ECONOMIC OUTLOOK

bounty management
unique investment insight

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The Federal Reserve Says "Never mind" After Talk of Exit

Since the financial crisis in 2008, the Federal Reserve and central banks worldwide have employed both traditional monetary policy, by lowering interest rates, and non-traditional monetary policies such as quantitative easing to coax growth in the economy. According to a recent Merrill Lynch report, there have been 520 rate cuts across the globe with $33 trillion in fiscal and monetary stimulus since the crisis started. This has led to the lowest U.S. government bond yields in 220 years. In June, the Federal Reserve said that it would soon start to cut back on its latest easing program (QE3) of $85 billion in monthly purchases of bonds and mortgages, citing increases in house prices, manufacturing, and retail sales, along with subdued inflation and indications that employment would improve soon. These comments, along with other signals in May, gave the most explicit withdrawal timeline yet to the markets. The result was anxiety and a whiff of panic – particularly in the bond market. May was the worst month for bonds in four years and Treasuries are on course for their worst year since 1978. Asked about the market's reaction, Fed Chairman Ben Bernanke admitted to being "puzzled" by the sharp rise in interest rates, claiming it "was bigger than can be explained." After the markets plunged, a parade of Fed governors came forward to calm the markets and stated that the Fed's easy money policy had not changed and purchases would be reduced only if the economic data continued to improve – basically "never mind." We think Fed purchases will be dialed down slowly given the market's recent reaction and the fact that the Federal Reserve is absorbing a large percentage of new Treasury bond issuance. The Fed is on track to purchase 84% of the Treasury bond issuance required to fund the deficit and, in certain months, the Fed has purchased 75% of new 30 year Treasuries. Regardless of the final deficit or easing totals, the Fed is the predominate buyer of Treasuries and there are not enough buyers on the sidelines to pick up the slack after the Fed exits. Even after all of the trillions in artificial stimulus, the economy is barely running at a 2% growth rate.

U.S. Economy

The U.S. recovery remained tepid over the past year, but the underlying fundamentals show signs of improvement in house prices, consumer confidence, and construction activity. GDP for the 1st quarter was less than expected and was revised down from 2.4% to 1.8%, primarily due to the effect of the increase of the payroll tax on income and consumer spending. This is the largest GDP revision since the 3rd quarter of 2009. Disposable income slumped at an 8.6% annual rate, the biggest drop since 2008. For the 2nd quarter, the median growth forecast by economists is 1.7% before strengthening to 2.3% in the second half of 2013. The Fed projects 2.3% to 2.6% GDP growth in 2013, a stretch given sub 2% growth in the first half. The

International Monetary Fund (IMF) recently lowered its projection for 2013 U.S. GDP growth from 1.9% to 1.7% due to U.S. budget cuts ("the sequester"). Our forecast calls for 2013 growth below 2% as automatic government budget cuts, increasing interest on the national debt, and the end of the payroll tax cut inhibit GDP growth.

Employment

June payrolls surprised on the upside to 195,000, but are still below the pace needed to lower unemployment which remained constant at 7.6%. 70% of the new jobs were in the lowest paying areas of leisure, hospitality and retail. U6, the measure that includes workers who are involuntarily part-time, actually rose from 13.8% to 14.3%. The number of workers in temporary jobs has jumped more than 50% since the recession ended four years ago. Temporary jobs do not provide the pay or benefits that allow for increased consumer spending and economic growth. The trend to hire contract or temporary workers is different from past recessions where companies typically retained staff through recessions. It also shows a lack of confidence in the economy. The labor participation rate of 63.5% remains near historic lows.

