BI -WEEKLY ECONOMIC REVIEW

Economic Releases

Report	Prior	Consensus	Actual
Durable Goods Orders	5.1%	-0.6%	-0.5%
Ex-Transportation	0.6%	0.4%	0.5%
S&P Case Shiller HPI	1.20%	0.90%	1.00%
PMI Services Flash	57.8	56.5	56.4
New Home Sales	484K	509K	517K
Consumer Confidence	94.3	95.1	95.4
Richmond Fed Mfg Index	-3.0	1.0	1.0
Dallas Fed Mfg Survey	-16.0	-10.0	-20.8
Jobless Claims	275K	270K	282K
Pending Home Sales	1.2%	0.8%	3.4%
GDP	0.2%	-0.8%	-0.7%
Chicago PMI	52.3	53.1	46.2
Consumer Sentiment	88.6	90.3	90.7
Personal Income	0.0%	0.3%	0.4%
Consumer Spending	0.5%	0.2%	0.0%
PCE Price Index	0.2%	0.1%	0.0%
PMI Mfg Index	54.1	53.8	54
ISM Mfg Index	51.5	51.8	52.8
Construction Spending	0.5%	0.7%	2.2%
Factory Orders	2.2%	-0.1%	-0.4%
ADP Employment Report	165K	200K	201K
International Trade	$-50.6B	$-44B	$-40.9B
PMI Services Index	57.4	56.5	56.2

ISM Non-Mfg Index	57.8	57.2	55.7
Challenger Job Cuts	61582.0		41034.0
Jobless Claims	284K	276K	276K
Non Farm Productivity	-1.90%	-2.90%	-3.10%
Unit Labor Costs	5.0%	6.0%	6.7%
Non Farm Payrolls	221K	220K	280K
Unemployment Rate	5.4%	5.4%	5.5%
Participation Rate	62.8%	62.7%	62.9%
Avg. Hourly Earnings	0.1%	0.2%	0.3%
Avg. Workweek	34.5Hrs	34.5Hrs	34.5Hrs

Items highlighted in green were reported better than consensus while those in red were worse than expected. Black is in line.

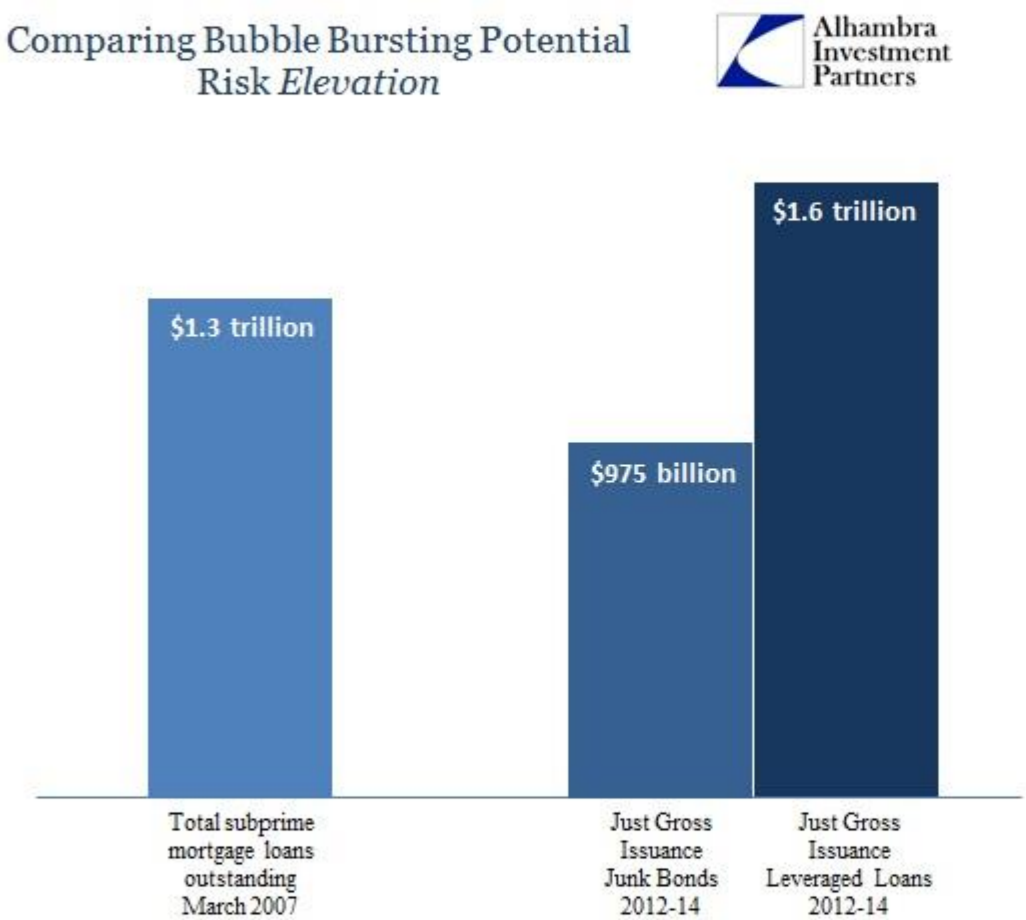
A pretty big shift in the data has occurred over the last two weeks. Previously the data flow had been almost uniformly negative, less than expected. That has changed dramatically over the last two weeks with 2/3 of the data coming in at or above the consensus estimate. The period was punctuated at the end by an employment report that was not only better than expected but better than we've seen in quite a while.

