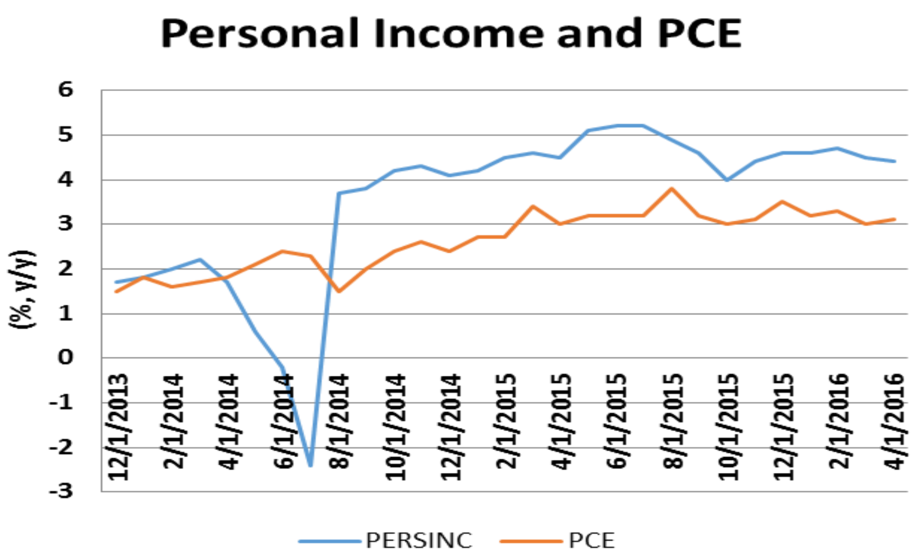
ADVOCACY INVESTING-MACROECONOMIC UPDATE
JUNE 8, 2016
ON THE CUSP

- ***Economic growth in 1Q16 was revised marginally upward to 0.8%***
- ***Household spending is taking hold, but manufacturing and services are soft***
- ***The pace of jobs creation in May fell unexpectedly to its lowest level in 6 years***
- ***The Fed is keen on raising rates, but is likely to delay rate action***
- ***The economy is on a cusp, with significant downside risks***
- ***The equity bull run could be over as the main market indices hit a ceiling***

Economic growth in 1Q16 was revised upwards from 0.5% (annualized) to 0.8% in the second estimate of national accounts. Little was changed in the components of economic growth. Personal consumption expenditures, residential fixed investment and state and local government spending provided a positive contribution, while business fixed capital expenditures, exports and federal government remained in the negative column.

Fig.1: <u>Robust Households</u>

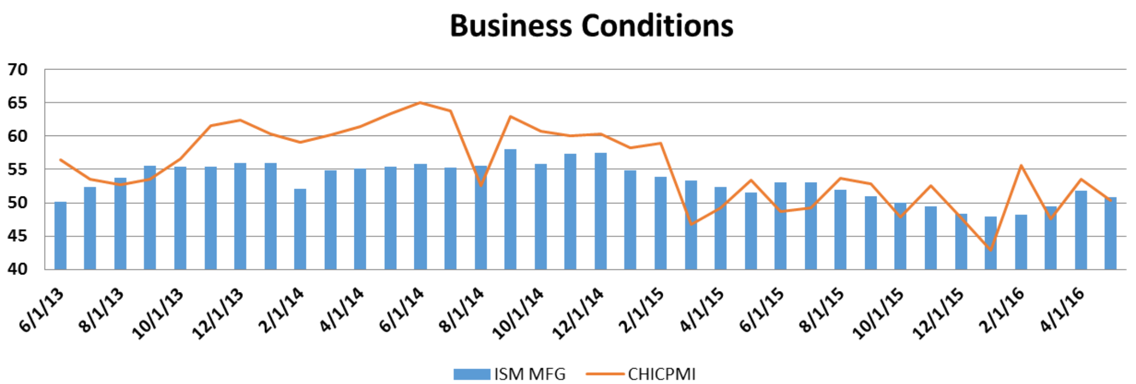


Recent data releases indicate that the economy accelerated at the beginning of the second quarter from a weak first quarter. The biggest gains have been on the household and consumer side. Personal income was up 0.4% month-on-month (m/m) in April, personal consumption expenditures (PCE) rose by 1% m/m and retail sales increased by 1.3% m/m. At the same time, we have seen a recent weakening in end-May consumer confidence: the University of Michigan-Reuters index was down 1.1 points to 94.7, and the Conference Board measure lost 1.6 points to 92.6.

