Weekly Economic Update
May 19, 2014

Economic numbers were mixed, with April figures like retail sales lower, but regional Fed surveys for May showing a bit more promise. Inflation in CPI/PPI was higher than expected, with food price and housing increases being the primary drivers.

• Markets were mixed, but small cap stocks have suffered in the last two months. Bond continued to rally as treasury yields have hit the lowest levels in several months. Stocks were flat to down on the week, depending on the size of company being discussed. 'Growth' sectors technology and health care led returns for the week, up in the +1% range, while financials and consumer staples lagged. Small-caps, as measured by the Russell 2000 were in the headlines as they entered 'correction' territory, down almost -10% from their levels in early March. Again, due to the higher valuations here, we aren't entirely surprised. Large-caps, however, generally haven't followed suit and that's an important differentiating factor. Several comments from a few higher-profile managers at some annual hedge fund conferences added to the confusion, as it was implied that 'fewer opportunities' were available which tends to be the obvious case when valuations reach the near-fair value area.

Developed markets on net weren't too dissimilar from domestic equities, with gains in the U.K, just above flat in Japan and losses of just over a half-percent in greater Europe. In emerging markets, Indian stocks gained +8% on the week following the victory of an opposition pro-business candidate (although not via a majority, so this may not be as historic as it's proclaimed to be). The hope is that reforms needed to get economic growth going again will begin to move forward, but that economy has been plagued with fits and starts as a member of the BRIC group; but it did excite foreign investors. Indonesia and China were in second place with decent gains in their own right, along with Russia, due to perceived tempering of Ukrainian concerns. In contrast to U.S. small cap, where any disappointing news could threaten expensive valuations, EM stock valuations are so low that any decent news could result (and has resulted) in positive sentiment. Bonds rallied again, taking the 10-year treasury down to just above 2.5%. Long

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bonds led the way, as did TIPs, due to the inflation figures this week. The bulk of other bond assets were positive. Internationally, rates fell as well (actually leading Treasuries a bit and perhaps the catalyst for lower rates) due to dovish comments from the Bank of England pushing the timeline out for rate hikes until likely mid-2015. The strongest returns originated from developed Europe and Canada, but emerging market debt also gained a bit.

Why are rates hitting their lowest levels since last fall? Everyone seems to have an opinion. Part of it is the current low inflation environment—with it running as low as it is, it allows for a lower nominal rate for the same 'real' rate (we discussed 'real' rates during our advisor meeting last week). Supply and demand behind the scenes may also be playing a role, as a lower deficit this year means lower Treasury bond issuance, so the supply dynamic is a bit tighter than it's been recently—so higher prices/lower yields.

Real estate returns were led by REIT indexes in Asia, which gained almost 4%; by contrast, European REITs fell on the week. The broader U.S. real estate categories were generally flat to slightly positive for the week, led by mortgage and retail.

Commodities were slightly lower on average. Sugar prices were a few percent higher, as was crude oil, which moved from just under \$100 to \$102. Nickel prices fell dramatically last week on some apparent profit-taking (following a surge due to Indonesia's export ban in recent weeks) and natural gas fell several percent on higher production/supply and warmer weather.

(-) **Retail sales** came in weaker than expected for April, gaining +0.1% compared to an expected +0.4%, but some upward revisions for the prior month (+0.4% to +1.5%) tempered this somewhat. The 'core' retail sales figure, removing gasoline, autos and building materials, was down -0.1% for the month which underperformed the expected +0.5% increase. Looking under the hood, the largest declines were in electronics, non-store retail (internet) and 'misc.,' which is office/stationary and other smaller components not captured in other categories. The difference between the headline and core was a half-percent increase in auto sales, as well as an almost-1% gain in gas station sales, on higher prices. The month was disappointing, but optimism persists for a decent 2nd quarter overall. Company earnings from large retailers seemed to follow this trend, as Wal-Mart disappointed while Nordstrom and J.C. Penney surprised on

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the positive side last week. It seems consumer results aren't an easy black-or-white story in recent months, but remain more nuanced and segmented.

(-) **Industrial production** for April fell -0.6%, which was a disappointment relative to expectations of no change. The manufacturing portion fell by almost a half-percent, explaining much of this—especially the non-auto piece (as auto production was flat) led by weakness in metals and machinery production. Utilities output also fell by over -5% upon improved weather, in contrast to strong utilities gains in prior colder months.

Capacity utilization for April came in at 78.6%, which was a half-percent below expectations.

(0) Business inventories for March were reported in line with forecast at +0.4%. In the details that came with the report, retail inventories were flat, while autos/auto parts fell and non-autos rose a small amount.

(+) The Empire manufacturing index for the New York area rose from +1.3 in April to +19.0 for May (compared to an expected +6.0 reading). The underlying figures were also strong, with new orders, shipments and employment all up several points. Expectations for capex on a forward-looking basis dropped a bit on the month but remained in the strong range overall.

(+) The Philly Fed report was also strong, at +15.4 for May, although it did drop a point from last month (did beat expectations of +14.0). Unlike the NY survey, however, new orders and shipments fell, while employment improved and prices received rose to their highest levels in three years. Capex expectations also fell a bit while staying on the strong side.