It should be emphasized, however, that the data is not strong, just better than expected. (Of course, that is to a large degree what matters for investors as security prices are moved by changes at the margin.) Durable goods orders, for instance, were down 0.5% on the month but that *was* better than expected. The trade report was also better than expected but primarily due to a fall in imports which is good for the GDP calculation but also confirms the weak consumption numbers. On the other hand, the factory orders number looks quite negative but the report is for April while most of the other data is for May.

One area of improvement, albeit fairly small, is real estate where new home sales and pending home sales were both higher and better than expected. Construction spending also surprised to the upside with solid gains in both single family and multi-family residential. Even so, new home sales have only recently recovered to the long term range:

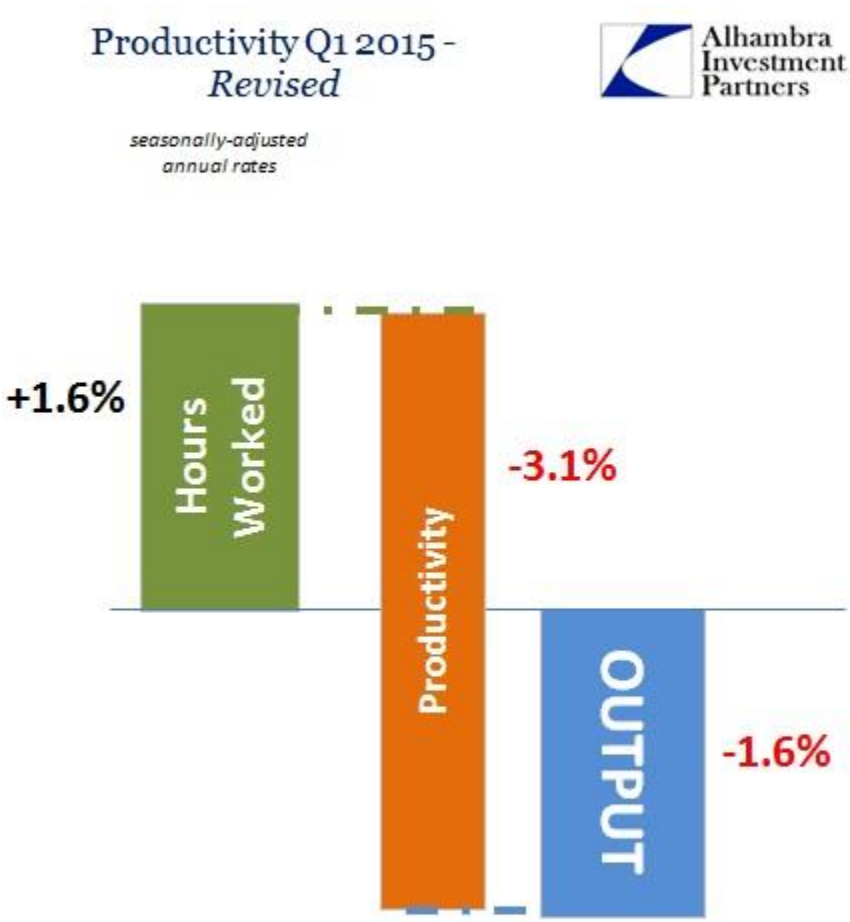
Assuming this trend continues though, residential investment looks to be adding to GDP – modestly – for some time to come.

