






ECONOMIC SUMMARY

Slow growth but strong returns

- The aggregate data show a continuation of the slow growth recovery in the US, around 2.25% gross domestic product (GDP) growth per annum in the first five years.
- The jobs market has been characterized by ongoing improvement across areas such as job creation, hiring and quitting and temporary jobs, while discouraged workers and involuntary part time are dropping.
- That said, we now have a shrinking pool of short term unemployed to fill rising vacancies and we don't know how this tightening will play out ... more wages growth than we have seen so far or simply slower activity.
- Households have remained cautious in their spending despite further aggressive gains in their net worth. One explanation might be that wealth gains are concentrated in high income earners, another that we are understating household spending on healthcare in the start up phase of Affordable Care Act.
- Slow household formation has suppressed everything from housing starts to business investment and one key to unlocking more growth lies in the 16-24 year old cohort.
- A flat global growth and trade outcome in the first half of 2014 could give way to some improvement in the second half. That might allow a resumption of the secular improvement in US debt and trade fundamentals.
- The key domestic risks occur when we near the point later this year that the Fed finishes its asset purchases program and markets wonder whether less easy money is not too far behind.
- This might be associated with a tighter labor market and a lower profits share of GDP.

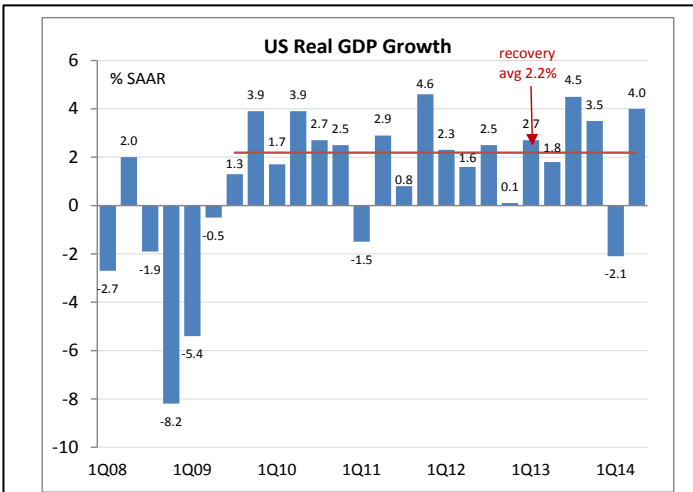
WHAT IS TRENDING

 Positive	 Same Trend	 Negative
<p>- GDP recovery Nice 2Q rebound in GDP growth after weather impacted Q1, despite low numbers on services.</p> <p>- Jobs growth this year Despite cold winter, jobs growth running 231K per month this year vs 194K in 2013.</p> <p>- Sharp rise in job openings Showing up in JOLT, ISM, small business and Empire State surveys.</p> <p>- Spending on cars, furnishings, chain stores Spending on 'services' has been slow but households have busy in some sectors.</p> <p>- Credit growth Bank lending continues to improve, especially for small banks (7.7% YoY).</p> <p>- Household conservatism Cautious behavior of households keeps Fed comfortable with low rates regime</p> <p>- Global cycle Indications from PMIs etc are that the global economy will have a better second half.</p>	<p>- Business capex Core capital goods orders growing at a steady, modestly improving pace.</p> <p>- Labor market 'spider' Labor market repair continues but not at a pace that would 'scare' Fed into tightening.</p> <p>- Policy clarity Fed's guidance suggests no asset purchases after Oct, tightening starts by mid 2015.</p>	<p>- Housing rebound less than anticipated Both the supply and demand side of the housing equation have cooled ... except rentals demand.</p> <p>- Inflation If inflation were to accelerate further, the Fed may signal greater tightening urgency.</p> <p>- Shrinking unemployed pool Drop in unemployed per opening, claims below 300K, surge in 'hard to fill', jump in quits.</p> <p>- Valuations? Household net worth as a multiple of income is approaching highs of past two cycles.</p> <p>- Global risks still tangible Geopolitics and concerns around stimulus prospects in Europe, Japan and China.</p>

