



Outlook and Market Review – First Quarter 2014

GDP growth was a dismal 0.1% in the first quarter according to the preliminary announcement by the Bureau of Economic Analysis. Growth in the fourth quarter was revised up to 2.6%. First quarter growth was below expectations, partly due to severe weather, but a number of fundamental weaknesses in the economy were also in play. The only positive component in GDP was consumption spending. Spending growth exceeded growth in personal income resulting in a decline of the saving rate to 4.1% in March with a continued decline to 3.8% in April. Consumers used nonrevolving credit heavily to support spending. High levels of consumer demand is encouraging but growth in personal income, growth in housing and equity values, and low interest rates will all be needed to generate sufficient spending for higher growth.

Job growth is rebounding and it appears as if the economy will expand employment by over 200,000 jobs per month. The unemployment rate fell to 6.3% from 6.7% in April, but much of the decline was due to another dip in the labor participation rate. Approximately 800,000 workers left the labor force and only a small amount of this reduction in work force was attributed to retirements. Even though the unemployment rate dipped below the 6.5% Fed target, the Fed will continue to provide ample liquidity and keep short term interest rates low. Fed tapering in the first quarter of approximately \$30 billion purchases in open market securities has not resulted in higher long term interest rates. The 10-year Treasury yield is currently 2.65% compared to a 3% yield at the start of the year. The Fed recently pledged to keep interest rates low even as unemployment continues to decline. Low inflation and excess capacity offer room for the Fed to follow easy money policies as the labor markets improve.

Housing should help boost GDP growth for the remainder of the year. Housing prices have been rising due to low inventories and favorable mortgage rates. Pent up demand and good weather should begin to bring on more housing construction. Credit conditions are improving and job expansion should allow for more household creation as younger workers begin to move out on their own. Business investment is likely to remain constrained due to excess capacity and high business uncertainty with respect to taxes, regulation, employee costs, and pricing power. Government will be a drag as initiatives to bring the budget under control continue. Trade may help somewhat but global economies continue to struggle with below trend growth.

Professional forecasters are likely to be too optimistic in their forecasts of a rebound around 3% for the remainder of 2014. Consumer spending will likely boost the economy but constraints on disposable income will limit the contribution to 2.5% or so. Housing will also offer a stimulus to GDP but Private Investment, Government, and Trade are likely to be drags on GDP. A more likely scenario is growth around 2.5% and continued low inflation (with the exception of higher food prices), low interest rates, and continued improvement in job growth.



Forward Guidance – The Fed Pledges Low Interest Rates

The April meeting of the Federal Reserve Open Market Committee (FOMC) resulted in a news release designed to calm the markets. Consistent with the Fed's forward guidance policy there was a pledge to keep the Fed Funds rate below normal even when the economy reaches full employment. This announcement is designed to manage expectations and suggests a commitment to easy money and ample liquidity even as tapering of long term bonds purchases takes place. Futures markets reacted by pricing in low expected short term interest rates. The futures contracts ending in 2016 reveal a 2% expected rate. The longer run "normal" Fed Fund rate is about 4%.

The forward guidance position of the Fed is based on an unusual set of economic relationships in the economy. The unemployment rate is currently 6.3%, which is below the Fed's prior target of 6.5% for full employment. Normally, the unemployment rate is the last measure to pick up in a recovery. Full employment occurs when the economy is operating at full capacity with a high GDP growth rate and when excess demand is building. The current situation is a stark contrast to normal relationships. Currently, the 6.3% unemployment rate has been achieved while there is significant slack in the labor market, personal income is growing slowly, excess production capacity exists, inflation is dormant, and GDP growth is well below the long run trend. The Fed's pledge will not really be tested until other fundamentals in the economy show significant improvement or inflation takes a strong upward turn. Most analysts don't expect overall improvement consistent with full employment until sometime in 2016.

