Alhambra Investment Partners

BI -WEEKLY ECONOMIC REVIEW

Economic Releases

Report	Prior	Consensus	Actual
Labor Market Conditions Index	-1.8	3.1	-1.9
NFIB Small Business Optimism	95.2	96	96.9
JOLTS Job Openings	5.144M	5.158M	4.994M
Retail Sales	1.1%	0.2%	0.0%
Less Autos & Gas	0.7%	0.4%	0.2%
Export Prices	0.1%	0.1%	-0.7%
Import Prices	-0.2%	0.4%	-0.3%
Business Inventories	0.2%	0.2%	0.1%
Jobless Claims	265K	276K	264K
Producer Price Index	0.2%	0.2%	-0.4%
Less Food & Energy	0.2%	0.1%	-0.2%
Empire State Mfg Survey	-1.19	5	3.09
Industrial Production	-0.3%	0.0%	-0.3%
Consumer Sentiment	95.9	95.8	88.6
Housing Market Index	56	57	54
Housing Starts	0.944M	1.029M	1.135M
Permits	1.038M	1.070M	1.143M
Jobless Claims	264K	270K	274K
Chicago Fed Nat'l Activity Index	-0.36	0.1	-0.15
PMI Manufacturing Flash Index	54.2	54.6	53.8
Philly Fed Business Outlook	7.5	8	6.7
Existing Home Sales	5.21M	5.22M	5.04M
Leading Economic Indicators	0.4%	0.3%	0.7%
Kansas City Fed Manufacturing Index	-7	-2	-13
Consumer Price Index	0.2%	0.1%	0.1%
Ex-Food & Energy	0.2%	0.1%	0.3%

The incoming economic data continues to disappoint although I don't think anything is so dire yet that we can call it a recession. Unfortunately though, the evidence that we are headed in that direction continues to pile up. One of my biggest concerns the last few years has been that growth was not sufficiently robust to withstand even a minor shock. The shale bust may be just such a shock. That situation appears to have stabilized recently along with oil prices but if we get another down-leg in crude prices, I suspect it will finally push us over the edge. The key to that puzzle will be, of course, the dollar which managed to rally last week after a pretty sharp pullback.

One area that has been consistently better than expected – a short list indeed – is employment, especially jobless claims. Claims are of particular interest because of their high degree of correlation with the stock market and they have continued to beat expectations. However, the Labor Market Conditions Index and the JOLTS report were both indicative of a labor market starting to soften. We'll see if there is follow through in coming weeks.

An area of consistent disappointment is retail sales. With lower gas prices the vast majority of economists and pundits expected a pick-up in retail activity. Our take was that it would take time for consumers to believe that gas prices were going to stay down. As gas prices have risen recently, I think it is obvious that we aren't there yet and the retail numbers bear that out. In fact, the retail sales series is tracking at levels that are decidedly recessionary.

