Outlook and Market Review – Second Quarter 2014

GDP growth rebounded in the second quarter of 2014 from a contraction of 2.1% in the first quarter. According to the Bureau of Economic Analysis advanced report, the economy grew 4% in the second quarter. When revised, the growth rate is likely to be closer to 3.5% due to inflated inventory. For the first half of the year the annualized GDP growth rate was less than 1%. The U.S. economy is expected to grow at a 3% annual rate for the rest of 2014, according to a WSJ journal survey of 43 economists. Quarterly GDP growth has been on a roller coaster for the past few years. We have yet to see a trend of strong growth to support a view that the economy is emerging from sub-par growth. Since the Great Recession the average annual growth rate has been about 2.4%, well below the trend line growth. Even if expectations of a 3% growth rate materialize for the remainder of the year, the growth rate for all of 2014 will only be about 2%.

Low interest rates continue to give tailwinds to the economy but rates have been artificially low for over a decade. Displacements due to artificially low rates have hurt savers and have pushed many investors into higher risk alternatives in search of returns. There is no precedent for how to unwind this set of relationships after they have existed for so long. Wealth effects from higher asset prices linked to low interest rates have helped widen income inequalities with retired savers and low income households losing ground. This disparity will make it difficult to achieve broad based spending required for a normal recovery.

The labor market appears to be tightening even though the unemployment rate eased back up to 6.2%. Significant reductions in the unemployment rate may be hard to achieve going forward because there are large numbers of potential workers who are not yet "participating" by looking for work. As job openings improve it is likely that the participation rate will increase, offsetting the effect of job openings on the unemployment rate. The overhang of available workers may keep wage gains relatively low. Currently, consumers are relying on credit and low savings rates, but consumption driven by these factors is not sustainable.

Both interest rates and inflation rates remain relatively low. The Fed has already "tapered" $60 billion a month from its quantitative easing program but the Fed's action has been offset by bond buying linked to risk aversion and global demand for U.S. Treasuries due to lower interest rates abroad. Excess capacity, low unit labor costs, and weakness in global economies have all contributed to a low inflation environment, which also helps keep interest rates low.

Recent data on July sales suggest a slowing of consumer spending and downward revisions in analysts' forecasts for the third quarter growth. The housing market has flattened out and government spending continues to be a drag on the economy. Analyst consensus growth of 3% will be difficult to achieve. Inflation should continue to hover around 2%. The 10-year Treasury yield is currently about 2.4%. Job creation will continue at a pace over 200,000 per month but the unemployment rate is not likely to move far from 6.2%.

Fed Watching – Economic Growth is Good and Bad News for the Markets

The percentage of S&P 500 companies reporting higher than expected earnings in the second quarter of 2014 was higher than normal. Earnings growth in aggregate for the S&P 500 has been stronger on both a year-over-year and sequential basis. Valuation based on present values of some form of expected future earnings is now hinging on what will happen to the discount rates used in the valuation process. Other than shifting risk premiums caused by geopolitical chaos around the world, the future initiatives of the Fed take center stage.

Janet Yellen and the Fed Doves

The Fed's tapering program has $25 billion of the original $85 billion a month left in quantitative easing. The Fed chair, Janet Yellen, has announced a commitment to low interest rates and ample liquidity until next year. The landscape for the Fed in 2015 will depend on how the economy, especially the labor market, unfolds for the rest of 2014. Janet Yellen's background is rooted in labor economics, suggesting that she will be a strong "dove" with respect to the growth-inflation tradeoff. As such, it is unlikely that she will support the first Fed interest rate increase since 2006 until the economy is clearly at full employment. While there is some evidence of an improved job market there is little support for declaring full employment until there is a broad gain in wages and a clear convergence toward full capacity utilization rates.

Wages have not established an upward trend and disposable income is not growing as fast as production. Payrolls rose over 200,000 per month for six straight months and job openings reached 4.64 million in May. However, over 9.7 million job seekers are currently unemployed and there are more than 11 million over the age of 16 who have left the workforce (no longer seeking jobs) since 2009, but could return. This dynamic is likely to keep wages and consumer disposable income from dramatically improving this year.

The Fed Hawks

The view that the Fed should raise the benchmark Fed Fund rate this year has support from some of the Fed bank Presidents and members of the Board of Governors. Lessons from the past clearly demonstrate the risk of waiting too long to address inflation. The soundness of the dollar is a more important objective of the Fed according to the "hawkish" view and is the only long run objective that monetary policy can achieve. Easy money policies have been in play now for over a decade with unintended consequences ranging from speculative bubbles to income redistribution from savers to spenders. Support for pre-emptive Fed moves is also coming from economists at the Kansas City and Dallas Federal Reserve Banks who see the labor market at a turning point where wages will have healthy growth in the second half of 2014. A recent survey from the National Federation of Independent Businesses shows that small businesses increasingly plan to raise pay in the coming year. History shows that price inflation follows wage inflation and that a spiraling interaction of the two is very difficult to stop once it starts.