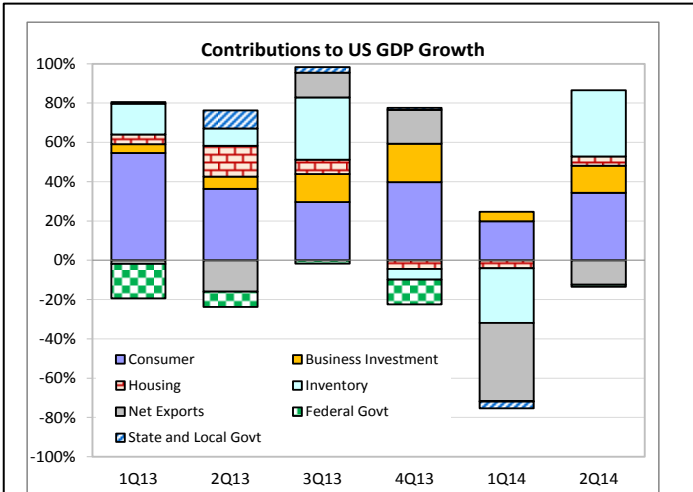
THE US ECONOMY IN AGGREGATE

SUMMARY

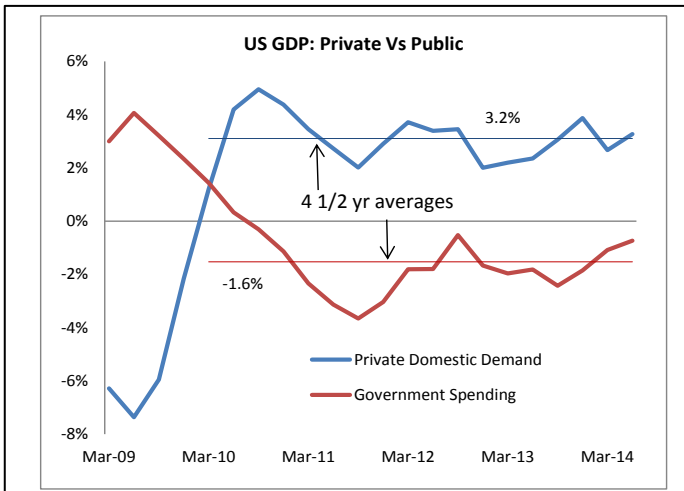
- As the Fed chair noted, the sharp drop in US GDP in 1Q 2014 "substantially understates momentum in the economy."



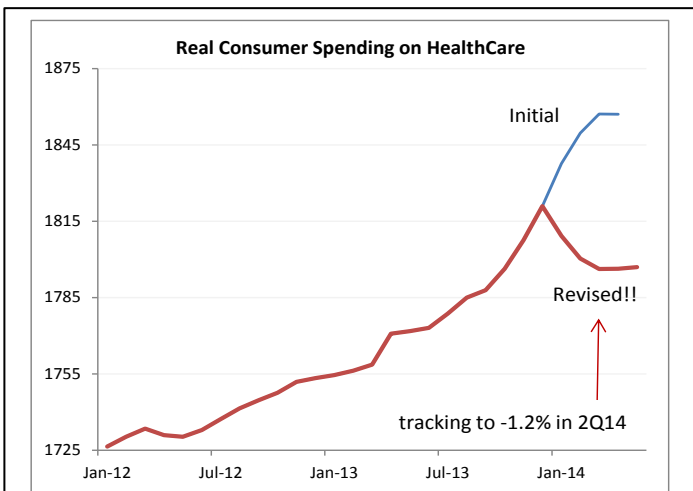
- The US economy rebounded nicely in the June quarter.



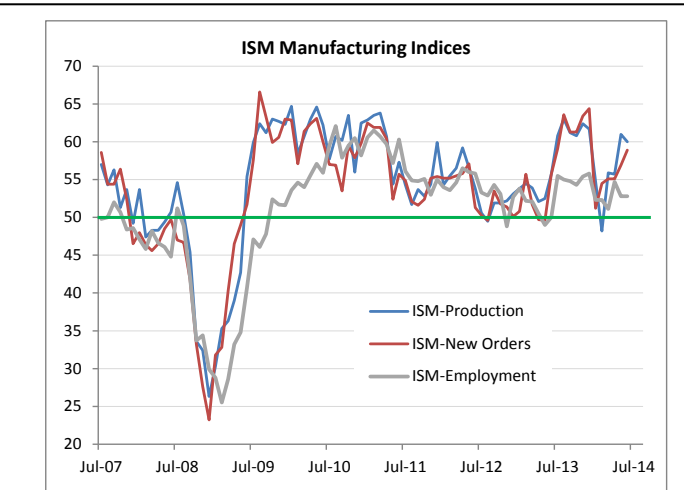
- Foreign trade and inventories were weak while household spending was tepid.



