RICHES FLORES RESEARCH

GLOBAL MACRO & THEMATIC INDEPENDENT RESEARCH

September 16, 2013

IN CHARTS

The U.S. Economy: Far Too Early to Break Out the Champagne

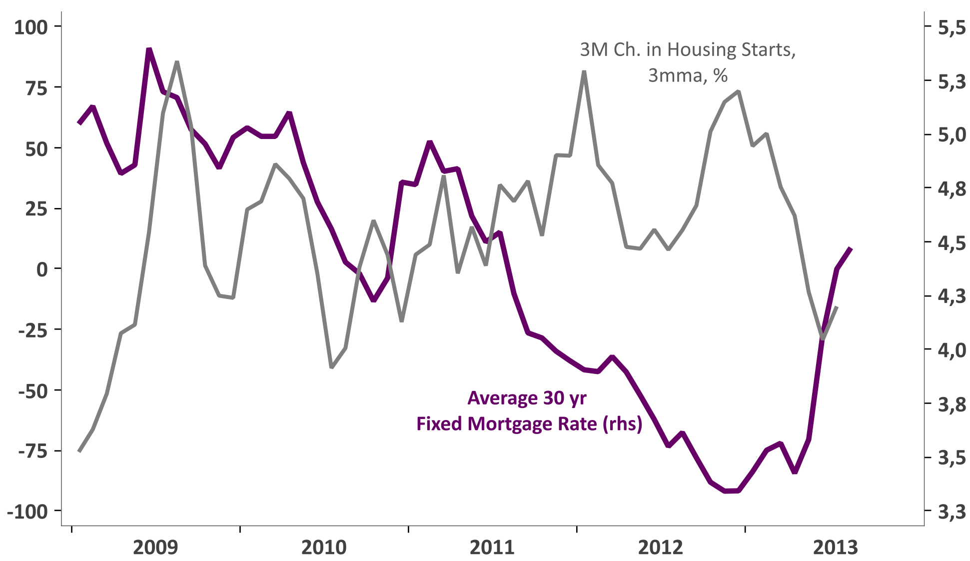
That markets are wildly optimistic about the U.S. economy is nothing new. What should draw our attention this time around is that such upbeat sentiment has rarely been harder to square with the numbers. For example, contrary to the dominant narrative:

- **The U.S. economy is doing worse than a few months ago, not better. Growth in industrial output is petering out, productivity has moved into negative territory, and employment data point to backsliding.**

- **The economy's ability to cope with higher interest rates simply can't be taken for granted. Not only has consumer spending yet to pick up, but the real estate market has been derailed by the rise in interest rates since the start of the year.**

- **While a change of course by the Federal Reserve may seem long overdue after five years of unconventional monetary policy, it makes no economic sense. This suggests that the Fed is very much in danger of jumping the gun.**

Housing Starts and Mortgage Rates



Sources: RichesFlores Research, Macrobond

What's Behind the Sentiment That Things Are Looking Up?

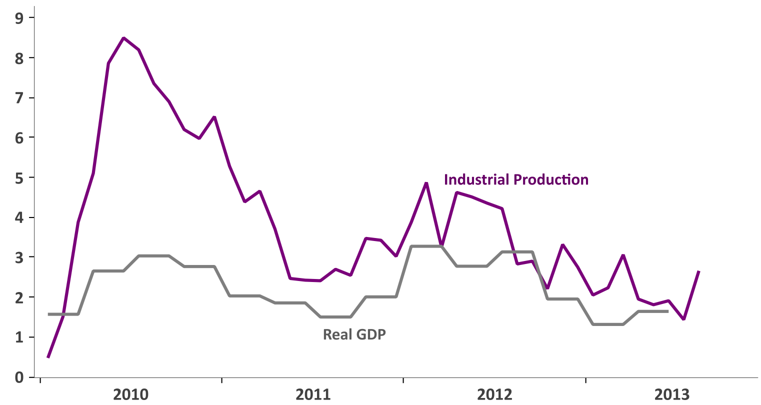
Growth Stuck Around 1.5 Percent

In July 2013, industrial production was a mere 1.4 percent higher than a year earlier, scoring its weakest gain in more than three years—and even trailing the second quarter's 1.6 percent rise in gross domestic product.

With GDP up by only 1.2 percent halfway through the year, the U.S. economy is unlikely to grow by more than 1.5 percent for all of 2013. If we're right, this will be its worst showing since 2009, and one that stands well below the Fed's June forecast of 2.3 to 2.6 percent.

