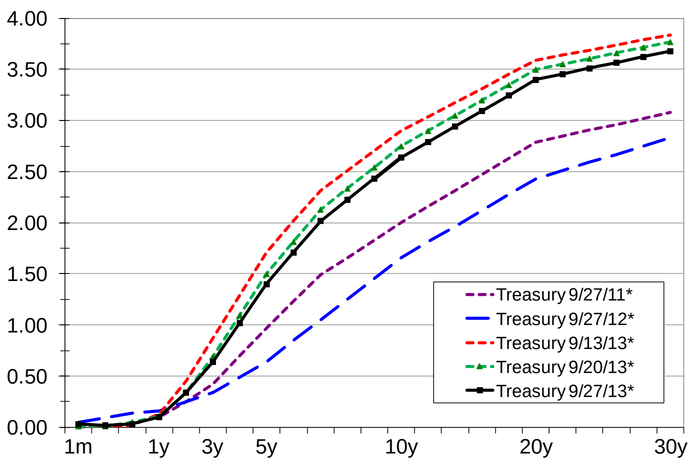
AFP EconWatch

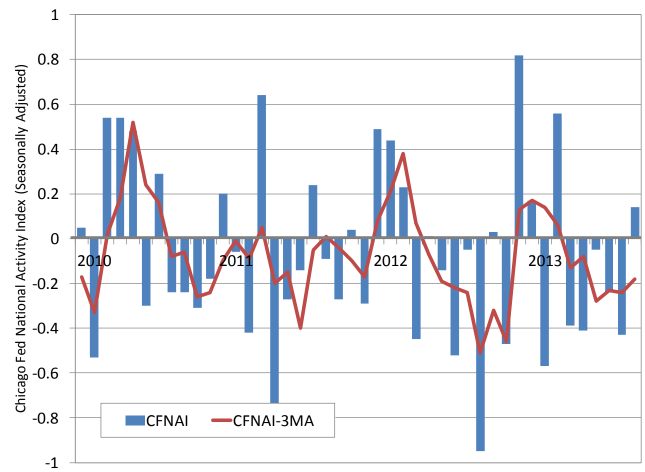
Weekly Economic Newsletter for Treasury and Finance

September 30, 2013

The Big Picture: Yield Curve & Chicago Fed National Activity Index

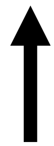
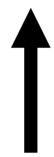
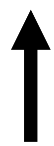


U.S. Treasury Yield Curve—Source: U.S. Department of the Treasury



Chicago Fed National Activity Index—Source: Federal Reserve Bank of Chicago

Measure	Numerical Trend	Current Trend	Analysis
GDP (third estimate) 2nd Quarter 2013 *Source:* Bureau of Economic Analysis	*Percentage Change from Previous Quarter Seasonally Adjusted Annualized Rate* Q2 13: +2.5% Q113: +1.2% Q2 12: +1.2%	↑	This estimate matches the growth rate reported in late August. The biggest positive contributor to GDP growth was consumption (as 1.8% growth during the quarter added 1.24 percentage points to GDP). The $56.6 billion increase in private inventories added 41-basis points to GDP growth, while the 14.2% jump in fixed residential investment and the 4.7% increase in non-residential investment added a combined 96-basis points to the growth rate of the economy. Net exports and government spending each made a negative contribution of 7-basis points. Corporate profits (with both inventory valuation and capital adjustments) were up 3.9% on a SAAR basis.
Personal Income August 2013 *Source:* Bureau of Economic Analysis	*Percentage Change from Previous Month Seasonally Adjusted Annualized Rate* Aug 13: +0.4% Jul 13: -0.2% Aug 12: +0.1%	↑	Personal incomes have risen 3.7% over the past year, its best 12-month comparable since last December. Wages also grew 0.4% during the month and have increased 3.5% since August 2012. Consumption grew 0.3% during August, with gains in spending for both durables (+0.5%) and services (+0.4%). Spending on non-durables was unchanged from July. The personal consumption expenditure (PCE) deflator was +0.1%, meaning "real" consumption spending was up +0.2%. The savings rate inched up 1/10th of a point to +4.6%.