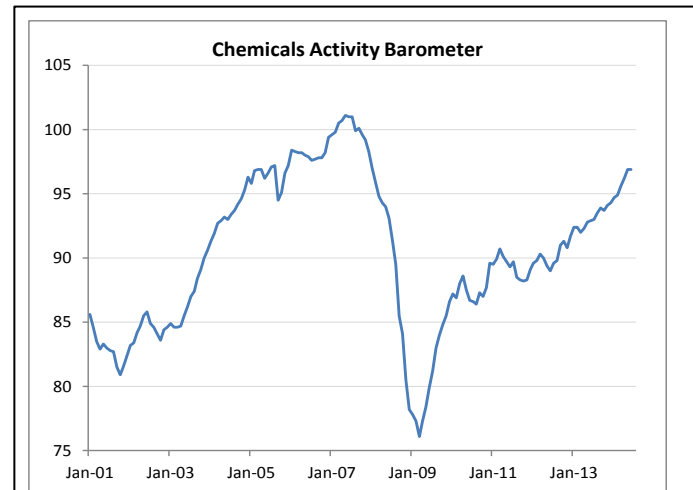
- Government remains a drag on growth despite being a year away from the 'fiscal cliff'.



- One 'technical' factor in weak growth was the sharp decline in household spending on healthcare.



- Weather and other factors have made the industrial sector volatile.

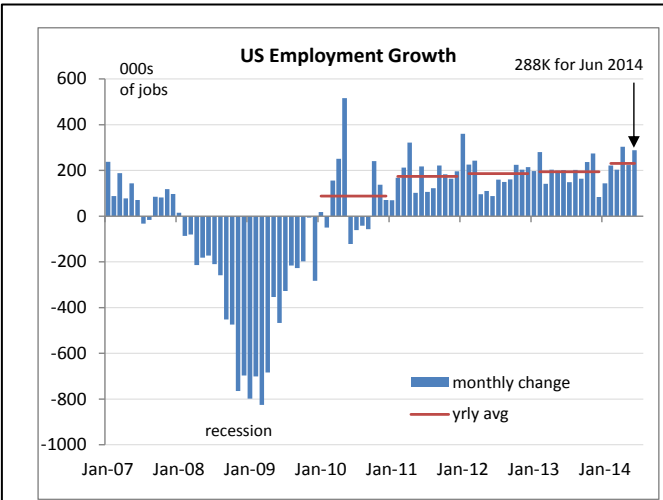


- Chemical sector strength has read through into robust activity in other sectors.