While there was some recovery in the industry area, the situation remains precarious. Industrial production rose sharply in April (+0.7%, m/m, Manufacturing +0.3% m/m) after declining for seven consecutive months. Durable goods also increased by 0.4% m/m and factory orders rose by 1.9% m/m. However, more recent surveys were not as positive. Early May surveys pointed to a slowing down in manufacturing: the Empire

State index shifted from +9.56 to -9.02; the Philadelphia measure fell from -1.6 to -1.8. Late-month indices also showed little improvement, with both the ISM-Manufacturing and the Markit

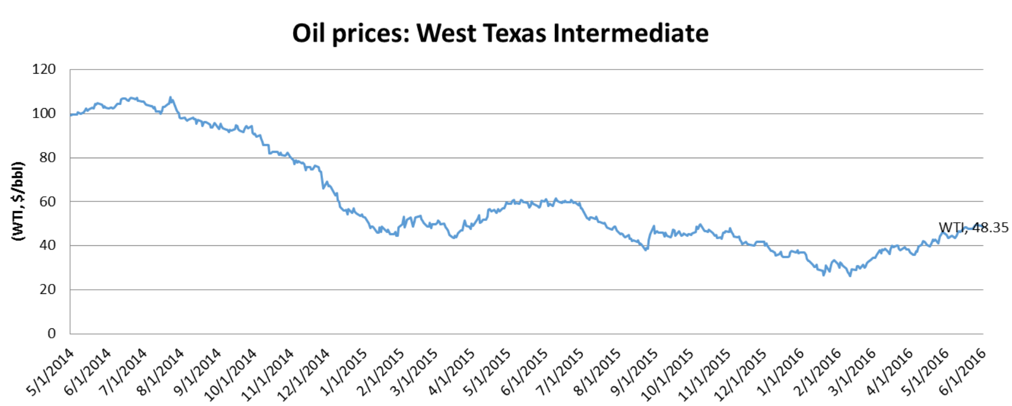
Fig.2: <u>Business Conditions Soften</u>



PMI basically flat at 50.7 and 51.3. The broad-based Chicago PMI actually fell back under 50 (49.3) for the first time in 3-months. The services sector weakened slightly, with the ISM-Nonmanufacturing declining to 52.9 in May from 55.7 the previous month. The trade deficit fell in April as both exports (+1.5% m/m) and imports (+2.1%) increased. The dollar index fell by 1.9% on June 3 after the release of the May payrolls report, the lowest since May 3rd, and 6.1% down from its end-November 2015 peak.

Housing shows continued strength, with housing starts, new homes sales and existing home sales all up in April. The Case-Shiller 20-city price index rose by 0.9% m/m in March. However, construction spending fell by 1.8% m/m in April, reflecting a predictable adjustment after several months of rapid growth.

