Weekly Economic Update
July 7, 2014

- Economic data was mixed early in the short week, but several industrial indicators remained in positive territory and the Friday employment report boosted investor spirits.

- Stock markets gained on par with stronger sentiment. In line with this expected strength, bond yields rose sharply, creating a bad week for fixed income.

In a four-day trading week, U.S. stocks continued their upward movement, with the Dow reaching the round 17,000 level—so no doubt extra media attention than usual. The S&P is also near a round 2,000 level, which would continue to generate headlines and perhaps more retail investor interest. It's often easy to forget that the majority of Americans don't track the investment markets on a daily basis like many of us do, so are only reminded of their success or lack thereof by their mention on the news.

From a sector standpoint, cyclical sectors technology and consumer discretionary outperformed, while utilities and energy underperformed. In coming weeks, we'll talk a bit more current market levels and valuation (hint: valuation remains 'fair,' while sentiment has started to improve with these headline numbers being reached, although not to the level where investors seem excited about stocks.)

Outside the U.S., returns between developed and emerging markets were generally indistinguishable on the week. In developed nations, U.K. led with 2% gains, while Europe and Japan were closer around the EAFE average, which was brought down overall by Australia. Overall, foreign returns from China and India led, up 3-4%, while the lowest returns came from Brazil/Latin America and Turkey; the latter was due to higher than-expected inflation, no doubt due to the proximity to Iraq, as well as some odd comments from the prime minister that puts to question the level of objectivity of the central bank (we only mention these details as they highlight the country-specific 'quirks' some emerging markets struggle with). The Chinese purchasing managers' index gained for the second

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straight month (now at 52.4), which spurred sentiment. European PMI fell a bit last month, but remained in expansionary territory.

Bonds struggled on the week, with rates rising on stronger economic and jobs data. Accordingly, U.S. floating rate, high yield and shorter-term credit provided the only positive returns, as long bonds lost up to several percent on the week (amazing what a few basis points can do on the long end of the yield curve). Abroad, German bonds and US denominated emerging market debt fell back, while local EM bonds, Australia, Canada and the European periphery shined with marginal gains.

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With rates at 3.0% last December, many investors were eagerly awaiting conditions to improve and rates to rise back towards 'fair value' levels of somewhere in the mid- to high-3's. Now...with traditional bonds/bond funds performing on the strong side this year, it's easy to look in the rear view mirror and look for what could have been. However, with rates now back down to 2.65%, investors have to weigh the pros and cons of potential yield gained by going out further on the curve versus interest rate risk should this 'fair value' yield be achieved...

In real estate, returns were led by Europe and developed Asia, on par with equity markets, while U.S. sectors also experienced positive results, with the exception of residential. Some of this could be the result of pushback from stronger housing results in recent weeks, which puts a question mark in front of investors hoping for continuing improvements in rental demand growth.

Commodities were mixed on the week, with industrial metals leading (nickel and copper in particular), gold and silver up a fraction of a percent. Crude oil fell about 2%, under $105 as supply disruptions in Iraq seemed a more remote possibility. Additionally, grain prices were down as the USDA estimates a record corn crop this year; there appears to be a bit of an oversupply in wheat, corn and a few other items, which has driven prices down in recent months.

(-) The ISM manufacturing index for June came in weaker than expected, at 55.3, which was below the forecasted 55.9. The report offered mixed details, with higher levels for new orders, slightly weaker production and no change in employment or inventories.

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Anecdotally, respondents had an optimistic tone, mentioning an improvement in general business conditions. As the chart shows, the trend remains solidly above 50, signifying solid month-over-month growth.

(0) The June ISM non-manufacturing version of the index came in at 56.0, which was just a bit down from 56.3 in May (the expectation was for no change). In the underlying data, employment gained several points, new orders were up, while overall business activity lost some ground. Respondents were positive, though, in the comment portion of the report.

(-) The Chicago PMI for June slipped from 65.5 the prior month to 62.6, compared to an expected 64.3. A drop in new orders was the primary culprit, but the trend of the index is still quite positive over the last several months.

(-) Factory orders for May were weaker, per expectations, falling -0.5% versus an anticipated drop of -0.3%; at the same time, April orders were revised up a tenth.