Only time will tell if the Fed has moderated its stance on inflation relative to economic growth. The composition of the FOMC is changing and the new Fed Chair has not yet been tested on the commitment to keep inflation low. Once started, price pressures can build rapidly and the Fed's track record is to raise the Fed Fund rate target more rapidly than expected. In the last three tightening cycles the Fed Fund rate has been raised more aggressively than the Fed projected. For now, the Fed is likely to keep short term rates well below normal and will offer liquidity to keep the economy growing.

The Fed tapering of its monthly bond purchase program has not led to higher long term rates as many analysts feared. The Fed announced another \$10 billion reduction in monthly purchases of Treasuries and mortgage-backed bonds at the April meeting. This brings the total reduction this year to \$40 billion of the \$85 billion total monthly purchase program. While tapering raised fears that longer term rates would rise as the Fed lowers its intervention position, the 10-year bond yield has actually declined since the start of the year. The yield at the start of the year was near 3% and is 2.54% in the third week of May. Figure 1 below illustrates the movement of the 10-year Treasury yield over the last calendar year. Fed tapering has not resulted in higher Treasury yields to this point. Even without artificial demand for Treasury securities by the Fed there appears to be ample demand keeping bond prices high and yields low.



Figure 1. Yields for the 10-Year Treasury over the last Calendar Year



Market Valuation – How Much More Room Remains for the Bulls to Run?

As the stock market flirts with all-time highs, many analysts are beginning to consider whether or not the market has more room for expansion. There are no sure-fire ways to determine the intrinsic value of the market in relation to the observed market pricing. Several alternative approaches are widely used in practice to gauge the extent to which observed market valuation is out of line with asset fundamentals. Three of the most popular measures of market over or under-valuation are examined in this section to include Shiller's cyclically adjusted price to earnings ratio (CAPE), the ratio of the market aggregate value to GDP (often referred to as the Buffet ratio), and Tobin's Q ratio.

Shiller's CAPE

The P/E ratio is arguably the most common method for determining valuations of both individual stocks and the market as a whole. The P/E ratio divides the current observed market price by the earnings of the trailing twelve months. A high P/E relative to a benchmark, such as the historic median value of the P/E, suggests a relatively high price given the earnings. Application of the simple constant growth dividend discount model for stock valuation illustrates how P/E ratios can be interpreted. It can be shown that the $P/E = (POR)(1+g) / (k - g)$ where POR is the payout ratio, g is the expected growth rate of earnings, and k is the required rate of return on equity (from the capital asset pricing model for example). These relationships suggest three reasons for a high P/E:



- 1.) high expected growth in earnings
- 2.) low required rate of return on equity (low risk and/or low market interest rates)
- 3.) overvaluation

Before a high P/E can be considered to be due to overvaluation the analysts must first determine if the high P/E is due to high earnings growth or low required rate of return on equity.

Using the P/E of the aggregate stock market to judge over and under-valuation is faulty when temporary business cycles cause earnings to either be temporarily depressed or exaggerated. Professor Robert Shiller of Yale University invented the cyclically adjusted price to earnings ratio (CAPE) to address this problem in P/E analysis. CAPE is calculated by taking the S&P 500 and dividing it by the inflation adjusted average of the last ten years of earnings. A naïve approach to interpreting CAPE is to simply compare the current value of the market CAPE to a long term measure of its normal value, such as the median CAPE. If the current CAPE is above the long-term median of 15.92, the stock market is considered expensive. Currently the CAPE is 25.58. Figure 2 below shows the time series of Shiller's CAPE.