Durable Goods August 2013 *Source:* *Census Bureau*	*Percentage Change from Previous Month* *Seasonally Adjusted* Aug 13: +0.1% Jul 13: -8.1% Aug 12: -12.9%		New orders totaled a seasonally adjusted $224.9 billion, up 13.7% from a year earlier. Orders for transportation equipment increased 0.7% during the month with orders for motor vehicles up 2.4% while those for civilian aircraft fell 1.2%. Non-transportation goods orders slipped 0.1%. Shipments grew 0.9% during August and were 4.9% above the year ago pace. Unfilled orders grew by >0.1% while inventories inched up 0.1%.
New Home Sales August 2013 *Source:* *Census Bureau*	*Previous Month* *Seasonally Adjusted* *Thousands* Aug 13: 421 Jul 13: 390 Aug 12: 374		New home sales regained half of what it had lost during July with a sales pace that was 12.6% above year ago levels. Sales grew during the month in 3 of 4 Census regions, with increases of 19.6% in the Midwest, 15.3% in the South and 8.8% in the Northeast. New home sales fell 14.6% in the West. The 175,000 unsold homes available at the end of August (+3.6% vs. July and +22.4% from August 2012) represented a 5.0 month supply.
Chicago Fed National Activity Index August 2013 *Source:* *Federal Reserve Bank of Chicago*	*Index* *Seasonally Adjusted* Aug 13: +0.14 Jul 13: -0.43 Aug 12: -0.95		This was the highest reading of the CFNAI since February. Components tied to production/income made a +0.22 point contribution (up 42-basis points from July). Sales/orders components made a 7-basis point positive contribution while employment added 3-basis points to the CFNAI. While consumption-related components cost 17-basis points to the CFNAI, this was an 1-basis point improvement from July.
Conference Board Consumer Confidence September 2013 *Source:* *The Conference Board*	*Index (1985 =100)* *Seasonally Adjusted* Sep 13: 79.7 Aug 13: 81.8 Sep 12: 68.4		A sizable drop in the expectations index (down 4.9 points to 84.1) resulted in the lowest reading for the headline index since last May. The present conditions gained 2.3 points to 73.2. 19.5% of survey respondents described current conditions as “good” while 23.9% said that they were “bad.” Only 11.5% reported jobs were “plentiful” while 32.7% said that they were “hard to get” (the latter being a 5-year low).
University of Michigan Surveys of Consumers September 2013 *Source:* *University of Michigan*	*Index (1966 Q1 =100)* *Seasonally Adjusted* Sep 13: 77.5 Aug 13: 82.1 Sep 12: 78.3		The consumer sentiment measure has fallen 7.6 points over the past 2 months, dropping to its lowest point since April. The indices for both present and current conditions declined during the month: the former dropped 2.6 points to 92.6 and the latter was off 5.9 points to 67.8. Respondents also expect higher prices: 1-year price expectations grew 3/10ths of a point to +3.3% as 5-year inflation expectations grew by 1/10th of a point to +3.0%.
Pending Home Sales September 2013 *Source:* *National Association of Realtors*	*Index (2001 = 100)* *Seasonally Adjusted* Sep 13: 107.7 Aug 13: 109.4 Sep 12: 101.8		The measure of contract signings to purchase a previously owned home declined for a 3rd straight month, but remained 5.8% above year ago levels. The index fell in 3 of 4 Census regions during the month; including, a 3.5% decline in the South, an 1.6% decrease in the West and a 1.4% drop in the Midwest. The index grew 4.0% in the Northeast. 12-month comparables spanned from +1.7% in the West to +13.8% in the South.