Real Estate

Home prices and building activity continued to pick up after a long drought. As the Fed talked of ending its purchases of mortgage bonds, rates for a 30 year mortgage rose to 4.51%, the highest in two years and up from 3.35% in May. The backup in mortgage rates since May reduced mortgage applications by over 40%. Refinancing applications fell 51% over that period. Lenders predicted that refinancings would taper off, but did not anticipate that rates would rise so quickly. New and existing home sales were up 2.1% and 4.2% m/m, respectively, in May, and up at a double-digit pace from a year ago. Inventories remain lean at 4.1 months for new homes and 5.1 months for existing homes. We remain concerned that up to one-third of housing sales are cash-based, which suggests investment driven purchases rather than families moving into their dream home. These types of sales may fade quickly as rates rise. The National Association of Home Builders (NAHB) index hit a fresh post-recession high in June. May housing starts rose to 928,000 units, but fell 9.9% in June to 836,000 houses. The average this year is about 900,000 housing starts - a large increase from the bottom, but still far below the pre-recession pace of 1.5 to 2 million units.

Consumer and Manufacturing

Since the end of the recession, confidence continues to improve, but remains weak relative to long-term history. The University of Michigan and Conference Board data rose in the 2nd quarter. Car sales in June were at the highest rate since 2007. Manufacturing performance has been far less robust than housing or auto sales in 2013. Outside of some strength in January and February, The Institute of Supply Management (ISM) Manufacturing Survey held near the 50 expansion/contraction breakeven level during the second quarter. After falling to 49 in May, the lowest level since June 2009, the index rose in June to 50.9 with moderately stronger orders and production. Weakness in overseas markets is still affecting manufacturing in the U.S. International trade data showed continued sluggish export performance and relatively stronger imports. Wholesale inventories fell in May by 0.5%, the largest decrease since September 2011. Economists had been expecting a rise of 0.3%. Analysts think this could subtract 0.4% from GDP.

World Economy

Europe

In May, the European Central Bank (ECB) eased further by cutting its interest rate to a record low 0.5% and pledging that monetary policy "will stay accommodative for the foreseeable future." The Bank of England (BoE) also signaled it is willing to provide further monetary stimulus, particularly if the recent rise in interest rates weighs on its tepid GDP growth of 0.3% in 1st quarter and 0.6% in the 2nd. The ECB stated that there may be additional easing measures and that an exit is "very distant." The euro zone has been in recession for six quarters and output is still 3.4% below the 2007 peak. Car sales in Europe fell -6.3% y/y in June and are down in 18 of the last 19 months. The European Union's sovereign debt crisis has been on the back burner of the market place for several months, but the situation has never been fully cleared up. Recently, Italy's sovereign credit rating was lowered to BBB, two notches above junk. France lost its AAA rating down to AA+ based on a weaker economic outlook. Credit remains tight as non-performing loans are 10% to 20% in Italy, Ireland, and Greece. Unemployment in the euro zone climbed to 12.2% with youth unemployment over 50% in Greece and Spain and above 40% in Italy and Portugal. However, retail sales in Spain rose for the fourth time in five months in May and output in Italy rose for the first time since January. Both the ECB and the Organization for Economic Cooperation and Development (OECD) forecast a -0.6% contraction in GDP for 2013.

Japan

Japan's experiment with record stimulus of $78.6 billion in asset purchases per month is injecting life into its stagnant economy. June's Bank of Japan report showed sentiment among large manufacturers turned positive for the first time in almost two years. Japan's huge monetary stimulus and still-evolving fiscal and structural reforms will likely be viewed as satisfactory for now with growth coming in at 4.1% annualized in the 1st quarter and forecasts for a relatively strong 2nd quarter. The yen is down nearly 25% from late-summer 2012 levels, benefitting exporters. However, the weaker yen has exacerbating the trade deficit in the near term especially since Japan has a high reliance on oil imports priced in dollars.