Investors are Fickle – Day to Day Gyrations

Analysts generally believe that there will be no change of Fed policy until the middle of 2015 but on any given day expectations change as economic data are released. Currently, market data are interpreted in terms of how the data might change the Fed's actions. This explains the rather odd observation on a given day when good news about the economy leads to lower equity valuation. It appears that in the short run the market is more fixated on interest rates than on growth.

Distortions from Easy Money Policies of the Past

All sectors of the economy have become wedded to low interest rates and easy money. Changes to more restrictive policies will have ripple effects and cause distortions during an adjustment period. For example, a recent FDIC report estimated that about one-third of U.S. banks are not prepared for interest rate hikes. Of the 2,900 banks reviewed, about 29% do not have balance sheet management programs in place to offset the risk exposure of higher interest rates. Without risk management programs, higher rates reduce the present value of long term assets more than the reduction in liabilities resulting in a loss of bank capital. This mismatch of durations of assets and liabilities creates a pending problem for solvency.

Easy Money-Cash Holdings and Leverage

Since 2008, the Fed's policies have allowed companies to buy back stock, pay dividends, and make acquisitions without tapping cash from overseas subsidiaries. By leaving foreign profit overseas, companies avoid paying the U.S.'s 35% federal tax rate. As a result U.S. companies have a record amount of cash holdings in foreign countries as well as at home. U.S. companies have also taken advantage of low rates by issuing record amounts of debt, both in nominal terms and as a percent of GDP. The economy is highly levered and the larger fixed cost increases the risk profile. From a household perspective, de-levering took place at the end of the recession. In its place we saw record growth in short term credit and a declining savings rate.

Easy Money -Macroeconomic Policy – No Room to Address a Downturn

From a macroeconomic perspective, prolonged easy money creates a situation where there is no room for Fed policy to maneuver if there should be another downturn. Monetary policy is already so "easy"; there is little room for additional measures to stimulate the economy. Once rates are driven to zero, it is difficult to do much more.

Easy Money - Moral Hazard – Artificially Low Interest Rates Lead to Excess Risk

Artificially low interest rates have prompted investors to take on more risk than they would under normal conditions and high risk assets become "over-priced." This phenomenon was behind the past stock market and housing market bubbles. A more current example is the high-yield debt market. In June 2013, after the Federal Reserve began hinting that it would scale back its monetary easing, the high-yield bond sector lost 2.62%. While "buyer-beware" is always present in investing, the Fed creates a type of moral hazard for investors leading to much higher risk profiles in the economy.

Moral Hazard – Artificially Low Rates lead to a Wider Gap in Income Distribution

The Fed's unprecedented QE bond buying program on top of a decade of artificially low interest rates has significantly benefitted owners of stocks, bonds and commodities that tend to be owned by higher income households. Lower income households do not own appreciating assets and have earned less from savings accounts while consuming more on credit. Higher commodity prices take a bigger relative chunk from low income budgets. For example, the stock market is up by more than 135% from its 2009 lows, benefitting primarily upper-income Americans. Meanwhile, prices for basic commodities from oil to coffee to eggs are up 40% since 2009. Low income households spend 10% of income on energy and about 33% on food.

The Bond Market – Risk Aversion, Global Easing, and Low Inflation

Yields on Treasury bonds have been falling in 2014 despite consensus analyst views at the beginning of the year that bond yields would rise. Given over a decade of artificially low interest rates with unprecedented monetary easing, conventional wisdom suggested that higher yields were inevitable. The Fed's systematic tapering program and unwinding of quantitative easing was first formally announced in May of 2013 and initiated a temporary rise in rates. Bond purchases have been scaled from $85 billion per month to $25 billion in August of 2014. Yet, the Fed is only one player in the bond market and other supply and demand pressures have kept rates low. The 10-year Treasury is currently hovering around 2.4% to 2.5%. The Figure below illustrates the movement of the 10-year Treasury yield over the past year.

Figure 1: 10-Year Treasury Yields over the Past Year

Source: Reuters

A combination of higher global risk aversion, global monetary easing, and low inflation has more than offset the Fed's tapering program. Geopolitical tensions have risen in Gaza, Iraq, Syria, and the Ukraine with renewed concerns that long protracted involvement by the U.S. and Europe are inevitable. Global investors have been reducing risk exposures by moving funds to safer holdings, causing renewed demand for U.S. Treasuries. Higher Treasury prices and lower yields are also linked to lower U.S. deficit spending, which reduces the supply of Treasuries, and global monetary easing. As foreign central banks keep interest rates low to stimulate their domestic economies, U. S. yields look more attractive on a relative basis. For example, the yield on 10-year German sovereign debt has fallen to 1.05% with even lower Japanese yields on 10-year sovereign debt hovering at 0.495%. The U.S. Treasury is a safe haven offering a higher yield than comparable debt offerings. A final factor leading to lower yields is a continued low level of inflation. Expected inflation is built into interest rates and expectations continue to be for low global price increases.

