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Advocacy Investing®

A CHALLENGING START TO PRESIDENT OBAMA'S SECOND TERM

- **President Obama wins reelection, but faces a mixed economic picture, with significant medium-term challenges. A first task to handle is the fiscal cliff**
- **Super-storm Sandy causes major short-term disruptions, but long-term economic impact should be minimal**
- **Labor markets deliver a string positive surprises**
- **The eurozone quiets down…for the time being**
- **3Q12 data underscore weak growth at a 2% trend**
- **The housing market continues to mend**
- **The consumer remains optimistic and manufacturing seems to be bottoming out**
- **No acceleration of growth expected until mid-2013**
- **Risk-on markets tread water in the face of weak earnings and policy uncertainty**

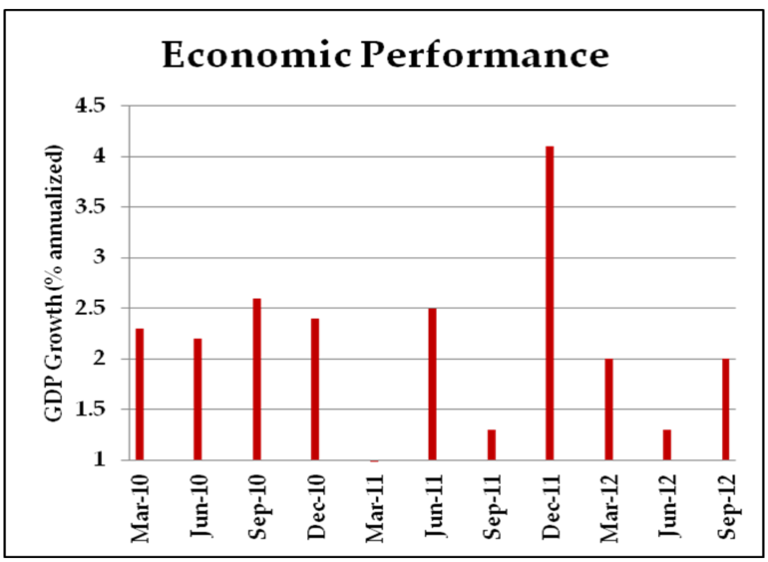
The Economy Inches Along: The first reading of third quarter GDP growth reflect a weak economy growing at trend. (Keep in mind that these numbers are the first 3Q12 growth estimate and that they are subject to two revisions.) Output rose at an anemic 2%, slightly better than market expectation of 1.9%, and up from 1.5% in 2Q12. The economy continued to show sharp divergences. On one hand, the biggest contributions to growth came from the consumer side, residential investment and government (the latter mostly from a sharp jump in defense spending). On the other, net exports, fixed business investment, inventories and state and local government all shrank.

Table 1: GDP Growth Composition (% annualized)

	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12
GDP	0.1	2.5	1.3	4.1	2	1.3	2
PCE	3.1	1	1.7	2	2.4	1.5	2
GPI	-5.3	12.5	5.9	33.9	6.1	0.7	0.5
GOV	-7	-0.8	-2.9	-2.2	-3	-0.7	3.7

Consumer Prospects Brighten: Two trends stand out in the U.S. economy. First, the consumer rebound seems to be continuing; and second, manufacturing has hit a soft patch, but could have bottomed out. Consumer confidence, supported by an improving labor market, a positive wealth effect and stabilizing gasoline prices, continued to rise. The University of Michigan survey reached a 4-year high in October, while the Conference Board measure of consumer confidence rose to a 6-month high. Disposable income and personal consumption expenditures rose by 0.4% and 0.8% month-on-month (m/m) respectively, and retail sales increased by 1.1% m/m, the third consecutive increase. The brighter consumer confidence outlook is also reflected in a rise in the demand for auto loans and mortgages in 3Q12. Industry and manufacturing remain weak, but activity in these sectors may have leveled off. Surveys also showed improvement. The Empire State survey of manufacturing in the New York area remained negative, but less so, while the Philadelphia Fed survey turned positive. The Chicago PMI inched up towards 50, rising from 49.7 to 49.9 at the end of October. The U.S. Markit PMI-manufacturing was stable at 51.0, and the ISM Manufacturing rose to 51.7 from 51.5. Industrial production rose by 0.4% m/m and durable goods jumped by 9.9% m/m. Automobile sales (annualized) in September reached 14.9 million vehicles, the highest level since March 2008. The ISM-nonmanufacturing fell slightly in October from 55.1 to 54.2.