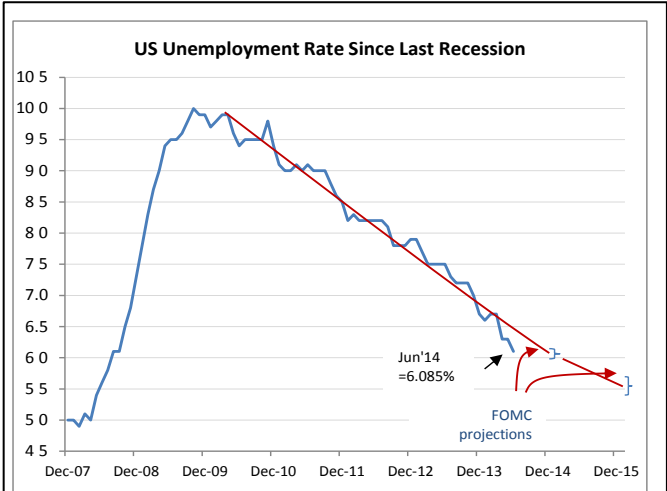
THE LABOR MARKET

SUMMARY

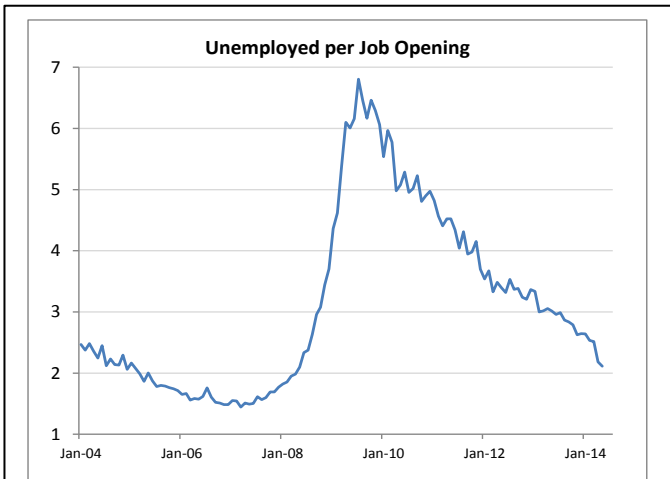
- Gradual repair of the labor market has continued but despite considerably tighter conditions (reduced pool of unemployed to fill openings), wages have yet to take off.



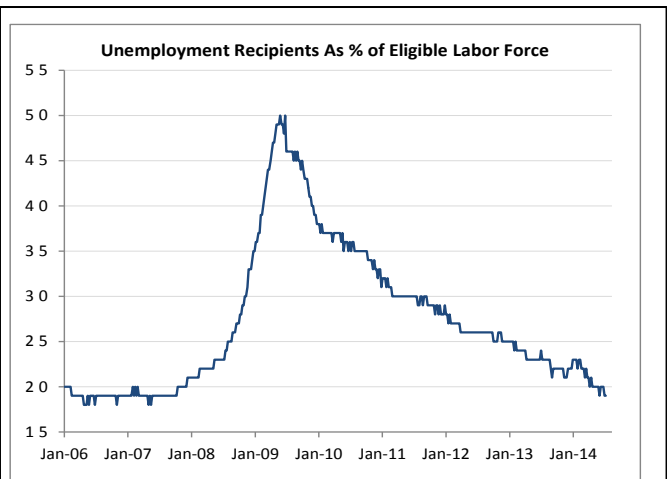
- Belying soft GDP, jobs growth picked up in the first half of this year.



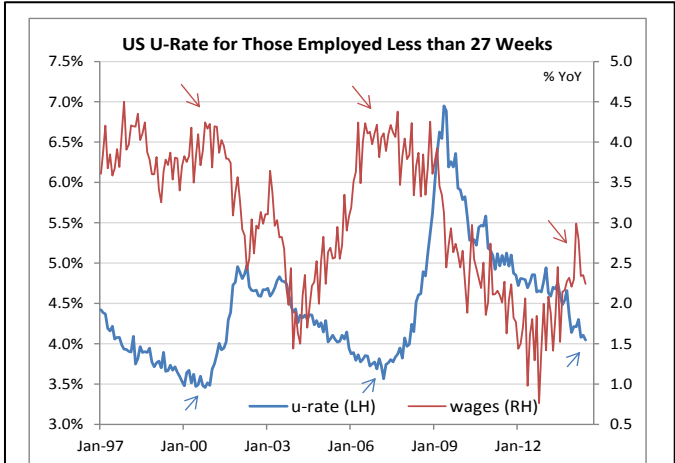
- Without any rebound in labor force growth, solid job creation is dropping unemployment quickly.



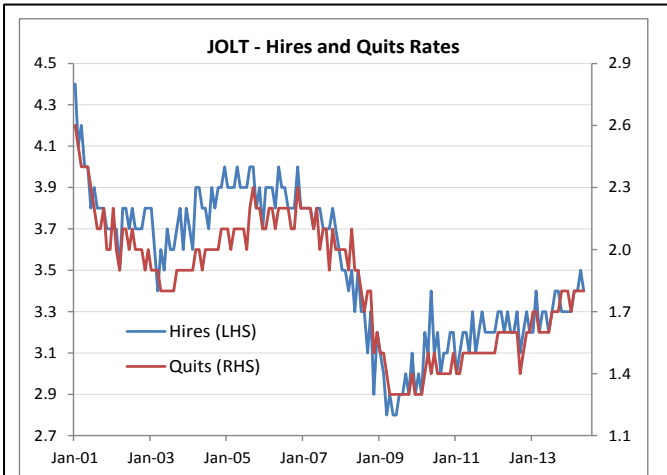
- The pool of unemployed per job opening has shrunk to pre recession rates.