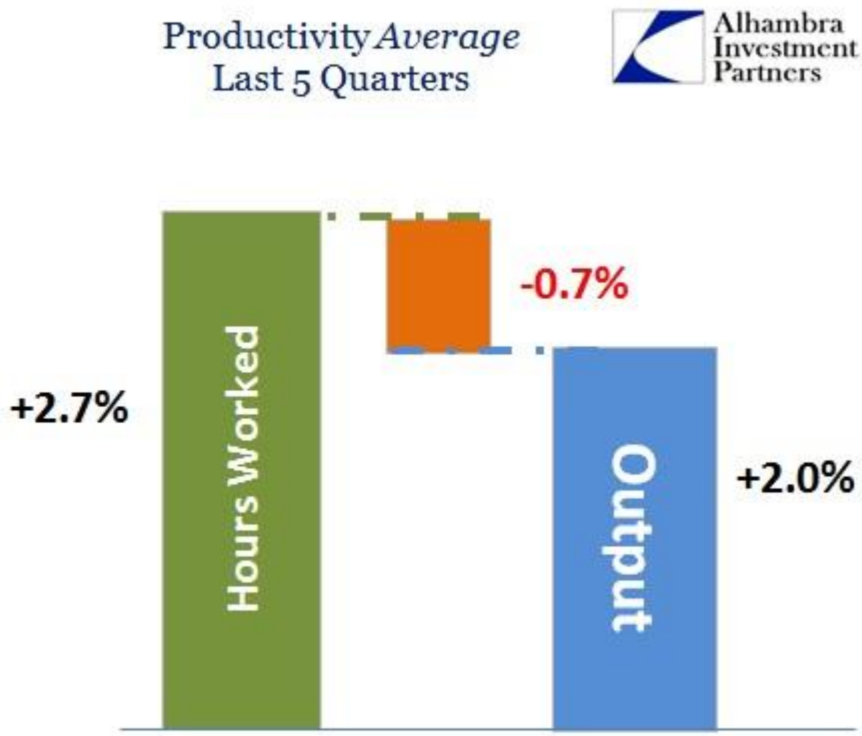
An area of major concern we've identified is that whatever recovery we've had since the 2008 debacle has been, like the last expansion, built on dodgy debt. Last time it was sub-prime mortgages. This time the issue is with corporate borrowing across the credit spectrum from investment grade (to pay dividends and buy back stock) to junk bonds (to drill shale oil wells among other things) and leveraged loans.



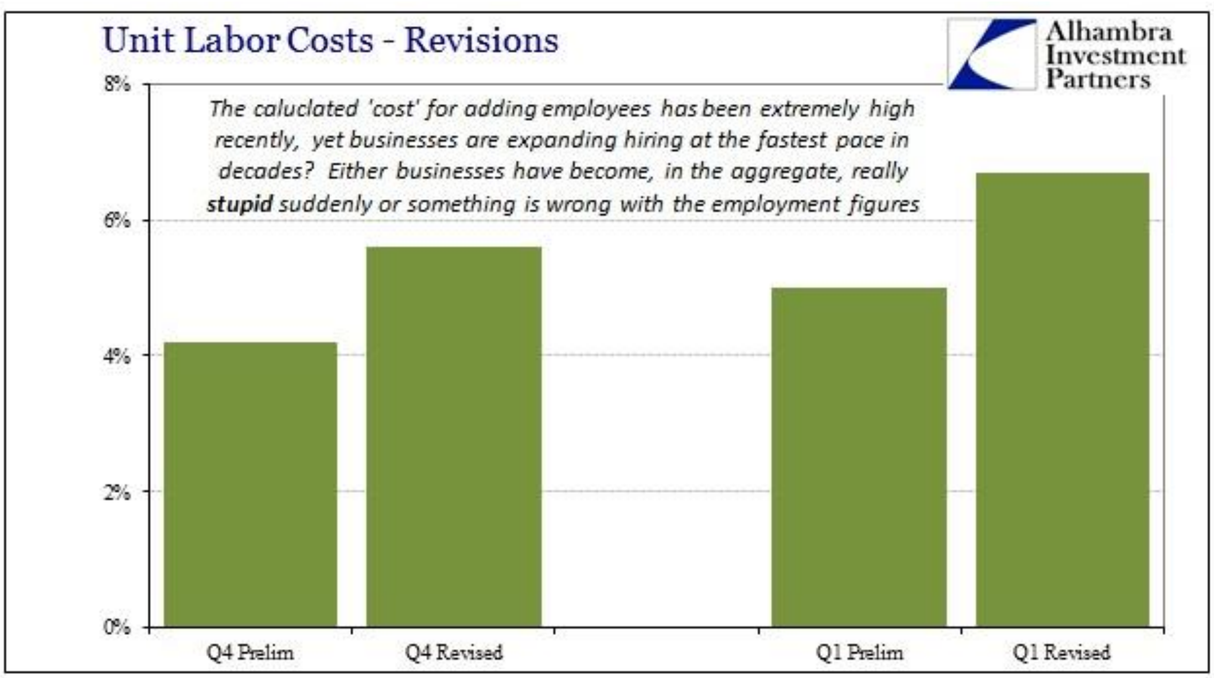
In addition, much of the gain in non-corporate debt has been for auto and student loans. While student loans could be construed as an investment with a future payoff – assuming degrees are being obtained and that they are in a field that has some prospects for growth – auto loans are pure consumption. And they have been increasingly of a very sub-prime like quality. We are already starting to see some issues with existing auto loans. Credit losses and delinquencies started rising last year and that trend has persisted this year. Default rates on sub-prime auto loans are well above the 10 year average if still a bit below what we've seen in recessions. The point is that despite all the talk about deleveraging, we still have a debt problem. It has merely shifted away from housing to other areas.

