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THE WEEKLY VIEW

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Updating 10 Conditions for Sustainable Growth: Recent Data Encouraging

For economic growth to be self-sustaining, without extraordinary fiscal and monetary accommodation, 'Main Street' needs to feel confident about its employment and financial prospects, in our view. Wall Street has clearly benefited from government and Federal Reserve policies – the stock market and earnings have risen to record levels – but the average household has struggled with depleted savings and stagnant incomes. Moreover, government support has already begun to 'taper' – temporary payroll tax reductions have ended, unemployment insurance has been scaled back, food security programs have been cut, and sequestration remains in effect (although further spending cuts may soon be lifted in budget negotiations). Given this backdrop, we think recent employment and manufacturing data are encouraging. In *The Weekly View*, 6/22/09, we set forth ten conditions that we thought were necessary for a sustainable economic recovery. When we last revisited this list on September 16, most of the conditions were met but still signaled below-average growth. Since then, despite a government shutdown, the most recent data show that nearly all of our requirements have been fulfilled and continue to improve. Thus, we expect accelerating year-over-year economic growth in 2014.

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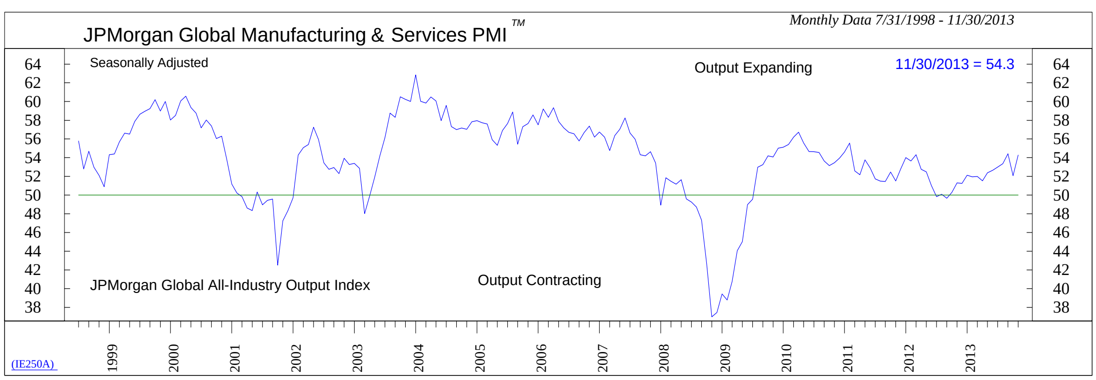
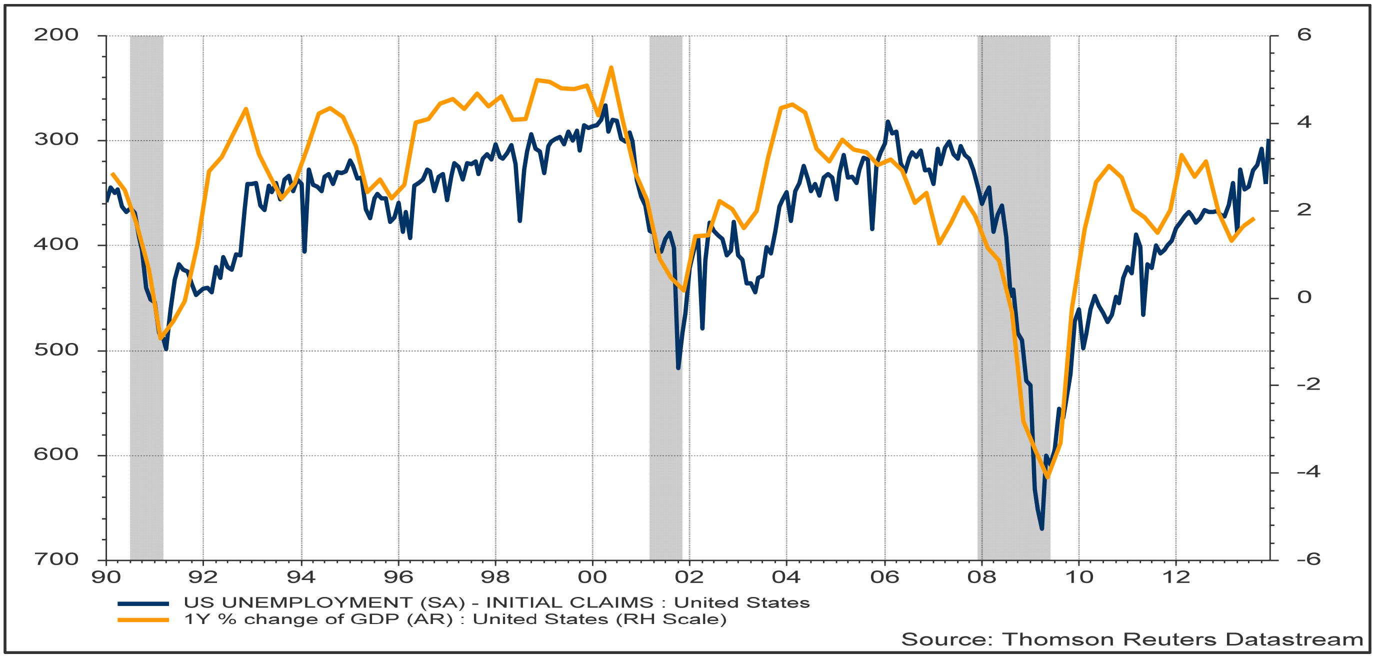
1. Purchasing Managers Indexes (PMIs) above 50: Purchasing managers have a unique insight into economic activity, thus we watch their surveys closely. The manufacturing PMI represents about 20% of the economy but because it tends to be more cyclical, it helps provide clues to the near-term direction of the economy; the services PMI gives a broader view on the health of US business. The latest readings for November, at 57.3 and 53.9, respectively, indicate ongoing expansion. We also pay close attention to global PMI data (see chart below), which currently suggest synchronized growth of the world's economies.