(-) Construction spending in May rose +0.1%, which lagged the forecasted gain of +0.5%. In the month, residential spending fell -1.4%, while non-residential rose +1.1%. Interestingly, the report contained substantial revisions for the past six years, but this didn't affect the more recent months (of current interest) to the same degree.

(+) Total auto sales for June came in better than expected—rising from 16.7 mil. Annualized units in May to 16.9 milion units (compared to expectations of 16.4 mil.), the highest annualized figure in 8 years. Of this, the domestic portion, rose from 13.1 million to 13.3 million, also surpassing expectations by a few hundred thousand vehicles. This was also accomplished with one less weekend than in the prior month (weekends are big in the auto sales world, so analysts make special note of this). Just to make this a bit more interesting, the graphic below depicts the differential in year-to-year sales among the larger car makers—Chrysler continues to lead, while Ford and Honda have lagged. In Ford's case, a pending truck redesign appears to be partially the cause for a lower sales push (important considering that almost two-thirds of sales have come from trucks and SUVs).

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Nevertheless, recent recalls from several manufacturers don't seem to be making a large dent in auto-buying and low financing rates (for now) continue to entice buyers, who seem to be increasingly confident.

(+) The trade balance for May narrowed a bit, to a deficit of -$44.4 billion, even further than the expected -$45.0 billion level. This was entirely due to the petroleum balance, which narrowed by $1.7 billion due to stronger oil exports, while the ex-petroleum balance widened.

Overall exports rose 1%, which was a positive—contributors were autos, engines and consumer goods.

(+) Pending home sales for May rose +6.1%, which was far better than the expected +1.5% increase (in contrast to a year-over-year decrease in this metric of -7%). It represented the third straight month of gains, with rising sales in all four regions—the Northeast and West led with 8-9% results. As a good indicator of future 'existing' home sales (the pending status implies they'll be converted to final sales at some point), this type of result is a positive. Increasingly, it also appears that fundamentals are taking over for low mortgage rates as inventories of foreclosures and other 'abnormal' properties are draining from the system in favor of more 'conventional' home purchases.

(-) Initial jobless claims for the June 28 ending week moved upward a bit (by 2k) to 315k, compared to the same 313k expected. Continuing claims for the June 21 week also rose a bit to 2,579k, up 11k from the week before, and higher than expectations of 2,560k. No strange or special factors affected the results.

(+) The ADP employment report for June showed a gain of +281k private sector jobs, which surpassed expectations of +205k—this was the strongest report in almost two years despite questions about how well the ADP and government payroll surveys correlate (still, good news is better than bad). Professional/business services jobs gained the most, up +77k, while trade/transports/utilities and construction were up +50k and +36k, respectively.

(+) The government's employment situation report for June was stronger than expected. Non-farm payrolls rose to +288k jobs, compared to an expected +215k. Professional/business services led, gaining +67k jobs, while retail jobs were up +40k, and gains were also seen in factory jobs and construction.

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Interestingly, government jobs were up +26k—mostly due to local education positions (although school year factors can sway this figure, however, it does demonstrate somewhat of an improvement in local gov't finances). On another positive note, revisions for the prior months added back almost +30k jobs. The household employment survey, adjusted for payroll consistency and definitional differences with non-farm payrolls, rose +373k, so equally strong.

The unemployment rate fell from 6.3% to 6.1%, despite consensus calls for no change; similarly, the U-6 broader 'underemployment' rate ticked down a notch to 12.1%. The long term unemployed also fell a few percent, and has dropped 5% in 2014. The headline rate decrease was somewhat of a surprise to many economists, as the labor force participation rate was unchanged from May. Average hourly earnings rose +0.2% for June, which was on target with expectations, and bringing the year-over-year figure to +2.0%, which is similar to current inflation levels. This is still considered to be subdued relative to similar historical points in the cycle.

After this stronger report, where do we stand now? Although it's only one month, better, and closer to where the Fed would like things to ultimately be. This is particularly true when also considering broader measures such as long-term unemployment and underemployment ratios that have also fallen this year. Now, there's additional speculation about the possibility of rates rising faster than the current estimates of an early-to-late 2015 timetable (the ranges vary dramatically). This probability remains data dependent, and, as they usually do, markets may react well in advance of actual Fed communication.

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