Economic Commentary edited by Kevin Roth

Even as consumer sentiment pulled back from its recent post-recession highs, consumer spending grew for a fourth straight month with a 0.3 percent increase during August. The Bureau of Economic Analysis (BEA) estimates personal consumption was at $11.529 trillion on a seasonally adjusted annualized rate, up 3.2 percent from a year earlier. The headline consumption numbers are nominal (i.e., not adjusted for inflation) figures. The personal consumption expenditure (PCE) deflator increased 0.1 percent during the month, leaving "real" consumer spending up 0.2 percent during Auugst. The 12-month PCE deflator was +1.2 percent, giving us an increase for "real" spending of 2.0 percent for the past year.

The growth in spending was funded through a 0.4 percent increase in personal income (or +0.3 percent in real terms), with wage income growing at the same rate. Personal income and wages have increased by 3.7 and 3.5 percent, respectively, over the past year. The savings rate grew 1/10th of a point to +4.6 percent. It was at +4.9 percent during August 2012.

Even with the pickup in income and spending, consumers have become less optimistic about business conditions and the state of the economy over the past few months.

- The Conference Board's Consumer Confidence Index lost 1.9 points during the month to a seasonally adjusted 79.7. The issue was a deteriorating outlook for the future, as the expectations index dropped 4.9 points to 84.1 (its lowest reading since April). The present conditions index added 2.3 points to 73.2. Fewer survey respondents expected their income will grow in the coming months than had in the previous month's survey (15.4 percent versus 17.5 percent), although the percentage reporting that jobs were "hard to find" dropped to a five-year low at 32.7 percent. The group noted in its press release that "consumers are uncertain that [recent] momentum can be sustained in the months ahead."
- The Index of Consumer Sentiment from the University of Michigan Surveys of Consumers shed 4.6 points during September to a seasonally adjusted 77.5 (1966 Q1 = 100). This was not only the second consecutive monthly decline but it also was 8/10^{ths} of a point below its year ago reading. Unlike the case with The Conference Board survey, *both* the current and expected conditions indices fell, with each declining to their lowest readings since April. The press release notes that most respondents did not anticipate a federal government shutdown when taking the survey, so the results do not reflect the impact of what appears to be a likely even this week. Half of survey respondents do not expect their income will grow over the next year, with a median income increase of just 0.5 percent.

The drop in consumer confidence comes even as economic activity appears to have picked up during August. The Chicago Fed National Activity Index gained 57-basis points to a seasonally adjusted +0.14. The three-month moving average improved by six-basis points to -0.18, its best reading since March but *still* indicative of an economy that is growing at a “below average” rate. The CFNAI is made up of 85 economic indicators, 48 of which made a positive contribution to the headline index during August. The source of much of the gain during the month was index components tied to production, with smaller positive contributions coming from index components related to employment and sales/orders. Meanwhile, consumption-related components remained a drag on the headline index.

The BEA, in addition to the aforementioned report on personal income and consumption, presented its third estimate of second quarter 2013 gross domestic product (GDP) last week. The report kept the rate of growth for GDP at a 2.5 percent seasonally adjusted annualized rate. The unchanged report was the product of lower than previous believed estimates for both private inventory accumulation and export activity that were offset by higher than previously believed levels of state/local government spending. The second quarter growth rate combined with the 1.2 percent gain during the first quarter, the 0.1 percent increase during the fourth quarter of 2012 and the 2.8 percent expansion during the third quarter of 2012 resulted in the U.S. economy growing a not particularly robust 1.6 percent over the past year.

Following a large 8.1 percent decline during the previous month, orders for durable goods managed only a small 0.1 percent increase during August. The Census Bureau estimates new orders for manufactured durable goods was a seasonally adjusted $224.9 billion, which was up 13.7 percent from a year earlier (although that extremely favorable 12-month comparable was because August 2012 was a very weak month for durable goods orders). A bit more positive was the $231.5 billion estimate for shipments made during the month. This was up 0.9 percent from July and 4.9 percent from a year earlier.