And finally, the most important figures released during the two weeks – at least to me – were the productivity numbers. Ultimately economic growth is dependent on productivity improvements and population gains (more specifically work force gains) and neither of those factors has improved recently. Productivity was down again in the 1st quarter (-3.1%) continuing a dreadful trend over the last 5 quarters:



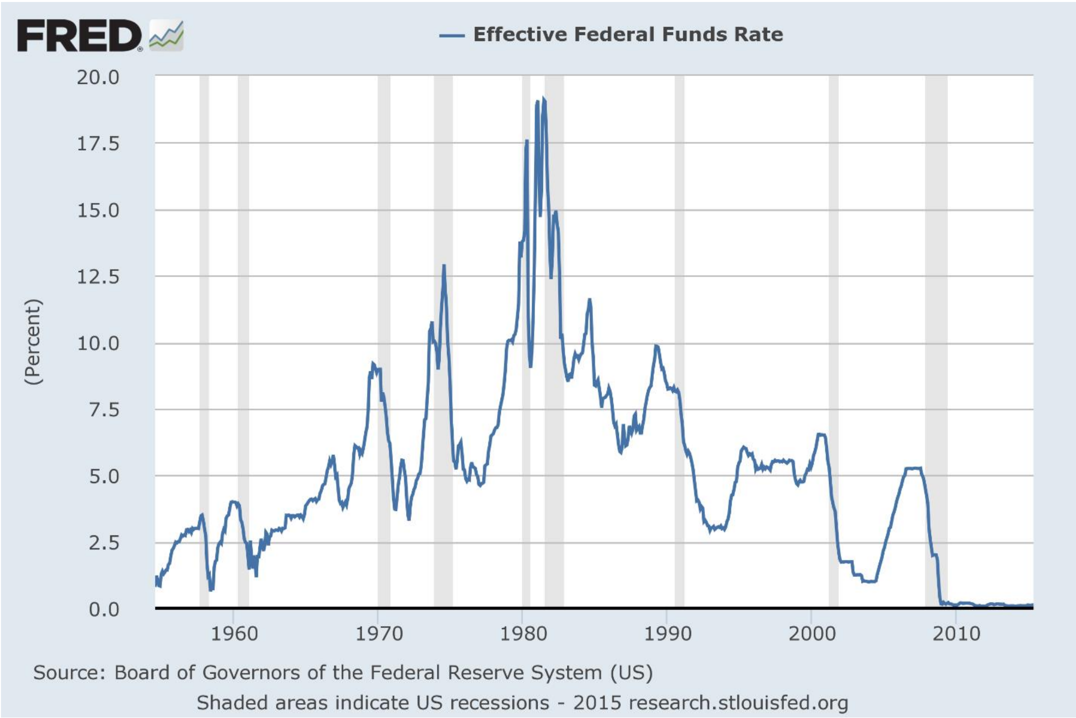


The drop in productivity is also reflected in unit labor costs:



Which, of course, brings up a very interesting question. If labor costs are rising so fast and productivity is falling so fast, why are employers hiring so many people? I can't help but wonder if we won't see some major revisions to the employment data somewhere down the road. For now though, the market sees the jobs market as healthy and that is probably all that matters in the short term. As the data has improved at the margin the last two weeks, bonds have sold off and stocks have marked time. If the economy is really that firm I would expect to see investors continue to mark down bonds and also bid up stocks. We'll see but the lack of follow through in the stock market is worrisome.