Worst Months of Retail Sales (ex Autos), NSA

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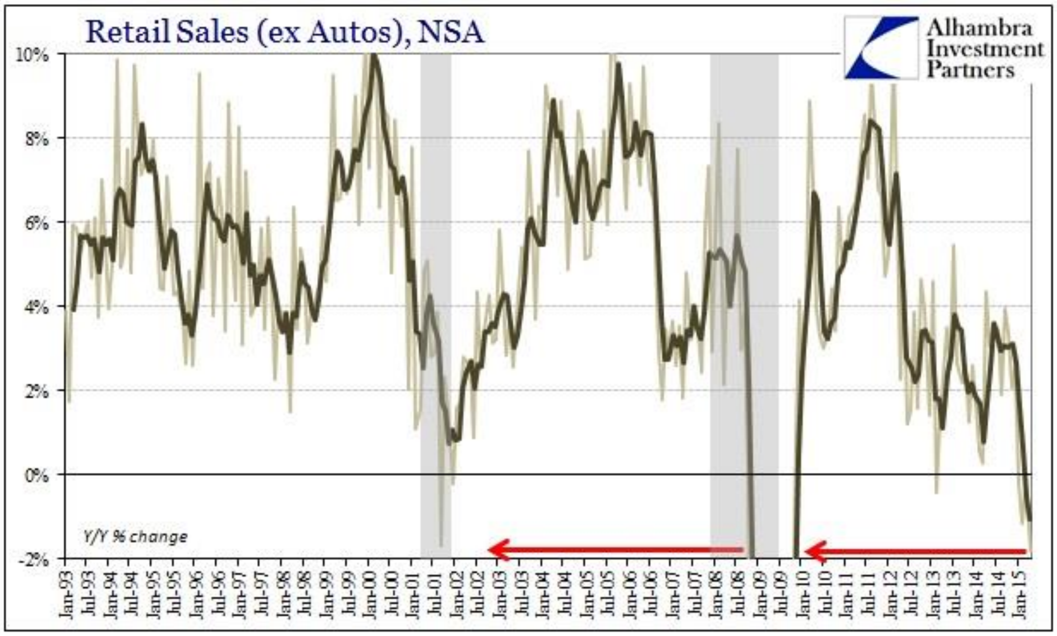
	Y/Y % change	
May-09	-10.98%	Great Recession
Feb-09	-10.07%	Great Recession
Jul-09	-10.02%	
Mar-09	-9.34%	Great Recession
Aug-09	-8.80%	
Jun-09	-8.58%	Great Recession
Nov-08	-8.23%	Great Recession
Apr-09	-7.99%	Great Recession
Dec-08	-7.30%	Great Recession
Jan-09	-7.13%	Great Recession
Sep-09	-6.58%	
Oct-09	-4.25%	
Apr-15	-1.80%	
Sep-01	-1.67%	Dot-com Recession
Feb-15	-1.15%	
Feb-13	-0.41%	
Jan-15	-0.21%	
Mar-15	-0.20%	
Dec-01	-0.20%	
Oct-08	-0.03%	Great Recession
Mar-14	0.27%	
Feb-14	0.57%	
Nov-09	0.83%	
Jun-02	0.89%	
Feb-01	1.11%	
Jun-12	1.22%	
Nov-13	1.26%	
Mar-13	1.33%	
Dec-12	1.42%	
Nov-01	1.52%	
Mar-98	1.52%	
Jul-12	1.53%	
Jan-02	1.57%	
Sep-12	1.61%	
Mar-01	1.61%	



And by the way, auto sales appear to have peaked as well.

The US economy is still weak early in the second quarter after a first quarter that seems destined for negative numbers (assuming the statistical wizards don't revise it away through seasonal adjustments). Unless we see a pick up very soon, full year economic growth is likely to be less than last year (and that wasn't a particularly robust year). The Fed seems content to believe that this slowdown is transitory or a statistical quirk and Yellen and Co. are still on track to hike rates this year. The market, however, keeps pushing that first hike further out and the betting is now for a December hike. I will not be surprised, in the least, if that gets pushed soon to 2016.

Calendar

Monday May 25	Tuesday May 26	Wednesday May 27	Thursday May 28	Friday May 29
US Holiday: Memorial Day *Markets Closed* **Loretta Mester Speaks** 9:10 AM ET	Durable Goods Orders CONSENSUS 8:30 AM ET FHFA House Price Index	Bank Reserve Settlement MBA Mortgage Applications 7:00 AM ET	*Weekly Bill Settlement* *52-Week Bill Settlement* **John Williams**	*2-Yr FRN Note Settlement* *10-Yr TIPS Settlement*