Higher grade corporate bonds have also benefitted from the flight to safety phenomenon and relatively higher rates in the U.S. Returns in the domestic bond market have been competitive with those in stocks so far this year, with the Barclays index rising 4.2% through July. High-yield bonds are in the higher risk category and risk premium spreads between high-yield and Treasury bonds returns have expanded, especially since the end of June. The high-yield spread to the Treasury yield was 335 basis points on June 23 and has now expanded to about 425 basis points.

Treasury Yields, Yield Curve Spread, and Expected Inflation Premium

Table 1 below provides data on current Treasury yields, yields one year ago, TIPS yields, and the implied expected inflation rates. These relationships reveal information about maturity risk spreads and market inflation expectations. The slope of the yield curve (difference between long term and shorter term yields) represents a maturity premium that has decreased from one-year ago. Over the past year investors have preferred longer term maturities over short term maturities, driving long term prices up and yields down relative to short term maturities. Normally, this is motivated by expectations that short term yields will remain low or sink lower.

Overall, yields are lower than one-year ago, even as the Fed has tapered its bond buying program. Demand for Treasuries has been propped up by investor flight to safety in response to global events in Ukraine, Syria, Iraq, and Gaza, not to mention defaults in Argentina, bank crisis in Portugal, and renewed problems in ECU countries. Low yields in other countries have also made the U.S. Treasury market relatively more attractive.

Treasury Inflation Protected Securities (TIPS) offer “real rates of return” to investors. The market yields on TIPS in the fourth column of the table represent the real rates of return for a given maturity. The fifth column of data represents market expected inflation rates for a given period. The expected inflation rates are only slightly higher than current inflation rates.

Table 1. Treasury Yield Term Structure with Nominal and Real Rates

Maturity	Treasury Yield Current	Treasury Yield One Year Ago	Current Real Yield (TIPS Yield)	Implied Inflation Expectations*
3 month	0.04%	0.06%		
1 year	0.1%	0.12%		
2 year	0.43%	0.34%		
5 year	1.59%	1.49%	-0.29%	1.88%
10 year	2.43%	2.71%	0.1%	2.33%
30 year	3.24%	3.75%	0.66%	2.58%

* *Expected Inflation = Nominal Rate – Real Rate (e.g., 2.435 – 0.1% = 2.33%).*

The data on Treasury yields suggests that investors do not expect higher short term rates for a very long time. Investors do have high risk aversion for inflation and accept very low real yields. There is an appetite for preserving capital in real terms rather than take a chance for loss of real value. For example, the historic real return on a risk free security is closer to 3% compared to only a 10 basis point real rate on the 10-year maturity.

Summary of Recent Data

***GDP –** The economy rebounded in the second quarter of 2014 from a contraction in the first quarter. Advanced estimates of 4% real GDP growth in the second quarter will most likely be revised downward to the 3.3% - 3.6% range. Overall, the economy grew less than 1% in the first half of 2014 and even with good growth in the second half, which is not certain; it is unlikely that a growth rate over 2% can be achieved for all of 2014.*

- According to the advanced estimate of real gross domestic product by the Bureau of Economic Analysis, the economy grew 4.0% in the second quarter of 2014. The first revision for second quarter growth will be released on August 28. The revision is likely to show lower growth than the advanced estimate of 4% due to overestimation of inventory investment. The revised estimate of GDP growth for the first quarter was a negative 2.1%. GDP growth for the first half of 2014 is less than 1%.

- The table below summarizes key drivers of GDP growth in the first two quarters of 2014. The consumer provided more support for growth in the second quarter, especially with durable goods consumption. Real residential investment and exports both picked up significantly in the second quarter. Components that slowed growth (noted in red) were imports, Federal government expenditures, spending on services, and spending on intellectual property.

Table 2. Comparison of First and Second Quarter Contributions to Growth

GDP Component	Second Quarter	First Quarter
Real Personal Consumption Expenditure	2.5%	1.2%
Durable Goods	14%	3.2%
Nondurable Goods	2.5%	0%
Services	**0.7%**	1.3%
Nonresidential Fixed Investment	5.5%	1.6%
Nonresidential Structure Investment	5.3%	2.9%
Equipment Investment	7%	-1%
Intellectual Property Investment	**3.5%**	4.6%
Real Residential Fixed Investment	7.5%	-5.3%
Real Exports	9.5%	-9.2%
Real Imports (**drag on GDP**)	**11.7%**	2.2%
Real Federal Government Expenditures	**-.8%**	-0.1%
Real State and Local Government	3.1%	-1.3%
Change in Real Private Inventories	1.66%	-1.16%

Note: Items in red contributed to slower growth in the second quarter.

- Real final sales of domestic product (GDP less change in private inventories) increased 2.3% in the second quarter, in contrast to a decrease of 1.0% in the first quarter.

- Disposable personal income increased 6.2%, in the second quarter following an increase of 4.9% in the first quarter. Personal income increased largely due to higher personal dividend income that offset low growth in wages and salaries. Real disposable personal income increased 3.8% in the second quarter following an increase of 3.5% in the first. Personal current taxes increased $15.2 billion in the second quarter, compared with an increase of $24.4 billion in the first.