Figure 2. Shiller CAPE Ratio for the S&P 500 (Median = 15.92; Current Value = 25.58)



Note: Maximum Value = 44.20 (December 1999)
Minimum Value = 4.78 (December 1920)

The fact that the current CAPE is so much higher than the historic CAPE is not a reason to panic and sell stocks. The CAPE can stay above the long run average for long periods of time as the graph above illustrates. A high CAPE is justified as long as the market expects aggregate corporate earnings to grow faster than normal or if the market has a lower than normal required rate of return on equity. CAPE is more useful in predicting longer-term returns. Studies have shown that subsequent 10-year rates of return on the market are lower the higher the CAPE at the start of the period. Shiller recommends using CAPE as a diversification guide rather than a market timing tool. An investor should never get completely in or completely out of stocks. The higher CAPE is relative to a benchmark the more you gradually move out of the market. In



short, with a high CAPE it may be that a CAPE can continue to be high but the investor should be more cautious and expect lower returns for the years to come.

Aggregate Stock Market Value to GDP – The Buffet Ratio

Warren Buffet's favorite measure of stock market under or over-valuation is defined as the total market capitalization to the total dollar value of the GDP. This metric can also be compared to an economy wide price to sales ratio. The calculation of the ratio is straight forward. The denominator (GDP) is the total dollar amount of goods and services produced within the U.S. in the last year. The total dollar amount of the market capitalization of all publicly traded equities is determined by adding up the market capitalization of several thousand publicly traded companies to determine the numerator (99% of the aggregate market cap in the U.S. is contained in the 3,000 largest publicly traded companies). The general interpretation of the ratio calls for a warning signal when the ratio exceeds 100%. The inference is that the economic output of a country, the earnings of its companies, and the valuation of these companies should bear some relationship to the attraction of investing in stocks. Normally, the ratio is below 1.0 and a ratio above 1.0 suggests higher than normal valuation. Figure 3 below illustrates the time series of the Buffet ratio. Currently, the ratio is 1.26 compared to a long run median value of .81. This relationship suggests market overvaluation.

Figure 3. Ratio of Aggregate Market Capitalization of Publicly Traded Stocks to GDP



The Buffet ratio rarely exceeded .8 until 1997 with the dot.com bubble when the ratio reached an all-time high of 1.55 in 2000. The ratio reached 1.15 in 2007 just before the housing bubble burst. However, the ratio exceeded 1.0 for a number of years before the market turned down, in 2000 and 2008, suggesting that reacting too soon may lead to sitting on the sidelines for years before the downturn. Taken by itself, the Buffet ratio coincides with elevated market valuations but it is a very blunt timing tool. It is attractive because it signals where market valuations stand at a given date and can condition expectations for future returns given these valuation levels.



Tobin's Q Ratio – Market Value to Replacement Costs of the Aggregate Market Assets

The CAPE and Buffet ratio both view market valuation in relation to income statements (earnings or sales) in the equity market. An alternative view comes from looking at how the financial market values the balance sheet (assets) of firms in the market. Tobin's Q was introduced in 1968 by economists James Tobin and William Brainard. The Q is the ratio between the market value and replacement value of the same physical asset. The Q ratio links financial market valuation with assets rather than earnings or profitability. The Q ratio is used to confirm the conclusions from measures based on earnings.

The formula for the stock market Q ratio is the ratio of the aggregate value for the stock market dividend by aggregate corporate net worth (rather than the replacement value). The Q ratio is essentially the market to book ratio for the stock market. If the market value reflected solely the recorded assets of a company, Tobin's Q would be 1.0. If the Q is greater than 1.0 the market value reflects an added premium paid for the stock. Overvalued markets have high Q ratios and undervalued stock markets have low Q ratios. When market-wide Q ratios are high investors tend to be overly optimistic and when Q ratios are low investors tend to be overly pessimistic.

Figure 4 below shows the time series of Tobin's Q ratio for the U.S. stock market. The median value of Q is .7 and the current value is 1.09. The Q value rarely exceeds .85. Currently the Q value of 1.09 is high and tends to confirm the conclusions reached from the CAPE and from Buffet's market capitalization to GDP ratio. But, like the other measures the Q ratio can stay above the median for a number of years before the correction occurs.