Two regional reports on manufacturing activity points suggest middling activity during September:

- The headline diffusion index from the Fifth District Survey of Manufacturing Activity from the Federal Reserve Bank of Richmond dropped 14 points during September to a neutral reading of zero. A number of index components deteriorated during the month; including, a 12 point drop in employment (to -6), an 11 point drop for new orders (to +5) and a two point drop for inventories (to +11).
- Similarly, the headline index from the Federal Reserve Bank of Kansas City’s Tenth District Manufacturing Survey lost six points during September to a seasonally adjusted reading of +2. Even with the drop, this was the third straight month in which the index was positive, but the decline in the index reading is best interpreted as suggesting slower growth. Index components for new orders, unfilled orders and employment each declined from their August readings.

Mortgage rates declined last week, a result of the Federal Open Market Committee’s decision to not taper its monthly purchase of securities. Freddie Mac estimates the average rate for a 30-year fixed-rate mortgage was 4.32 percent (with 7/10th of an origination point) during the week ending September 26. The average rate has declined 25-basis points (and 1/10th of a point) over the past two weeks, but remained up nearly by a full percentage point from the average of early May.

Much attention is now being paid as to the degree higher mortgage rates (which, admittedly, remain very low by historic standards) may slow the momentum in the housing market. Two August reports suggest that housing demand continues to be holding its own. New home sales grew 7.9 percent during the month to a seasonally adjusted annualized rate of 421,000 units. While this was below the mid-400k range that we were seeing during much of the first half of 2013, the sales pace was 12.6 percent above year ago levels. Meanwhile, the National Association of Realtors' measure of contract signings to purchase a previously owned home declined for a third straight month. Still the seasonally adjusted pending home sales index reading of 109.3 (2001 = 100) was up 5.8 percent from a year earlier.

Last week also featured two reports home prices, both of which showed continued straight during July:

- The 20-city S&P/Case-Shiller Home Price Index increased 0.6 percent on a seasonally adjusted basis during July, with prices rising in 17 of 20 tracked markets. The biggest one-month seasonally adjusted gains were in Las Vegas (+2.5 percent), Los Angeles (+1.5 percent) and San Diego (+1.5 percent). The index has increased 12.4 percent over the past year with year-to-year gains in all 20 markets, including growth of at least 20 percent in Las Vegas, San Francisco, Los Angeles and San Diego.
- The Federal Housing Finance Agency's House Price Index grew 1.0 percent on a seasonally adjusted basis during the month. The index increased in seven of nine Census regions during July, with the largest percentage gains enjoyed in the Pacific (+2.2 percent), Mountain (+1.6 percent) and New England (+1.4 percent) regions. The index, which tracks the purchase price of homes made with a conforming mortgage, was up 8.8 percent from July 2012 but stayed 9.6 percent below its July 2007 peak value.

Although perhaps still feeling the effects of some reporting issues earlier in the month, the count of first-time claims made for unemployment insurance benefits declined for the fourth time in five weeks. The seasonally adjusted count of 305,000 first-time claims for the Department of Labor data series during the week ending September 21 was down 5,000 from the previous week. The four-week moving average of 308,000 was off 7,000 claims from the previous week and was well before the 373,750 from a year earlier.

Following the previous week's surprise decision by the Federal Open Market Committee to not taper the Fed's monthly $85 billion purchase of securities, attention and speculation has turned on when the central bank would act. A review of comments made by FOMC members since the previous provided little clarity on this question, except that there appears to be little consensus for a move at the late October meeting:

- Federal Reserve Bank of New York president William Dudley, explained in a speech on Monday why he supported not slowing the pace of securities purchase by noting "the economy still needs the support of a very accommodative monetary policy."
- Federal Reserve Bank of St. Louis president James Bullard said that the decision as to when to taper will "depend on incoming macroeconomic data." He noted that the FOMC had downgraded their 2013 and 2014 forecasts and "would not want to reduce policy accommodation in this situation."
- Federal Reserve Bank of Atlanta president Dennis Lockhart told the Wall Street Journal on Monday that he did not "think there will be an accumulation of enough evidence to dramatically change the picture," signaling that a move at the late October FOMC meeting was unlikely.
- Federal Reserve Bank of Kansas City president Esther George was quoted in press accounts from a speech she made days after the FOMC meeting that the decision to not start slowing the monthly purchase of securities after a summer of saying that a tapering was in offing "created confusion, created a disconnect" that could harm the long-term credibility of the Federal Reserve.