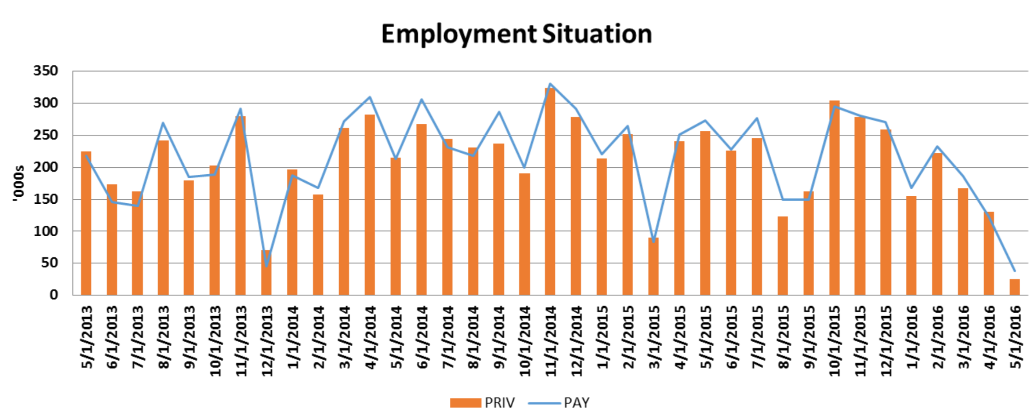
Fig.3: <u>Breaking $50?</u>



Breaking $50? Oil prices continued their upward swing in May, capping the longest recovery in 5 years. West Texas Intermediate (WTI) crude prices rose by 6.9% in May to $49.10/barrel (bbl), up 87% from their 2016 low of $26.21/bbl on 2/11. Oil prices have been hovering around $50/bbl in the last week of May, but seemed unable to break through that level. The market remains very sensitive to disruptions, and recent problems in Nigeria have pushed oil prices to annual highs. However, with Iran almost back at full capacity, a pickup in the pace of drilling in the United States, and the likely quick return of Canadian production—all capped by an unsuccessful OPEC meeting—means in combination that markets remain on the soft side and oil prices should remain in the $45-50 range over the next few months.

Major Disappointment: The May employment report was definitely a downer. Total payrolls increased by 38,000 (private employment increased by 25,000), significantly lower than market expectations of 158,000, and the slowest pace in 6 years. The previous two months results were also revised downward by a total of 59,000. These results brought the three-month moving average to 115,000, down from over 200,000 for the previous 12 months. While part of the decline is explained by the Verizon strike (which affected 35,000 workers), the fall is significant. The deterioration was broad. The goods producing sector fell by 36,000, with all three areas—construction, manufacturing and mining showing declines—and private services only increased by 61,000. Government employment rise by 13,000. Average hourly earnings went up by 0.2% m/m, but average weekly hours worked fell by 0.1 to 34.4. In combination, this resulted in a 3.5% increase (annualized) of the labor income proxy. The Employment Diffusion Index, which measures the distribution of unemployment across sectors, fell to its lowest level since 2010. This mediocre report was compounded by the fact that the labor supply fell sharply, down 458,000 in the past two months, reversing two-thirds of the gains of the previous nine months. Labor participation fell to 62.2%, down 0.4% in the past two months, which resulted in a drop in the unemployment rate (U3) to 4.7%. The broader unemployment and underemployment rate (U6) was stable at 9.7%.

Fig. 4: <u>A Major Disappointment</u>

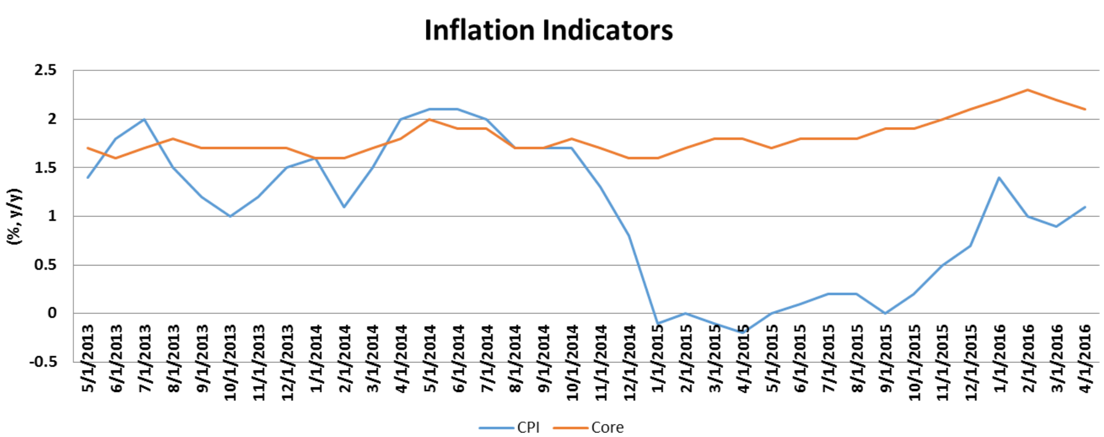


While this report is disappointing, it comes after a long period of strong employment gains. Moreover, the high-frequency data remains positive, with the initial jobless claims remaining in the 270,000 vicinity. We will need one or two more months of data to confirm the trend.