China and Developing World

Slowing growth in the world's second largest economy has sent shivers through global markets. China's growth took a hit from weak manufacturing and a quarter-end liquidity squeeze in the official and shadow banking sectors - interbank lending rates skyrocketed well above 20% in June, but have since come down with an injection of liquidity from the central bank. The Chinese stock market fell over 5% in a single day and reached its lowest point since August 2009. Chinese exports fell 3.1% in June vs. expectations of a gain of 3.3% and imports were down 0.7% on the year. This is the worst y/y performance since October 2009. The economy grew 7.7% y/y in the 1st quarter and 7.5% in the 2nd quarter. At this rate China's growth could be the slowest since 1990. Central authorities are attempting to put less emphasis on GDP growth as a measure of success after pressure to meet targets may have prompted local governments to fudge figures. The government is also trying to shift the economy towards consumer consumption and away from industry. In 2010, the IMF projected 9.5% growth in 2013 and then revised growth to 8.8% in April 2012. April 2013 saw another downgrade to 8.0%, and now growth looks like it could round down to 7%. The world can not expect China to drive world growth.

Elsewhere in emerging markets, Brazil's central bank raised its interest rate to 8.5% as consumer prices rose 6.7% y/y in June while GDP slipped to 0.55% in the 1st quarter. Unrest in Egypt after the military takeover is making its neighbors uneasy and roiling energy markets. Growth in India decelerated to 3% y/y, well below the double-digit gain recorded in 2010, the 7.7% in 2011, and 3.8% in 2012. Inflation in India accelerated to 9.9% in June. The IMF lowered their 2013 world growth forecast from 3.3% to 3.1% due to weakness in emerging markets. Our forecast is for slower growth and higher inflation in emerging markets with 2% to 3% world GDP growth in 2013.

Investment Perspective

As we have written in past updates, the rotation away from the bond market will be painful for those investors holding long-term fixed income and other riskier income producers (e.g., mortgage REITS). After all these years, there is still so much money printing, quantitative easing, and currency intervention. Cash has no yield. Bonds have little yield, no purchasing power protection, and lots of potential price risk. Investors may still be hesitant to invest in equities and some companies are overvalued, but there are few alternatives given bonds' artificially low yields, low to negative real interest rates, and government support for the equity markets. As the fear of the economy collapsing fades from memory, more investors will be willing to make the leap into equities. Even though there are reports that investors have started to rotate into stocks from bonds, the trend has yet to reverse the huge inflows into bonds in recent years: alarmed by one crisis or another, investors have poured $1.25 trillion into bonds since 2007 vs. $388 billion for stocks. It is no wonder the exit from falling bond values can become quickly clogged with so many sellers.

Companies have once again lowered earnings' expectations. Earnings growth in the second quarter is expected to grow at an anemic 0.7% y/y – three months ago the expectation was for 4.2% earning's growth. Revenues are expected to climb a dismal 1% y/y in the 2nd quarter. However, the Fed's easy monetary policy, and the hoped for economic recovery with higher future profits, will continue to support equity valuations. With excess money printing and world-wide currency debasement, precious metals remain attractive even after giving up ground in the 2nd quarter. Oil prices in the first half of the year were up about 6%. Despite the increasing supply from the U.S., world supply/demand is tight: world consumption rose +0.99% in 2013 vs. supply +0.84%. Consumption for oil from emerging markets grew +3.06% and will dominate demand, a position "they should hold in perpetuity," according to the International Energy Agency. For equities, we continue to look for opportunities in health care, industrials, technology, agriculture, and energy. Quality counts, dividends count, and well run businesses count. As the Fed continues to consider heading toward the exit door with its bond buying program, volatility is likely to increase for all asset classes. We remain vigilant.

June 30, 2013
DJIA: 14,909.60
S&P 500: 1,606.28

About Bounty Management
Bounty is an investment firm based in Boston that provides personalized, professional management of investment portfolios. Since 1971, we have successfully managed investment, trust and retirement portfolios for clients including individuals, families, non-profits, and endowments. Our primary goals are to preserve purchasing power and to produce long-term appreciation of capital.

If you would like to learn more about our investment management services, performance, and how we can help you, please give Ray Bligh a call at (617) 357-8285 or access our web site at http://www.bountymanagement.com.