Growth in Real GDP and Industrial Production

YoY (%)



Sources: RichesFlores Research, Macrobond

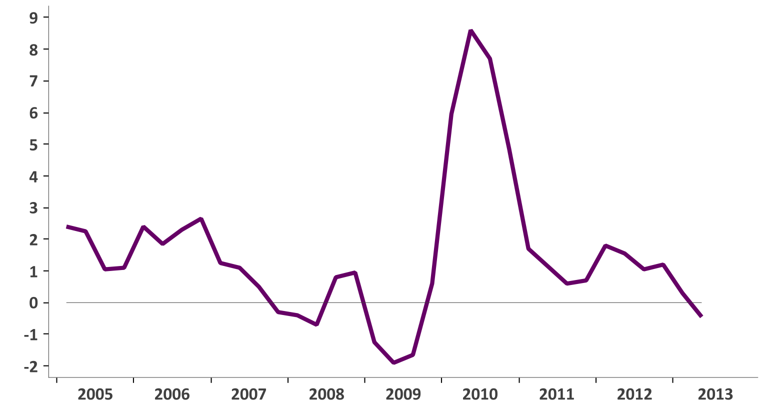
Flagging Productivity

The productivity boost from post-2009 recession adjustments has clearly run out of steam. Over the last few quarters, productivity growth has been steadily winding down, and by mid-year had fallen into negative territory.

This contraction in productivity is currently the primary obstacle to job creation and an upswing in corporate investment.

Non-Financial Corporate Productivity

Output per person employed, YoY Change (%)



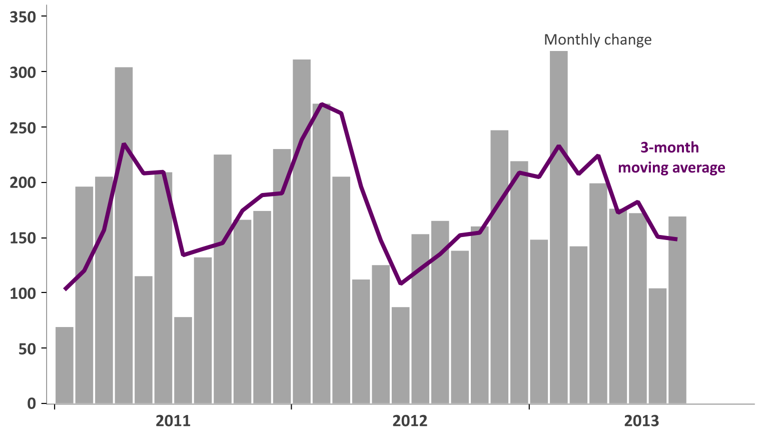
Sources: RichesFlores Research, Macrobond

Job Creation Flatlining

Even with unemployment down to 7.3 percent in August—the lowest since December 2008—the job market shows precious little punch.

Nonfarm payrolls grew by an average of 148,000 a month over the past three months—nearly 100,000 less than the average at the start of the year. At this pace, we can expect a full-year increase of only 1.6 percent, which falls far short of what usually occurs during recoveries.

Monthly Growth in Nonfarm Payrolls (thousands)



Sources: RichesFlores Research, Macrobond

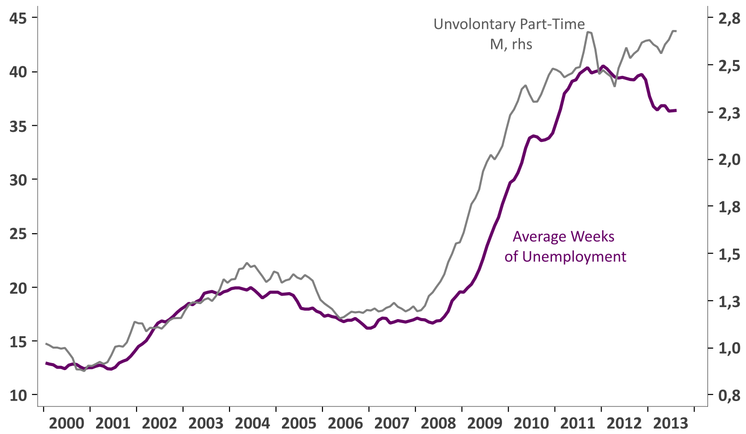
The Short-Lived Springtime Uptick in Consumer Spending

An End to Job Market Improvement

Job market indicators suggest that we've seen all the improvement we're going to get:

- The labor force participation rate has continued downward.
- The youth unemployment rate has stopped receding—for the 16-to-19 age group, it currently stands at around 37 percent.
- The average duration of unemployment is no longer falling, while a dearth of full-time positions has started pushing the involuntary part-time employment numbers back up.