- The pool of unemployment insurance recipients is also low.



- Wage growth (2 to 2%) is atypically low for such a tight pool of short term unemployed.

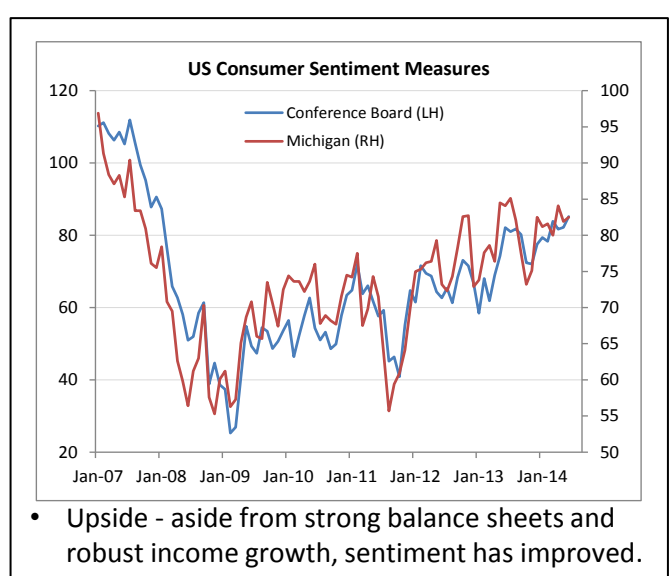