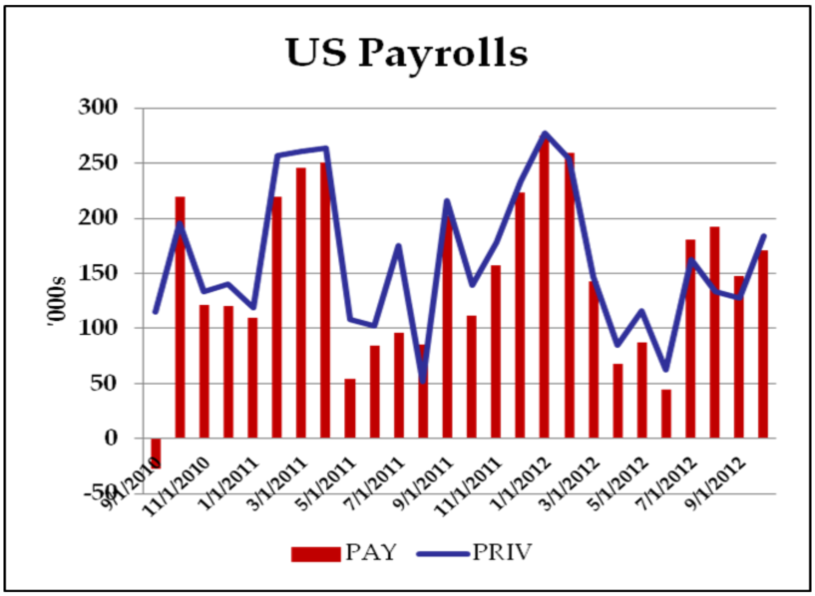
Fig. 1: US GDP Growth



Labor Markets Improve: October payrolls delivered a strong positive surprise, with employment up by 171,000, almost 50,000 over market consensus. In addition, payroll numbers in the previous two months were revised upward by an aggregate 84,000. Private payrolls increased by 184,000, with gains across the board: private services (+163,000), manufacturing (+13,000), and construction (+

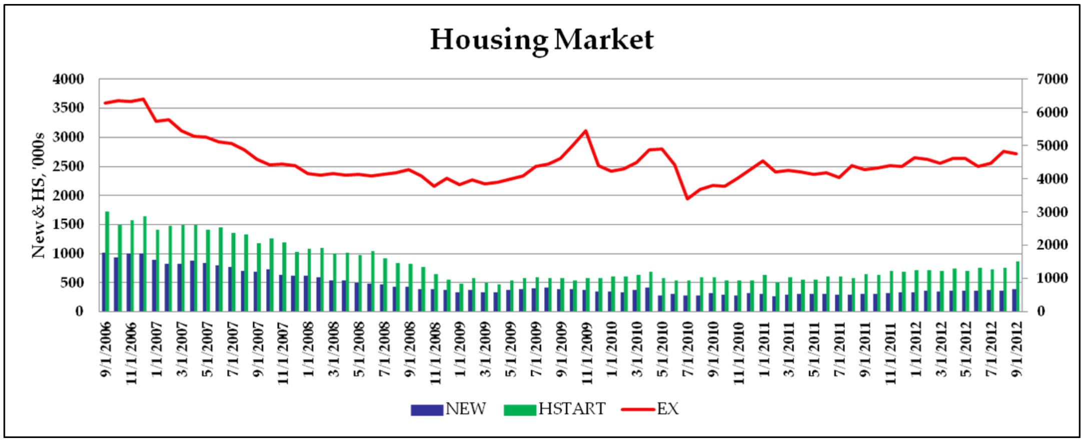
17,000). The unemployment rate, which is derived from a separate household survey, inched up from 7.8% to 7.9%, reflecting a rise in the labor supply (the participation rate inched up by 0.2% to 63.8%). The strong payroll report was somewhat offset by weak labor earnings result—flat weekly hours worked and slowing wage inflation. In combination, the labor earnings' proxy rose by only 2.4% (annualized) in the last three months. High frequency data also point out to a labor market improvement, with first time jobless claims falling to 363,000 in the first week of November. We should note however that labor market data was collected before Sandy hit the American shores, and related data in the next few weeks is likely to be highly volatile.

Fig. 2: <u>Payrolls</u>



Housing on the Mend: The housing market recovery seems well under way. Housing starts rose to a four-year high, while new home sales also increased to a 3-year high. Existing home sales remained constant at 4.75 million units, paradoxically because of the low inventory. Home prices also continue to recover. The Case-Shiller price index rose by 0.5% m/m (+1.2% year-on-year) in August, the seventh consecutive monthly (and the third consecutive year-on-year) increase. Overall, everything else equal, the solidifying gains in housing and real estate should contribute to a firming up of the economy through a rise in construction jobs, stronger demand for construction material and a further boost in consumer confidence.

