MORNING BRIEFING
November 11, 2013

Four Shades of Grey

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(1) Talking Ed. (2) Three shades of grey scenarios. (3) Latest GDP and employment reports aren’t black and white. (4) Final sales growing slowly. (5) Is Obamacare draining confidence? (6) New highs for R&D and software spending, and exports too. (7) Preliminary payroll data unreliable. (8) YRI Earned Income Proxy at record high. (9) Europe’s recovery is still a slow-go. (10) ECB spooked by deflation. (11) Obamacare is sickening so far, but could be bullish for stocks.

US Economy. This week’s Barron’s includes an interview with yours truly. In it, I say: “Since the beginning of the year, I’ve been forecasting 60% probability of a rational exuberance scenario, 30% melt-up, and 10% meltdown. I’m still there, but I’m wavering and leaning toward the melt-up.” Those have been my three “shades of grey” scenarios for 2013. So why is my commentary this morning titled, “Four Shades of Grey”? Have a look at the color of my hair in the picture included in the article.

There are lots of grey shades in the latest batch of global economic indicators and in the stock market’s reaction to them. On Thursday, US real GDP for Q3 showed a better-than-expected gain of 2.8% (saar). The S&P 500 fell 1.3% that day. The financial press noted that good news was bad news because it might encourage the Fed to taper QE sooner rather than later. On Friday, payroll employment was also up more than expected, but the S&P 500 rose 1.3%. Good news was good news.

However, the GDP report wasn’t that good since it was boosted by a big increase in inventories, while final demand was actually quite weak, as Debbie reports below. The employment report was also not as good on closer inspection. Let’s have a look at all the recent shades of grey in the US, and Europe too while we are at it:

(1) GDP growth isn’t red hot. Excluding inventories, real final sales in GDP increased 2.0%. Real final sales to domestic purchasers rose just 1.7%, following a gain of 2.1% during Q2. The $86 billion increase in real business inventories was widespread in manufacturing ($21bn), wholesale ($17bn), non-auto retail ($13bn), and auto retail ($5bn) (Fig. 1). Debbie and I noted last week that both weekly intermodal railcar loadings and business short-term credit suggested rising inventories.

The problem is that final demand was weak during Q3 and could remain weak during Q4 and early 2014. Debbie and I are particularly concerned about the impact of Obamacare on consumer spending. While the latest employment gains are solid, the Consumer Sentiment Index dropped again in November following a decline in October (Fig. 2). Last month’s decline can be explained by Washington’s political impasse, which was temporarily resolved on October 16. But the decline in early November’s sentiment readings is surprising given the recent drop in gasoline prices and record highs in the stock market. There may be widening concerns about Obamacare, as discussed below (Fig. 3).

For now, the data show that real GDP on a y/y basis rose only 1.6%, continuing to grow just below the dreaded “stall speed” of 2%, as it has been since the start of the year (Fig. 4). However, excluding government spending, it is up to 2.7% from Q1’s 2.1%, suggesting that the private sector may be resuming its relatively steady growth since mid-2010 around 3%.
There was some other encouraging news in the GDP report. While total real capital equipment spending edged down during Q3, industrial equipment spending jumped to a new cyclical high ($195bn saar), R&D spending rose to a new record high ($250bn), and software outlays remained around a record high ($297bn) (Fig. 5). One more cheery item: Exports rose to a new high, suggesting that the global economy continues to grow and to offer sales opportunities to US companies (Fig. 6). (Click ★ to add GDP to MyPage.)

(2) Less blue in the labor market. Payrolls rose 204,000 during October despite the temporary shutdown of the federal government. (Maybe a longer shutdown would have boosted jobs more!) The previous two months were revised higher by 60,000 (Fig. 7). The recent revisions confirm how unreliable the first estimates can be. July was first reported as having a gain of 162,000, which was revised down twice to 89,000. August’s preliminary gain of 169,000 is now 238,000 after two revisions. September’s first revision boosted it slightly, by 15,000 to a gain of 163,000.

So October’s number is unreliable since it is also likely to be revised. It certainly doesn’t jibe with the household measure, which dropped a whopping 735,000 during October (Fig. 8). However, the latter measure excluded furloughed federal workers from employment, while the former kept them on the payrolls.

Jobs gains continue to be mostly in industries that hire part-time workers, according to the payroll measure, which counts the number of jobs whether they are part-time or full-time ones. The household measure counts people with jobs, no matter whether they have one or more of them. In any event, our YRI Earned Income Proxy—the product of aggregate hours worked times average hourly earnings in the private sector—rose 0.3% during October to yet another new record high (Fig. 9). This augurs well for wages and salaries in the private sector.