Figure 4. Tobin's Q Ratio (Median = 0.7; Current Q=1.09)





Summary of Recent Economic Data

GDP and Production – An unexpected slump in the first quarter makes it unlikely that the economy can reach the overall 2.8% growth rate forecast for 2014 by the Survey of Professional Forecasters. The economy should pick up steam in the last three quarters but growth for the year will likely be closer to 2.4% than the 2.8% forecast. Consumer spending is the only GDP component to consistently add to growth. Going forward, consumers are not likely to sustain current spending rates without more robust increases in personal income and continued growth in equity values. Higher taxes, falling equity values, and loss of consumer confidence would be especially damaging to the economy at this point.

- Real GDP grew at a seasonally adjusted annual rate of only 0.1% in the first quarter of 2014, according to the BEA's preliminary estimate. First quarter growth was well below expectations (1.5%) and was the lowest since the last quarter of 2012. The 0.1% first quarter growth followed a 2.6% gain in the fourth quarter of 2013.
- Consumer spending contributed 2 percentage points to growth, slightly less than the prior quarter. However, it was the only major component of GDP to contribute. Investment, government spending and net exports all fell.
- Real disposable income increased by 1.9% in the first quarter following a 0.8% gain in the fourth quarter. The saving rate fell from 4.3% to 4.1% in March and to 3.8% in April.
- The biggest drag on GDP came from reduced inventory. Even so, "Final Sales," which exclude the drag on GDP from inventories, rose only 0.7% for the quarter.
- Foreign trade also was a major drag, reducing growth by 0.8% after making a 1% contribution in the fourth quarter.
- Table 1 summarizes the last eight quarters of growth in GDP and its components.


Table 1. Annualized Percentage Change in GDP and GDP Components by Quarter

GDP Component	2014 Q1	2013 Q4	2013 Q3	2013 Q2	2013 Q1	2012 Q4	2012 Q3	2012 Q2
Real GDP Growth	0.11	2.63	4.13	2.48	1.15	0.14	2.78	1.20
Consumption	2.04	2.22	1.36	1.24	1.54	1.13	1.15	1.28
Fixed Investment	- 0.44	0.43	0.89	0.96	- 0.23	1.63	0.39	0.68
Inventories	- 0.57	- 0.02	1.67	0.41	0.93	- 2.00	0.60	- 0.91
Net Exports	- 0.83	0.99	0.14	- 0.07	- 0.28	0.68	- 0.03	0.10
Government	- 0.09	- 0.99	0.08	- 0.07	- 0.82	- 1.31	0.67	0.05

Source: Bureau of Economic Analysis

Note: Average annual growth rate for the last four quarters = $[(1.0011)(1.0263)(1.0413)(1.0248)]^{25} - 1 = \underline{2.327\%}$

Average annual growth rate for the last eight quarters =

$(1.0011)(1.0263)(1.0413)(1.0248)(1.0115)(1.0014)(1.0278)(1.012)]^{125} - 1 = \underline{1.819\%}$

- Business inventories increased 0.4% in March while manufacturer inventories rose 0.1%. Retail inventories were unchanged and wholesale inventories gained 1.1%.
- The business inventory-to-sales ratio increased to 1.3 in March and was above its year-ago level of 1.29. The manufacturer I/S ratio was unchanged from its year-ago level. The overall I/S ratio is above the cyclical low of 1.25 and below its high of 1.49 during the recession. Analysts expect inventory investment to boost GDP in the second quarter.
- Industrial production fell 0.6% in April, partly due to a 5.3% decline in utility production from more normal weather. Manufacturing production fell 0.4% in April.
- Capacity utilization fell from 79.3% in March to 78.6% in April. Inflationary pressures due to bottlenecks do not tend to build until capacity utilization approaches 82%.
- Seasonally adjusted nonfarm business productivity fell 1.7% in the first quarter. While the decline was larger than expected, prior forecasts were revised upward. Table 2. shows quarterly data for productivity, unit labor cost, and compensation per hour.

