Weekly Economic Update
June 17, 2014

In a slow week for economic data, stats like retail sales were weaker, but PPI also came in flat, which appeared to temper core inflation concerns from prior weeks.

• Equity markets were largely off, due to increased concerns about violence and possible military action in Iraq and skepticism about European stimulus. Stocks fell on the week, with small-caps losing a bit less than large-caps. Industry results were led by energy and technology, while consumer discretionary and industrials lagged.

This came alongside increased tensions in Iraq as rebels took control of two key Northern cities. Obviously, the ramifications are in the spectrum of: What will be the U.S. involvement if any (undecided, but seems likely at some level)? What will it do to energy costs (a bit higher so far, and intensification of violence would pressure the per barrel price of crude upward)? Will it spread regionally (the wildcard and biggest fear in that part of the world for most investors)? If oil prices do rise for an extended period, how much of a negative impact will that have on consumer behavior/spending?

There were also several mergers/acquisitions during the week, involving Tyson Foods/Hillshire Brands, as well as Merck and Priceline buying what are hoped to be complimentary business lines. The prices paid in a few cases appear to be at significant premiums to fair value/current market, which signifies optimism for both the prospects of the target firm and/or the underlying economy's ability to support these prospects.

In foreign markets, Japan gained slightly, while the U.K. and Europe each lost up to a percent. European stocks have tended to experience mixed/less outright positive reactions than U.S. issues in response to more accommodative measures. Emerging markets were the best-performing equity group, with positive gains on net. Brazil was sharply higher, in keeping with World Cup excitement, as was China, where industrial output and retail sales rose. From a

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regional contrast standpoint, China has been accelerating government spending to boost economic growth, while Japan decided against additional stimulus. We've certainly seen a divergence in central bank and government monetary (both stimulus and interest rate) policies in the last several months as conditions have diverged, and we would expect such a pattern to continue. Normally, policies move a bit more in unison during times of general crisis, and slowly diverge as conditions moderate, normalize and improve, as the degree of improvement generally varies by region—the U.S. and U.K. certainly seem to be a bit ahead of Europe.

Bonds were little changed on the week (BarCap Agg was flat), despite the Iraq headline fears, with short bonds a few ticks higher on the yield curve, and long bonds a few lower, so you could say the overall curve flattened somewhat. Long treasuries naturally gained, as did high yield bonds by a fraction of a percent. A recent treasury auction of short-term notes was fairly strong, with higher demand, but long-term notes seemed a bit weaker—especially from primary dealer sources—at current low rates. Outside the U.S., Canadian and Australian bonds gained while emerging market bond indexes lost ground on the week.

Commodities were largely higher this week, led by higher crude oil prices driven by new strife in Iraq—a prime oil-producing region—although the key drilling regions are to the southeast of the affected cities. Naturally, any geopolitical activity that threatens potential production is going to have an impact on pricing. Gold and silver were also higher on the global uncertainty. Nickel prices corrected by a few percent, due what's perceived to be a possible overshoot, as did grain prices with USDA reports indicating current growing conditions as quite strong.

(-) Retail sales for May were a bit disappointing, showing a gain of +0.3% versus expectations of +0.6%. Similarly, the 'core' component, removing the volatile items, was flat compared to a consensus guess of +0.4%. The difference between the two was largely determined by the cyclical components of auto sales (up +2%) and building materials (up +1%), while 'general' merchandise and apparel lost ground.

(0) The Producer Price Index fell -0.2% in May, which ran counter to the expected slight +0.1% gain. The core PPI figure was down a less significant -0.1%. This brought the year-over-year figures for both headline and core to

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+2.0%. Much of the one-month decline was due to a half-percent drop in the newly added 'trade services margins' earned by retailers/wholesalers—without this effect, the older calculation of core PPI would have gained 0.05%.

(+) Import prices in May rose +0.1%, half the forecast increase. Food/beverage imports fell roughly -1%, while petroleum increased by +1%, with all other core prices neutral. Over the past twelve months, import prices have risen +0.4% on a headline level, while falling -0.2% on a core basis, removing food and energy from the mix.

(0) Wholesale inventories rose just over a percent for April, double the expectation, led by near-3% increases in both computers and drugs. Business inventories, which include not only wholesale but also manufacturing and retail, rose +0.6%, just over forecast. Autos and auto parts inventories rose a bit higher than trend, creating the difference.

(+) The NFIB small business optimism index rose more than expected, from 95.2 in April to 96.6 for May, surpassing expectations of a 95.8 reading and hitting another post crisis high point. The underlying metrics were driven by improved sentiment surrounding expectations for a better economy and higher sales. Positive, but more tempered sentiment surrounded plans to hire and business expansion prospects.

(-) By contrast, the preliminary Univ. of Michigan consumer sentiment survey fell a bit from 81.9 in May to 81.2 for June (expectations called for an increase to 83.0). Expectations about the future worsened, but current conditions improved a bit, although neither change was dramatic. Inflation assumptions for the coming year moved back down a few ticks to the long-term average of 3%, which is where the 5- and 10-year ahead metrics also fall. Overall, the survey is quite positive, and is as positive as it's been over the last several years; inflation also doesn't appear to be a major concern among consumers.

(-) Initial jobless claims for the June 7 ending week fell backward a bit, rising by 4k and 7k more than expected, to 317k. Continuing claims for the May 31 week were also a bit higher than last week and 9k higher than expected at 2,614k. No special factors appeared to convolute the data.

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(+) The JOLTs government job openings report for April rose to 4,455k, which was better than the expected 4,050k and got the measure near the high point from the last business cycle expansion. (Yes, employment is improving, even if it doesn't quite feel like it.) The biggest growth in openings were in private services, such as retail/business services and leisure. The hiring rate, at 3.4%, and quit rate, at 1.8%, were unchanged for April. We know from earlier comments that Fed would like to see the quit rate rise, as it implies better worker choice and mobility.

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