- Personal saving (disposable personal income less personal outlays) increased to $682.9 billion in the second quarter from $629.0 billion in the first. The personal saving rate in the second quarter (personal saving as a percentage of disposable personal income) was 5.3% compared with 4.9% in the first quarter. The Figure below shows the long run decline in the U.S. savings rate following the 1982 recession. Since that time, there is a strong relationship linking the 10-year Treasury yield and the savings rate. As the long term interest rate declined consumers reduced savings in response to the lower returns on savings.

Figure 2. Personal Saving Rate and 10-year Treasury Bond Relationship

- Consumer credit increased at a seasonally adjusted annual rate of 7.8% during the second quarter of 2014, continuing a trend of growing use of consumer credit. Revolving credit increased at an annual rate of 5.4%, while non-revolving credit increased at an annual rate of 8.8% in the second quarter. In June, consumer credit increased at an annual rate of 6.5%. The Table below illustrates the rising pattern of credit use.

Table 3. Total, Revolving, and Nonrevolving Consumer Credit

	2009	2010	2011	2012	2013	QI 2014	QII 2014
Total	**-3.9%**	**-1.0%**	4.1%	6.2%	6.0%	6.7%	7.8%
Revolving (annual %)	**-8.8%**	**-7.6%**	0.2%	0.6%	1.3%	1.8%	5.4%
Nonrevolving (annual %)	**-1.0%**	2.7%	5.9%	8.6%	7.9 %	8.5%	8.8%

Note: Contraction in Consumer Credit is noted in red.

Production- *Production is picking up based on the recent ISM surveys, suggesting a stronger second half of 2014. Productivity is rising, keeping unit labor costs low. It still remains to be seen if consumer demand will be robust enough to sustain high levels of production without excess inventory accumulation in the next quarter.*

- The ISM manufacturing index surged to a three-year high in July and exceeded the reading prior to the contraction in the first quarter. As Figure 3 illustrates the index can be volatile over longer periods. The ISM increased to a better than expected 57.1 in July from 55.2 in June. An index over 50 signals an expansion but does not forecast the "strength" of the expansion.

Figure 3. ISM Index - July 2011 through July 2014

Source: Federal Reserve Bank of St. Louis (FRED)

- The new orders component of the ISM index rose 4.5 points to a strong 63.4, while production edged up 1.2 points to 61.2 and employment jumped 5.4 points to 58.2. The employment reading is the highest rate of employment since April 2011.

- For the second quarter as a whole, manufacturing production rose at a 7% annual rate. Manufacturing sector productivity increased 3.6% in the second quarter of 2014, as output increased 7.0% and hours worked increased 3.2%. Productivity increased 2.9% in the durable goods sector and increased 5.9% in the nondurable goods sector.

- Over the last four quarters, manufacturing productivity increased 2.1%, as output increased 3.7% and hours increased 1.5%. Unit labor costs in manufacturing fell 1.3% in the second quarter of 2014 and increased 0.8% from the same quarter a year ago.

- Industrial production increased 0.2% in June and advanced at an annual rate of 5.5% for the second quarter of 2014. In June, manufacturing output edged up 0.1% for its fifth consecutive monthly gain.

- The capacity utilization rate for total industry was unchanged in June at 79.1%, a rate that is now only 1% point below its long-run (1972–2013) average. For manufacturing, capacity utilization in June fell slightly to 77%. The Table below shows how current capacity utilization compares to the long run average for both total industry and manufacturing. The utilization rates are now closing-in on the long run average, suggesting that inflation pressures may begin building if utilization rates continue to improve. A strong recovery without the emergence of inflation will require higher real investment growth.

Table 4. Capacity Utilization Data

	Capacity Utilization April '14	Capacity Utilization May '14	Capacity Utilization June '14	Capacity Utilization Average 1972-2013	Capacity Growth June '13-June '14
Total Industry	79%	79.1%	79.1%	80.1%	2.6%
Manufacturing	77%	77.2%	77.1%	78.7%	2.0%

***Inflation** – Measures of inflation were higher in the second quarter but they remained within the Fed targets of 2% to 2.5%. The PCE index grew at a 2.3% annual rate in the second quarter. Energy prices were a large part of the inflation picture. The core inflation rate, without food and energy components, was only 2%. While inflation is not yet a problem there is now little room for additional price pressure without a Fed response*

- The Fed's preferred inflation measure, the Personal Consumption Expenditure Index (PCE), jumped in the second quarter to the highest annual rate in three years. The PCE rose at a 2.3% annual rate in the April-to-June period, compared to only 1.4% in the first quarter The "core" PCE that excludes food and energy climbed at a 2% rate, up from 1.2% in the first quarter. The Fed would like to see PCE inflation in an annual range of 2% to 2.5%. Anything much higher or lower is viewed by most central bankers as harmful to the economy in the long run.

