Economic Commentary

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Riding the Economic Roller Coaster – Hang On!

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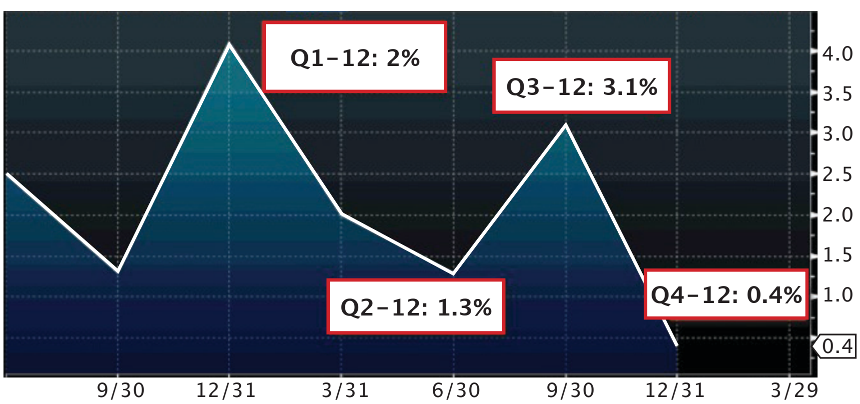
The analogy that perhaps best describes the economic environment in the United States is a roller coaster ride. Given that the S&P 500 stock index increased more than 10% during the first quarter of 2013, one would naturally think the economy also experienced above normal growth. However, that is not the case.

The relationship between the market and the economy is not perfectly correlated. Economist Roger Farmer describes it this way: *Two staggering drunks connected by a long rope. Sometimes the stock market and the economy go in the same direction, other times not. Since they are tied together they can never get too far apart.* During the first quarter they moved apart.

Gross Domestic Product



Looking back at calendar year 2012, we see a major downturn during the first quarter as the economy's annual growth rate slowed from 4.1% to only 2%. The slowing growth trend continued in the second quarter as the economy only grew 1.3%. The economy climbed in the third quarter, turning in a strong 3.1% growth. Then in the fourth quarter, the economic roller coaster went over the cliff. In fact, the media was fixated on the "fiscal cliff" with the result being an annualized "growth" rate of only 0.1%. Hurricane Sandy also had a negative impact on GDP during the fourth quarter of 2012.

A Crisis of Confidence

The roller coaster analogy definitely applied to 2012. Will the wild ride continue in 2013?

To answer this question, let's start by reviewing the business sector. Industrial production, capacity utilization, new factory orders and bank loans and leases were all sluggish during the first quarter of 2013. The business sector is growing but no faster than in 2012. World demand remains muted as Europe wrestles with a deepening recession. There's a risk that "the solution" in Cyprus—taxing bank depositors and penalizing investors—may need to be applied to other weak European countries, which suggests that Europe is in for a roller coaster ride as well.

One of the most important measures of the future strength of the manufacturing sector is the ISM (Institute for Supply Management) Manufacturing Survey. The results of the first quarter were not very encouraging as the gains in January and February were nearly all erased in March. The ISM Non-Manufacturing index was more encouraging, showing a service sector growing faster in the first quarter of 2013 than the anemic previous quarter.

Consumer balance sheets were enhanced during the first quarter of 2013. Given the double digit stock market returns and the rise in home prices, many consumers saw their wealth increase. Many will be pleasantly surprised when they receive their retirement plan performance reports for the first quarter. It will be interesting to observe whether the "wealth effect" will have an impact on second quarter spending.

