Weekly Economic Update
August 11, 2014

- Economic data reports for the week were relatively good, led by ISM non-manufacturing, factory orders and the Fed's Senior Loan Officer Survey showing positive results.

- Stocks experienced a more volatile week as events in the Ukraine raised anxiety again, which dissipated by the end of the week with net small positive effect in the U.S., although it weighed on foreign equities. Bonds performed well with safe haven rates falling, while some riskier foreign issues sold off a bit.

Markets were negatively affected early in the week, due to again increased tensions in the Ukraine, and comments from Poland's Prime Minister about the situation, but equities recovered some losses by Friday as Russian military exercises ended—U.S. equities were actually in the black. Small-cap stocks bucked the trend of late by posting stronger returns than large-caps; some of the valuation premium had been trimmed during the last several weeks of poor performance, but it's still present. From a sector perspective, consumer discretionary and materials outperformed while telecom lagged by dropping several percent on the week (although telecom is a tiny sector, with results impacted by Sprint's extreme price drop after deciding to not pursue T-Mobile).

From its peak on July 24, the S&P has pared back by just under -3%, although it has certainly felt like more, with volatility (measuring by VIX) rising up from lows around 10 at that time to 16 last week. Then again, as we've previously discussed, the VIX offers a fairly limited view on things, as a week of +/- 1% daily changes is certainly more volatile than one with a series of +/- 0.25% changes—although the net result could be exactly the same.

Outside the U.S., the Bank of England, ECB and Bank of Japan left policy rates unchanged and equities were all generally negative in the same range of 1-2%. The ECB appears to be doing 'intense preliminary work' on an asset-buying program to keep deflationary impulses at bay. Apparently, Italy has slipped back into recession, which GDP falling -0.2% for the second quarter following a -0.1% result for Q1.

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Trade reports also showed that exports from China showed nearly a 15% year-over-year increase, which pushed Chinese stocks to the top of the list in terms of weekly performance, along with smaller related Asian nations. Emerging market stocks have now overtaken developed foreign equities on the year (a benefit to portfolios, as we've had an overweight to EM for some time that has paid off recently).

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Bucking the trend was Turkey, as the expected (and actual) re-election of PM Erdogan didn't inspire investors. Formerly one of the stars of the emerging market universe, Turkey has undergone a period of greater uncertainty as government influence in central bank policy raises concerns of a stall in business-friendly reforms.

Bonds performed well on the week overall with rates falling across the curve by several basis points. High yield bounced back with a strong week, gaining a percent and leading all groups, while long Treasuries were just a step behind and most categories were in the positive by at least a few basis points. Foreign bonds in developed 'safer haven' areas performed well, in line with U.S. issues, while peripheral Europe and emerging market names generally sold off.

Real estate sectors were led by mortgages, along with lower interest rates. U.S. industrial/office and Asian REITs lost the most ground, down over a percent.

Commodities were led by natural gas, agriculture (wheat and soybeans, the latter likely due to Ukraine's status as a large producer), and precious metals, all of which gained at least a percent on the week. Livestock returns in both hogs and cattle corrected by a few percent continuing a paring back from a peak last month. Commodity index returns have moved from sharply higher to generally flat from the start of the year, mostly due to weaker contributions from agricultural contracts, all of which have price declines in the double-digits as crop conditions improved from early forecasts. Precious metals (palladium, but also good) have moved upward on the year and have added to index returns.

(+) The ISM non-manufacturing report for July came in stronger than expected, rising from 56.0 last month to 58.7 (besting expectations calling for 56.5). New orders, production and employment all rose by several points, while inventories declined by a few. The commentary in the report generally noted improving conditions and stronger expectations for the second half of 2014.

(+) Factory orders for June rose +1.1%, beating expectations of +0.6%. Core capital goods orders were revised higher for May (by +2%), as were shipments.

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(-) Wholesale inventories rose +0.3% in June, which was just under half the expected gain of +0.7%; additionally, May results were revised down a few tenths.
(0) Nonfarm productivity, which measures the relationship between real output and the labor hours involved in production, recovered from the 1st quarter's drop of -4.5% (worst quarter since 1981) with a stronger than expected result for the 2nd, rising +2.5% (consensus called for +1.6%). Over the past year as a whole, productivity rose +1.2% as output rose +3.2% and hours worked were +2.0% higher. Unit labor costs (ratio of hourly compensation to labor productivity) rose +0.6%, a lower rate than the expected +1.0% increase, bringing the year-over-year change to +2%. Rates of change were much higher in manufacturing productivity than in other parts of the economy, although unit labor costs were more tempered there. Despite the recent bump, wage growth remains far lower than pre-crisis levels and continues to be 'under control' from the inflation-watch standpoint.

(-) The Fed's report on consumer credit from June showed an increase of +$17.6 bil., more than +$2 bil. below the pace of May's increase, so a bit of a disappointment. The bulk of the increase was in student loan debt and auto loans, but credit card debt also increased. The annual rate of growth implied by the release was +6.5%, which is a bit weaker than earlier months of 2014, but far stronger than the last several years.

(+) On a related note, the Fed's Senior Loan Officer Opinion Survey for July is a more obscure but important economic report. This is largely true because it reports on a realtime basis without the encumbrances of revisions and other clutter after the fact—it has also been shown historically to be a decent predictor of upcoming business investment growth.

Summarizing the 100-page survey, the results showed a continued loosening of credit across the universe of loans for commercial/industrial (C&I) as well as commercial real estate (CRE)—roughly 10% of banks reported easier conditions than last period, at reduced spreads compared to April's survey (10% is actually a fair amount). Additionally, and perhaps more importantly, demand for C&I as well as CRE loans picked up dramatically.

Perhaps more significantly than this, residential mortgage loan standards, demand and spreads improved for the first time since October (improvement implying that loans were easier to get and at cheaper prices, although consistently lower rates may have had something to do with this). Non-traditional mortgage demand and standards also eased a bit, and demand for auto/credit card loans saw some improvement.

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Despite the improvement, however, current bank loan spreads vs. the Fed Funds rate remain at high levels. Permanently higher bank capital requirements and other regulatory costs have been cited (noted in a recent paper from the San Francisco Fed) as possible reasons for the deviation from long-term averages.

(+) The trade deficit for June narrowed a bit more than expected, from -$44.7 bil. to -$41.5 bil. (consensus called for -$44.8 bil.). The real petroleum balance saw a narrowing of $0.7 bil., accounting for much of the difference, as total exports gained +0.1% and imports fell - 1.2%. This may also have a positive impact on 2nd quarter GDP revisions, due to the higher exports number.

(+) Initial jobless claims for the Aug. 2 ending week fell more than expected to 289k, down -14k from the prior week (consensus called for a similar 304k). No special factors affected results, according to the DOL, and the four-week moving average declined again to a post-recession low. Continuing claims for the Jul. 26 week fell, but by less than the expected 2,512k, to 2,518k.

The above information is believed to be reliable and accurate as of August 11, 2014. Several sources are used to compile the information, which include the Wall Street Journal, the Financial Times and Investor's Business Daily. Opinions expressed are solely those of Kenneth P. Butze, Jr. and Integrity First Planners, Inc. (a registered investment advisor). Questions and comments should be directed to Ken Butze, 216.751.4229. Triad Advisors, member FINRA /SIPC and Integrity First Planners, Inc. are not affiliated.

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Weekly Economic Notes

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Question of the Week

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