- The price index for gross domestic purchases, which measures prices paid by U.S. residents, increased 1.9% in the second quarter, compared with an increase of 1.4% in the first. Excluding food and energy prices, the price index for gross domestic purchases increased 1.7% compared with an increase of 1.3% in the first quarter.

- The Consumer Price Index for All Urban Consumers (CPI-U) increased 0.3% in June on a seasonally adjusted basis. Higher gasoline prices were largely responsible for the higher index in June. Over the last 12 months, the all items index increased 2.1% before seasonal adjustment and the index for all items less food and energy rose 1.9%.

- The seasonally adjusted Producer Price Index for final demand rose 0.4% in June following a 0.2% decline in May and a 0.6% advance in April.

Labor and Employment *- The labor market appears to be tightening, creating conditions for wage growth. The number of unemployed job seekers per job opening reached its lowest level since April of 2008. The U-3 unemployment rate rose to 6.2% from 6.1% as the labor force participation rate increased. This pattern of an improved labor market without significant reduction in the unemployment rate may continue in the second quarter if more job seekers enter the labor market. There is a large overhang of potential workers who could boost the participation rate significantly.*

- July's announcement of job creation provided a mixed picture. The Bureau of Labor Statistics estimated that 209,000 jobs were created in July, marking the sixth consecutive month with over 200,000 new jobs. Nevertheless, July's announcement was well below the consensus expectation of 230,000 jobs.

- The unemployment rate (U-3) ticked up slightly to 6.2%, from 6.1% in June, which had not been expected. The broader measure of unemployment (U-6) reached 12.2%. The number of unemployed Americans, those who do not have a job even though they are looking for work, increased by about 200,000 to 9,671,000.

- The labor force participation rate ticked up to 62.9% from 62.8% for the three prior months. More working-age people are either working or looking for a job. The increased participation rate was a key factor in the unexpected increase in the unemployment rate.

- There is a lot of room for improvement in the labor force participation rate. The BLS reported that about 11.5 million Americans age 16 and over have left the workforce since January 2009. In July 2014, there were 92,001,000 Americans, 16 and over, who were classified as *"not in the labor force,"* meaning that they did not have a job and had not actively looked for work in the previous four weeks. This number has increased by 11,472,000 since January 2009, when the number of Americans not in the labor force was 80,529,000.

- Reuters reported that the share of unemployed Americans competing for each open job hit a six-year low in June. The Labor Department's monthly Job Openings and Labor Turnover Survey suggested that the labor market is tightening. The ratio of unemployed job seekers per job opening fell to 2.02 in June, the lowest level since April 2008. The ratio was at 2.14 in May and is now below the 2002 to 2006 average.

- Job openings, a measure of labor demand, increased to a seasonally adjusted 4.67 million in June, the highest level since February 2001. Much of the increase in employment growth since the 2007-2009 recession ended has been driven by a sharp decline in the pace of layoffs. Now the economy appears to be shifting to improvements due to hiring rather than reduced layoffs.

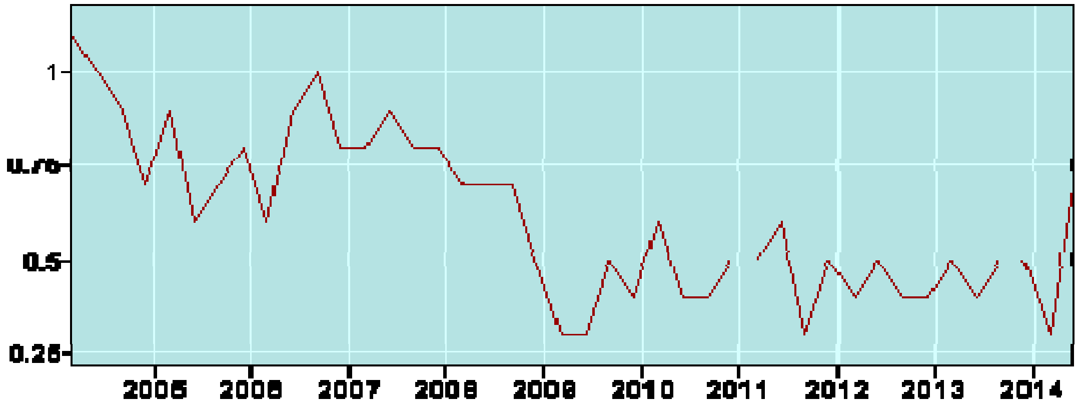
- Nonfarm business sector labor productivity increased at a 2.5% annual rate during the second quarter of 2014. Hours increased 2.7% and output increased 5.2%. From the second quarter of 2013 to the second quarter of 2014, productivity increased 1.2% as output and hours worked rose 3.2% and 2.0%, respectively. Sustained improvement in productivity will support a trend of higher wages.

- An NFIB survey showed its compensation gauge held at a six-year high in July.

- The BLS announced that compensation (wages, benefits, and salaries) for civilian workers in all industries and all occupations increased at a healthy seasonally adjusted annual rate of 0.7% for the 3-month period ending in June. The 12-month rate ending in June was 2%. The Figure below illustrates the history of quarter-to-quarter percentage change in compensation to civilian workers. The compensation data includes wages, salaries, and employer costs for benefits.