Fed in a Bind: Following the April meeting of the Federal Open Market Committee (FOMC), Fed chair Janet Yellen and a number of Fed presidents had indicated that economic conditions were ripe for a rate increase in one of the next Federal Open Market Committee (FOMC) meetings—scheduled for June 14-15 or July 26-27. The Fed's argument rested on the belief that a rate increase is overdue, and while economic growth is still mediocre, improvements in the labor markets and the firming of inflation called for a rate increase in the near future, followed by another one later in the year. However, the weak employment report is likely to delay a rate increase in June and possible in July. The 10-year yield dropped to 1.63%, 71 bp below its level a year ago.

More broadly, the Fed faces a credibility problem stemming from mission creep. The Fed charter states that the central bank has a dual mandate: price stability and maximum employment. However, since the financial crisis of 2008, stabilizing the financial markets addicted to easy money has also emerged as a Fed responsibility. Complicating things is the more recent focus on international conditions in a weakening global economy. So, while the Fed claims to be data-driven, its market and global concerns have created market confusion.

Fig.5: Inflation Picks Up



Subdued Global Growth: The IMF's recently published annual economic report, World Economic Outlook, projects 2016 global growth at 3.2%, down from a 3.4% projection in January. The IMF report characterizes the economic situation in 2016 as subdued, with higher downside risks.

Table 1: **IMF Growth Forecasts**

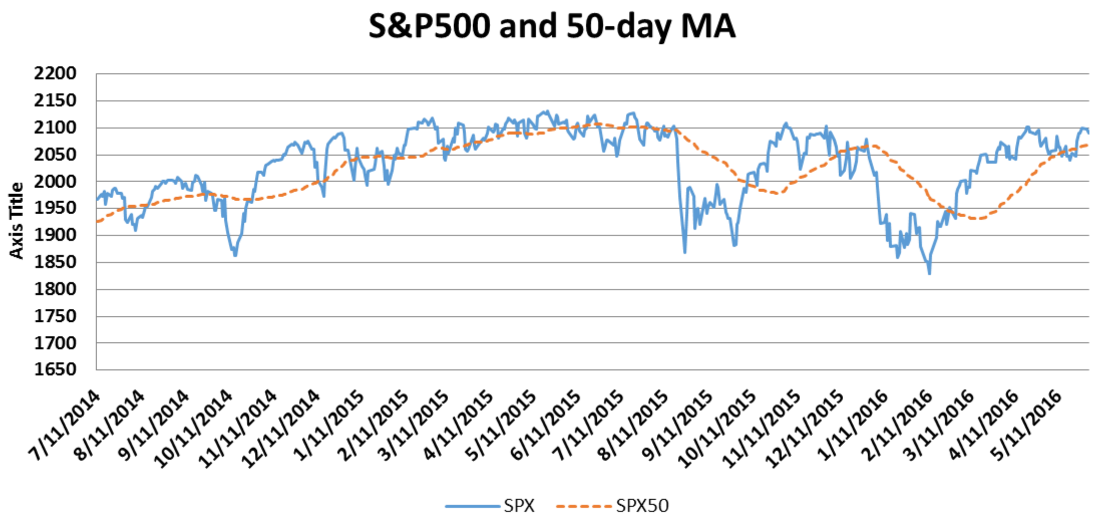
GDP (%)	2015	2016	2017
World	3.1	3.2	3.5
Advanced Economies	1.9	2.9	1.2
Emerging Markets	4.0	4.1	4.6
United States	2.4	2.4	2.5
Eurozone	1.6	1.5	1.6
Japan	0.5	0.5	-0.1
China	6.9	6.5	6.2

