Ashdon Investment Management

Q4 2013 ECONOMIC COMMENTARY

January 2014

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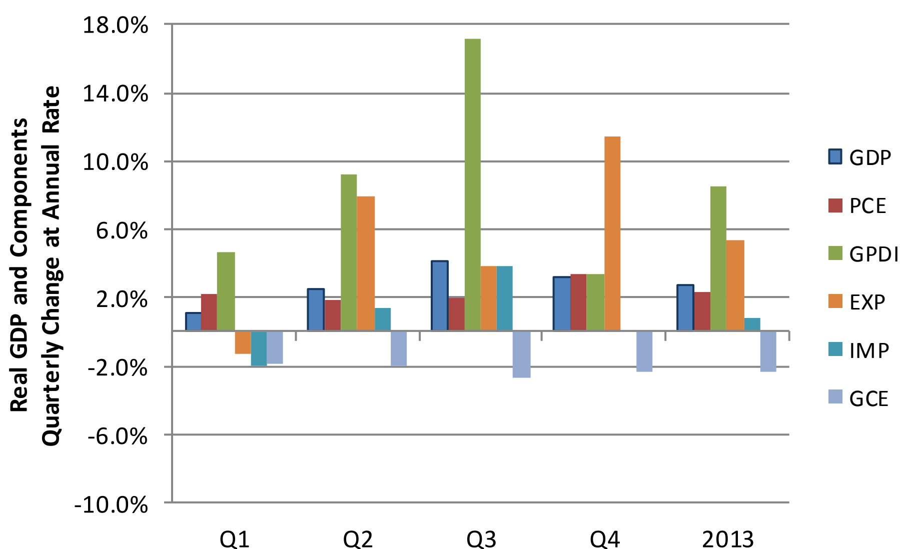
Fourth Quarter 2013 Economic Commentary

The end of the fourth quarter brought the end of a remarkable year for capital markets. US equity markets were up 32% – the largest annual rise since the rocketing technology boom of 1997. It is true that economic data for the year were broadly consistent with a growing economy. However, the growth is modest – the US economy continues to be held back by significant headwinds. We'll step through the good and bad data for the quarter and then look ahead a bit.

Strong GDP data released in Q4 topped off the year with GDP up 2.74% measured from Q4 2012 to Q4 2103 (advance release). This growth rate is a bit shy of "normal" growth rates, consistent with the headwinds that are in place. GDP components that were responsible for growth in Q4 were found across the economy: Private consumption and investment and net exports. The drag on the economy was federal government consumption which detracted -0.93% from GDP. State and Local governments were a positive contributor and have now contributed for the last three quarters. This is good news, as that segment of the economy should continue to contribute positively.



Labor conditions also continued their improvement. By the end of December, the unemployment rate had dropped to 6.7%. The US economy continued to create jobs, but after two months of strong job creation (+200K October, +241K November), the economy posted a meager +74K in December.

Note the following two points: the monthly average for the quarter was +171K and the year average was +182K so the December number wasn't sufficiently weak to change the trend in job creation. Job creation has lagged past recoveries since 2009 – consistent with the economic headwinds. A moderated rate of job growth continues to be the forecast.

Inflation is muted. Annual changes in the inflation index are well below FOMC target rates (1.5% in December vs 2% target range). There are no reasons on the horizon to suspect greater inflation. The Producer's Price index (PPI) which measures input costs, is telegraphing deflation. Combined with low wage growth rates there seems to be no inflation in the pipeline. The US economy is still working off the slack from the recession. The inflation data is also consistent with moderated economic growth.

Policy risk remains the key risk to consider. The FOMC continues to implement incremental policy changes. The FOMC's new transparency gives investors a clear view of the FOMC outlook: the recovery is stable and self-sustaining. This means the FOMC can confidently begin to carefully remove support. Since the summer announcement of a coming policy change, the FOMC has reduced its QE program purchases by $10B on 18 December. This decrease was a $5B decrease in Treasuring buying and a $5B decrease in MBS buying. We expect more decreases to be coming under Janet Yellen – new chair of FOMC. This begs the questions: what will be the likely path of interest rates (i.e. cost of capital) and what will be the knock effect for the broad US and global economies? Clearly, the absence of a large marginal buyer of Treasuries like the Fed will remove demand and drive rates up (prices have to go down). But that's just one force. We are watching other forces as well. There are indications of allocation shifts in US pension plans away from equities to increase fixed income allocations. Pension managers see that Treasury rates are high enough and credit risk is low enough that they feel secure in using Treasuries to meet their long term liabilities. The pension business is large and allocation changes like this could offset the Fed. Also, the preference of other buyers for US Treasuries could keep rates lower than might otherwise be expected. Demand for Treasuries combined with low inflation – the big component on the long end in normal times – likely means that interest rates will be well controlled for the time being.

In summary, the coupling between rates and growth is such that moderated growth will keep inflationary forces – and rates – low. And low rates will keep the cost of capital low, so growth will not suffer from a cost-of-capital headwind. This gives us a fairly clear outlook for the next 12 to 24 months – slow, persistent growth.

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