The all-important Personal Income measure exemplifies the roller coaster ride. Consumer expenditures are the

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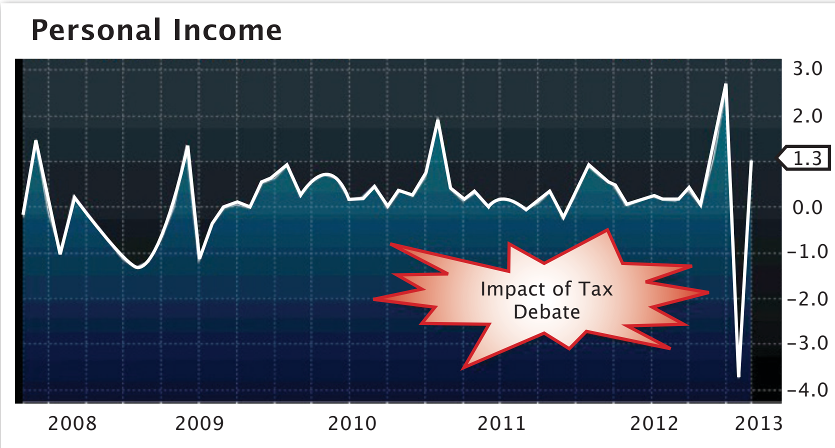
driving force of the economy which requires a reliable stream of income to support the expenditures. Because of proposed Congressional tax rate changes, many firms pre-paid 2013 dividends and bonuses before year-end, which resulted in the personal income volatility.



Personal Income should stabilize in the second quarter and provide clues to economic recovery for the rest of the year. Unfortunately the jobs recovery is not gaining momentum, and consumer spending remains range-bound, increasing in a monthly range of 0% to 0.4%

The deleveraging theme which started in 2007 and accelerated during the Great Recession has now reached levels not seen since 1980. Since the Federal Reserve created the Debt Service measure in 1980, the record high and the record low have both been recorded within the past five years. Talk about a roller coaster ride!

The good news is that not only are business balance sheets now in a strong position, consumer balance sheets have the ability to take on additional debt as well. The stage is set for an expanding economy—all that is needed is confidence.

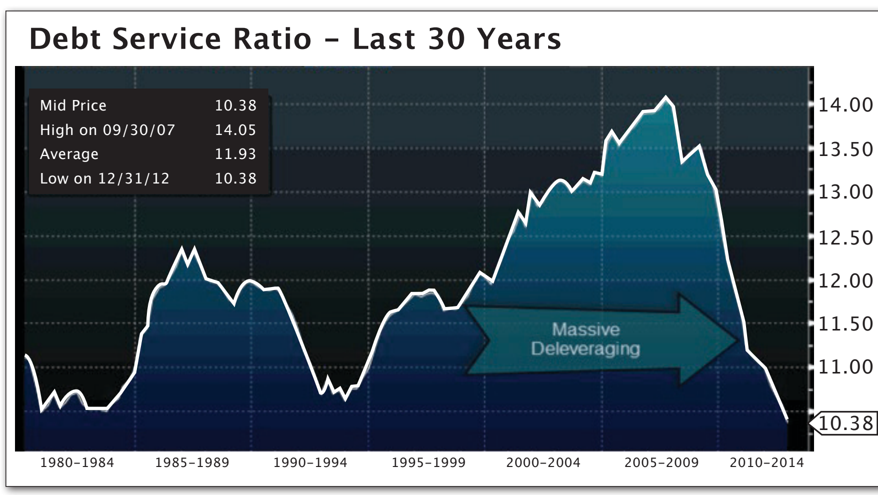
What is holding back business and consumer confidence?

I blame the third engine of the economy, government, for the overall lack of confidence. The first quarter was dominated with discussion of "fiscal cliff," sequester budget, tax policy, and budget deficits. After all the rhetoric, what were the results?

On March 1, 2013, the federal spending cuts under sequestration took effect. What? The world has not come to an end!

Spending in March 2013 was only slightly less than March 2012, and the federal deficit continues to grow—now approaching $17 trillion. If treasury rates increase just 1%, the deficit will increase $170 billion—two times the sequestration cuts.

In summary, I believe that U.S. GDP increased from the 0.4% in the fourth quarter of 2012 to approximately 2% in the first quarter of 2013. The initial release will be April 26th (two adjustments will follow). I feel the second quarter GDP will be lower than the first quarter. We'll see...



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