Table 2. Annual Percentage Change in Productivity, Compensation, and Unit Labor Costs

	2014 Q1	2013 Q4	2013 Q3	2013 Q2	2013 Q1	2012 Q3
Output per Hour	-1.7	2.3	3.5	1.8	-1.8	-1.5
Compensation per Hour	2.4	1.9	1.3	3.8	-5.3	10.2
Unit Labor Costs	4.2	-0.4	-2.1	2.0	-3.5	11.8

Source: Bureau of Labor Statistics



Inflation - Inflation remains low but it should pick up slightly during the remainder of 2014. While unemployment is below the Fed's target of 6.5% there still remains room for further improvement in the labor market and capacity utilization before price pressures develop.

- Producer prices were 0.6% higher in April following a strong 0.5% increase in March.
- The year-ago change in producer prices was a modest 2.1% but the rate picked up in the last few months. Table 3. shows the index data since September 2013.

Table 3. Percentage Change in the Producer Price Index – September 2013 to April 2014

Index	Apr 2014	Mar 2014	Feb 2014	Jan 2014	Dec 2013	Nov 2013	Oct 2013	Sep 2013
PPI – annualized % change	0.6	0.5	-0.1	0.2	0.0	0.0	0.3	0.1
Year-ago Percentage Change	2.1	1.5	0.9	1.2	1.1	1.2	1.2	1.1

Source: Bureau of Labor Statistics

- The personal consumption expenditures index (PCE) increased at an annualized rate of 1.4% in the first quarter and 1.1% in the prior quarter. The core PCE, excluding food and energy, rose 1.3% in both the first quarter of 2014 and last quarter of 2013. April's 0.3% increase in the consumer price index was the largest in almost a year. Higher gasoline and food prices were key drivers of the overall index. The core CPI also posted a sizeable gain of 0.2% on broad gains. Consumer prices will likely strengthen through the year with higher food and energy price pressure.
- The year-ago rate of inflation for the CPI was 2% and 1.8% for the core CPI. Table 4 summarizes monthly CPI and Core CPI Changes since September of 2013.

Table 4. Percentage Change in the Consumer Price Index -September 2013 to April 2014

Index	Apr 2014	Mar 2014	Feb 2014	Jan 2014	Dec 2013	Nov 2013	Oct 2013	Sep 2013
CPI	0.3	0.2	0.1	0.1	0.2	0.1	0.0	0.1
Core CPI	0.2	0.2	0.1	0.1	0.1	0.2	0.1	0.1

Source: Bureau of Labor Statistics

- The implicit price deflator used to adjust from nominal to real GDP also remains well below 2%. Table 5 below summarizes the quarterly deflator data.



Table 5. Implicit Price Deflator – Second Quarter 2012 to First Quarter 2014

Implicit Price Deflator	2014 Q1	2013 Q4	2013 Q3	2013 Q2	2013 Q1	2012 Q4	2012 Q3	2012 Q2
Annual % Change	1.30	1.58	1.97	0.58	1.67	1.43	2.09	1.77

Source: Bureau of Economic Analysis

Labor Market, Employment, and Income – The first take on the labor market data is encouraging. The unemployment rate fell to 6.3% in April from 6.7% and monthly payrolls expanded by over 200,000 jobs per month since January. The broad-based U6 unemployment rate fell from 12.7% to 12.3%. Yet, growth was essentially unchanged in average hourly earnings and the workweek held steady at 34.5 hours. A very sharp reduction in the labor force moved the labor force participation rate to a post-recession low of 62.8%. The labor market is improving but the lack of wage pressure and excess capacity in the economy suggests that the full employment rate is much lower than 6.3%.

