

Orlando's Outlook: Happy four-year anniversary

As of 03-11-2013

Bottom Line Over the past four years, the financial markets have shrugged off a mixed, but improving, economic picture, while largely ignoring the ongoing fiscal-policy dysfunction in Washington. Focusing instead on the resilience of the U.S. economy and a powerful rebound in corporate profits, stock investors have driven the Dow Jones Industrial Average to an all-time record high on the fourth anniversary of the Great Recession's market's trough, while the other major equity indices are not far off:

- Dow Jones Industrial Average Bottomed at 6,469.95 on March 6, 2009, and has since surged by 121% to an all-time record of 14,320.65 on March 6, 2013.
- S&P 500 Bottomed at 666.79 on March 6, 2009, and has since rallied by 132% to a five-year high of 1,545.25 on March 6, 2013. The index remains 2% shy of an all-time record high of 1,576.09, achieved on Oct. 11, 2007.
- Russell 2000 This small-cap index bottomed at 342.57 on March 9, 2009, and has since soared by 172% to an all-time record of 932.00 on February 19, 2013.
- Nasdaq Composite This technology-laden index bottomed at 1,265.52 on March 9, 2009, and has since recovered by 155% to a 12-year high of 3,233.44 on March 6, 2013. But the index still remains 37% below its all-time record high of 5,132.52, achieved at the peak of the technology bubble on March 10, 2000.

At present, manufacturing, housing, autos, employment and consumer confidence have all strengthened in recent months, although consumer spending has been soft thus far this year, likely due to tax-law changes and higher energy prices. With winter fading, Hurricane Sandy may soon shift from a headwind to an economic tailwind, as the rebuilding in the northeast commences. But Washington just can't help itself, as the \$600-billion tax increase passed on New Year's Day and the automatic spending sequester that went into effect on March 1 will likely combine to slow the economy and cost jobs. But investors remain oblivious to it all, as stocks keep running to record highs.

The equity and fixed-income investment professionals who comprise Federated's Macro Economic policy committee met last Wednesday to review the current status of economic growth and developments in Washington, and we tweaked our estimates for Gross Domestic Product (GDP) slightly higher, although they remain below consensus:

- On Feb. 28, the Commerce Department revised its preliminary fourth-quarter GDP from -0.1% to its first revision at 0.1%, largely due to stronger net exports, housing, and business investment. That leaves full-year 2012 GDP at 2.2%, versus 1.8% in 2011.
- Sandy is still a first-quarter economic drag, and Washington's tax increases and the spending sequester will pressure first-quarter GDP. But with manufacturing, housing and autos improving, we are raising our first-quarter GDP estimate in 2013 from 1.2% to 1.7%, while the Blue Chip consensus estimate moves up from 1.6% to 2.0%.
- We remain hopeful that Washington will begin to address some of its issues by the end of the first quarter, and we also expect that the northeast will begin to rebuild from Sandy. So we are ticking up our second-quarter GDP growth estimate from 1.7% to 1.8%, while the consensus estimate ticks up from 2.1% to 2.2%.
- Manufacturing activity and inventory rebuilding may begin to recover during the second half, so we are raising our third-quarter estimate from 2.1% to 2.3%, while the consensus ticks up its estimate from 2.5% to 2.6%.
- We are ticking up our estimate for fourth-quarter GDP growth from 2.5% to 2.6%, while the consensus estimate remains unchanged at 2.8%.
- That increases our full-year 2013 GDP estimate from 1.5% to 1.7%, versus the Blue Chip consensus, which lowers its estimate from 2.0% to 1.9%. Both full-year GDP estimates (ours and the consensus) remain well below trend-line economic growth of 3.0%, which implies that the U.S. economy continues to underperform due to Washington's poor fiscal policies.

The Macro Policy Committee also made the following investment observations:

Fourth-quarter earnings season was surprisingly good Revenues were up 5.2% year-over-year, which is a 1.9% positive surprise, with 53% of companies beating consensus estimates. Earnings rose by 4.9%, which represents a 5.6% positive surprise, with 70% of companies beating consensus estimates. But first-quarter management earnings guidance

was poor—likely due to Washington-related concerns over economic visibility—with 68% guiding lower by an average of 3.3% below consensus. According to the Labor Department, another concern is that nonfarm productivity plunged from an increase of 3.2% in the third quarter to a decline of 1.9% in the fourth quarter, which was the largest drop in four years, while unit labor costs surged from a decline of 2.3% in the third quarter to an increase of 4.6% in the fourth quarter. This decline in productivity and increase in labor costs is due to generally improving labor conditions, but it suggests that profit margins likely peaked last year.

Inflation benign On a year-over-year basis through January, core inflation is now running at well-behaved levels of 1.8% and 1.9%, respectively, for the wholesale Producer Price Index (PPI) and the retail Consumer Price Index (CPI). The core Personal Consumption Expenditure (PCE) index—the Federal Reserve's preferred measure of inflation—is now running at a very benign 1.3% year-over-year, which remains well within the Fed's 1.0% to 2.0% target range.

