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RESEARCH

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Daniel Alpert Managing Partner • dalpert@westwoodcapital.com • +1-212-953-6448

The Devil's in the Data:
It Appears as if No One Knows What to Make of the U.S. Economy, and Here's Why

The first half of May has produced a series of very confusing, and often misleading, U.S. (and some foreign) data that has set off considerable market volatility – for good reason. A good deal of the headline data is driven by conflicting underlying factors buried deeply in data releases, and pulling all of those dynamics together to form a clear picture of macroeconomic trends has been very challenging. I will do my best here to add some clarity and vision.

In the larger view, it is clear that the major economies are not near to firing on all, or even a preponderance of, cylinders. While the U.S. was thought to be defying gravity, the Q1 GDP number (up 0.1% and likely to be revised into negative territory) gave markets and forecasters a bracing splash of icy cold water. While weather may have played a significant role in that data point, it did reflect a deepening of slowing that was already felt in November and December of 2013.

More importantly, as recent data has demonstrated, the three other large economic engines of the world—the Eurozone, China and Japan—are incredibly soft.

- The Eurozone ex-Germany would be in near negative growth territory and continued slowing in the periphery is threatening real Japanese-style moderate deflation for an extended period (with the ECB perhaps about to cut rates again to try to forestall that outcome). Unemployment in the Eurozone ex-Germany is not repairing itself and can't without much faster growth.

- Japan itself reversed its deflationary pattern for a brief moment by forcibly tanking the yen and seeing imports (energy) rise in price. Japanese GDP skyrocketed in the first quarter (by 5.9% annualized), but it seems that was a response to the then-impending sales tax increase in the second quarter, a quarter that has seen less impressive data. "Abenomics" is threatening to turn into "Abegeddon" as wages refuse to budge while prices (and that sales tax) are rising. And the fiscal and structural changes promised by the Japanese prime minister are nowhere close on the horizon.

- China has seen its rate of GDP growth slow to 7.4% in Q1 but, far more ominously, its inflation rate has plummeted to 1.8% Y/Y. As the world's largest creditor and trade/current account surplus nation, the advanced economies desperately need Chinese inflation to ramp back up in order to resolve the huge imbalances in wages, costs, and capital flows that underpins many of world's macroeconomic troubles. Current and growing difficulties in China's real estate sector, and generalized slowness, will place even greater pressure on the country to remain competitive on the export front and use all means available (including foreign exchange mechanisms) to do so, further complicating matters for the developed economies.

There was one other bit of additional non-data news hit this month concerning another large nation that seeks to be competitive with U.S. Narendra Modi's party won undisputed control of the parliament of India, tossing out the

Congress Party that has governed India almost continuously since its independence from Britain. The Congress Party's cronyism and its tolerance of structural economic barriers to growth and competitiveness has meant that India has heretofore not been able to become a sustained net export economy, challenging the advanced nations much as China has. Imagine if those barriers now fall.

All of the foregoing portend an absence of demand growth necessary to reverse disinflationary (and, quite possibly, deflationary) trends in advanced economies. As I have written before, the disinflationary forces present in this *"Age of Oversupply,"* coupled with the persistent debt overhang in the developed nations that is constraining consumer and government spending, are overwhelming. Those consistently fearing inflation are being proved more and more misguided as time goes on and, this month has demonstrated that bond markets are beginning to catch on to deflationary risk, even as equity markets hover around new highs (although small cap stocks and indices have seen meaningful retracements).

So how has this fundamental global macroeconomic problem been reflected in U.S. data and what are we not seeing clearly enough that has given rise to market and analytical confusion? One area of dispute has been over the issue of the severe weather in the U.S. during Q1 2014. This certainly had an adverse impact on Q1 economic results, but the "catch up" effect is also wreaking havoc with trend analysis in Q2. Nevertheless, given the larger global macroeconomic picture and its logical impact on the U.S. economy, I don't think snowstorms were the only things keeping the U.S. economy grounded.

The following is a summary of recent headline data, together with underlying facts and mitigating factors, that should bring us closer to appreciating what is really going on (which I shall summarize at the end of this piece). Note that I have avoided poll data below, simply because I think such data has relevance only over very long time frames and is not particularly accurate in reflecting macroeconomic conditions in real time. I tag each item with [BETTER] or [WORSE] to make clear my assessment of each situation, relative to the U.S. economy.