Fig. 3: <u>Housing Data</u>



The Global Economy Quiets Down: The global economy continues to be dominated by the European financial crisis and Chinese growth prospects. While unemployment in Europe is reaching record highs, (and has started rising in Germany), European financial markets have experienced a lull. Spain, Italy and even Greece have seen a shrinking of their risk premium and have been able to issue bonds at lower yields. The European Central Bank's commitment to act as a backstop to troubled eurozone countries' bond issues seems to have calmed financial markets and bought time for policymakers, even if most of the key eurozone policy issues remain unresolved. China's PMI –Manufacturing rose for the first time in four months, edging over 50, indicating that the Chinese economy may have stabilized, albeit at lower growth levels of 7-8%.

The Fed on a Steady Course: The October 23rd-24th meeting of the Federal Open market Committee (FOMC) did not lead to any new developments. The FOMC reiterated its message of a weak economy, and monetary policy remained unchanged: the Fed funds rate will stay close to zero for the foreseeable future, "Operation Twist" is in place to the end of the year, and open-ended quantitative easing continues.

Superstorm: The Sandy Super storm created havoc all the way from the Eastern seaboard to the Midwest, causing death, massive destruction and plunging 8 million people in the dark. However, while the immediate negative impact could last weeks, if not months, the long-term economic impact of the storm should be limited. Nevertheless, we should recognize that there is considerable uncertainty, and the final tally of losses tied to the storm is weeks, if not months away. However, it will probably figure in as one of the major natural disaster related economic shocks.

- In the past 20 years, the highest-cost storm in terms of human lives and financial cost was Katrina (2005), with over 1,000 fatalities and costs well over $100 billion. Katrina was followed by Andrew (1992, $45.6 billion, Ike (2008, $37.6 billion), Wilma (2000, $29.2 billion) and Irene (2011, $19 billion).

- The impact can be divided in three parts: immediate and short-term, medium-term and long-term. The area damaged by the storm along the Eastern Seaboard accounts for 20% of the US population and 27% of GDP. Thus, Sandy's immediate cost could be $100 billion-plus: a loss of output of about 0.5% of GDP, or $70 billion and physical damage of about $20-30 billion. There will also be some disruption of the pre-Christmas season supply chain—although there is still enough time to reroute shipments. However, assuming that reconstruction and recovery will start immediately, the impact on 4Q12 GDP could be smaller, around 0.2% of GDP.
- The medium-term macroeconomic picture should be better, since natural disasters have little medium-term impact on economic growth in advanced economies. The reconstruction and recovery efforts, funded by both insurance companies and government, should easily offset the early losses, and in fact could contribute to an acceleration of economic growth in 2013. In the longer term, an upgrade of the coastal infrastructure to withstand what have become more frequent major storms could positively affect economic growth and productivity.

Oil markets: Sandy had a limited impact on oil markets, as oil refineries in particular escaped major damage and quickly resumed normal operations. (The same thing happened in the aftermath of Katrina, when fears of major damage to oil facilities did not materialize.) Oil prices (West Texas Intermediate, WTI, $/barrel, bbl), have been on a downward path since peaking on 9/13/2012 at over $98/barrel falling by about 13% to around $85/bbl at the end of October, the lowest since mid-July. Crude price declines have translated into lower gasoline prices, providing households with welcome pocketbook relief at the pump and have played an important role in boosting consumer confidence. Oil prices are expected to remain in the $85-90/bbl range for the next few weeks as a result of abundant global supplies, weak demand from China and record levels of US crude inventories.

