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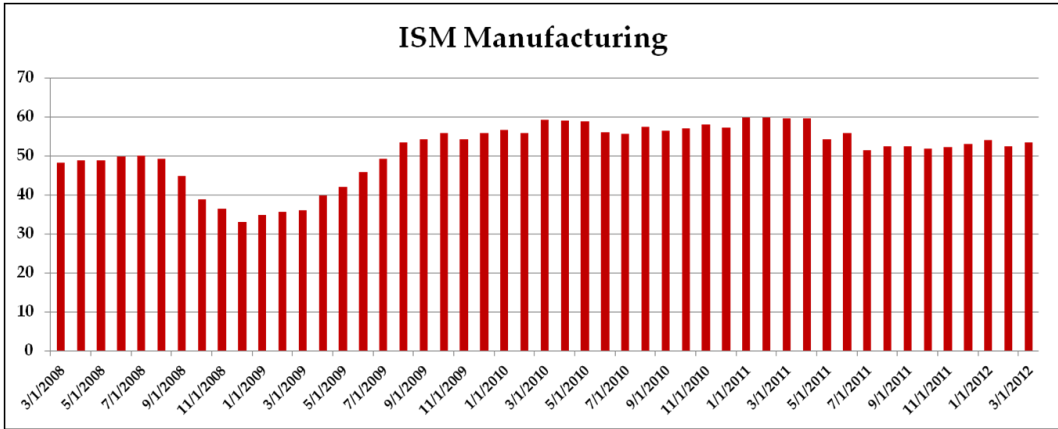
Advocacy Investing[®]

SPRINGTIME IN AMERICA?

- **Economic data releases underscore a steady, albeit unspectacular recovery**
- **Crude oil prices have retreated, but gasoline remains expensive**
- **The global economic picture is mixed, with Europe entering recession, China slowing down and other Asian economies accelerating**
- **Economic prospects in 1Q12 should beat expectations, but momentum might be difficult to maintain**
- **S&P bull streak coming to an end as the index clings to 1,400**

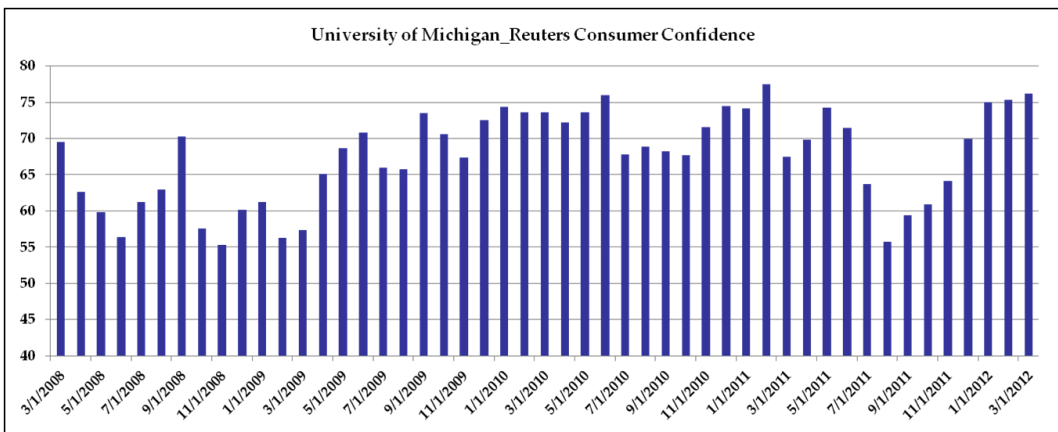
The third and last revision in fourth quarter 2011 GDP confirmed that economic growth accelerated to 3% (annualized) in that time period. Since then, the recovery has continued, underscored by a steady stream of positive economic releases, which has fed a more upbeat assessment of economic prospects for 2012. Nevertheless, economic policymakers remain cautious, as reflected in recent comments by Fed Chairman Ben Bernanke, who has stated concerns about the weak legs of the economic recovery and the need to maintain an expansive monetary policy. The Fed chairman's caution was reflected in the Minutes of the March 13th-14th Federal Open Market Committee (FOMC), which were released on April 3rd. These minutes, while recognizing the unexpected buoyancy of the economy in the past few months, also warned that the improvements in the employment picture might prove difficult to maintain through the coming months.