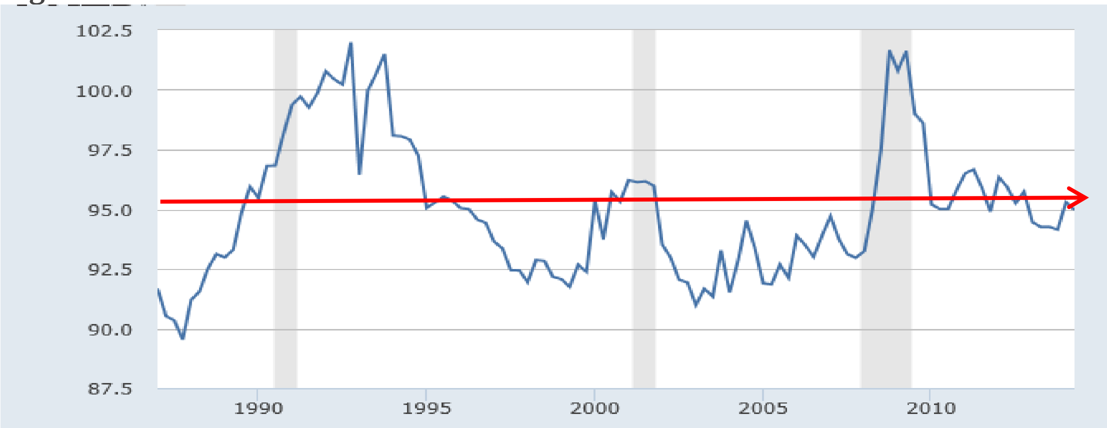
Figure 4. Quarter to Quarter Annual Rate for Civilian Compensation (Data are Seasonally Adjusted Quarterly Average Percentage Change)

% Change



- Unit labor costs in nonfarm businesses increased 0.6% in the second quarter of 2014, as the 3.1% increase in hourly compensation was larger than the increase in productivity. Unit labor costs increased 1.9% over the last four quarters. As the Figure below shows, unit labor costs are currently back to the long run average.

Figure 5. Unit Labor Cost Index 1985-Present



Source: Federal Reserve Bank of St. Louis (FRED)

- Average hourly earnings increased just 2% in July from a year earlier, barely keeping up with the rise in inflation. The average workweek was also unchanged at 34.5 hours.

Sentiment and Confidence *– Results from various sentiment surveys are mixed. The Conference Board Confidence Index improved but the University of Michigan survey turned worse. These surveys provide a composite average but sentiment is much different for high and low income groups. Overall, even though traditional confidence index data suggests an improvement in sentiment, a majority of Americans believe the country is drifting in the wrong direction. Most analysts believe confidence data supports a strong second half of 2014.*

- The *Conference Board Consumer Confidence Index* improved to 90.9 in July compared to an 86.4 reading in June. The July index is the highest since the 95.2 level reached in October 2007, just prior to the Great Recession. Strong short-term outlooks for the economy and jobs drove the gain in expectations.

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- The Conference Board survey results were generally optimistic. The percent of consumers expecting business conditions to improve over the next six months increased to 20.2% from 18.4%, while those expecting business conditions to be worse held steady at 11.5%. Those anticipating more jobs in the months ahead increased to 19.1% from 16.3%, while those anticipating fewer jobs declined to 16.4% from 18.4%. Slightly more consumers expect their incomes to grow, 17.3% in July versus 16.7% in June, while those expecting a drop in their incomes declined to 11.0% from 11.4%.

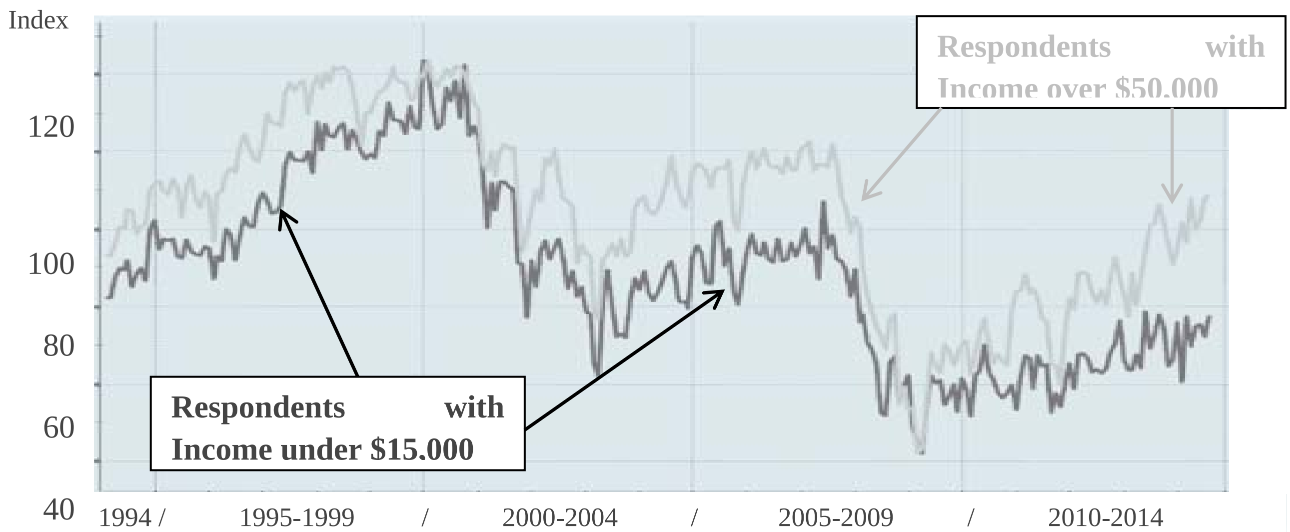
- The University of Michigan consumer sentiment fell to 81.8 in July following a reading of 82.5 in June (index = 100 in 1964). The July index is the lowest reading since March.