(3) Europe’s recovery is pale green. As I noted last week, European forward P/Es are now back to the levels of 2009, prior to the Greek crisis that stirred fears of the disintegration of the euro zone. European bourses seem to have discounted a strong economic recovery since they bottomed during the spring of 2012. That was a good call, as the region’s economy seemed to have bottomed this past summer. However, the recovery has been lackluster.

That’s corroborated by September’s industrial production numbers for Germany (- 0.9% m/m), France (-0.5%), and Spain (flat). They continue to flat-line as they have since the start of the year along with the overall euro zone production index (Fig. 10). In addition, the region’s flash CPI compiled by Eurostat for October was up just 0.7% y/y, down from 1.1% the previous month and below the ECB’s target of 2% (Fig. 11).

That spooked the ECB to lower the central bank’s official rate by 25bps to 0.25%. In his 11/7 press conference, ECB President Mario Draghi said this action was in response to the “latest indications of further diminishing underlying price pressures in the euro area over the medium term.” He added that the recent “decline was stronger than expected and reflected, in particular, lower food price inflation, a larger fall in energy prices and some weakening in services price inflation.”

Obamacare. There are no shades of grey in debates about the role of the government in our economy. The country is torn between Red (Republican-leaning) and Blue (Democratic-leaning) states. The terms were coined by journalist Tim Russert, during his televised coverage of the 2000 presidential election. The political schism between the conservative and liberal states seems to have worsened since then. It sometimes seems like a civil war, though it remains civil with no black-and-blue marks on anybody’s body so far.
However, lots of Americans are turning pale as they realize that, thanks to Obamacare, their health insurance providers no longer care to provide them with the same policies, with the same coverage and network of doctors, in 2014 as they had in the past. Add me to the list of Americans who are sickened by this development.

Here is the email message I received from our insurance agent last week: “As we discussed on the phone, Emblem is discontinuing all of their current insurance plans effective at midnight, 12/31/2013. They just sent us three options that they decided to offer to small groups after all. They are all HMOs, and they are in the Select Care Network. They are effective 1/1/2014. If you would like to stay with Emblem and sign up for one of these plans, please let me know, and I will obtain the paperwork needed. I do suggest searching for [your] providers at [Emblem’s website] to verify that they participate in the Select Care Network, as there will be no out-of-network coverage. If the providers do participate, this will be your most cost-effective option. If you are not interested in these options, I should be able to obtain rates and quotes from the NYS group exchange as well as other carrier options for you by the end of next week.”

I looked on the website and found that none of my doctors are in their network. So I asked our agent to keep looking. Consider the following broader consequences:

(1) Lots of Americans may get increasingly anxious over the remainder of the year that they will have more out-of-pocket health care costs next year to pay for doctors who aren’t in the networks of the policies available to them as a result of Obamacare. If their concerns are realized, then they might actually have to spend more of their budgets on health care and less on everything else.

(2) I discussed this possibility in visits to our accounts in Chicago and Toronto at the end of last week. They asked if Obamacare might depress the economy. I think it could, which might reduce the likelihood of a melt-up.

(3) On the other hand, the Fed has demonstrated that ultra-easy monetary policy will persist as long as economic growth remains subpar and the labor market remains challenging. If the Yellen-led Fed tries to offset the negative economic consequences of Obamacare with more easy money, watch the stock market go vertical.

(4) If Obamacare’s website continues to malfunction and Democrats start to fear that continuing the botched program will hurt them in next year’s elections, President Barack Obama might issue an executive order delaying his plan by a year. See you north of 2000 on the S&P 500 early next year if that happens.

**CALENDARS**

**US. Tues:** NFIB Small Business Survey Index 93.3. (Bloomberg estimates)

**Global. Tues:** Germany CPI 1.2% y/y, UK Headline & Core CPI 2.5%/2.0% y/y, Japan Machine Orders 12.5% y/y. (DailyFX estimates)

**PERFORMANCE & ASSET ALLOCATION**

**Global Stock Markets Performance (link):** The S&P 500 rose 0.5% last week, ranking 16th among the 49 stock markets we monitor in a week when 19 rose. Its 0.8% gain November-t-d is outperforming the major indexes and ranks 10/49, up from 22/49 in October. November’s major indexes and their
performance: World (-0.2%), Europe (-0.3), EAFE (-0.6), EM Asia (-2.3), and EM Latin America (-2.9). The S&P 500 is up 24.1% ytd, ranking 7th among the 49 stock markets and ahead of the top-performing EAFE index (19.6). The next best performer ytd is World (18.7), followed by Europe (16.4). The worst performers ytd are EM Latin America (-6.5) and EM Asia (0.8).

S&P 1500/500/400/600 Performance (link): SmallCap’s 1.0% gain was last week’s top performance, ahead of LargeCap (0.5%) and MidCap (-0.4). Seventeen of the 30 market-cap sectors rose w/w for the three indexes, up from 10 rising in the prior week. Eighteen of the 30 sectors are up November to date, down from all 30 rising in October, which was the best performance since December 2010. In the ytd derby, SmallCap (32.8) is on track for its best year since 2003 and leads MidCap (26.0) and LargeCap (24.1). Three SmallCap sectors top the ytd performance list.

