Weekly Economic Update
September 29, 2014

- Economic news was generally mixed on the week, with housing providing a slightly more optimistic tone. GDP for the 2nd quarter was revised a bit higher as well, casting a more positive light on the prior period.

- Markets experienced a bit more volatility this week, ending in the negative, with U.S. blue chips the best of a bad bunch. Bonds eked out a small return on slightly lower yields, as the broader market news was strangely overshadowed late in the week by Bill Gross' move from PIMCO to Janus.

U.S. stocks bounced around a bit this week, mostly determined by a bad Thursday. While all sectors lost ground, materials and consumer staples held up the best, while telecom and industrials performed the worst, losing over -2%. What appeared to spook markers?

A few things: The Fed and interest rates increases, Apple's operating system update troubles, which sent the stock down (it's a big index member); Russia's threats to confiscate foreign assets; and ongoing worries about Chinese growth vs. need for additional stimulus (the default fear du jour when there is need for something to worry about), although these worries tend to affect non-Chinese often more than they do Chinese shares directly.

There have been some downgrades in China's expected GDP growth for 2014-2015, from the upper 7's, down to a revised just over 7%, then into the high 6's for the following few years. In absolute terms, that's still high growth, just not as high as it once was. In more specific terms, their PMI is trailing that of the U.S. by about 10 points, about the widest it's ever been—so there is a gap in momentum. This deceleration of growth is a natural progression as an economy evolves, and the extreme improvements seen at the early stages are less possible at the margin as the *quality* of growth becomes a higher priority than the *quantity*. Most economists agree that with generally slow growth in the developed (consuming) world, relying on exports won't do the trick, nor will indefinitely large infrastructure projects. It has to come from internal consumption; this is the careful and difficult balance the Chinese government is hoping to accomplish. (Part of the Alibaba story is based on hopes for that latter theme.) Perhaps more on this in another

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weekly review at some point.

In other markets, actually Japanese shares actually gained almost a percent, following a poor CPI result (only 1% versus the Abenomics target of 2%+), which raises probabilities of additional central bank stimulus action. Currency effects and USD strength appeared to add additional weakness to foreign markets, which generally lost ground across the board—emerging markets performing a bit worse than developed.

Bond prices experienced a positive week, as yields fell. Although things came to halt later as fears over the impact of Bill Gross (specifics below) leaving PIMCO and potential for significant outflows of bond assets. Markets don't like disruption, and being of the size PIMCO is, this is a management shift affecting a $2 trillion firm, mostly in bond money. Long treasuries performed best, high yield and bank loans lost some ground, while most other segments were flat. The 1% gain in the dollar proved to be an equivalent headwind for the bulk of foreign bonds on the week; emerging market bond spreads widened a bit. The investment industry news of the week was certainly Bill Gross' departure from PIMCO, a firm he helped create and certainly put on the map as the long-time face of the firm, and relocation to Janus, a firm that has been working for some time to beef up their fixed income footprint to supplement an already well-regarded equity group. The move was surprising, especially as it is obviously rare to see a firm founder depart to a competitor; but rumors of dissent and recent management reshuffling around PIMCO haven't exactly been quiet. We don't know if the move was voluntary or involuntary exactly, but these things don't happen overnight. PIMCO remains a sizable force in the fixed income world, and employs a deep bench featuring a world-class staff of economic and fixed income specialists, so the impact to the firm is yet to be determined (but it may not be as severe as feared). As we have inferred through our own due diligence and discussions with personnel there in recent years, a larger size can offer pros and cons.
On the positive side, being a behemoth can put a firm in the position for better access and leverage for upcoming deals, and, in fact, provide enough power to mold and customize new issues to their benefit, to some extent. The negatives, though, are that the impact of individual security selection is more diluted, and the use of derivatives and other exposures are required to express views.

Real estate sector returns were all negative, in line with equities, but with a little better result from residential (in keeping with housing stats on the week) and Europe bringing up the rear.

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Commodities were generally flat on the week as a whole. Continued strength in coffee, sugar and cocoa were the primary positive drivers (for the first two, production cuts in Brazil, while the latter continued to be impacted by fears over Ebola in West Africa, that could affect normal harvest and production operations). Precious metals and industrial metals suffered the largest losses on the week, while crude oil ticked up a bit above $93, off its lows.

(-/0) Durable goods orders for August came in down -18.2%, which was disappointing but just two-tenths of a percent worse than consensus estimates. However, removing transports from the equation resulted in a +0.7% gain (a tick better than expected). The obvious culprit was a -75% drop in non-defense aircraft orders (from Boeing), which was a bit of a normalization after a very strong prior month. Core capital goods orders and shipments also gained for the month, so the underlying figure perhaps wasn't as bad as it looked. Another lesson as to why these month-to-month headline changes are so noisy; it's often hard to give a single month too much credit.

(-) Existing home sales fell -1.8% for August to 5.05 mil. units, which was a disappointment relative to an expected gain of +1.0%. Both single-family and condos/coops fell by roughly the same magnitude. On perhaps a positive note, it appeared the investor and 'all-cash' share of buyers declined again, in keeping with trend of fewer foreclosures and higher ratios of owner-occupiers vs. investors over time (only 8% of last month's sales were investor-driven, compared to 12% last year, and all-cash buyers fell from 32% last year to 25%). Months' supply came in at 5.5.

(-) The FHFA house price index gained a modest +0.1% for July, which lagged expectations calling for a gain of +0.5%. From a regional standpoint on the month, prices in the Pacific region were flat, while the Middle Atlantic and Mountain fell a few tics. Year-over-year, the index has gained +4.4%—a pace which has slowed over the past year.

(+) New home sales rose +18.0% in August to a new post-recession high level of 504k, which sharply outperformed expectations of a more modest +4.4% gain. Again, these monthly figures are noisy, but statistically it was the largest 1-month gain since the early 1990's and represents a +33% gain over the levels of last year. The Western U.S. was the largest contributor for the month (+50%) and trailing 12-months for that matter, but positive results were also seen in the

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Northeast (+30%) and South, while the Midwest was unchanged. The median new home price last month was $275,600, while the average came in at $347,900 (unsurprisingly high, as new homes tend to be more expensive than existing homes), with a months' supply decline of almost a month to 4.8. The natural question of what is 'normal' is probably relevant here, and that's likely somewhere in the broad average of 1 mil. units. There is certainly no over-supply condition at this point that would act as a normal destroyer of the housing cycle, per past history—quite the opposite.

(0) The final University of Michigan consumer sentiment survey results were just two tenths of a point below expectations and unchanged from the preliminary reading, at 84.6. Consumer assessments of current conditions and future expectations were flat, as were inflation forecasts, which continue to hover in the upper 2's to 3%, as they're prone to do.

(0/+) The final GDP release for the 2nd quarter came in better than expected, moving from 4.2% to 4.6%, on par with general expectations. The difference in figures came from a boost in nonresidential fixed investment, and some upward contribution from net exports and consumer spending. For the third quarter, tracking estimates (calculated by several economic departments to provide more of a 'real time' look into conditions) are falling in the 3.0-3.5% range, with perhaps a bit better than that for the 4th quarter. As we all know, take these with a grain of salt for now.

(0) Initial jobless claims for the Sept. 20 ending week rose a bit to 293k, but remained 3k below the consensus forecast. Continuing claims for the Sept. 13 week also rose a bit, to 2,439k, which was 1k below forecast. No special factors or estimates were reported to affect the results on the week.

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Weekly Economic Notes

Question of the Week

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