- A new WSJ/NBC news poll conducted in the first week of August found that many Americans remain pessimistic about the country's long-term growth prospects, even with recent improvements in the labor market. A key concern is for the quality of life for future generations given long term economic issues.

- Based on a survey by *RealClearPolitics* an overwhelming majority of Americans, 64.3%, believe the country is headed in the wrong direction, while only 26.0% believe the country is headed in the right direction. This finding takes away some of the significance of the positive Conference Board Index results.

- Over the past twenty-five years, the confidence gap between the top and the bottom income earners has never been greater than it is today. While the average Consumer Confidence Index for July reported by the Conference Board was 90.9, for those with annual incomes greater than $50,000, the measure was 112.1. For those with annual incomes of $15,000 or less, the measure was just only 57.7. For most people with higher incomes, confidence has returned to near-peak 2007 levels, while for most near the bottom, confidence remains at 2008 recession levels. Strong support for the economy requires all income groups to participate. There is too much dispersion of "confidence" under current conditions. Figure 6 below illustrates the difference in confidence for high income (greater than $50,000 annual income) and low income (less than $15,000 annual income) survey respondents.

Figure 6. Confidence Index for High and Low income Respondents



Housing – *The housing market has cooled off as lenders responded to higher risk and higher insurance concerns by reducing lending. Mortgage rates have leveled off and much of the pent-up demand that responded to lower rates has been served. First-time homeowners have yet to find sufficient income and job security to boost demand. Significant improvements in the economy with sustained low interest rates will be required for stronger housing markets.*

- In a semiannual report to Congress, the Fed Chair, Janet Yellen, noted that "The housing sector has shown little recent progress…While this sector has recovered notably from its earlier trough, housing activity leveled off in the wake of last year's increase in mortgage rates, and readings this year have, overall, continued to be disappointing."

- Mortgage rates increased in June of 2013 but have barely moved since. The average rate for 30-year fixed-rate mortgages with conforming loan balances is about 4.33%.

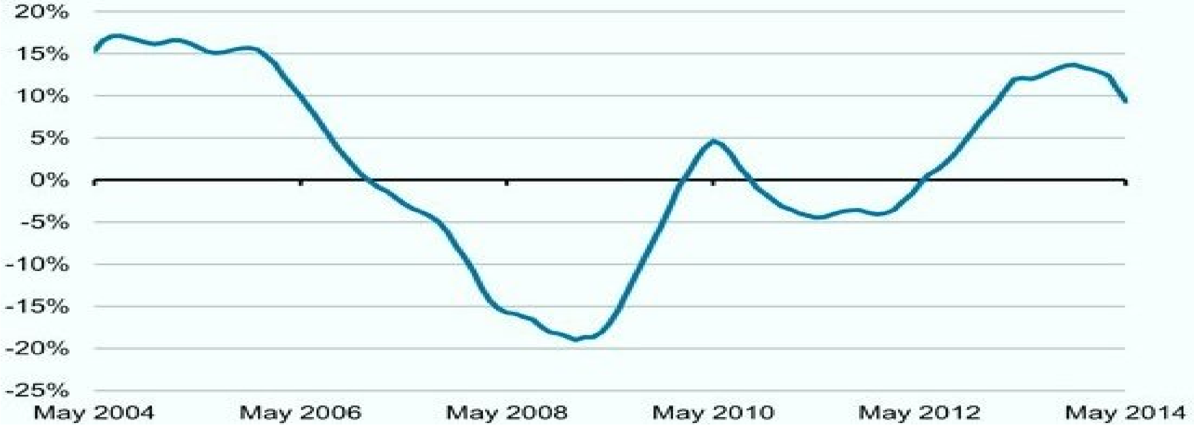
- A weakness in the mortgage market occurs for loans backed by the federal government, with applications down nearly 37% from a year ago. The Federal Housing Administration (FHA), which insures but does not originate home loans, has contributed to the sluggish market by raising insurance premiums and going after big banks for making bad loans.