(+) Import prices for April fell -0.4%, compared to an expected increase of +0.3%. Interestingly, both petroleum and food/beverage prices fell -0.7% in the month, which stood in contrast to the changes in PPI/CPI (noted below). This took the year-over-year trailing price index to a -0.3% decline (-1.0% outside of food/fuel), which implies a deflationary influence as opposed to an inflationary one. Given the choices, a nation would probably prefer to create/control their own inflation as a byproduct of their own growth, then import inflation from forces you can't control and others benefit from (such as commodity exporters).

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(0) The producer price index for April rose +0.6%, which was firmer than the +0.2% expected. The core version, which excludes the food/energy segments, rose +0.5%, and also outgained the same expected +0.2%. Year-over-year, the headline and core PPI rose +2.1% and +1.9%, respectively, which is the strongest in two years. For the month, food prices gaining close to +3% was a primary reason behind the headline figure. The large increase in the core component was again due to trade services profit margin adjustments for wholesalers/retailers, which is a fairly new and more convoluted addition to the traditional index series.

(0) The more notable consumer price index for April rose +0.3%, which was on par with forecast; the core number was roughly twice expectations at +0.2%. That took the yearover-year gain in CPI for the headline and core measures to +2.0% and 1.8%, respectively. The headline portion was heavily influenced by its differentiating components of food and energy, as both were several tenths of a percent higher; the core portion was led by +1% higher transportation prices, which in itself was broken out into gains in both airline tickets and used cars (you think it would be more substantial than these types of things). Rent of primary residence and owners' equivalent rent were both a third of a percent higher, which added to underlying upward pressure.

We list the inflation metrics as somewhat neutral in terms of impact, since they are good and bad. No one wants to see too much inflation begin to emerge, as that has economic consequences, but having some is a byproduct of growth. The higher food price component is often weather-related and typically self-correcting over time, so not as worrisome, at least in wealthier developed economies that can handle that strain relative to emerging nations, where a higher percentage of household budgets are dedicated to food spending.

Overall, inflation continues to look subdued by conventional metrics. The Fed tends to use PCE as opposed to CPI as their preferred measure (due to its breadth), with a target of 2%. Both the PCE and CPI are government-generated, but come from different agencies. As the composition differs, PCE tends to run a quarter- to half-percent lower than CPI over the last several decades, so call it -2.50% for an equivalent Fed CPI target (if they had one). We're not there yet. Arguments for embedded inflation from monetary buildup on the Treasury's balance sheet has many concerned of an inflation overshoot if/when the floodgates open. One trigger is wider credit dispersion from banks expanding

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lending to accelerate the multiplier effect, but this hasn't happened to a wide extent as banks remain hesitant about credit quality (echos of 2008). This is probably a good thing long term and hasn't helped during the recovery, but this is how it often works—banks lend too much and too recklessly when conditions are going well, get burned, then pare back excessively when conditions have bottomed and are improving. Part of the Fed's job is providing incentives to offset this behavioral cycle, and we've found this is easier said than done.

(+) Housing starts for April jumped strongly by +13.2%, to 1,072k, outperforming the forecast gain of +3.6%. The multi-family group was the driver behind the increase, rising +39.6%, showing it was volatile as always. The other category, single-family homes, were up a much more tempered +0.8%, but was also coupled with an upward revision for March. Regionally, the NE and Midwest areas led starts, which appeared to be related to some spring weather recovery.

Building permits also rose strongly by +8.0%, a positive surprise relative to the +1.3% forecast.

(-) The NAHB housing market index fell a point to 45 in May, compared to a forecast 49. Present single-family housing activity deteriorated by a few points, while expected activity improved as did prospective buyer traffic. Regionally, the Northeast and Midwest areas were flat, while the South and West fell a point or so. So generally, a flattish month all the way around and not showing a rebound yet from the bad winter. Sometimes, this index carries some predictive value in terms of future housing starts for coming months.

(+) The NFIB Small Business Optimism survey showed an increase for April, from 93.4 to 95.2, and outperforming forecast by 7 tenths of a point. Economic expectations and earnings trends both rose but remained in negative territory, while plans to hire and selling prices rose a few points to become more positive. Interestingly, a quarter of survey respondents noted that job openings were 'hard to fill,' a level that hasn't been reached in several years and implies somewhat of a job/skill mismatch. While better overall, the survey results have just emerged from very low/recession-like readings and remain low for this point in the cycle.

(-) The preliminary University of Michigan consumer sentiment survey showed a decline in May, from 84.1 to 81.8 (forecast called for 84.5), though

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still decent and on the higher end of the post-recession cycle. Consumer assessments of current conditions were a bit worse by a few points, while future expectations fell by a lesser amount. From an anecdotal standpoint, reasons were focused on slightly higher inflation for food and energy (as discussed above). However, inflation expectations for the 1-year ahead period remained unchanged at just over 3%.

(+) **Initial jobless claims** for the May 10 ending week fell to 297k, from a revised 321k the prior week—better than the 320k estimate. **Continuing claims** for the May 3 week came in lower at 2,667k, and also lower than the 2,690k expected. There appeared to be no special factors affecting the data, and the weekly moving average continued to edge lower, implying a stronger employment environment.

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