Labour Market Indicators



Sources: RichesFlores Research, Macrobond

Gains in Disposable Income Below 1 Percent a Year

Disposable income growth, although slightly higher today than just after the early-year tax bite, didn't make it past the 0.8 percent post in July on an annualized basis. So it's only by taking a large chunk out of their savings that households have been able to keep consumer spending growth at around 2 percent over the past few quarters. That obviously can't go on indefinitely.

Household Real Disposable Income and Consumption

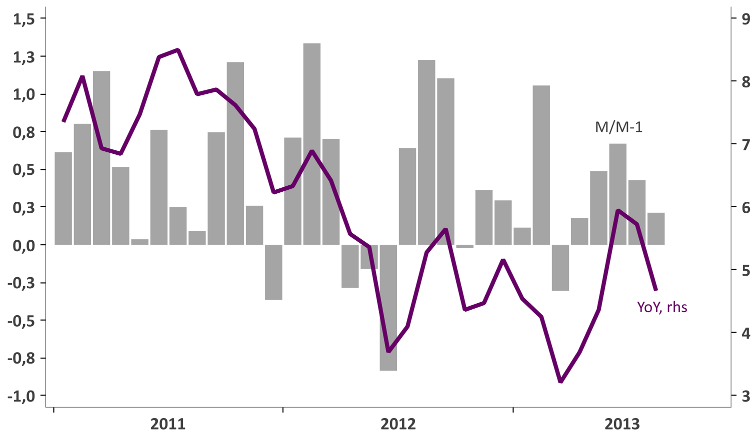
Sources: RichesFlores Research, Macrobond

Weaker Spending in Q3

The spring rebound in retail sales has proved to be short-lived. Sales edged up just 0.4 percent in July and 0.2 percent in August -in other words, by close to zero once you factor in price inflation.

We can expect to see a sharp slowdown in consumer spending in the third quarter.

Growth in Retail Sales, USD, Current, in %



Sources: RichesFlores Research, Macrobond

A Worsening Capital Investment Outlook

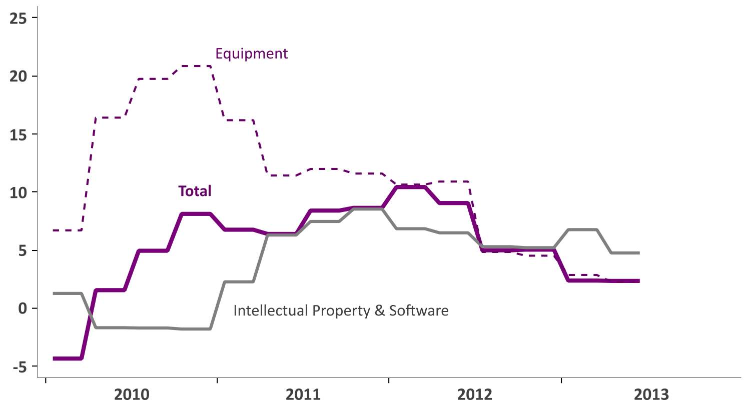
A Lid on Capital Spending

Those betting on a pick-up in capital investment are still coming away empty-handed. Corporate spending on equipment, intellectual property, and software has been steadily losing steam since the beginning of 2013.

And the outlook for the next few quarters isn't exactly rosy, either.

Non-residential Fixed Investment

Constant Prices, YoY (%)



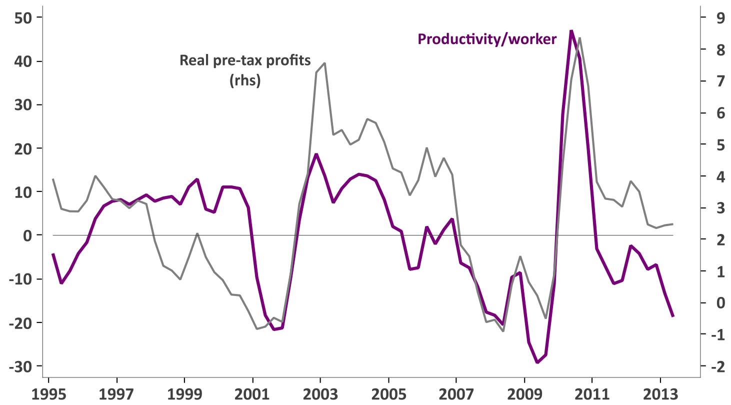
Sources: RichesFlores Research, Macrobond

Dwindling Productivity Gains

A key indicator here -and a disturbing one- is falling productivity growth, which foreshadows lower profits at non-financial corporations. This makes any near-term improvement in capital expenditure and job creation highly unlikely.