Regardless of the expectations of the Fed and the market though, a return to trend growth of 3% or better is not likely until we see a change in productivity growth. Even the rate since the last recession of roughly 1.7% is not enough to get us back to the trend of the 1990s and that is a lot higher than we've seen the last 5 quarters. The economic data will ebb and flow but until we start to see investment and subsequent productivity improvements, the "new normal" economic growth rate of 2 to 2.5% is likely to persist. I would not get too concerned about the bond market as there is a limit to how high rates can go in that environment. In fact, I think the economy's sensitivity to rate hikes is probably considerably higher in this cycle than it was in the previous one. Each cycle since the 80s has seen the expansion terminate at successively lower rates. Where will this one end?



Calendar

Monday Jun 8	Tuesday Jun 9	Wednesday Jun 10	Thursday Jun 11	Friday Jun 12
Labor Market Conditions Index 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 TD Ameritrade IMX 12:30 PM ET	Redbook 8:55 AM ET NFIB Small Business Optimism Index 9:00 AM ET JOLTS 10:00 AM ET Wholesale Trade 10:00 AM ET 4-Week Bill Auction 11:30 AM ET	Bank Reserve Settlement MBA Mortgage Applications 7:00 AM ET Quarterly Services Survey 10:00 AM ET EIA Petroleum Status Report 10:30 AM ET 10-Yr Note Auction 1:00 PM ET Treasury Budget 2:00 PM ET	*Weekly Bill Settlement* Jobless Claims 8:30 AM ET Retail Sales 8:30 AM ET Import and Export Prices 8:30 AM ET Bloomberg Consumer Comfort Index 9:45 AM ET	PPI-FD 8:30 AM ET Consumer Sentiment 10:00 AM ET

	3-Yr Note Auction 1:00 PM ET		Business Inventories 10:00 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 30-Yr TIPS Announcement 11:00 AM ET 30-Yr Bond Auction 1:00 PM ET Fed Balance Sheet 4:30 PM ET Money Supply 4:30 PM ET	

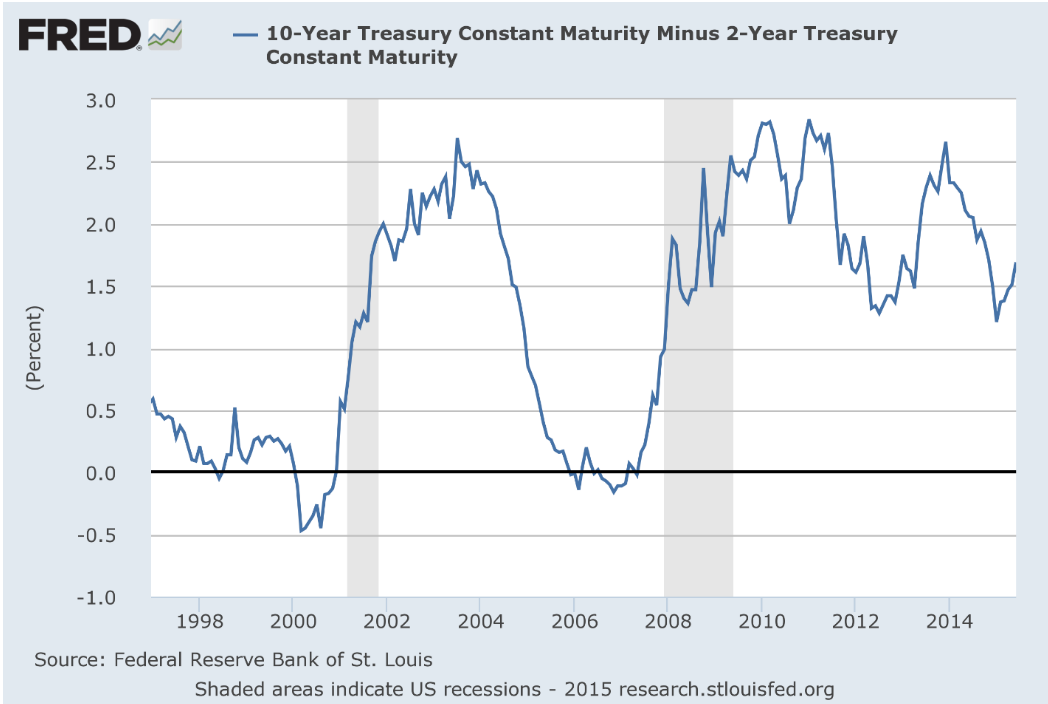
Monday Jun 15	Tuesday Jun 16	Wednesday Jun 17	Thursday Jun 18	Friday Jun 19
3-Yr Note Settlement *10-Yr Note Settlement* *30-Yr Bond Settlement*	FOMC Meeting Begins Housing Starts 8:30 AM ET Redbook 8:55 AM ET	MBA Mortgage Applications 7:00 AM ET EIA Petroleum Status Report 10:30 AM ET FOMC Meeting Announcement 2:00 PM ET	*Weekly Bill Settlement* Consumer Price Index 8:30 AM ET Jobless Claims 8:30 AM ET	*Quadruple Witching* Atlanta Fed Business Inflation Expectations 10:00 AM ET