- The unemployment rate fell by 0.4% to 6.3% in April but the decline was created by a large drop in the labor force and labor force participation. Approximately 800,000 people dropped out of the labor force. The dropout was equally spread across age groups, suggesting that retirement was not the driving force behind the shrinking labor pool.
- Payroll employment in April grew by 288,000 jobs following a revised 203,000 increase in payrolls in March. Revisions for March and February resulted in payroll gains over 200,000 in each of those months.
- Average hourly earnings remained unchanged in April with the average hourly wage rate at \$24.31. There was no change in the workweek, which stands at 34.5 hours. The net result of flat average hourly earnings and flat hours worked left the average weekly earnings unchanged. Increased employment without extending the workweek suggests that employers were “catching up” in hiring rather than expanding the use of labor.
- Monthly employment data are provided in Table 6 below.

**Table 6. Monthly Labor Market Statistics from September 2013 through April 2014**

	Apr 2014	Mar 2014	Feb 2014	Jan 2014	Dec 2013	Nov 2013	Oct 2013	Sep 2013
Unemployment Rate (%)	6.3	6.7	6.7	6.6	6.7	7.0	7.2	7.2
Labor Force Participation Rate (%)	62.8	63.2	63.0	63.0	62.8	63.0	62.8	63.2
Change in Nonfarm Payrolls (thousands)	288	203	222	144	84	274	237	164
% Change in Average Hourly Earnings	0.0	0.1	0.3	0.2	0.1	0.2	0.1	0.1
Average Workweek (hours)	34.5	34.5	34.3	34.4	34.3	34.5	34.4	34.5

Source: Bureau of Labor Statistics

- Real personal income rose 0.4%, in March following a 0.3% growth rate in the prior two months. Wage income grew by 0.6% in March and dividend income gained 1% for the second straight month. Personal income growth failed to keep up with consumer spending .
- Real consumer spending accelerated in March with a 0.7% growth rate following a 0.4% growth in February. March's gain in real consumer spending is the highest rate since August of 2009. Vehicle spending was the primary driver of the increase. Consumer spending growth in excess of personal income growth resulted in a continued trend of a declining saving rate. The real saving rate dipped to 3.8% in April, which is the lowest since 2008.
- Growth of real consumer disposable income in March matched the 2.2% rate of February. Consumer spending is clearly fueled by “wealth” from refinancing, equity market gains, and rising housing values rather than income. This fact suggests that the “recovery” is very fragile and dependent on sustained equity market growth and a continuation of low interest rates. The Fed is taking note of these relationships and will continue to offer ample liquidity to keep equity values growing.
- Table 7 shows monthly data on personal income, consumption, saving rates, and disposable income.

Table 7. Real Income, Consumption, and Saving – March 2014 to August 2013

	Mar '14	Feb '14	Jan '14	Dec '13	Nov '13	Oct '13	Sep '13	Aug '13
Real Personal Income (% Change)	0.4	0.3	0.3	-0.2	0.2	-0.1	0.3	0.4
Real Consumption (% Change)	0.7	0.4	0.1	-0.1	0.5	0.3	0.2	0.2
Saving Rate (%)	3.8	4.2	4.3	4.1	4.3	4.6	5.1	4.9
Real Disposable Income (Year ago % Change)	2.2	2.2	2.8	-2.7	0.6	1.8	2.2	2.0



- Durable good spending increased by 2.6% in March with a 0.8% gain in nondurable goods and a 0.7% increase in services. Consumers are beginning to spend on durable goods as they react to pent-up demand, even though personal income is not supporting large ticket item goods.
- Retail sales posted a rather anemic 0.1% gain in April following a revised 1.5% gain in March. Sales in April were 4% above their year-ago level and well above winter lows. Retail sales slumped at the end of 2013 and have been slow to recover in 2014.
- Consumer spending was fueled by credit in March. Consumer credit balances increased by \$17.5 billion in March following an increase of \$13 billion in February and \$13.4 billion in January. Most of the jump in total credit in March was due to the \$16.4 billion increase in non-revolving credit. Consumers took advantage of low interest rates to finance large ticket items, which also helps explain the boost in durable good consumption in the first quarter.
- Consumers have been cautious with revolving credit but have been aggressively using nonrevolving credit. Table 8 below shows the monthly increase in total consumer credit as well as the corresponding increases in the revolving and non-revolving components.