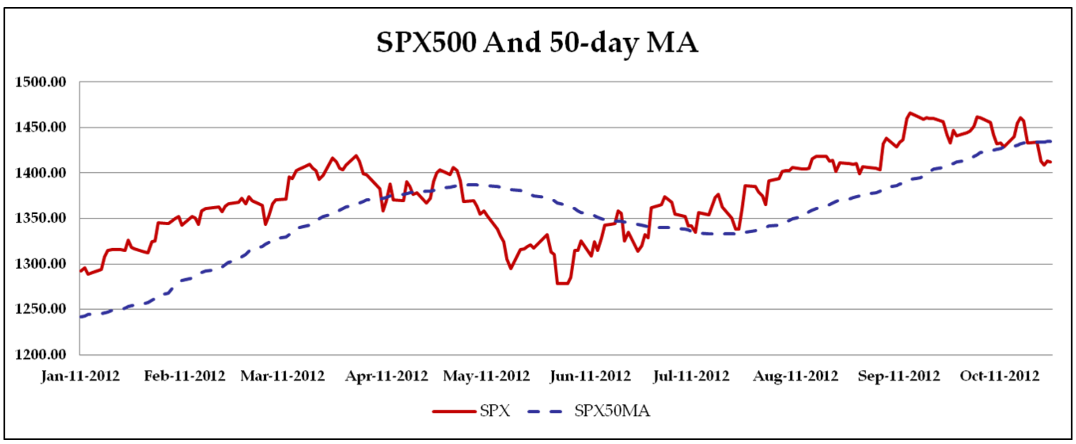
Headwinds or Momentum? The latest batch of economic data seems to indicate that once again, we are on the cusp of somewhat improved economic performance, with continued optimism on the consumer side, solid gains in housing and some degree of stabilization on the manufacturing side. Yet, neither the existing headwinds nor the uncertainties have been removed. If anything, Europe is drifting into a second recession in five years, while Chinese and emerging markets growth remains weak.

Over the past eight quarters, the economy has been growing by an average of about 2%, so 3Q12 performance is essentially at trend. However, this trend growth has masked increased sectoral volatility. Manufacturing and business investment, which were strong growth drivers in 1Q12, have been in retreat ever since, with households and residential investment taking over.

The fiscal cliff continues to create uncertainty. Prior to the election the Economic Policy Uncertainty Index (created jointly by professors at Stanford and the University of Chicago) reached a one-year high.

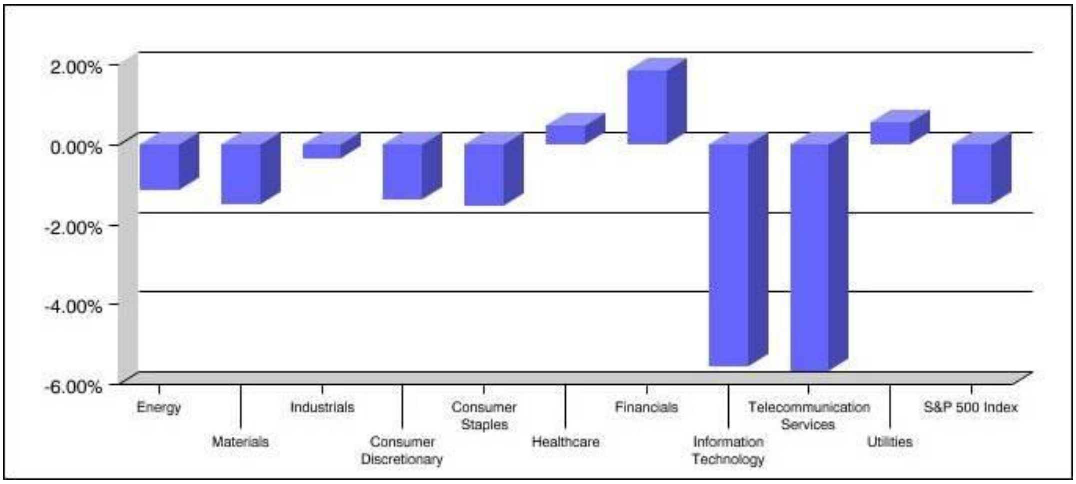
Broadly speaking, the prospects of sharp government cutbacks and higher taxes are a negative for the economy, as abundantly proven with the European experience with austerity measures of the past three years. The president and the Republican Congress are under huge pressure from the business sector to compromise on the cliff issue. Nevertheless, even if the two sides agree on a solution to the fiscal conundrum, the economy faces a drag on economic growth coming from the end of the payroll tax relief (which will be equivalent to a $125 billion tax increase, close to 1% of GDP) and further reductions in federal expenditures. This drag could be offset by the positive impact on business confidence and markets, once a deal is reached between the White House and Congress. Moreover, any solution to the cliff problem is likely to be part of a broader long-term deficit reduction plan, another positive factor for the economy. Nevertheless, these uncertainties potentially could remain well into 2013, making forecasting even more difficult. The three other potential sources of economic shock (Europe, another Middle East war, and a sharper slowdown in economic growth in China and other main emerging markets will continue to loom over the global economy. Overall, we do not expect an acceleration of growth above the 2% trend level before the middle of 2013.

Fig. 4: S&P500 falls below 50-days moving average



Risk On: The financial markets greeted President Obama's re-election with a sharp correction, continuing the risk-on mode which began at the start of the fourth quarter, following a bullish third quarter. Sandy also forced the financial markets to close for two days, prior to that unusual closing, the markets were very volatile in October, with the S&P500 in the 1,408 to 1,461 range, reaching a 58-month high on October 16th and then dropping by 3.4% for the month (to 1,411) on October 26th, the last trading day before Sandy forced the markets to close.