Fig. 1: Dynamic Manufacturing



Economic data releases reflect a robust manufacturing sector and more optimistic consumer. Higher gasoline prices, which elicited a great deal of consumer unhappiness, have yet to impact consumer confidence in a meaningful manner. (Gasoline accounts for only about 5% of consumer expenditures overall, which mitigates the impact of gas price increases). While the University of Michigan-Reuters survey index for March slipped slightly to 74.3 from 75.3, the Conference Board measure gained 2 points to 76.4. Disposable income rose by 0.2% (month-on-month, m/m) in February, but personal consumption expenditures jumped by 0.8% m/m. On the manufacturing side, survey data all pointed towards continued expansion. The Empire State (New York Fed) and the Philadelphia Fed indices both rose sharply. The Chicago PMI gave some ground, but remains strong at 62.2, while the ISM manufacturing index rose from 52 to 52.4. Industrial production (+0.1% m/m), durable goods (+2.2% m/m) and factory orders (+1.3% m/m) were all in positive territory. The ISM-nonmanufacturing index fell slightly in March to 56, but remains solid.

Fig. 2: Positive consumers



The housing market has stabilized at these low levels, although house prices at the national level continue to decline. However, there are early signs of a recovery, including a revival of the MBS (mortgage backed securities) market.

Labor Markets: The labor market saw a hiatus at the end of 1Q12, with the March payrolls rising by only 120,000, significantly below market expectations of 205,000. This drop came after 4 months of strong growth. The breakdown of the March payrolls number shows that the main drops came in retail (minus 34,000), construction (minus 7,000) and temporary business jobs. Manufacturing gained 34,000 jobs and business services (ex-temp jobs) rose by 100,000 positions. Government employment stabilized for the first time since the end of 2008. Hours worked declined by 0.1(m/m), to 34.5 hours and hourly earnings rose by 0.2% (m/m). In combination with the previous two months, this led to total earnings rising by 5.5% (annualized) in 1Q12. The unemployment rate, which is based on a separate household survey, fell from 8.3% to 8.2%, but that drop reflected a fall in the labor supply. There were small upward adjustments to January and February payrolls totaling 8,000, and the average numbers of jobs created in the first three months remained above 200,000 despite the lower March number.

The weather played a role in the sharp shift, since the mild winter led to an unseasonal rise in construction and retail jobs, a trend which reversed itself in the last month of the quarter. Do these numbers represent merely a break in the trend of the past few months, or are we seeing a repeat of 2010 and 2011, where strong early gains gave way to weakness in the spring? There is no doubt that Bernanke is right when he states that strong jobs growth cannot be maintained without a more vigorous economic recovery. So, some of the decline is an adjustment to this reality. At the same time, high frequency data provide us with an important indicator of continued dynamism in the labor markets. Initial jobless claims continue to decline, falling to 357,000 in the first week of April, the lowest level in 4-years. The smoothed series (4 week moving average) has also dropped to 465,000. The April payroll number will provide us with an important test of the labor market trends (200,000+ or mid-100,000s?)

What will the Fed do? "Operation Twist"--the purchase of long-term bonds by the Fed—will come to an end in June 2012, and we do not expect the Fed to extend or replace it. However, the Fed is likely to continue some form of monetary easing by replacing maturing mortgage-backed securities on its balance sheet. Nevertheless, a third round of quantitative easing is unlikely unless the economy weakens significantly—not our base-case scenario. At the same time, the Fed will hold short-term rates at or near zero for the foreseeable future, at least until mid-2014.

Fig. 3: Payrolls at 4-year low



Global economic conditions are mixed. The eurozone is slipping into a mild recession, with output expected to be flat or in slight decline in the first three quarters of the year. The Eurozone Markit PMI fell to 47.7 in March—this index has been below the critical 50 level that demarcates growth from contraction since August of last year. Manufacturing output shrank last month in the two largest European economies (Germany and France), while Italy and Spain have experienced even longer periods of manufacturing contraction in the last twelve months. Chinese growth slowed to 8.4% (annualized) in 1Q12, the lowest in three years. In contrast, output growth in other Asian countries, in particular Japan and South Korea, was expected to accelerate in 1Q12. The JPMorgan All-Industry Global PMI (which includes both goods and services) reversed itself in March, falling by 0.8 to 54.6 after four consecutive months of growth.

The European sovereign debt crisis has abated with the Greek debt rescheduling last month, but has in no way been resolved. Financial markets remain nervous. The focus is now on Spain, in the midst of a drastic austerity and economic reform program. The country is facing sharply higher yields, as well as massive social protests. In the meantime, the European Union has agreed to increase the funds available for the European Financial Stability Fund (EFSF), the so-called “firewall”, to €700 billion. While significantly higher than the previous level, this amount is still considered insufficient by many analysts and policy-makers.