Table 8. Consumer Credit and Credit Components – August 2013 to March 2014

	Mar '14	Feb '14	Jan '14	Dec '13	Nov '13	Oct '13	Sep '13	Aug '13
Total Consumer Credit (\$ billions)	17.5	13.0	13.4	15.6	8.1	16.9	16.6	14.8
Revolving Credit (\$ billions)	1.1	-2.7	0.7	4.1	-2.7	2.8	0.2	0.2
Nonrevolving (\$ billions)	16.4	15.7	12.7	11.5	10.9	14.1	16.4	14.6
Total Consumer Credit (Annualized % Change)	6.7	5.0	5.2	6.1	3.2	6.6	6.6	5.9
Revolving Credit (Annualized % Change)	1.6	-3.7	1.0	6.0	-3.7	4.0	0.3	0.3
Non-revolving (Annualized % Change)	9.0	8.7	7.0	6.4	6.0	7.9	9.4	8.4

Source: Federal Reserve Bank

Sentiment and Confidence – Measures of confidence and sentiment in the economy are mixed. The University of Michigan Consumer Sentiment Index dropped in May with both the economic outlook and present conditions components falling. The Conference Board Consumer Confidence Index showed similar data. Yet, the Leading Index has increased for three consecutive months, consistent with an expansion later in the year.

- Consumer sentiment measured by the University of Michigan's Preliminary Index Report for May fell below analyst expectations. The index for May declined from 84.1 in April to 81.8. The economic conditions index fell from 98.7 to 95.1 and the economic outlook index fell from 74.7 to 73.2. Inflation expectations remained unchanged from April.



- The Conference Board Consumer Confidence Index® was 82.3 (for both revolving and non-revolving components.) in April, down from 83.9 in March. The Present Situation Index decreased to 78.3 from 82.5, while the Expectations Index was virtually unchanged at 84.9 versus 84.8 in March.
- The Conference Board Leading Economic Index (LEI) increased .8% in March to a level of 100.9. The base for the index is 2004 where the index = 100. The index has increased for three consecutive months with a 0.5% increase in February and a 0.2% increase in January. The three-month trend in the index suggests economic momentum and is consistent with a stronger recovery in the second quarter.
- The ISM nonmanufacturing index measurement for April improved to 55.2 from 53.1 in March. The index improvement made up for the 2.4% drop in February and is now at its highest reading since last August. An index over 50 suggests an expansion.

Housing - With the end of winter, home prices are showing a strong rebound. Distressed sales are slowing and are not as large a drag on sale prices. Housing inventory is thin and should prompt more homebuilding throughout the remainder of 2014. Housing is less affordable but lower interest rates since November should help ease financing costs in the second quarter.

- Home values were 8.6 % higher from the first quarter of 2013 to the same period of 2014.
- The U.S. CoreLogic Home Price Index rose 1.4% in March and increased by 11.1% on a year-over-year basis. The index is still 16% below its April 2006 peak, but is about 24% above its March 2011 trough.
- The U.S. CoreLogic house price index excluding distressed sales increased 0.9% in March and is 9.5% higher since March 2013. The index is 11.6% below its early 2006 peak but is about 20% above its February 2012 trough.
- April housing sales were reported to be 433,000 on an annualized basis. Housing sales in normal times are closer to 700,000 per year, suggesting that there may be a spring rebound in home buying.
- At the national level, housing affordability fell in March. The median single family home price was \$198,200, representing a 7.4% increase from one-year ago. Housing price gains are linked to a lack of inventory that will continue until housing construction picks up.



- Mortgage rates are up 72 basis points from one-year-ago and the overall affordability index is down from 195.3 in March 2013 to 170.3 in March 2014. Going forward, interest rates have moved lower over the last several months and lower rates should help potential homebuyers.