- A Federal Reserve survey of financial institutions shows that many large U.S. banks lowered their mortgage-lending standards in the second quarter. The shift to easier credit may help boost household consumption and growth, but the effect could be limited due to high household debt levels and relatively low income growth.

- The supply of homes for sale today represents about 5.8 months of demand, the most since October 2011. A second rebound in the housing market requires a return on first-time home buyers, which is dependent on an improved job market with higher wages.

- U.S. home prices grew at a slower rate over the past year. Prices rose 9.3% from a year earlier in May in 20 cities tracked by the Standard & Poor’s/Case-Shiller Index, down from the 10.8% increase reported last month for April. Price gains have been expected to flatten out following last summer’s run-up in mortgage rates and prices. The index has a lag in its measurement such that current data reflects conditions six months earlier.

Figure 7. Case-Shiller 20-city Index of U.S. home Prices (% change from year ago)



Social Security *– While there is little attention paid to solving the problem, the growing federal liability for social security is a cause for concern. Demographic change with lower birthrates, increasing inclusion of beneficiaries, and pending growth of retirees represents a disaster in the making. While the plus $16 trillion federal budget debt is bad enough, the unfunded liability in government benefit programs are approximately four times that amount. Long run prospects for economic growth must begin to account for this imbalance.*

- In 2014, over 59 million (out of approximately 330 million) Americans will receive Social Security payments. The 59 million include 38 million retired workers, 9 million survivors and dependents, and 11 million disabled workers and dependents.

- In 1950 there were 16 workers per Social Security recipient. In 1960 there were 5 workers per recipient. By the year 2033, there will only be 2.1 workers per recipient. The program must undergo significant changes with some combination of higher taxes, lower benefits, and more restrictive access to benefits. None of these options are likely to help the economy.

- The share of American workers ages 55 and over hit 22.2% in July, the highest ever.

Global Economy *– Geopolitical events are casting a cloud on the prospects for improved global growth. Europe continues to struggle with economic performance of "periphery" countries like Spain, Portugal, and Italy. Sanctions and instability linked to the Ukraine will take time to play out. Japan continues to use expansionary policies to reverse decade long underperformance with little effect. Risks of conflicts and extensions of the Middle East turmoil are high. While all of these events are monitored daily they represent long run problems that will not go away soon.*

- While the Eurozone economy appears to be stalling as the Ukraine crisis escalates, the European Central Bank announced that there are bigger structural problems holding back economic growth, such as high taxation and stifling bureaucracy. In the monthly press conference, the European Central Bank President stated that reforms, especially in Italy and France, were more important concerns than a "knee-jerk" reaction to trade wars with Russia. By sticking to long run neutral monetary and fiscal policies to overcome chronic debt problems of its members, the ECU stands in stark contrast to most other developed countries. As a result, the Euro-zone has inflation rates and economic growth rates that are lagging behind other nations and remain below its targets.

- Faced with a weak economy and inflation rates edging toward zero, the ECB's balance sheet—its holdings of securities and loans—has been shrinking fast, by over €1 trillion since 2012. That runs contrary to trends at the U.S. Federal Reserve, the Bank of England and the Bank of Japan where balance sheets are growing with expansionary policies of bond purchasing.

- In the second quarter, the Eurozone's third largest economy, Italy, slid into recession for the third time since 2008. Necessary reforms are not yet in place and the economy remains fragile. GDP for Italy fell 0.2% in the second quarter following a .1% decline in the first quarter. Italy has posted only one quarter of growth since mid-2011, expanding 0.1% in late 2013. Adjusted for inflation, second quarter GDP was the lowest for 14 years, ISTAT said. Italy's bond yields have plunged since the ECB pledged at the peak of the crisis to save the euro. It will be difficult to address the problems of an economy that has stagnated for more than a decade.

- Spain, once at the front of the euro zone debt crisis alongside Italy, recently posted second quarter growth of 0.6%, suggesting their economic fortunes are diverging. Peripheral EU economies, like Spain and Ireland, are outperforming countries that have not implemented structural reforms and improved competitiveness. Countries like Italy and France that have been slow and unwilling to embrace reforms, are a drag on the wider Eurozone economy.

- The International Monetary Fund (IMF) recently reported that China's reliance on debt and investment has created "rising vulnerabilities" and that failure to change its growth pattern increases the likelihood of a sharp economic slowdown. The IMF urged the nation's leaders to lower the country's annual expansion target, rein in credit and speed up reforms. The People's Bank of China (PBOC) announced that the country's credit and money supply have increased rapidly and indicated that it will refrain from broader monetary easing to support growth. Corrections will slow growth in China but not immediately.

- Argentina recently defaulted on $29 billion in debt after a 30-day grace period on a $539 million interest payment expired. Argentina has defaulted on seven previous occasions – in 1827, 1890, 1951, 1956, 1982, 1989, and 2001. Almost every emerging-market country has experienced recurrent sovereign-debt problems. Argentina's latest debt trauma shows that the global system for sovereign-debt workouts remains badly in need of repair.