Fed on hold into next year Despite the recent financial-market noise surrounding the Federal Reserve's intentions regarding future monetary policy, we believe that the Fed's new trigger mechanisms will help achieve their dual inflation and employment mandates. The Fed plans to keep its Zero Interest Rate Policy (ZIRP) and its expansive "QE to Infinity" \$85 billion per month bond-buying program in place until the unemployment rate comes down to at least 6.5% (from 7.7% in February) and so long as core PCE inflation does not exceed its 2.5% target (from 1.3% now). So with low levels of core inflation and an abnormally high rate of unemployment due to ineffective fiscal policies in Washington, the Fed is likely to remain on hold for now.

Retail sales slump, but confidence rebounds After a relatively healthy November and December, retail sales performed poorly in January and February. The low-end consumer was hurt by a spike in gas prices, the increase in the Social Security payroll tax, and delayed tax refunds from the IRS. While the high-end consumer was hurt by the increase in tax rates and the reduction of deductions and exemptions as part of President Obama's fiscal-cliff tax increase on New Year's Day, that's offset by a positive wealth effect associated with the rising equity and real estate markets. Consumer confidence hit an air pocket over the past several months into January, but confidence surprisingly strengthened in February, which suggests that perhaps spending may improve later this year. The Conference Board's consumer confidence indicator jumped from 58.4 in January to 69.6 in February, while Michigan sentiment rose from 73.8 in January to 77.6 in February.

Autos and housing remain strong Auto sales have rebounded nicely from Hurricane Sandy over the past four months, with sales at 15.33 million annualized units in February. Autos are now up nearly 70% from the bottom of the cycle in February 2009, sitting just under a four-year high, with plenty of room to run higher, in our view. The housing-market index—a key confidence indicator—has plateaued over the past four months and is now sitting at 46 in February, which is still more than triple where it was when the housing market bottomed in September 2011. We remain very positive on this sector, as starts and permits have surged by 80% off of half-century lows, mortgage delinquencies and foreclosures are falling sharply, pricing is strengthening, and new and existing home sales are accelerating.

Manufacturing improving The national ISM manufacturing index has steadily improved over the past three months, sitting at 54.2 in February, which implies economic growth. While the important regional Fed indices we monitor have been something of a mixed bag, indicators out of New York, Chicago, Milwaukee and Richmond improved sharply in February. The surge in net exports we enjoyed in December reversed with January's trade balance, which is likely to be a drag on first-quarter GDP. Moreover, factory orders fell in January, while wholesale and business inventories were soft in December, which is consistent with the inventory destocking we've seen in recent months. But core durable and capital goods orders were strong in January, which suggests that we could see a reversal of this inventory liquidation trend by midyear. Finally, industrial production was down in January, but capacity utilization has been steady above the 79.0 level for several months now.

Employment strengthening February's results were strong across the board. Initial weekly jobless claims—an important leading economic and employment indicator—fell to a six-week low of 340,000 for the week ended March 2, 2013, which is just above the five-year cycle low of 335,000 we saw in early January. The smoother four-week moving average of 348,750 last week is a five-year low. The ADP report, which is a forward-looking proxy for private payroll growth, gained a surprisingly strong 198,000 jobs in February, with solid upside revisions in the prior three months. The ADP survey is now five months into a new methodology, and it's averaging an impressive 209,000 jobs per month over this period. Finally, the February labor report showed a surprisingly strong gain of 236,000 nonfarm workers, with a jump of 170,000 household employees and 48,000 construction workers.



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Orlando's Outlook: Solid jobs report for February 🗋

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Views are as of the date above and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

Consumer Price Index (CPI): A measure of inflation at the retail level.

Dow Jones Industrial Average ("DJIA"): An unmanaged index which represents share prices of selected blue chip industrial corporations as well as public utility and transportation companies. The DJIA indicates daily changes in the average price of stocks in any of its categories. It also reports total sales for each group of industries. Because it represents the top corporations of America, the DJIA's index movements are leading economic indicators for the stock market as a whole. Indexes are unmanaged and investments cannot be made in an index.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

Nasdaq Composite Index: An unmanaged index that measures all Nasdaq domestic and non-U.S.-based common stocks listed on the Nasdaq Stock Market. Indexes are unmanaged and investments cannot be made in an index.

Personal Consumption Expenditure (PCE) Index: A measure of inflation at the consumer level.

Producer Price Index (PPI): A measure of inflation at the wholesale level.

Russell 2000 Index: Measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index. Investments cannot be made directly in an

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

The Chicago Purchasing Managers Index, produced by the The National Association of Purchasing Management-Chicago, gauges factory health in the upper Midwest based on surveys of companies in that region.

The Consumer Confidence Index is based on a survey by the Conference Board that measures how optimistic or pessimistic consumers are with respect to the economy in the near future.

The Empire State Manufacturing Index gauges the level of activity and expectations for the future among manufacturers in New York.

The Federal Reserve Bank of Richmond surveys manufacturing and services businesses monthly to gauge their level of activity and expectations for the future.

The Institute of Supply Management (ISM) manufacturing index is a composite, forward-looking derived from a monthly survey of U.S. businesses.

The Milwaukee Purchasing Managers Index, produced by the The National Association of Purchasing Management-Milwaukee, gauges factory health in the upper Midwest based on surveys of companies in that region.

The University of Michigan Consumer Sentiment Index is a measure of consumer confidence based on a monthly telephone survey by the University of Michigan that gathers information on consumer expectations regarding the overall economy.

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