2. Unemployment rate continuing to fall: The Fed has explicitly tied monetary policy to "substantial improvement in the outlook for the labor market." A 6.5% unemployment rate is the Fed's current threshold to consider hiking interest rates, but it could be lowered if Janet Yellen as Fed Chairman implements more aggressive forward guidance as a complement to quantitative easing. We think the Fed would also like to see hiring and quit rates (a measure of labor confidence) improve to pre-recession levels before signaling an all clear (see Weekly

Chart). Additionally, aggregate payrolls — hours worked times hourly earnings — grew 4.2% year over year In November, comfortably ahead of 0.9% inflation and supportive of stable consumer demand.

3. Weekly initial jobless claims in the low 300,000s: Jobless claims peaked at 670,000 in 2009 (just below 1982's record high of 695,000). Claims are now at 298,000, the lowest since April 2006 (near the peak of the housing bubble). Jobless claims are a good real time indicator of economic growth since they are reported weekly, and at current levels suggest more than 3% year-over-year growth. Note the inverted left scale for initial claims (blue line) versus annual GDP growth (yellow line) on the right.



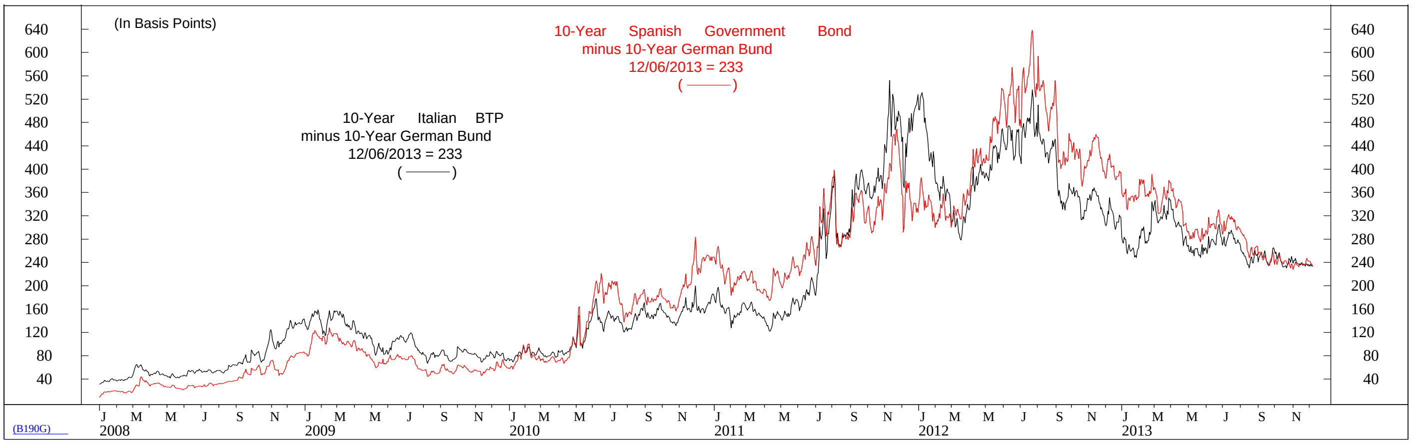
4. Savings rates at 8% or higher: Personal savings rates (income minus spending, as a percent of income) at 4.8% remain low by historical standards, but with good reason given negative real returns for liquid short-term financial assets (e.g., cash, bank deposits, CDs). However, just as housing had become an overvalued savings substitute when prices were high, we are less concerned about real estate assets as a savings vehicle with national single-family rental yields currently around 5%. Indeed, including *tangible* assets, household savings are 10.8%.