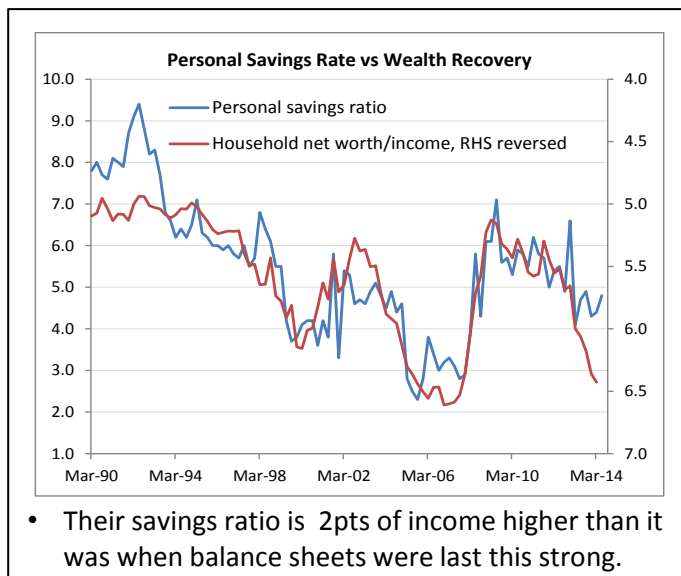
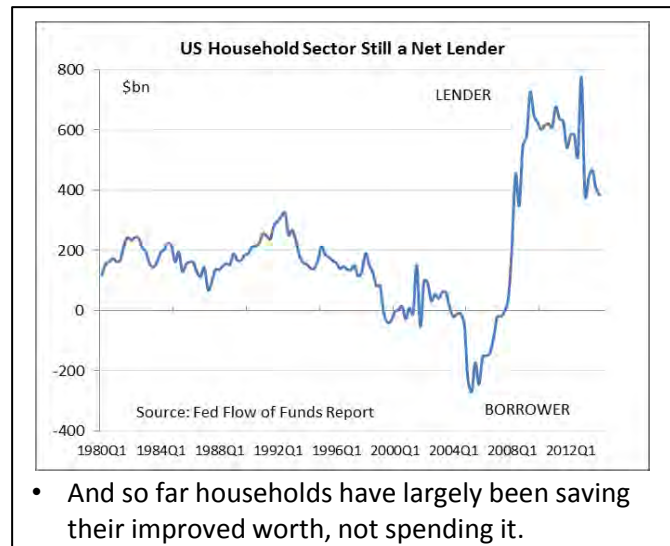
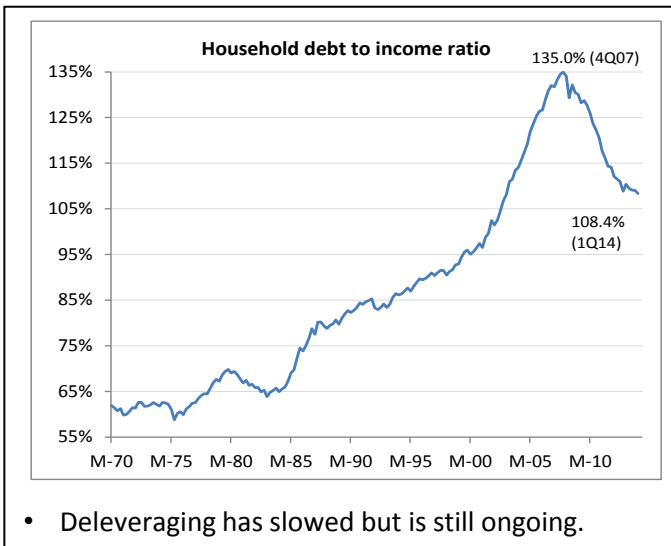
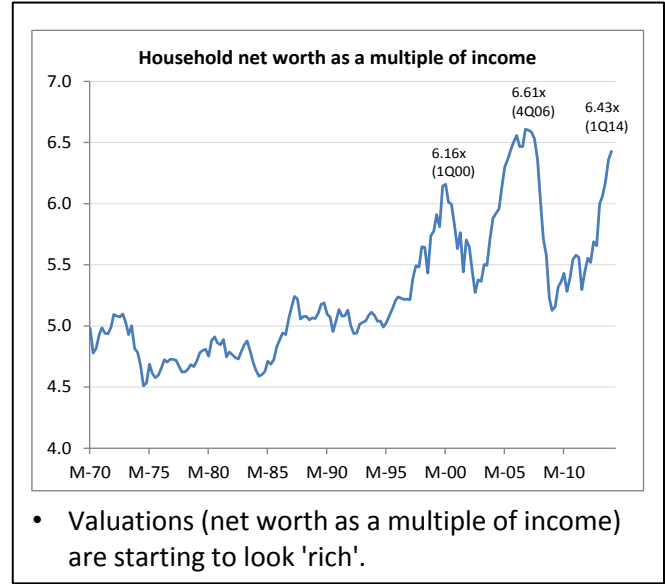
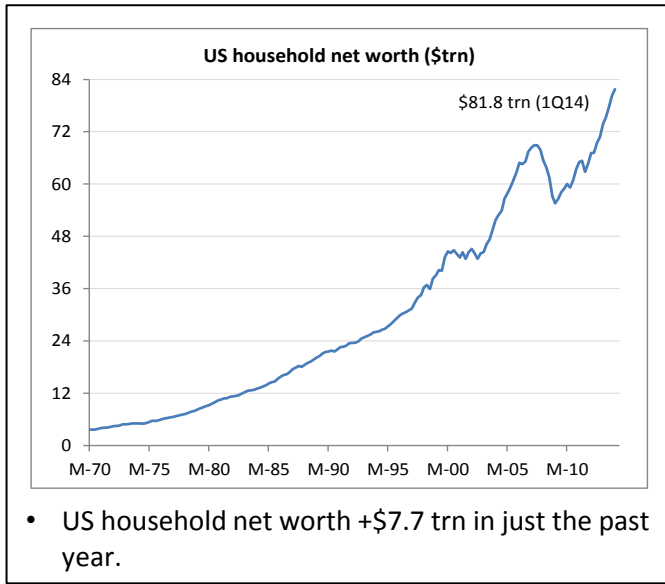