Stanley Fischer Speaks 11:30 AM ET	CONSENSUS 9:00 AM ET S&P Case-Shiller HPI CONSENSUS 9:00 AM ET PMI Services Flash CONSENSUS 9:45 AM ET New Home Sales CONSENSUS 10:00 AM ET Consumer Confidence CONSENSUS 10:00 AM ET Richmond Fed Manufacturing Index CONSENSUS 10:00 AM ET State Street Investor Confidence Index 10:00 AM ET Dallas Fed Mfg Survey CONSENSUS 10:30 AM ET 4-Week Bill Announcement 11:00 AM ET	Redbook 8:55 AM ET 4-Week Bill Auction 11:30 AM ET 52-Week Bill Auction 11:30 AM ET 2-Yr FRN Note Auction 1:00 PM ET 5-Yr Note Auction 1:00 PM ET	**Speaks** 2:20 AM ET Jobless Claims CONSENSUS 8:30 AM ET Bloomberg Consumer Comfort Index 9:45 AM ET Pending Home Sales Index CONSENSUS 10:00 AM ET EIA Natural Gas Report 10:30 AM ET EIA Petroleum Status Report 11:00 AM ET 3-Month Bill Announcement 11:00 AM ET 6-Month Bill Announcement 11:00 AM ET 7-Yr Note Auction 1:00 PM ET **Narayana Kocherlakota Speaks** 2:45 PM ET Farm Prices 3:00 PM ET	GDP CONSENSUS 8:30 AM ET Corporate Profits 8:30 AM ET Chicago PMI CONSENSUS 9:45 AM ET Consumer Sentiment CONSENSUS 10:00 AM ET

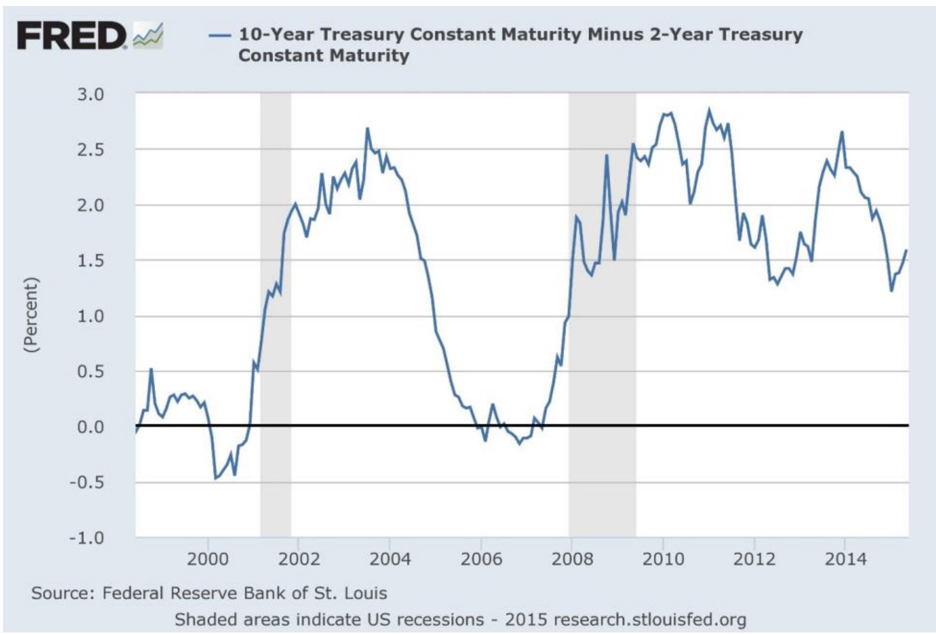
	3-Month Bill Auction 11:30 AM ET 6-Month Bill Auction 11:30 AM ET **Stanley Fischer Speaks** 12:30 PM ET 2-Yr Note Auction 1:00 PM ET **Jeffrey Lacker Speaks** 7:10 PM ET		Fed Balance Sheet 4:30 PM ET Money Supply 4:30 PM ET	