Oil Market Reversal: Oil markets have softened somewhat since mid-March as the supply situation remains comfortable. First, Saudi Arabia has pledged to ensure ample supplies to the market. Second, OPEC output in March reached its highest level in three years to 31.22 million barrels per day (mbd) despite the fact that Iranian production is at its lowest level in 10 years. Third, US crude inventories are at their highest level in a decade. As a result, oil prices declined by 6.5% between their mid-February high of \$109 per barrel (\$/bbl) and the end of 1Q12. Moreover, oil futures for May fell to \$102/bbl. Overall fuel use in the US continued to fall, declining by 0.1% week-on-week at the end of March, standing almost 6% lower on a year-on-year basis. However, high gasoline prices in Europe

have diverted gasoline supplies from the US, so lower oil prices have yet to translate in relief at the pump.

On the geopolitical side, we are in a waiting mode. Talk of imminent military intervention has been muted as Iran has agreed to resume negotiations with the so-called "P5+1" meeting scheduled for mid-April.

Overall economic conditions have improved further in the first quarter of the year. The beginning of 2012 has shown unexpected strength, with both the manufacturing sector and employment trends exceeding earlier market expectations, so we could be heading towards 2.5-3.0% growth (annualized) in 1Q12. Manufacturing has been growing at an annualized rate of 7% in the past two quarters, while net exports and inventories have also provided a lift to the economy. Overall, the economy has probably grown at about 2.5% (annualized) in the last two quarters.

The key question is whether the 1Q12 momentum will be maintained over the next few months or will we return to lower growth of 1.5-2.0%. In other words, could we be at a tipping point? The major factors to consider are:

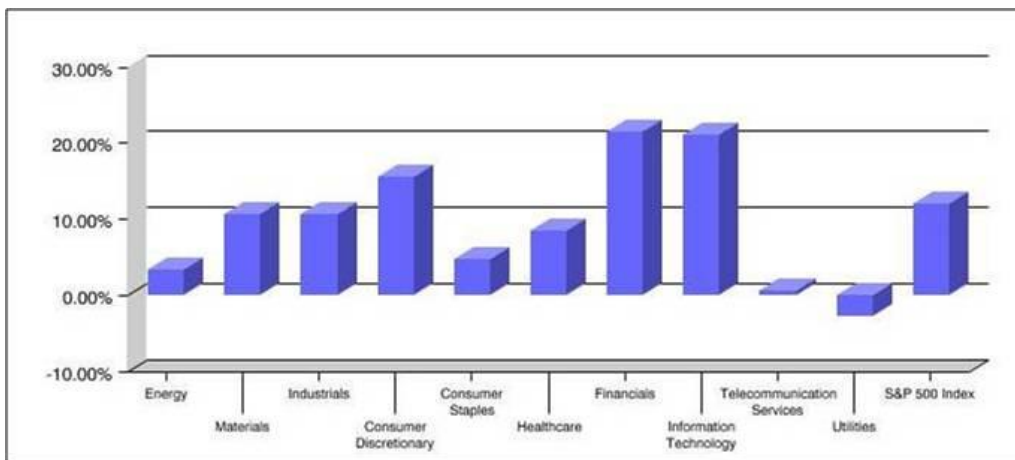
- On the plus side:
 - Oil market pressures have abated somewhat
 - Consumer confidence has been maintained despite higher gasoline prices
 - Household balance sheets and net worth have improved as a result of the recovery in the equity markets and continued deleveraging
 - Local government finances are on the mend
 - Productivity gains have slowed and labor shortages have emerged, which should sustain payroll growth
- On the minus side:
 - In the absence of a political agreement at the Federal level—unlikely in an election year—we could be facing a fiscal "cliff" by the beginning of 2013-- mandated sharp spending cuts combined with an end to the Bush tax cuts
 - The pace of manufacturing growth could slow down from what many consider to be unsustainable in the face of lower global growth
 - Housing is still a drag on household spending

On one hand, in the absence of another European debt or oil shock, economic growth seems to have reached a 2-2.5% growth plateau. On the other, a sharp improvement in payroll numbers could translate into an upward shift in economic growth. Overall, the economy is on the cusp, and an acceleration of growth is still a distinct possibility.

However, a weakening global economic picture presents the greatest risk to the US economy, potentially cutting into an already weak recovery. Moreover, the two major sources of systemic and event risk, (the European Union debt crisis and the tension with Iran), have receded to the background in recent weeks, but the fundamentals driving both situations have remained the same.