Fig. 5: S&P500 (30-days performance, Oct 2012)



Markets fueled mostly by super-easy monetary policy seemed to catch up with both macro and micro-economic risks. On the macro-side, weak growth and fiscal uncertainty dominate market sentiment. On the micro side, while 71% of the S&P500 companies reporting beat their estimates, a similar percentage reported falling sales. Overall, for most of the S&P500 companies reporting, 3Q12 profits were flat or down, with some of the major bellwether companies (UPS, Fedex, Alcoa) reporting declines in 3Q12 earnings. Overall, most of the S&P500 subsector indices were in the red for October, with the exception of Financials, Utilities and Healthcare, with Information technology and Telecoms losing the most.

The earnings situation is not expected to improve in 4Q12 or 1Q13 considering the current slow-growth climate and lack of further cost savings available to domestic companies as they have already wrung most of the inefficiencies from their operations. Globally, weakening growth is cutting into the overseas profits, which account for a significant portion of US multinationals' earnings. Overall, the S&P500 is expected to move sideways, and will probably have a hard time breaking through the 1,500 level in the next few months.

October 2012 Economic Data

October 2012	Prior	Consensus	Actual	Min	Max
Macroeconomy					
GDP (3Q12, % Annualized) 1st estimate	1.3%	1.9%	2.0%	1.0%	3.9%
CPI (m/m) Sep	0.6%	0.5%	0.6%	0.3%	0.6%
Core CPI (% m/m) Sep	0.1%	0.2%	0.1%	0.1%	0.2%
Balance of Payments					
Exports (% m/m) (Aug)	-1.0%				
Imports (% m/m) (Aug)	-0.8%				
Trade Deficit $ billion (Jul)	$42.0				
Current Account Deficit ($ billion) (2Q12)	$117.4				
Industrial Production					
Empire State (Oct)	-10.41	-3.0	-6.16	-6.5	-1.0
Philadelphia Fed (Oct)	-1.9	0.5	5.7	-2.0	5.8
ISM-Mfg Oct	51.5	51.5	51.7	49.5	52.0
Chicago PMI (Oct)	49.7	51.0	49.9	49.5	52.0
Markit PMI Mfg Oct	51.1	51.5	51	50.6	52.0
Industrial Production (% m/m) Sep	-1.4%	0.2%	0.4%	0.0%	1.0%
Durable Goods (m/m) Sep	-13.1%	7.0%	9.9%	3.5%	12.1%
Durable Goods, ex transp (m/m)	-2.1%	1.0%	2.0%		
Inventories (m/m) Aug	0.8%				
Factory Orders (m/m) Aug	-5.1%	4.9%			
Services					
ISM non-mfg Sep	55.1	54.9	54.2	53.0	56.0
Consumer Spending					
Retail Sales (% m/m) Sep	1.2%	0.7%	1.1%	0.4%	1.3%
UMich Consumer Sentiment (2d half Oct)	83.1	83.1	82.6	76	85.0
ConfBd Consumer Confidence	70.3	74.0	72.2	68.5	76.0
Personal Income (m/m) Sep	0.1%	0.4%	0.4%	0.1%	0.6%
Consumer Spending (m/m) Sep	0.5%	0.6%	0.8%	0.3%	0.8%
Housing Market					
Housing Starts ('000) Sep	758	765	872	745	785
New Home Sale ('000) Sep	368	385	389	373	410
Existing Home Sales (MM) Sep	4.82	4.75	4.75	4.53	4.82
Case Shiller-20 (m/m) SA Jul	0.4%				
Case Shiller-20(y/y) Jun					
Employment					
First Time Claims ('000) (1st week Nov)	372	369	363	361	380
Non-Farm Payroll (Oct)	148,000	125,000	171000	30,000	168,000
o/w Private Sector (Oct)	128,000	120,000	184000	104,000	167,000

Dr. Pakravan has been a senior economic strategist in global financial markets for 25 years. Dr. Pakravan is a recognized specialist in leading-edge applied macroeconomic and financial research on currencies and emerging markets, country risk assessment and modeling in an enterprise-wide risk management context, as well as international financial architecture. Dr. Pakravan has a Ph.D. in Economics, University of Chicago, a M.Sc. in Econometrics and Mathematical Economies, London School of Economics, and a B.A. in Mathematical Economics, University of Geneva. He is the author of numerous publications and is an Associate Professor of Finance at the Kellstadt Graduate School of Management at DePaul University.