Empire State Mfg Survey 8:30 AM ET Industrial Production 9:15 AM ET Housing Market Index 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 Treasury International Capital 4:00 PM ET	4-Week Bill Auction 11:30 AM ET	Fed Chair Press Conference 2:30 PM ET FOMC Forecasts 2:30 PM ET	Current Account 8:30 AM ET Bloomberg Consumer Comfort Index 9:45 AM ET Philadelphia Fed Business Outlook Survey 10:00 AM ET Leading Indicators 10:00 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 52-Week Bill Announcement 11:00 AM ET 2-Yr Note Announcement 11:00 AM ET 2-Yr FRN Note Announcement 11:00 AM ET 5-Yr Note Announcement 11:00 AM ET	

			7-Yr Note Announcement 11:00 AM ET 30-Yr TIPS Auction 1:00 PM ET Fed Balance Sheet 4:30 PM ET Money Supply 4:30 PM ET	

Yield Curves

As I said in the last update, either the economic data would improve to validate the bond market move or the bond market would adjust to weaker data. In this case it was the former – the data improved. Indeed term spreads have been moving wider since the last update. It is a bit odd to see the yield curve steepen at this point in the economic cycle so it is important to understand why it is happening. In this case, based on movements in the TIPs market, it appears that both inflation and real growth expectations are rising although most of the movement appears to be on the inflation side. Unless we see a significant fall in the value of the dollar I would not expect those fears to be realized.


FRED
10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity
3.0
2.5
2.0
1.5
1.0
0.5
0.0
-0.5
-1.0
(Percent)
1998
2000
2002
2004
2006
2008
2010
2012
2014
Source: Federal Reserve Bank of St. Louis
Shaded areas indicate US recessions - 2015 research.stlouisfed.org