Monday Jun 1	Tuesday Jun 2	Wednesday Jun 3	Thursday Jun 4	Friday Jun 5
2-Yr Note Settlement *5-Yr Note Settlement* *7-Yr Note Settlement* Personal Income and Outlays 8:30 AM ET Gallup US Consumer Spending Measure 8:30 AM ET **Eric Rosengren**	Motor Vehicle Sales Gallup US ECI 8:30 AM ET Redbook 8:55 AM ET Factory Orders 10:00 AM ET 4-Week Bill Auction 11:30 AM ET	MBA Mortgage Applications 7:00 AM ET ADP Employment Report 8:15 AM ET International Trade 8:30 AM ET Gallup U.S. Job Creation Index 8:30 AM ET PMI Services Index 9:45 AM ET	*Weekly Bill Settlement* Chain Store Sales Challenger Job-Cut Report 7:30 AM ET Jobless Claims 8:30 AM ET Productivity and Costs 8:30 AM ET Gallup US Payroll to Population 8:30 AM ET	Employment Situation 8:30 AM ET **William Dudley Speaks** 12:30 PM ET Consumer Credit 3:00 PM ET

Speaks 9:05 AM ET PMI Manufacturing Index 9:45 AM ET ISM Mfg Index 10:00 AM ET Construction Spending 10:00 AM ET 4-Week Bill Announcement 11:00 AM ET 3-Month Bill Auction 11:30 AM ET 6-Month Bill Auction 11:30 AM ET		ISM Non-Mfg Index 10:00 AM ET EIA Petroleum Status Report 10:30 AM ET Beige Book 2:00 PM ET **Charles Evans Speaks** 2:15 PM ET	Bloomberg Consumer Comfort Index 9:45 AM ET EIA Natural Gas Report 10:30 AM ET 3-Month Bill Announcement 11:00 AM ET 6-Month Bill Announcement 11:00 AM ET 3-Yr Note Announcement 11:00 AM ET 10-Yr Note Announcement 11:00 AM ET 30-Yr Bond Announcement 11:00 AM ET **Daniel Tarullo Speaks** 12:00 PM ET Treasury STRIPS 3:00 PM ET Fed Balance Sheet 4:30 PM ET Money Supply 4:30 PM ET	

Yield Curves

Term spreads flattened ever so slightly over the last week and may be ready to resume the flattening trend that started in early 2014. It has been an extremely interesting few weeks as weak economic data has produced a weak bond market. I don't expect that to continue. Either the data will improve or the bond market will start acting as if the data actually means something. For now, there is nothing that can be gleaned from the yield curve. We are far from flat and the recent steepening was not enough to say that the market was anticipating some kind of Fed action to fend off recession.



I am concentrating on the 10/5 curve now because of the Fed's influence over the shorter end of the curve. I divide the curve into zones:

Zone 0 = Inverted

Zone 1 = 0.0% to 0.25%

Zone 2 = 0.25% to 0.50%

Zone 3 = 0.50% to 0.75%

Zone 4 = 0.75% and higher

Recession probability:

Zone 0 = 50%+

Zone 1 = 25 – 50%

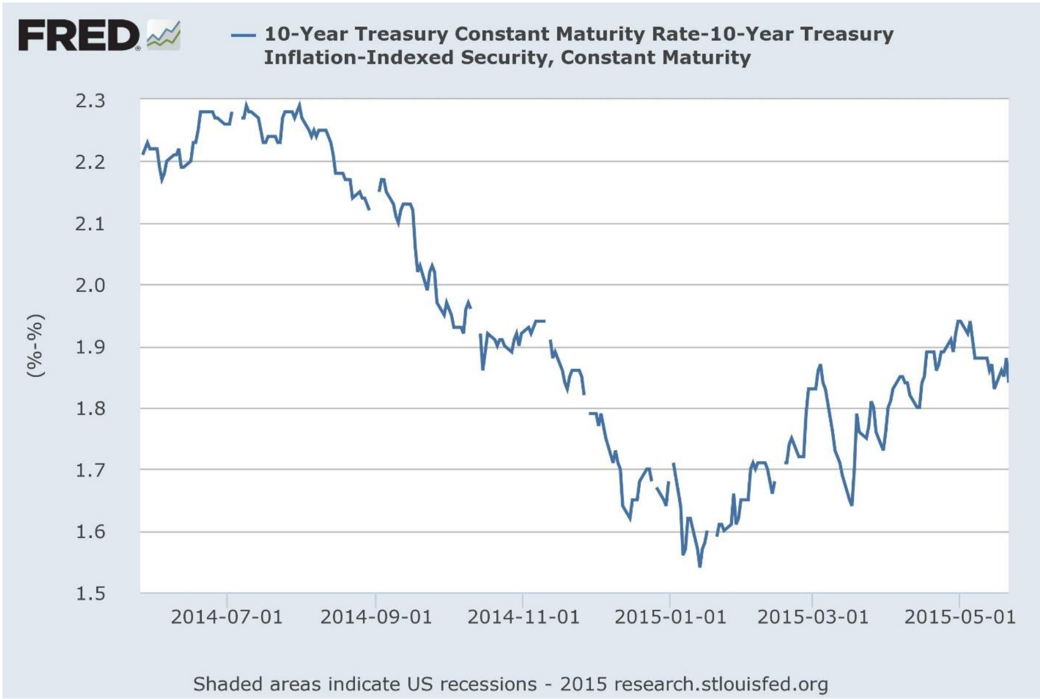
Zone 2 = 15 – 25%

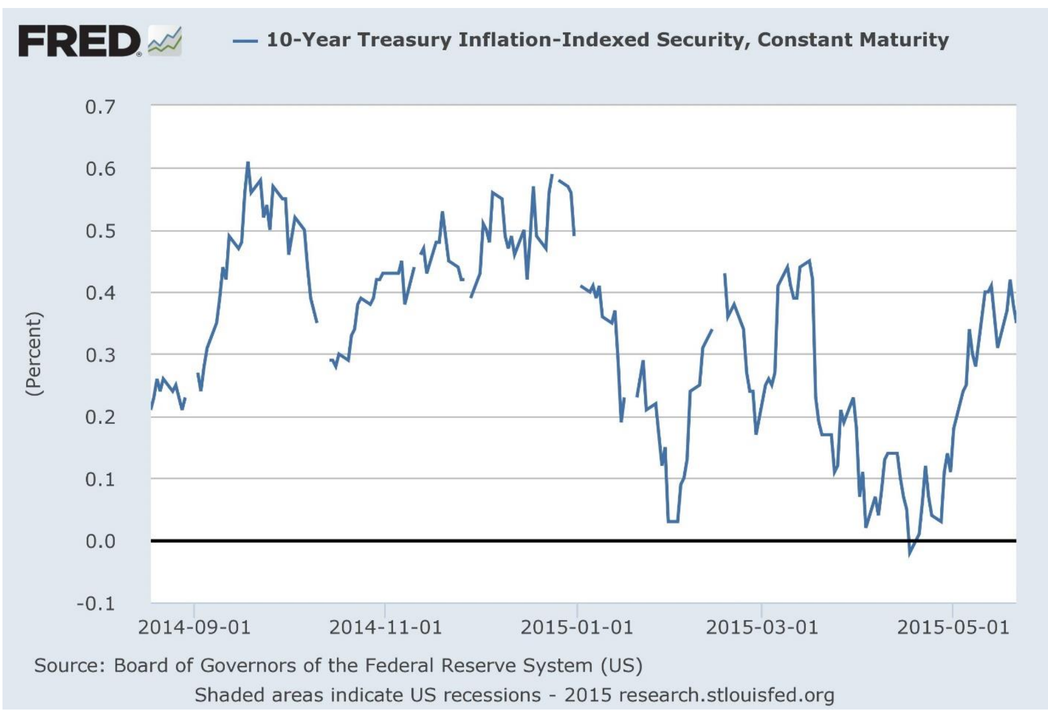
Zone 3 = 5 – 15%

Zone 4 = 0 – 5%

We are still in ***Zone 3*** with the 10/5 curve at 0.66 which translates to a fairly low probability of recession. Of course, this is a new era for the yield curve. We have no idea if an inversion will need to occur before the onset of recession. I think the answer is probably no and the next recession will start before we get to flat.