Productivity and Real Profit Growth* of Non-financial Corporations

*CPI-deflated, YoY (%)



Sources: RichesFlores Research, Macrobond

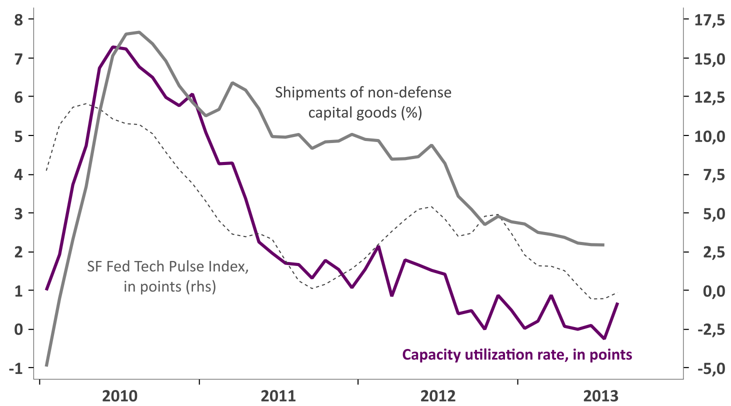
No Comfort in Leading Indicators

A number of leading indicators paint an equally dreary capital investment outlook:

- Capacity utilization is stuck well below its long-term average and hasn't scored any gains for months.
- Shipments of capital goods, which tend to move in lockstep with shipments of durable goods, are on the decline.
- The San Francisco Fed's Tech Pulse Index shows further considerable weakness.

Leading Indicators of Capex

12-month changes in % or points



Sources: RichesFlores Research, Macrobond

Bad News on the Residential Property Front

Downslide in Transactions

Rising interest rates have hastened a sharp downturn in the housing market.

The pace of new housing starts has been skidding downward since June, while the data on building permits and pending home sales preclude any near-term turnaround.

Housing Starts and Building Permits, YoY (%), 2MMA

Sources: RichesFlores Research, Macrobond

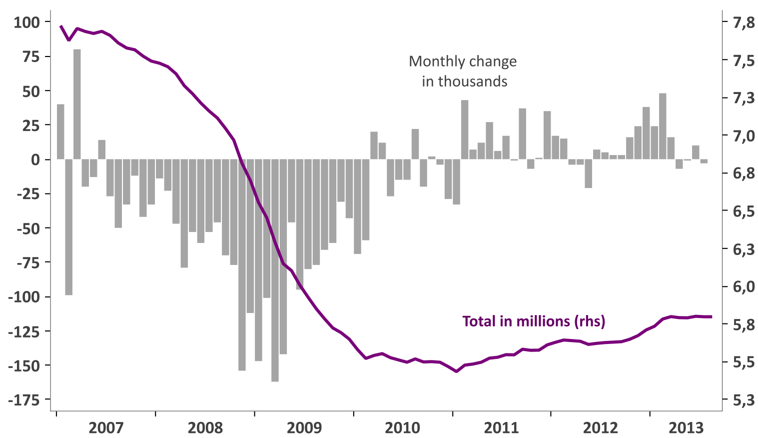
Pending Home Sales, Ch. YoY in %

Sources: RichesFlores Research, Macrobond

An End to Construction Employment Recovery

A further sign of the ailing housing market is that the rebound in construction employment ground to a halt in the spring, and has been dragging ever since.