Federal Government Budget – *The federal government has reduced deficit spending to approximately half of the annual average for the last three years. Nevertheless, the Federal Government Debt will grow by approximately \$500 billion during the fiscal year and push the national debt to approximately \$17.7 trillion.*

- The cumulative fiscal year deficit has been \$306.4 billion over the first seven months, which is \$181.2 billion less than one-year ago. The federal government budget is positioned to be about half of the \$1 trillion plus annual deficits posted in the past years. Government national debt will still grow by about one-half a trillion dollars but the growth rate is smaller.
- Net interest payments on the national debt are down 3.9% to \$142 billion for the fiscal year.

International Trade and Global Economic Conditions - *The U.S., Latin America and East Asia are likely to lead world economic growth this year. Europe is still weak and will require many years to recover from the EU debt crisis. Growth in China is fragile and India is adjusting to a new set of policies directed by a new political party.*

- The U.S. foreign trade deficit for March narrowed to \$40.4 billion from a downwardly revised \$41.9 billion in February. Exports rose to \$193.9 billion from \$190 billion in February, while imports rose to \$234.3 billion from a downwardly revised \$231.8 billion. The March trade data reflects improvement in the U.S. economy and stronger U.S. exports suggests an improved global economy.
- The global economy is growing below trend. The OECD leading indicator for member countries and the six largest non-member economies is below 100.
- The euro zone is beginning to stabilize but the EU economies continue to struggle with high unemployment, spending cuts, weak demand, and shrinking tax revenues. For example, France cut spending by more than €50 billion but is still likely to miss the deficit target set by the EU. Fiscal austerity and high unemployment in southern Europe are adding to downward price pressures. Spain is under pressure to further raise the



country's value-added tax to maintain a target budget. Italy has less fiscal policy pressure but is constrained by tight bank lending and deflation. Rather than building healthy export relationships in the peripheral EU countries to correct current account problems adjustments have taken place with fiscal restraint and unemployment. Weakness in these periphery countries is making the recovery for the overall EU difficult.

- The Ukraine situation is causing euro zone business confidence to fade. Increased tension may raise energy prices and derail the European recovery. Russia's intervention and the prospect of further sanctions have not greatly affected the world economy thus far, but the potential for trouble is growing. A shutdown of natural gas exports through Ukrainian pipelines would eliminate a substantial chunk of Russia's foreign currency earnings. Combined with further sanctions, this could seriously damage the Russian economy, which is already experiencing problems due to a lack of business investment.
- China's growth is slowing due to a fragile banking system and a shift toward domestic consumption. China's financial institutions appear to be stabilizing, but policy mistakes would likely prompt a more serious downturn. China's banks clearly need help and it remains to be seen when and how the necessary bail outs will work. The People's Bank of China appears to be willing to take whatever steps may be necessary to prevent a financial crisis.
- Emerging market prospects also look brighter as improved domestic demand, stabilizing exchange rates and improvements in world growth are slowly taking place.
- India's outlook has improved but new initiatives linked to recent elections are not yet clear. Narendra Modi, the candidate of the BJP who has been the opposition party for the last ten years, has promised to address the corruption, inflation, and lack of cooperation between the provinces and the central government that deters foreign investment and business creation. On the other hand, the BJP's emphasis on economic nationalism is not a good sign for foreign investors.
- Latin America's larger economies had a difficult 2013 but are now facing better conditions. Brazil's is having a boost from the World Cup preparations. More important, the unwinding of quantitative easing in the U.S. has slowed capital inflows and reduced inflation pressures. Asset prices are returning to fundamentals making macroeconomic policy initiatives easier. Argentina and Venezuela have more serious problems. Political unrest is growing as middle class consumers are seeing living standards decline. Venezuela has a long standing problem with shortages of both goods and investments, but oil resources may allow for needed adjustments. Argentina does not have oil or other natural resource assets and is trying to find a mix of fiscal and monetary policies that will reverse capital outflows and help stabilize the currency.