Downside risks and structural problems continue to plague the global economy. China's manufacturing production continues to slip, with the Caixin PMI-Manufacturing down to 49.2 at the end of May from 49.4 a month earlier—it has been under 50 since the end of 2014. In the eurozone, both the PMI-Manufacturing and the PMI Composite have dropped, although they remain above 50. The European Central Bank left its interest rate unchanged at its last meeting in early, reflecting the bank's concerns over continued deflationary pressures and weak growth. In Japan, Prime Minister Abe postponed a sales tax increase over fears that such a move would push the economy back into recession. Instead, the government is expected to introduce yet another stimulus package—a triumph of hope over experience. Brazil's economic output entered its fifth quarter of decline, falling by 5.4% y/y in 1Q16. Overall, India is the only country in the BRICS group to show strong economic growth.

Loss of momentum: The data releases in the past few weeks show a U.S economy moving on two tracks. On one hand, we are seeing stronger households opening up the purse strings, and on the other corporations keeping a lid on business spending. Household disposable incomes have been boosted by employment gains and low oil prices. Corporate profits, in contrast, have been hit by falling energy prices, low productivity and the strong dollar, resulting in two quarters of double-digit quarter-on-quarter declines. As a consequence, business fixed investment has declined sharply for the past two quarters. In 2015, we saw a strong economic rebound in 2Q15 after a poor 1Q15 performance. This is unlikely to be repeated this year, and 2Q16 growth is likely to remain at about 2.0%. The mediocre May employment report could represent a shift in corporate behavior, leading to a softening of labor demand.

The rise in energy prices and the weakening of the dollar are welcome signs for the corporate sector, but the impact will only be gradual. In the meantime, we are seeing a rise in downside risks as the economy seems to be on the cusp of a slowdown—although a recession in the next 12 months remains a low probability event.

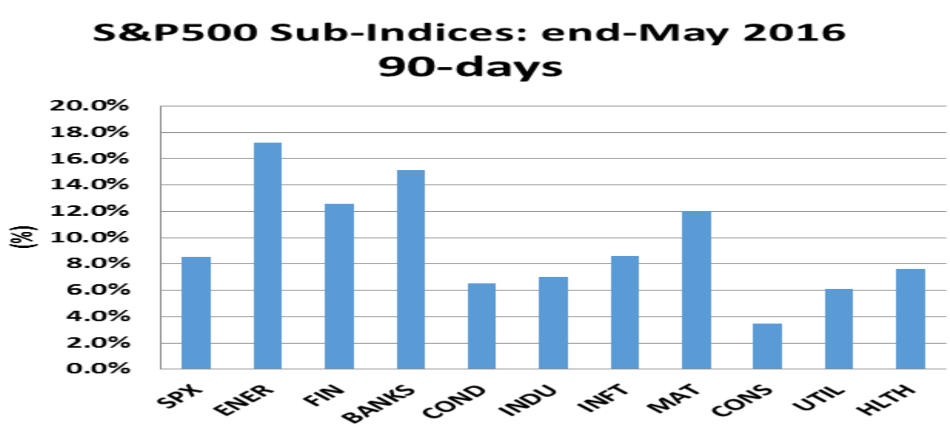
Fig.6: The Bulls Prevail



Stagnant Markets: The equity markets took a hit after a strong May and an equally strong start of June. The S&P500 gained 1.9% in May and broke through the 2,100 level in early June, hitting a 7-month high on June 2. However, the poor employment report broke the surge and the markets ended the first week of June at 2,100.

The three-month old bull market does not seem to have legs, despite the relatively strong performance of the S&P500 and its sub-indices in the past 90 days. In fact, the equity markets have been stagnant since 3Q14, not a very common occurrence in the past 30 years. In addition to the continued slide in corporate profits, the markets are facing three downside risks. In the short-term, the markets are concerned by the very close Brexit referendum, as a successful "leave" vote would create significant macroeconomic and financial upheaval. Beyond the Brexit risk, markets are concerned about the Fed—will it or won't it tighten—and a Chinese hard-landing.