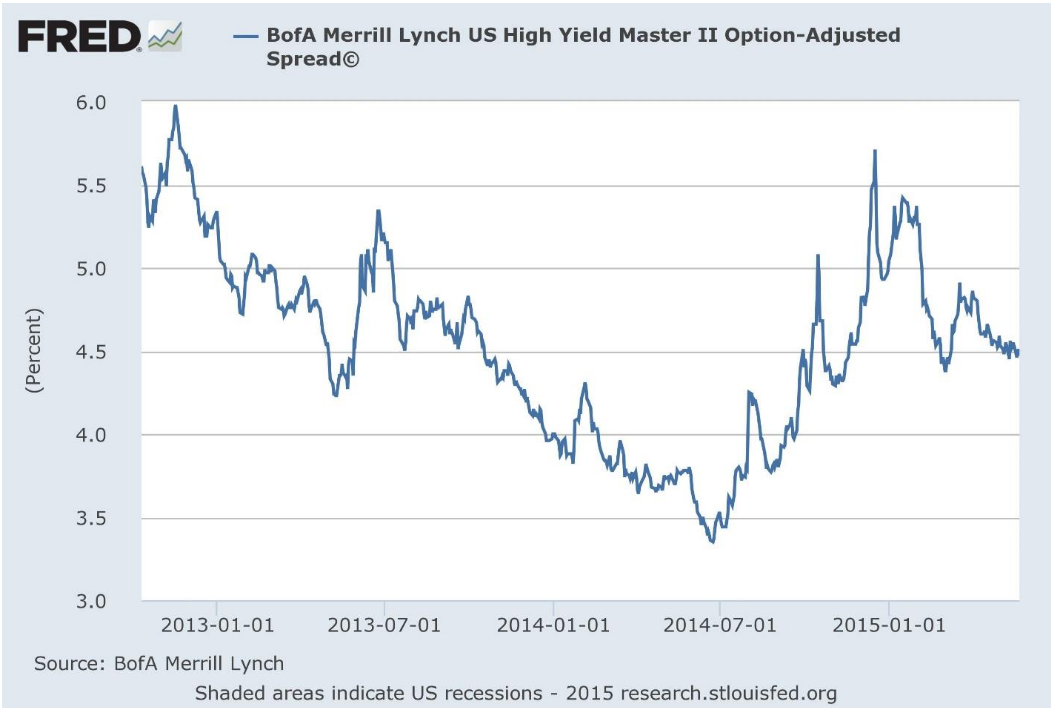
Another way to look at growth expectatios is the TIPS market. Theoretically, the TIPS market should tell us about inflation and real growth expectations. Inflation expectations will be the difference between nominal and real rates (TIPS rates) while real growth expectations will be reflected in real yields. Inflation expectations were rising all year until peaking at the beginning of May. Real growth expectations have been low and fairly stable.