5. Home prices stable to rising: House prices bottomed in early 2012 as they had become attractive relative to rents and income. A major part of Fed policy, besides stabilizing the financial system, has been supporting housing and mortgage markets given the trillions of dollars in lost homeowners' equity. The total value of household real estate was $3.6 trillion below its 2006 peak in the third quarter of 2013 (although it has recovered more than $3.1 trillion from the bottom). We expect current 13% year-over-year home price appreciation to moderate as inventories rise (with fewer homes 'under water') and as mortgage rates creep higher.

6. Mortgage rates below 5.5%: The rise of mortgage rates from record lows of around 3.5% has dampened refinancing activity, but homes remain affordable based on household income and home prices. We think home affordability will likely remain attractive even if mortgage rates, now around 4.5%, rise by another percentage point. However, if double-digit home price appreciation continues without commensurate household income gains, potential homebuyers would rapidly be priced out of the market. We think that the last thing the Fed wants to do is abort the housing recovery, so we expect them to remain supportive.

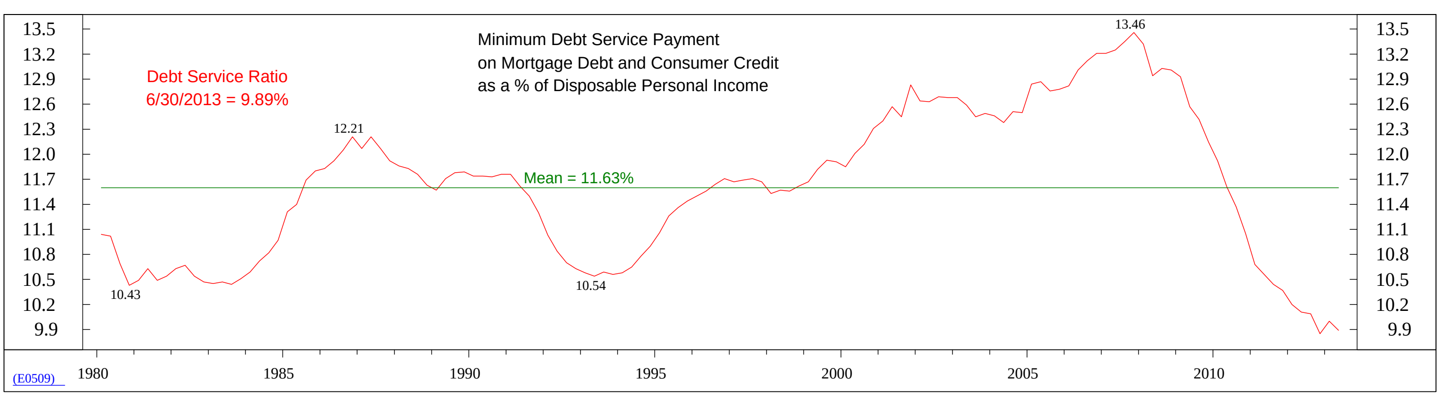
7. Inflation expectations under 3%: 'Well anchored' inflation expectations are critical for the Fed to maintain extraordinary monetary accommodation. Massive levels of money printing have not caused higher inflation, mostly due to low 'velocity' (cash on balance sheets is not being lent or paid out) and a still-large 'output gap' (underutilized productive capacity), in our view. Ten-year inflation expectations are 2.1%, as measured by the difference between Treasury inflation-protected securities (TIPS) yields and regular (nominal) Treasury yields, just above the Fed's 2% long-term target.