Fig.7: S&P500 SubIndices



Corporate profits were down 6% y/y in 1Q16. Some of the main drags on corporate profits could abate as oil prices have recovered and seem to have stabilized around $45-50/bbl and the dollar is losing ground. However, weak global growth and concerns over the US economy could continue to affect corporate profitability. With a P/E ratio of over 24, the market seems overpriced. Overall, 2,100 seems to have established itself as a strong resistance level.

Economic Data Releases-May 2016	*Prior*	*Consensus*	*Actual*	*Min*	*Max*
Macroeconomy					
GDP(1Q16 % Annualized, Second estimate	0.5%	0.9%	0.8%	0.5%	1.1%
CPI (m/m) Apr	0.1%	0.3%	0.4%	0.3%	0.5%
Core CPI (% m/m)	0.1%	0.2%	0.2%	0.1%	0.3%
Employment					
First Time Claims ('000) (Last week May)	268	267	267	263	275
Non-Farm Payroll May	123,000	158,000	38,000	110,000	219,000
o/w Private Sector	130,000	150,000	25,000	105,000	211,000
Balance of Payments					
Trade Deficit $ billion) Apr	$35.5	$41.0	$37.4	$40.4	$44.0
Exports (% m/m)	-0.9%		1.5%		
Imports (% m/m)	-3.6%		2.1%		
Current Account Deficit ($ billion) (4Q2015)	$125.3				
Oil Prices (WTI, $/bbl, eom) May	$45.92		$49.10		
Industrial & Manufacturing					
Corporate Profits (y/y) 1Q16	-3.6%		-3.6%		
Empire State (May)	9.56	7.00	-9.02	2.50	11.20
Philadelphia (May)	-1.6	3.00	-1.8	0.00	6.50
Chicago PMI May	50.4	51.70	49.3	49.00	52.20
Markit PMI Mfg May	50.8	50.5	50.7	50.4	51.1
ISM Mfg (May)	50.8	50.60	51.3	49.90	51.00
Industrial Production (% m/m) Apr	-0.9%	0.2%	0.7%	0.0%	0.6%
Manufacturing (% m/m) Apr	-0.3%	0.2%	0.3%	0.0%	0.3%
Durable Goods (m/m) Apr	1.9%	0.3%	3.4%	-0.6%	1.3%
Durable Goods, ex transp (m/m)	0.1%	0.4%	0.4%	0.1%	0.8%
Factory Orders (m/m) Apr	1.7%	2.0%	1.9%	0.3%	3.0%
Services					
PMI Services (May)	52.8		51.3		
ISM Non-MFG (May)	55.7	55.5	52.9	54.8	56.5
Consumer Spending					
Retail Sales (% m/m) Apr	-0.3%	0.9%	1.3%	0.4%	1.2%
UMich Consumer Sentiment (end-May)	95.8	95.5	94.7	94.0	96.5
ConfBd Consumer Confidence (end-May)	94.2	94.7	92.6	95.0	33.0
Personal Income (m/m) Apr	0.4%	0.4%	0.4%	0.3%	0.8%
Personal Consumption Expenditures (m/m) Apr	0.0%	0.7%	1.0%	0.4%	0.9%

Economic Data Releases-May 2016	*Prior*	*Consensus*	*Actual*	*Min*	*Max*
Housing Market					
Housing Starts ('000) Apr	1099	1035	1172	100	1185
New Home Sale ('000) Apr	531	523	619	510	520
Existing Home Sales (MM) Apr	5.36	5.40	5.45	5.35	5.46
Construction Spending (m/m) Mar	1.5%	0.6%	-1.8%	0.1%	0.9%
Case Shiller-20 (m/m) Mar	0.7%	0.7%	0.9%	0.6%	0.8%
Case Shiller-20(y/y)	5.4%	5.1%	5.4%	4.9%	5.6%