Headline Data	Underlying Facts and Mitigating Factors
Consumer Price Index – The data for April came in with a relatively hot headline number of 0.3% M/M which may indicate a reversal of recent disinflationary trends. Particularly promising was the fact that commodity (goods) prices rose 0.4% after falling on a sustained basis for many months and services, which have comprised the major source of inflation (and kept inflation positive) for many months rose only 0.1%, making for what appeared to be a more equitable distribution of price movements. [BETTER]	**Consumer Price Index –** Commodities were up only 0.1% excluding food and energy. There was a pass through of energy prices through gasoline that was reflective of previously higher crude oil prices that have since fallen. With respect to food, all of the increase was in perishables, with huge M/M jumps in beef (3.0%) and pork (4.1%), as well as meaningful moves in dairy (0.5%) and fruits and vegetables (0.7%). As it happens, the U.S. is experiencing severe drought conditions in the far west and they are undoubtedly impacting prices on the supply, rather than reflecting pressures on the—healthier—demand side. Proof of this conclusion may be found in the fact that all other foodstuffs were down or flat. On the services side, all price rises were in rents (with future rises likely unsustainable given stagnant wages—more about that below), airfare and medical services. Both of the latter two are the subject of unique industry circumstance—consolidation of U.S.

airlines (decreased competition) and fluctuations in insurance costs relating to the phase in of the ACA law. [WORSE]

Industrial Production – April industrial production fell 0.6% M/M and capacity utilization fell to 78.6% from 79.3%. This came on the heels of healthy prior advances in both statistics and was unexpected by economists and markets alike. Non-durable, non-energy consumer goods and business equipment and supplies accounted for about half of the decline in production. [WORSE]

Industrial Production – Roughly the other half of the April 0.6% M/M drop in industrial production was the result of a decline in utility production, something that would be expected after the end of an especially harsh winter season. [BETTER]

Payrolls and Unemployment – May began with a very bullish gain of 288,000 jobs per the establishment survey component of the Bureau of Labor Statistics Employment Situation report for April, and the headline unemployment rate fell by a whopping 4/10^{ths} of 1% to 6.3%. The new job formation was more concentrated in higher paying job categories, whereas most post-recession job growth had previously been in very low paying sectors. [BETTER]

Payrolls and Unemployment – The rise increase in payrolls was accompanied by no rise in wages. In fact, wages in goods producing jobs fell by 2 cents/hour (for manufacturing down 5 cents/hour). More unfortunately, the falloff in the headline unemployment rate, in the household survey, was due to a huge reduction in the labor force by 806,000 (the denominator in the calculation of the unemployment rate), as longer term unemployed continue to drop out of looking for work, The labor force participation rate, accordingly, fell back 0.4% to its late-2013 low of 62.8%. Moreover, employment in the inexpensive under-20 years old cadre is rising, as is employment in the over 55 age group, as older folks try to hold on. The middle age demographic groups are being hollowed out. [WORSE]

Jobless Claims – For the week ending May 10th, new jobless claims hit a post-Great Recession low of 297,000, indicating that more people are being retained in their positions and/or switching jobs voluntarily. [BETTER]

Jobless Claims – The fall in jobless claims followed a spike higher in claims in April, so the four week moving average only fell by 2,000 to 323,250. But this cannot be regarded as mitigating the good news.

Housing Starts and Permits – Housing starts in April grew a sizable 13.2% from March to an annualized pace of 1.072 million. Permits for new construction rose by 8.0% from March to an annualized level of 1.080 million. [BETTER]

Housing Starts and Permits – The growth in both housing starts and permits was almost entirely in multifamily housing, a very volatile component to begin with. The demand for new single family homes appears to have plateaued despite still-tight inventories of existing homes (see below) in many markets. This is occasion for pause in two senses. For one, multifamily construction employs fewer people per unit constructed than single family. But of additional concern is the fact that multifamily housing has attracted a lot of capital for new construction, owing to rising rents. As noted in the CPI and payroll discussions above, rents may not be support additional demand at present levels and there is a meaningful risk that excess construction (together with the huge pool of single family home acquired for rental by investors since 2012) may have a depressive effect on rents and inflation. [WORSE]

Retail Sales – April retail sales grew only 0.1% from March, and ex-autos were flat, severely disappointing the markets. In particular, the housing-related furniture and appliances sectors were down materially. A meaningful offset to decline was gasoline sales (unit price driven, up 0.8%) which is exactly opposite of where we would want to see sales increasing in a low generalized wage and price inflation environment. [WORSE]

Retail Sales – March retail sales had been up smartly and was revised further upwards to +1.5% M/M. This was likely a “catch-up” response to winter weather doldrums, but the upward revision was welcome. Additionally, apparel stores and department stores showed considerable strength (up 1.2% and 1.8% M/M, respectively) and these sectors had been weak in 2013. [BETTER]