Of course, one factor that has led the Fed to defer on reining in its accommodative policies is the seemingly never ending budgetary fight in Washington. The FOMC's statement from the other week notes that "fiscal policy is restraining policy." As this newsletter was being edited, we were gearing up for another potential partial shutdown of the federal government. The macroeconomic impact of a government shutdown remains to be seen and would be determined by its actual length and the market's reaction. In addition (and admittedly less important), any federal government shutdown will likely have a significant detrimental impact on the release of economic data series scheduled for release next week; including the September employment report scheduled for Friday.

The Week in Corporate Finance edited by Brian Kalish

It has certainly been an interesting August and September in the financial markets. As we wrap-up the third quarter and start to look forward to year-end, we are facing a number of challenges as we attempt to traverse the next 92 days.

The market is still adjusting to the head fake made by Chairman Bernanke earlier this month. Most of the market felt that some type of "tapering" was baked-in-the-cake (I personally was looking for $15 billion reduction- comprised of $10 billion in Treasuries and an additional $5 billion in MBS). Alas, it was not to be. With only two FOMC meetings remaining in 2013, the question remains open as to whether the Fed will begin the process of decelerating the stimulus known as "Quantitative Easing" prior to 2014. My personal belief is that lacking any extraordinary news on the inflation front, the Fed will hold off on any change in policy until the installation of a new Chairman. The current "smart" money is on Janet Yellen, the current Vice Chairman to become the next Chairman. We shall see.

For all the trials and tribulations the market has been through since early August, it's somewhat surprising to realize the U.S. Treasury market is actually relatively unchanged. The 2-year note yield is only up 3bps to 33bps (indicating the Fed will not raise interest rates until early 2015); the 5-year note yield is up 4bps to 1.40 percent: the 10-year note yield is up 1bp to 2.62 percent (after being as high as 3.01 percent on September 6th); and the 30-year bond yield is unchanged at 3.69 percent.

Over the past year, the U.S. Treasury curve has steepened significantly. Yields on T-bills have actually dropped (from -11bps to -8bps), with the current yield on the 3-month T-bill at a negative 1bp. The 2-year Treasury yield has increased +8bps, while further out the curve (five-plus years) yields are up 76 to 98 bps, with the 10-yr note off the most. Rates are still low, historically speaking.

The U.S. stock market took the news of "no tapering" as a positive sign, and subsequently posted all-time and multi-year highs. The Dow peaked at 15,709.58, the S&P 500 soared to 1,729.86 and the NASDAQ reached 3,788.30. All three indices have since retreated from those levels, but they are still up +13.19 percent, +17.00 percent and +20.76 percent, respectively, over the past year.

The corporate bond market answered the question "How big a bond deal can a corporate bring?" The answer was Verizon's $49 billion eight-tranche transaction. The Verizon deal helped make September the busiest month ever for corporate bond issuance at $147.8 billion, breaking the previous monthly record of $133.9 billion back in May 2008.

This coming week the market will be focused on the employment report, but given the possibility of a government shutdown, the report (like many government reports) may be delayed.

Stay tuned.

What to watch over the next week:

Note economic data releases subject to change due to the possible partial federal government shutdown

Monday, September 30, 2013

- *No Major Releases*

Tuesday, October 1, 2013

- ISM Report on Business--Manufacturing (September 2013)
- Construction Spending (August 2013)
- Vehicle Sales (September 2013)

Wednesday, October 2, 2013

- *No Major Releases*

Thursday, October 3, 2013

- ISM Report on Business—Non-Manufacturing (September 2013)
- Factory Orders (August 2013)

Friday, October 4, 2013

- Employment (September 2013)

AFP EconWatch—Weekly Economic Newsletter by:
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