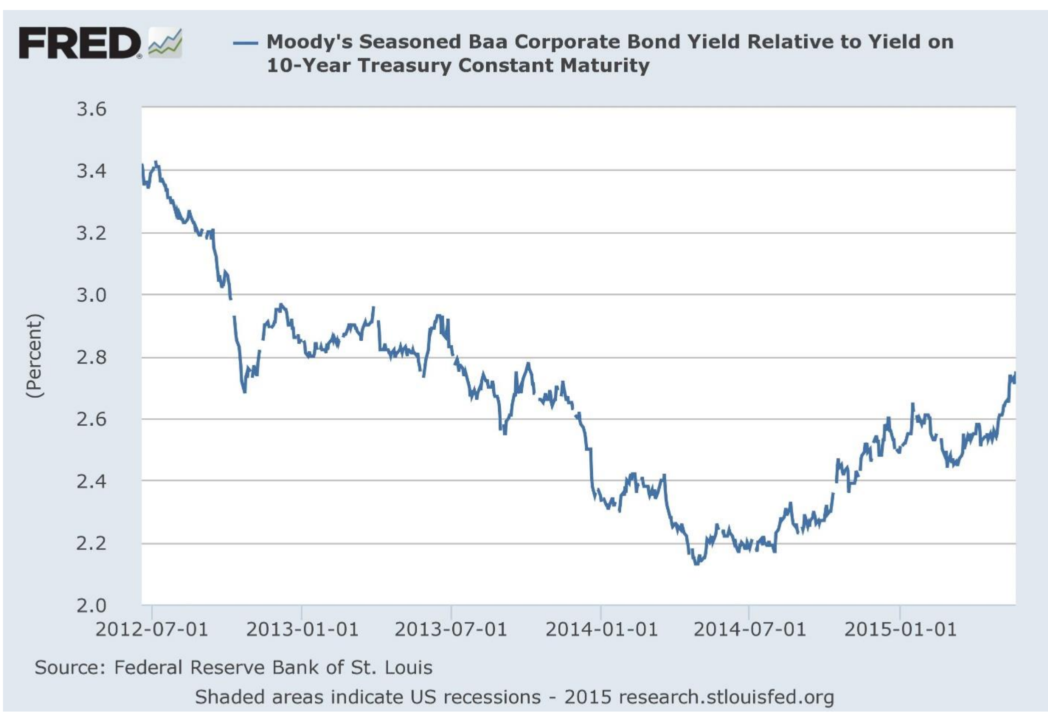


Credit Spreads

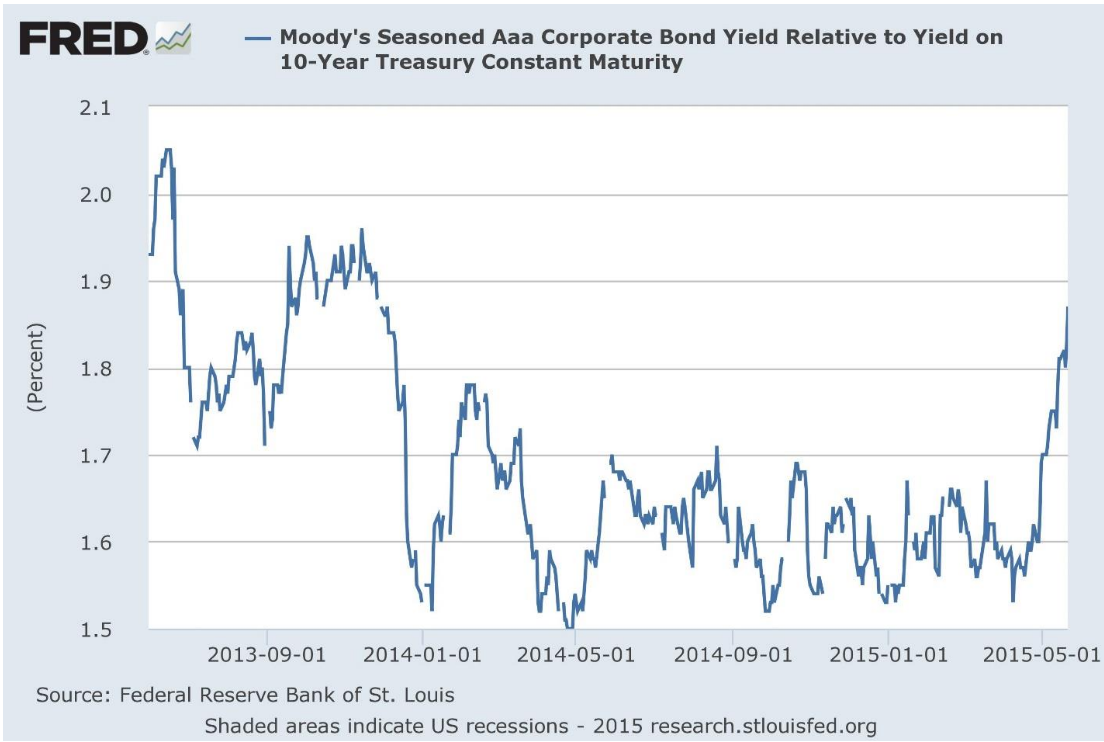
Credit spreads, at least for the HY Master II OAS, narrowed a bit over the last two weeks. That only tells part of the story though and there are perhaps more interesting things going on with other spreads. There has been little change in the HY option adjusted spread. If anything they narrowed slightly over the last two weeks.