S&P 500 Sectors and Industries Performance (link): Seven of the 10 S&P 500 sectors and 73/128 industries rose last week, versus 6/10 and 61/128 in the prior week. Materials (1.2%) and Financials (1.1) performed the best; Telecom (-2.1) fared the worst. The S&P 500 is up 0.8% November-t-d with 8/10 sectors and 73/128 industries higher, slower than October when all 10 sectors and 106/128 industries rose. The best sectors November-t-d: Industrials (1.6), Financials (1.3), and Tech (1.1). On a ytd basis, four sectors are ahead of the S&P 500 (24.1): Consumer Discretionary (33.4), Health Care (32.9), Industrials (30.1), and Financials (26.8). The worst performers ytd: Telecom (7.4) and Utilities (11.1).

Commodities Performance (link): Six of the 16 commodities we follow rose w/w last week, up from three a week earlier. The week’s top performers: Stainless Steel (10.1%), Tin (6.8), and Soybean (3.2). Four commodities are higher in November-t-d, fewer than the five commodities that ended higher in October and September. Prices rose in 2012 for 13/16 commodities, but only three are up ytd: Natural Gas (6.2), WTI Crude Oil (3.0), and Cotton (2.3). 2013’s laggards to date: Corn (-38.9), Silver (-29.4), and Gold (-23.3).

Assets Sorted by Spread w/ 200-dmas (link): Spreads between prices and 200-day moving averages (200-dmas) rose last week for 11/19 commodities, 3/9 global stock indexes, and 19/44 US stock indexes versus 7/19, 5/9, and 7/44 the week earlier. Only 2/19 commodity indexes trade above their 200-dmas, down from nine in early October. Commodities account for 17 of the 22 indexes trading below their 200-dmas: Corn (-27.7%) and Silver (-9.7) are the lowest. Commodities’ average spread improved to -4.7% last week from -5.2%. Five of the nine global indexes trade above their 200-dmas, down from six a week earlier. The average global index spread slipped to 1.0% from 2.1% a week earlier. Forty-three of the 44 US stock indexes trade above their 200-dmas, down from 44 a week earlier; their average spread edged down to 8.7% from 8.9%.

Commitments of Traders (link): What were Large Speculators doing in the futures pits on November 5? They were bullish on the S&P 500 and bearish on the 10-year Treasury Note. They were much less bullish on the US Dollar and bullish on the Euro. They were neutral on the Pound and bearish on both the Canadian Dollar and on the Aussie Dollar. They remained very bearish on the Yen. They are more bullish on Gold again. They had large bullish positions in Crude Oil and on Gasoline.

US ECONOMIC INDICATORS

GDP (link): The first look at Q3 real GDP shows the economy expanded at a larger-than-expected 2.8% (saar)--best in a year--as inventory investment picked up. (The yearly growth rate remained subdued at 1.6%.) Companies accumulated inventories at an $86.0 billion (saar) pace, up from $56.6 billion during Q2 and the strongest since Q1-2012. Real consumer spending growth slowed to 1.5% (saar), the weakest since Q2-2011. Growth in nonresidential investment decelerated to 1.6% (saar) from 4.7%
during Q2; gains in structures (12.3%) and intellectual property products (2.2) were partially offset by a drop in equipment (-3.7) spending. Residential investment (14.6) continued its double-digit pace. The trade gap narrowed, with exports (4.5%) outpacing imports (1.9). Government spending (0.2) was basically flat; a 1.5% increase in state & local spending offset a 1.7% decrease in federal spending.

**Contributions to GDP growth** (link): Real consumer spending and inventory investment provided the biggest boost to growth last quarter. Here’s a tally (in order of contribution): (1) Real PCE added 1.04pps (its weakest contribution in nine quarters). Durable (0.57) and nondurable (0.42) goods consumption accounted for the gain; the services’ contribution was only (0.05). (2) Inventory investment supplied 0.83pps, mostly nonfarm (0.71). (3) Real residential investment added 0.43pps, the twelfth straight positive reading. (4) Trade provided 0.31pps, with exports adding 0.60pps and imports subtracting 0.30pps. (5) Real nonresidential fixed investment contributed 0.20pps, led by structures (0.32). Intellectual properties products added another 0.09pps; equipment subtracted 0.21. (6) Real government spending (0.04) had little impact, with state & local spending adding 0.17 and federal spending subtracting 0.13.