The Ides of March: American and global equity markets have experienced their strongest quarter in more than a decade. The S&P500's 12% gain in 1Q12 propelled it back to 1,416 on March 15th (which happened to be the Ides of March its highest level in 951 days --since May 2008—and 107% higher than its low point in March 2009. Global indices also showed strong gains, with the MSCI (ex-United States) rising by 7.6% in 1Q12. The rise in the S&P was led by a shift from defensive stocks (utilities, consumer staples and telecoms), which had led the 2011 rally, to cyclical ones. In particular, we saw a strong recovery in financials, technology and homebuilders. The star performer was Apple, which accounted for 20% of the rise of the S&P500 in the first three months of the year. However, April has proven to be less friendly, with the S&P500 losing 1.5% in the first week of the month to 1,398, showing that the current index S&P500 level of 1,400 will be difficult to exceed.

Fig. 4: The S&P500's cyclical play (1Q12)



American business is sitting on mountains of cash. Some of this trove has been used for stock buybacks, totaling almost \$400 billion in 2011—a contributing factor to equity markets strength. Corporations have also returned record amounts to shareholders in the form of dividends. The profit picture is mixed as the era of double-digit profit growth seems to be over. Corporate profits in 4Q11 declined marginally relative to the previous quarter, although they were 11.7% higher on a year-on-year basis. In the near future, profit growth should return to its historic trend of shadowing nominal GDP, which means 4-6% per year. An improved appetite for risky assets will be balanced by profit taking by the market participants. At the same time, slowly improving fundamentals should prevent sharp reversals. Overall, we can expect the S&P500 and the DJIA to plateau at around respectively 1,400 and 13,000, with some event-driven volatility.

March 2012 Economic Data

March 2012	Prior	Consensus	Actual	Min	Max
Macroeconomy					
GDP (4Q11, % Annualized)	3.0%				
CPI (m/m) Feb	0.2%	0.5%	0.4%	0.3%	0.6%
Core CPI (% m/m) Feb	0.2%	0.2%	0.1%	0.1%	0.2%
Balance of Payments					
Exports (% m/m) (Jan)	0.4%		1.4%		
Imports (% m/m) (Jan)	1.6%		2.1%		
Trade Deficit \$ billion (Jan)	\$50.40	\$48.40	\$52.6	\$46.50	\$50.80
Current Account Deficit (\$ billion) (4Q11)	\$107.60		\$124.10		
Industrial Production					
Empire State (Mar)	19.53	17.5	20.21	12.0	24.7
Philadelphia Fed (Mar)	10.2	11.5	12.5	6.7	16.0
ISM-Mfg Mar	52.4	53.0	53.4	51.9	54.2
Chicago PMI (Feb)	64	63.0	62.2	59.7	66.0
Industrial Production (% m/m) Feb	0.5%	0.4%	0.1%	0.10%	1.0%
Durable Goods (m/m) Feb	-3.6%	2.9%	2.2%	0.9%	6.4%
Durable Goods (y/y)	8.7%		12.2%		
Durable Goods, ex transp (m/m)	-3.0%	1.5%	1.6%	0.4%	2.6%
Durable Goods, ex Transp (y/y)	6.1%		9.5%		
Inventories (m/m) Feb	0.6%	0.5%	0.7%	0.3%	0.6%
Factory Orders (m/m) Feb	-1.1%	1.5%	1.3%	0.8%	2.0%
Services					
ISM non-mfg Feb	57.3	57.0	56	55.7	58.0
Consumer Spending					
Retail Sales (% m/m) Feb	0.6%	1.2%	1.1%	0.7%	2.1%
UMich Consumer Sentiment Mar	75.3	76	74.3	73	78.8
ConfBd Consumer Confidence (Mar)	74.3	75.0	76.2	72.0	78.9
Personal Income (m/m) Feb	0.2%	0.4%	0.2%	-0.2%	0.6%
Personal Income (y/y)	3.5%		3.6%		
Consumer Spending (m/m) Feb	0.4%	0.6%	0.8%	0.2%	0.8%
Consumer Spending (y/y)	4.1%		4.1%		
Housing Market					
Housing Starts ('000) Feb	706	700	698	650	775
New Home Sale ('000) Feb	318	325	313	315	345
Existing Home Sales (MM) Feb	4.63	4.61	4.59	4.40	4.80
Case Shiller-20 (m/m) SA Jan	-0.5%	-0.2%	0.0%	-0.5%	-0.3%
Case Shiller-20(y/y) Jan	-4.1%		-3.8%		
Employment					
First Time Claims ('000) (1st Week April)	363	360	357	347	455
Non-Farm Payroll (Mar)	240,000	201000	120,000	180,000	239,000
o/w Private Sector (Mar)	233,000	224000	121,000	205,000	246,000

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