GDP – The real wakeup call this month came actually on the last day of the prior month in the form of the initial GDP estimate for Q1 2014 which, at +0.1% annualized, was up far less than markets and economists had expected. Based on information that subsequently became available, it appears that Q1 GDP will be revised into negative territory next month. The savings rate fell back to 4.1%, a considerable retreat to its year ago level. [WORSE]

GDP – The best thing you can say about the stagnant GDP level is that it is a figure firmly in the rear view mirror. Nevertheless, data obtained during the first half of May indicates that earlier estimates of GDP growth for Q2 2014 have been overstated. There is really nothing that mitigates the disappointment of the Q1 GDP situation.

Import and Export Prices – Import prices fell 0.4% in April and export prices fell a whopping 1.0 for the month, the largest decline since June 2012. This is a headwind relative to Q2 GDP growth and is indicative of the competitive landscape globally. The drop off for non-agricultural exports was -1.2%. [WORSE]

Import and Export Prices – Gasoline, highly price-volatile, was responsible for the drop in import prices, so that was a relief. Non-fuel import prices were flat—i.e. not necessarily going to hit overall price levels hard to the downside. On the export side it was intermediate goods that fell far in price, rather than finished goods, which rose a bit. Still it is hard to say these mitigating factors really constitute “better” news, so we will give this a [MEH].

Keep in mind that much of the foregoing—starts, CPI, GDP, even payrolls—is impacted by the housing sector. Moreover, the Fed has been relying on the post-June 2012 housing sector recovery as its shining star and generator of overall economic health going forward. During the month, Fed Chair Yellen expressed some concerns about housing and I will add my own words of caution here.

U.S. housing, which did not reach its post-bubble statistical low valuation until early 2012 (a fact that seems forgotten two years later), took off in correlation with the historically low bond yields that were reached between the Fed’s QE2 and QE3 initiatives, and then accelerated greatly during QE3. By the end of 2013, U.S. housing prices had, on average, retraced nearly half the value lost since their bubble-era peak. Prices were fueled by low interest rates, but were driven higher-still by what is still a post-crises anomaly…tight inventories of for-sale housing, amid rates of household formation (and thus incremental demand) that continue at levels lower than at any time since the Great Depression (no, that isn't a typo - and that's in nominal, non-population-adjusted terms).

Looking back at the recovery in home prices that occurred simultaneously with QE3, we saw inventories constrained by homeowners remaining underwater relative to their bubble-era mortgage and thus unable, or unwilling, to sell their homes—combined with those with very low levels of home equity, insufficient to afford a down payment on a new home and therefore de-facto non-sellers. We also experienced a large number of investor purchasers of homes able to access low cost capital to acquire the limited inventory that was available, and pay up for it when necessary. Writing about the third quarter of 2013, the real estate database firm, Zillow, noted

“…one in five American homeowners with a mortgage remains underwater, a stubbornly high rate that is contributing to inventory shortages and holding back a full market recovery. The “effective” negative equity rate, which includes those homeowners with a mortgage with 20 percent or less equity in their homes, was 39.2 percent in the third quarter. Listing a home for sale and buying a new one generally requires equity of 20 percent or more to comfortably meet related expenses.”

One cannot find a more classic example of a market unable to find a true “clearing” price level because of non-market influences (i.e. government policy initiatives). And like much of post-crisis history, much has been made of headline data in housing without careful consideration of underlying dynamics.

We are living with an economy that appears to have been able to generate annual growth in the 2% range and has created enough jobs to replace those lost in the Great Recession, but nowhere near enough to absorb the increase in working age population since then. Certainly, the U.S. economy has not achieved anything remotely close to the escape velocity necessary to sustain the virtuous circle of job and wage growth, consumption, and creation/absorption of new capacity. To a certain extent, the devilish data unveiled so far this month merely underscores that. The household debt overhang of the bubble period remains with us, and it is only an acceleration of growth that can whittle that away.

Meanwhile, we remain beset by continuing, and possibly worsening, global wage and price imbalances with, and insufficient domestic demand in, our trading partners.

The data is still mixed and so are the markets. Equities (at least large cap equities) are near all-time highs, while 10 year bond yields are around 50 basis points lower than they were at year end. One market is telling us that we are on the cusp of something big. The other market is signaling more of the same or worse. What I don’t see is the event that will give rise to vigorous growth in 2014, and this month may prove to have been the period in which those more optimistic than I battled with the data devil and lost their innocence.

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