FRED
10-Year Treasury Constant Maturity Rate-5-Year Treasury Constant Maturity Rate
1.6
1.4
1.2
1.0
0.8
0.6
0.4
0.2
0.0
-0.2
-0.4
(%-%)
1998
2000
2002
2004
2006
2008
2010
2012
2014
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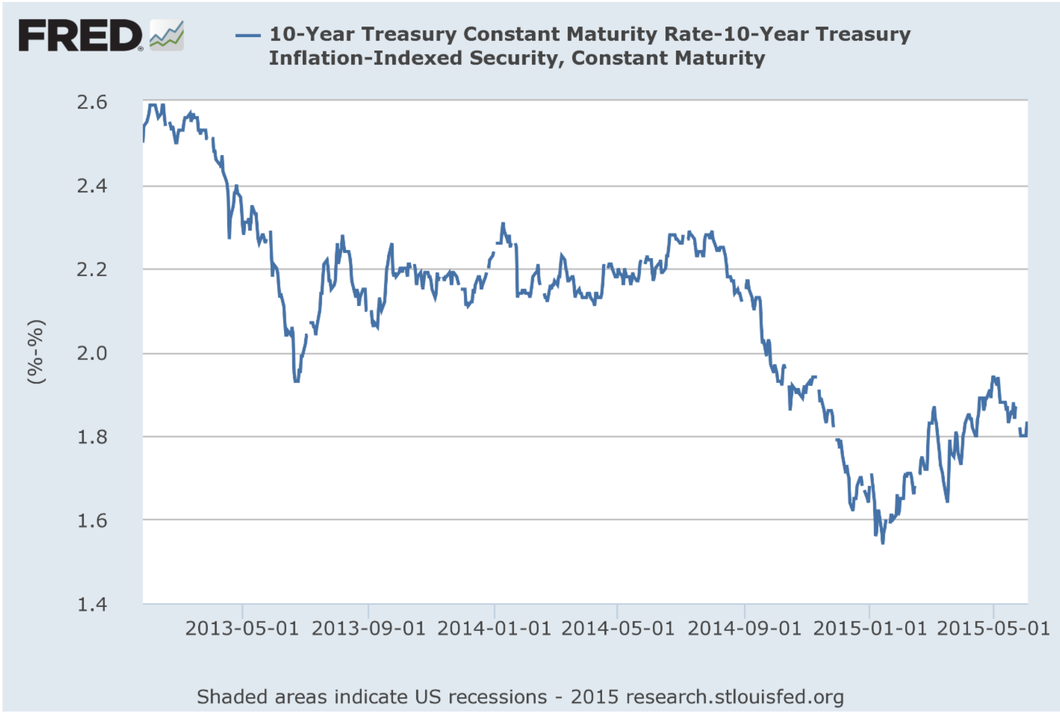
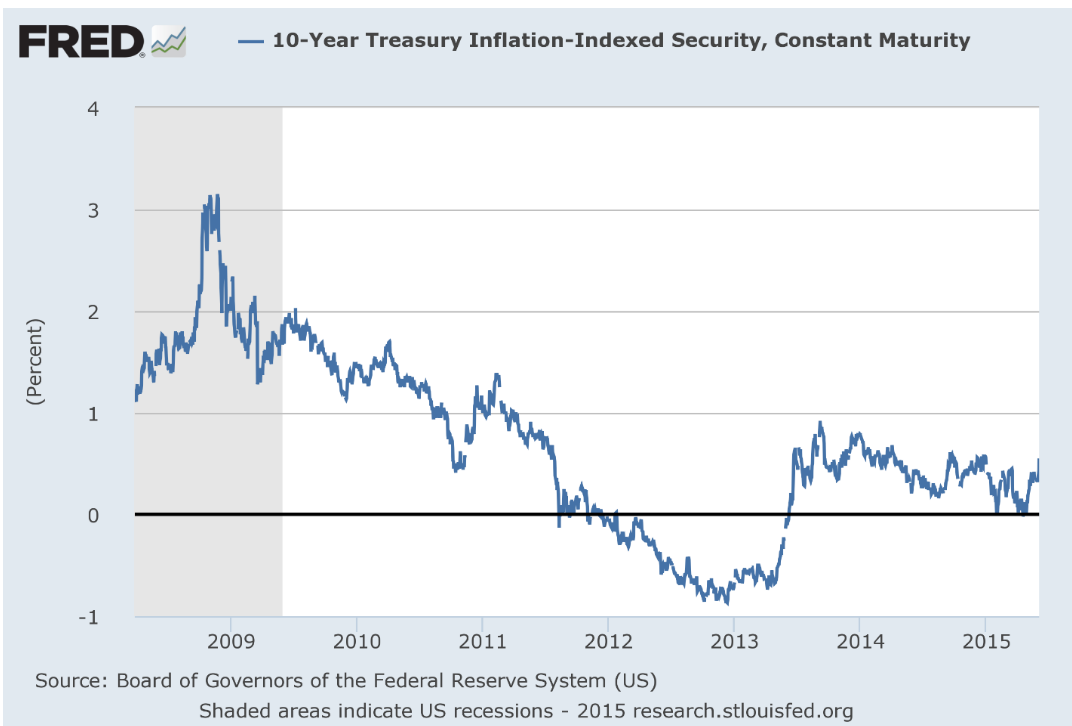

FRED
10-Year Treasury Constant Maturity Rate-10-Year Treasury Inflation-Indexed Security, Constant Maturity
(%-%)
2.6
2.4
2.2
2.0
1.8
1.6
1.4
2013-05-01 2013-09-01 2014-01-01 2014-05-01 2014-09-01 2015-01-01 2015-05-01
Shaded areas indicate US recessions - 2015 research.stlouisfed.org


