Ashdon Investment Management

Q2 2013 ECONOMIC COMMENTARY

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Second Quarter 2013 Economic Commentary

In commentary last quarter, we suggested that the time had come to consider the end game for current US monetary policy and how that might affect the broader economy and investment markets. Our conclusion was that the US economy was moving forward on its own steam while declining government spending (particularly in states and municipalities) was causing a persistent drag on the overall GDP metrics. The supposed economic weakness gives support to the need for ongoing loose monetary policy, but the less evident strength gives the clearance for the self-sustained economy, leaving us sanguine about the prospects for an end to policy.

As the second quarter evolved, we had a front row seat to the test of this hypothesis. During the quarter, FOMC Chairman Ben Bernanke revealed that the central bank could begin to taper bond purchases later this year. The resulting market reaction was violent and widespread. Normally quiescent fixed income markets made historic short term moves. Equity market movement was volatile as well.

As the quarter drew to a close, the 10-year yield was a high of 2.8% and the US equity market was flat after starting the quarter up 4% in April. Just a few days into the third quarter, however, both markets had stabilized and the turbulence of May and June dissipated. This short period is perhaps a model for what to expect from news flow and market reaction in the coming 18 to 24 months ahead, during which we expect policy course changes to begin.

The advance GDP release for Q2 was issued on 7/31 and included a scheduled revision of several years of past data. While inherently backward looking, this release provided valuable perspective and helps to inform and refine our current positions.

Gross Domestic Product for Q2 was 1.7%, ahead of consensus expectations. This reading is consistent with the trend of slow, persistent growth of the economy overall and with actually robust growth from the private sector being partially offset by ongoing weakness in the public sector. So there are essentially no surprises there. The data release bolstered the view that the private economy continued to grow nicely while being held back by a further decline in government consumption. There were two other pieces of GDP news. First, the GDP historical record was updated to reflect more complete data collections than had been available to date. This restatement of historical GDP is part of the BEA's Program. The other element of GDP that is remarkable is that GDP has been reformulated to reflect our modern economy. In particular, the BEA has introduced modifications that are designed to capture the creation of intellectual capital in the economy. The popular press has noted this includes creations such as music and movies. While that is technically true, it is more important that the revision captures creations that are a direct result of corporate research and development spending.

Restated GDP did not introduce any real surprises. On balance, the restatement showed that the US economy was incrementally stronger over the last decade than indicated by earlier reports.

The employment picture was little changed in the second quarter. The economy continued to produce new jobs and the unemployment rate declined slightly further, from 7.8% to 7.6%.