.4 | 51.1 | 51.5 | 52.3 | 50.7 | 52.2 | 52.5 | 54.2 | 55.1 | 55.2 | 56.6 |
| China | 49.3 | 47.6 | 47.9 | 49.5 | 50.5 | 51.5 | 52.3 | 50.4 | 51.6 | 50.4 | 49.2 | 48.2 | 47.7 | 50.1 | 50.2 | 50.9 | 50.8 | 50.5 | 49.5 |
| Indonesia | 51.4 | 51.6 | 50.5 | 51.9 | 51.5 | 50.7 | 49.7 | 50.5 | 51.3 | 51.7 | 51.6 | 51.0 | 50.7 | 48.5 | 50.2 | 50.9 | 50.3 | 50.9 | 51.0 |
| Korea | 47.2 | 47.5 | 45.7 | 47.4 | 48.2 | 50.1 | 49.9 | 50.9 | 52.0 | 52.6 | 51.1 | 49.4 | 47.2 | 47.5 | 49.7 | 50.2 | 50.4 | 50.8 | 50.9 |
| Taiwan | 47.5 | 46.1 | 45.6 | 47.8 | 47.4 | 50.6 | 51.5 | 50.2 | 51.2 | 50.7 | 47.1 | 49.5 | 48.6 | 50.0 | 52.0 | 53.0 | 53.4 | 55.2 | 55.5 |
| India | 52.9 | 52.8 | 52.8 | 52.9 | 53.7 | 54.7 | 53.2 | 54.2 | 52.0 | 51.0 | 50.1 | 50.3 | 50.1 | 48.5 | 49.6 | 49.6 | 51.3 | 50.7 | 51.4 |
| Brazil | 48.7 | 49.3 | 49.8 | 50.2 | 52.2 | 51.1 | 53.2 | 52.5 | 51.8 | 50.8 | 50.4 | 50.4 | 48.5 | 49.4 | 49.9 | 50.2 | 49.7 | 50.5 | 50.8 |
| Mexico | 55.2 | 55.1 | 54.4 | 55.5 | 55.6 | 57.1 | 55.0 | 53.4 | 52.2 | 51.7 | 51.8 | 51.3 | 49.7 | 50.8 | 50.0 | 50.2 | 51.9 | 52.6 | 54.0 |
| Russia | 52.0 | 51.0 | 52.4 | 52.9 | 52.2 | 50.0 | 52.0 | 52.0 | 50.8 | 50.6 | 50.4 | 51.7 | 49.2 | 49.4 | 49.4 | 51.8 | 49.4 | 48.8 | 48.0 |

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