Construction Employment



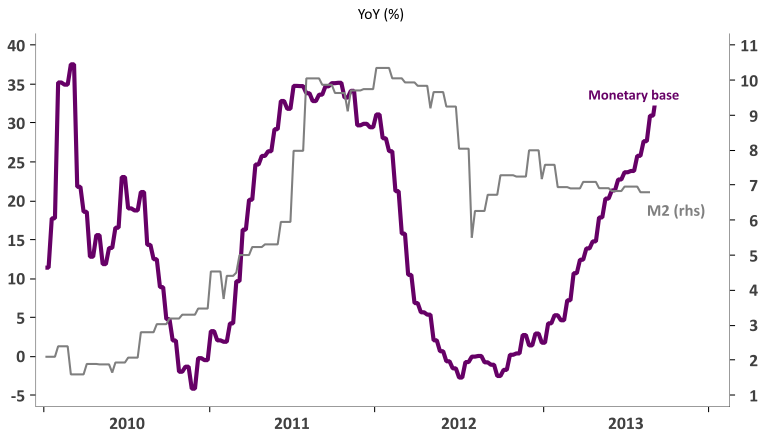
Sources: RichesFlores Research, Macrobond

The Fed Struggling to Meet Its Loan-Boosting Targets

M2 Losing Momentum

The considerable expansion of the monetary base following the onset of QE4. Late last year hasn't really translated into expansion of the broader money supply. The M2 monetary aggregate has been growing more sluggishly than in early 2012 -or even at the end of last year.

Monetary Base and M2 Monetary Aggregate

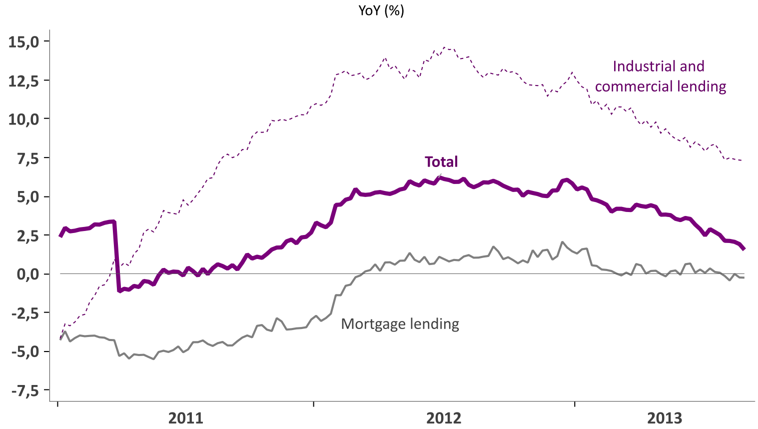


Sources: RichesFlores Research, Macrobond

Private Sector Loans Increasing at Just 1.5 Percent a Year

Weak annual M2 growth -less than 7 percent- wouldn't be so troubling if it didn't reflect an increasingly marked slowdown in loans to the private sector. At the end of August, total bank lending was up by just 1.5 percent on an annualized basis -its worst performance since the end of 2011. Mortgage lending showed a mild annual decrease, while industrial and commercial lending grew at only half the pace recorded in mid-2012.

Bank Loans to the Private Sector

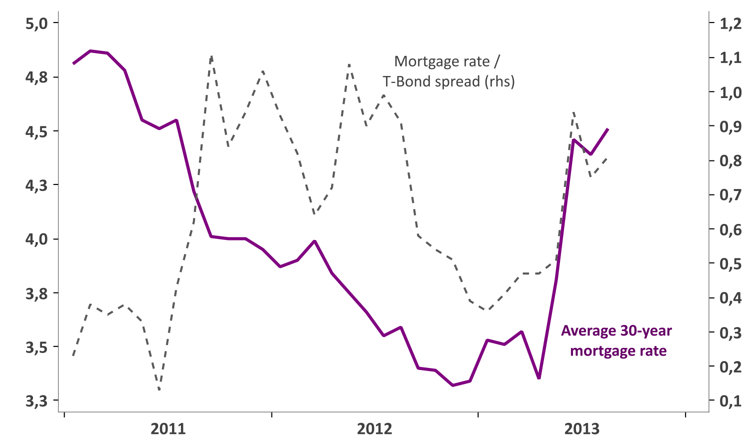


Sources: RichesFlores Research, Macrobond

Danger Ahead

All in all, the central bank appears to be falling short of its targets. At the same time, the housing sector's extreme sensitivity to higher interest rates strongly suggests that the U.S. economy as a whole is still in shaky condition -shaky enough to make it a bad idea for the Fed to unwind its support and start phasing out its asset purchases.

Average Mortgage Rate and Bank Mortgage Lending Spread



Sources: RichesFlores Research, Macrobond

Véronique Riches-Flores,contact@richesflores.com