The Baa spread, on the other hand, has continued to widen:



Even more curious are AAA spreads which have also moved wider:



It is quite curious and unusual to see higher grade bond spreads moving wider while junk bond spreads continue to narrow. Is this a statement about liquidity in the high grade corporate bond market? Or is it a testament to the impact of stretching for yield? Frankly, I'm not sure but it definitely bears watching.

For now, credit spreads are not widening sufficiently to indicate a problem. The High Yield market has been remarkably stable recently while all the action has shifted to the Treasury market. That is more likely a function of the rising uncertainty regarding future Fed policy than a statement about the high yield market. Credit spreads are still a cause for concern though as they are elevated from the best levels of this expansion. The action in the higher rated spreads is additional cause for concern.

Not much has changed since the update two weeks ago. The economic data, as mentioned above, has continued to show a weakening US economy. The data from overseas has been somewhat encouraging although frankly I'm not sure where the enthusiasm and confidence in a European upturn derives. Germany's PMIs, released last week, were down for the 5th month in a row, although both the manufacturing and service sides are both over 50. We may be seeing a cyclical upturn develop but let's be clear; nothing has changed for the better long term. There is a reason the ECB is accelerating their QE efforts.

Japan though appears to be emerging from its sales tax induced slump. 1st quarter GDP rose a more than expected 2.4% annualized although a disturbing amount of that growth was attributable to an inventory build. Whether that was intentional or not will determine whether this surge is sustainable. Some of the data was encouraging with household spending up 0.4% from the previous quarter and residential investment up 1.8%. Corporate spending was also up as companies are shifting some production back home.

Since the dollar index peaked in early March, there has been a convergence of growth expectations between the US and the rest of the world with the US getting worse and the rest of the world getting better. That has been reflected in the currency markets where the dollar index corrected 7% in a little over a month. That, by the way, is the probable culprit for the poor Treasury bond market action the last couple of months. It seems likely to me that at least some of the selling in Treasuries was due to the unwinding of a carry trade. Short Euro/Long dollar/Long Treasures was a bet on a weakening Euro and a convergence between US and European bond yields. We have seen a rise in Euro denominated yields but the Euro rally likely made the trade unprofitable.

I expect the relative shift in growth expectations to continue. There may be a little more to this countertrend rally in the dollar especially if the Greece situation doesn't have a happy ending. However, the industrial upturn outside the US I've been tracking is not robust enough to withstand a US recession. If the US data continues to deteriorate, all bets are off.

I have said for many months that I don't know if the shale bust will be sufficient to push the US economy into recession – and I still don't know. The drop in the price of oil so far has only been sufficient to push the most marginal players over the edge. It would probably take a drop back to the lows for an extended period to have a more profound impact. It is a very interesting and delicate balance that is developing right now - a dollar weak enough to keep the shale industry in business but not so weak that it pushes prices up enough to warrant a Fed response.

To sum up, the risks to the economy have increased somewhat since the last update but neither of our two main early warnings indicators are alarming right now. The yield curve is still in Zone 3 indicating little stress. Credit spreads are elevated but behaving quite well at the junk level. Investment grade credit spreads are, however, indicating some minor stress that didn't exist at the last update two weeks ago. We will be monitoring this very closely in coming weeks for signs of increased stress.

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"Wealth preservation and accumulation through thoughtful investing."

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