8. Stable credit spreads: Credit spreads gained prominence as a gauge of sentiment during the global financial crisis and Europe's sovereign debt crisis. We follow credit default swap (CDS) spreads and also monitor cash spreads in the market. High yield CDS spreads are currently near record lows at 352 basis points after rising to more than 1800 basis points in 2009 (a basis point equals 0.01 of one percentage point). European credit spreads have narrowed under 240 basis points from over 520 in 2012 based on 10-year Spanish and Italian yields over German bunds (although they still remain well above pre-crisis levels under 200). In contrast, emerging market CDS spreads have widened out from just over 200 basis points at the start of the year to 300 now, reflecting funding stresses in vulnerable countries like India, Indonesia, Brazil, and Turkey. However, we expect little spillover to the developed world, which we expect will continue to gradually recover.



9. Positive productivity: Third-quarter output per hour (i.e., productivity) was flat year over year. We are concerned because we believe productivity — making and doing things better and more efficiently, using less time and resources — is the key to long-run prosperity and wealth generation. However, private investment has recently picked up and reductions in government investment are diminishing. We regard this as positive since higher productivity requires long-term investment by both business and government. Although productivity growth has been stagnant over the last few quarters, its five-year average is just below 2%. Current low labor costs and high profit margins should be supportive for hiring and investment, which we expect will eventually bring productivity growth closer to the longer-term average.

10. Lower leverage: A combination of defaults and ultra-low interest rates has driven household debt service and financial obligations ratios to their lowest levels in decades. Three years ago when the debt service ratio was at 12% we wrote: "We expect more defaults, ongoing restructuring, asset sales, and income generation to be a slow process, but one which will ultimately leave US consumers better able to support sustainable economic growth." With the debt service ratio now below 10%, we do not expect a quick ramp up in leverage (in the early-1980s it stayed low for four years). Thus we believe that low leverage and better credit allocation will provide a solid foundation to sustain economic growth.



THE WEEKLY CHART: HOW THE FED JUDGES 'SIGNIFICANT LABOR MARKET IMPROVEMENT'

Source: U.S. Bureau of Labor Statistics, U.S. Department of Labor, National Federation of Independent Business, and The Conference Board

The spider chart above, from the Federal Reserve Bank of Atlanta, helps illustrate some of the labor market indicators the Fed watches relative to pre-recession levels and the worst of the recession. The green line represents pre-recession as a baseline, while the orange line indicates the worst levels reached during the Great Recession at the end of 2009; the blue line shows the latest readings. Some indicators such as 'temporary help' have exceeded their December 2007 peaks, but many still remain below pre-recession levels, particularly in the 'utilization' category. Presumably when most of the green circle is 'filled' by the blue, the Fed will feel comfortable reducing accommodation.

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