FRED
10-Year Treasury Inflation-Indexed Security, Constant Maturity
(Percent)
4
3
2
1
0
-1
2009 2010 2011 2012 2013 2014 2015
Source: Board of Governors of the Federal Reserve System (US)
Shaded areas indicate US recessions - 2015 research.stlouisfed.org

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%

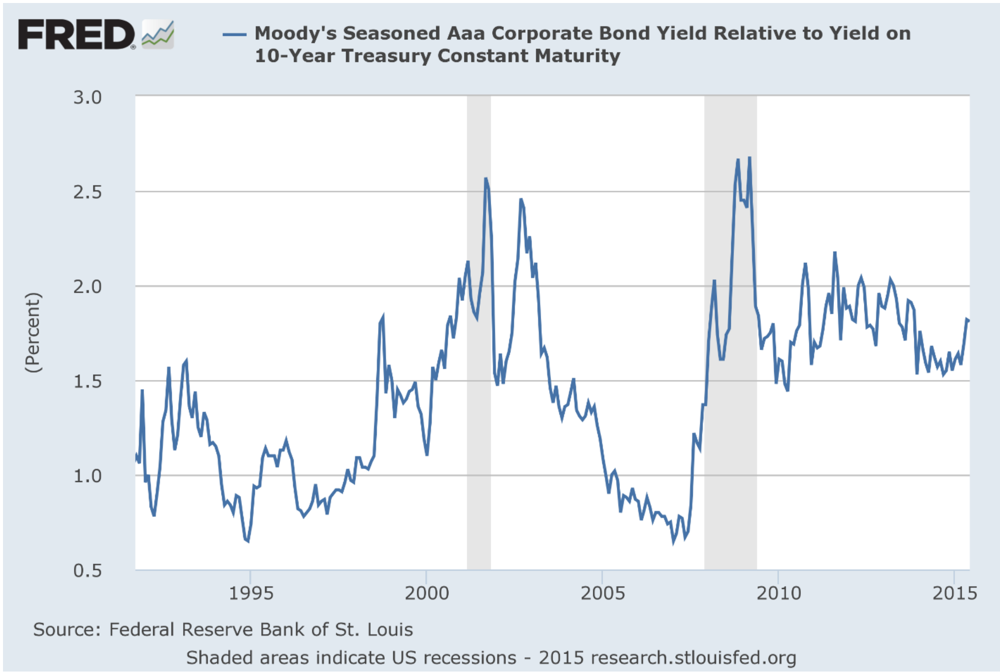
We are still in ***Zone 3*** with the 10/5 curve at 0.69 which translates to a fairly low probability of recession. Of course, this is a new era for the yield curve. We have no idea if an inversion will need to occur before the onset of recession. I think the answer is probably no and the next recession will start before we get to flat.

Credit Spreads

Very little change in the High Yield Master credit spreads which are flatlining around 4.5%.

No change in Baa spreads either. Like the change in the yield curve though, credit spreads are not acting normally for this part of the cycle. In previous cycles spreads narrowed much more before starting to widen again:

AAA spreads show a similar movement. This may be an effect of the large increase in corporate debt issuance in this cycle.:



As I said in the last update, I'm not sure why AAA spreads are widening right now. It may be about a lack of liquidity in that market and is something we should expect in the future during periods of Treasury weakness. Selling of any size has an outsized effect on markets that are less liquid than Treasuries. If so, this does not bode well for the day when there is a more urgent desire – or need – to sell bonds.

I don't see much change in the global economic outlook. The recent pull back in the dollar means less pressure on foreign economies, particularly emerging markets so stress and fear over an EM debt accident have eased. The Euro has stabilized as growth expectations have recovered and equalized with the US. That is as I expected and the markets have reacted accordingly. We've seen some firming in commodities but that is a self-correcting mechanism at this point. Overall growth is so weak that any significant rise in commodity prices will be met with weaker growth that will limit the rise in the commodity prices.

This is the environment in which the Fed wants and feels it needs to raise interest rates. While higher rates are certainly needed at this point to head off bigger imbalances down the road – we already have inflated asset prices and keeping rates pegged at zero is just going to make that worse – it is hard to justify rate hikes based on a traditional analysis of the economy. If the Fed hikes, my suspicion is that it won't be for long.

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"Wealth preservation and accumulation through thoughtful investing."

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