**Employment** (link): October payrolls increased a greater-than-expected 204,000, with sizeable upward revisions--a net 60,000--to the prior two months. Private payrolls climbed 212,000, with a net upward revision of 70,000. The breadth of job creation (percent of private industries increasing payrolls) was above 60% for the first time since February, climbing from 57.5% to 61.5%. Temporary help jobs increased for the 18th time in 19 months (by a total 272,000) to yet another record high, though the pace has slowed. The index of average weekly hours increased 0.2%--reversing September’s decline--while average hourly earnings rose 0.1% (building on gains of 0.1% and 0.3% the prior two months). That pushed our earned income proxy up 1.0% since July to a new record high.

**Employment By Industry** (link): Two part-timer-heavy industries led October’s job gains: Leisure & hospitality (led by restaurants) saw payrolls climb 53,000, the most in six months; retailers added 44,400 jobs (291,700 ytd), double September’s gain. Other industries with employment advances include: professional & tech services, up 21,400 in October (213,000 the past 12 months); manufacturers, up 19,000 (an eight-month high, though little changed since February); and health care, up 15,000 (near 2013’s monthly average but below 2012’s 27,000 average). Employment showed little change in mining & logging, construction, wholesale trade, transportation & warehousing, information, and financial activities. (Federal government payrolls fell only 12,000 despite the government shutdown since furloughed workers were considered employed, having worked or received pay for the period that included the 12th of the month.)

**Unemployment** (link): The unemployment rate ticked up to 7.3% in October from 7.2% (lowest since November 2008). The adult rate was at 6.7% for the third month, the lowest since December 2008. The teenage rate, 22.2%, rose for the first time in five months off a four-year-plus low (21.4%). The college grad rate rose for the second month to 3.8% from 3.5% in August (lowest since November 2008). The participation rate plunged from 63.2% to 62.8% as 720,000 people dropped out of the workforce. (Furloughed federal workers were not counted as employed under the household survey’s definition, unlike the payroll survey.) Those working part-time for economic reasons barely changed at 8.1 million (5.2% of the civilian labor force). The sum of the underemployment and jobless rates (12.5%) held near October’s 12.3% cyclical low. The U6-Rate (includes marginally attached workers) edged up to 13.8% from its 13.6% cyclical low.

**Wages** (link): The average hourly earnings rate for all workers on private nonfarm payrolls (2.2%) remained just above 2.0% in October. The wage rate for goods-producing industries (2.5) climbed to a four-year high; the service-providing rate (2.1) moved sideways. Within goods-producing, the manufacturing (2.7) and mining (3.9) rates accelerated; construction (1.5) remained in a flat trend below
2%. Within service-providing, the leisure & hospitality rate (0.8) was below 1.0%. Wage rates for professional & business services (1.6), education & health services (1.7), and retail trade remained between 1%-2%--with retail trade trending lower. Rates accelerated for information services (4.5) and transportation & warehousing (3.1), decelerated for financial services (2.9), and remained in a flat trend for wholesale trade (3.3).

**Personal Income & Consumption** ([link]): Consumer spending slowed in September as consumers put more of their income into savings heading into the government shutdown. Personal income increased 0.5%, matching August’s upwardly revised gain--first reported as a 0.3% increase. Wages advanced a solid 0.4%; rental and proprietors’ income also added to the gain. Nominal personal consumption expenditures (PCE) growth slowed to 0.2% from 0.3% in August. Real spending advanced only 0.1% m/m, with Q3’s increase slowing to a nine-quarter low of 1.5% (saar). The personal saving rate climbed to a high for the year of 4.9%, up from 4.4% at the end of Q2.

**Consumer Sentiment Index** ([link]): Consumer confidence continued to deteriorate in early November to its lowest level since December 2011. The Consumer sentiment index dropped 1.2 points this month (or 13.1 points from July’s cyclical peak) to 72.0. The present situation component accounted for nearly all of this month’s decline, falling to from 89.9 to 87.2, the lowest since January. The expectations component lost ground for the fifth month, edging down from 62.5 to a two-year low of 62.3 this month, and sliding 15.5 points since June. “Following the end of the shutdown, consumers were somewhat more optimistic about the outlook for the economy, but thus far the rebound has been lackluster,” Richard Curtin, director of the survey, said in a statement.

**GLOBAL ECONOMIC INDICATORS**

**Germany Industrial Production** ([link]): German industrial production slumped 0.9% in September after a revised 1.6% gain in August (vs. 1.4% preliminary) and a 1.1% loss in July. Factory output drove September’s decline, falling 1.1%, led by a 2.1% drop in investment goods from their cyclical high. Construction output was 1.8% lower, energy output 2.1% higher. “Despite the current slight decline, the trend for industrial production remains upward. The rising trend in manufacturing and construction orders points to a continued economic recovery,” the Economic Ministry said in their statement. Output was up 1.0% y/y. Forward-looking indicators show October’s Ifo business climate index was little changed around recent highs. The country’s M-PMI remained in expansionary territory, climbing from 51.1 to 51.7.