- Higher rate of turnover (hiring and quitting) is a good sign of less impairment, pay upside.

HOUSEHOLD SECTOR

SUMMARY

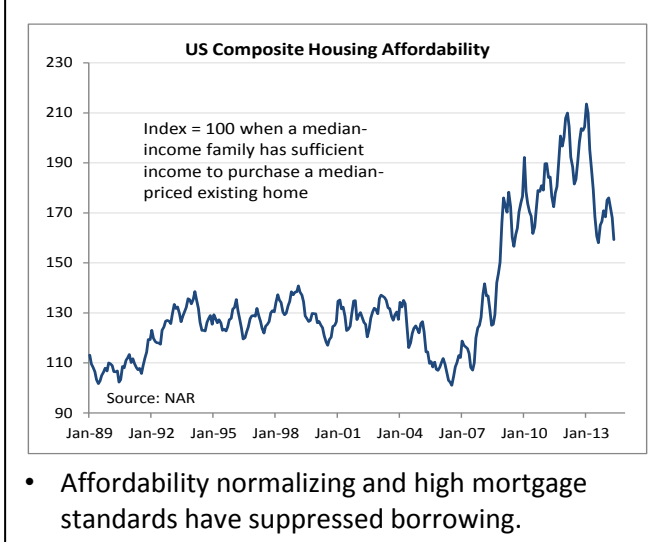
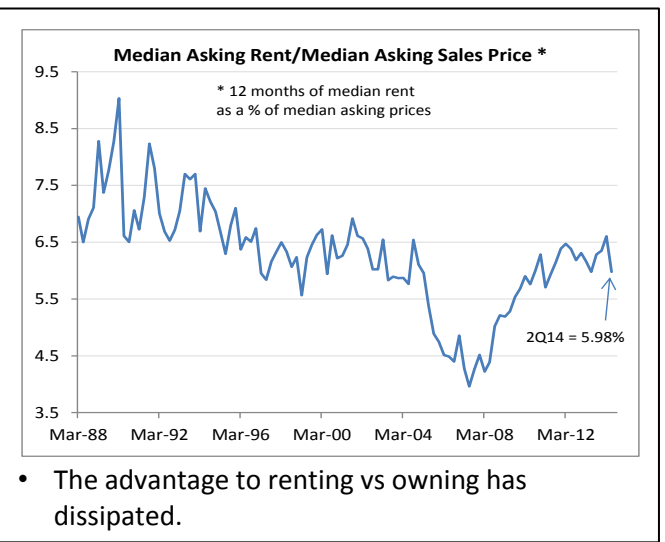
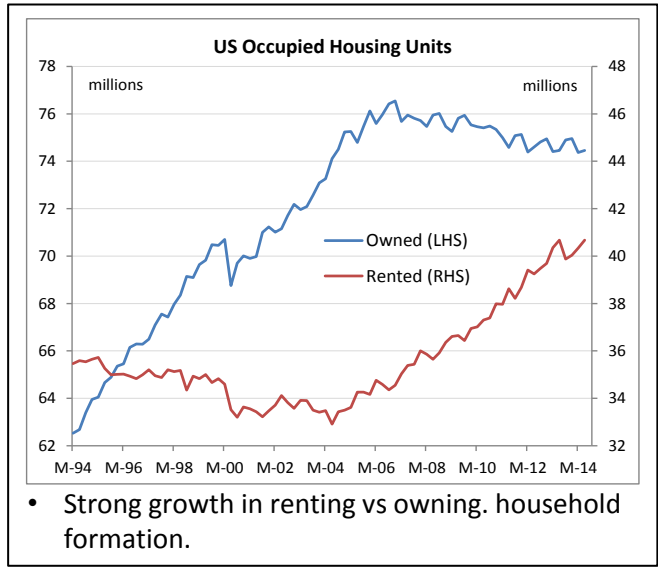
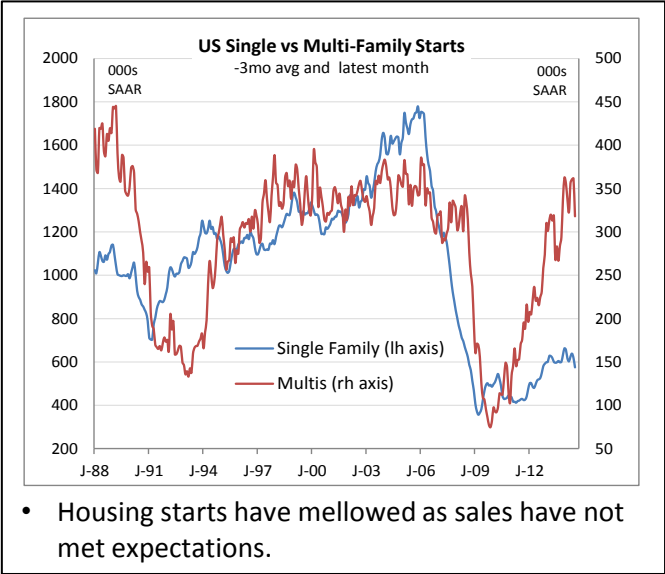
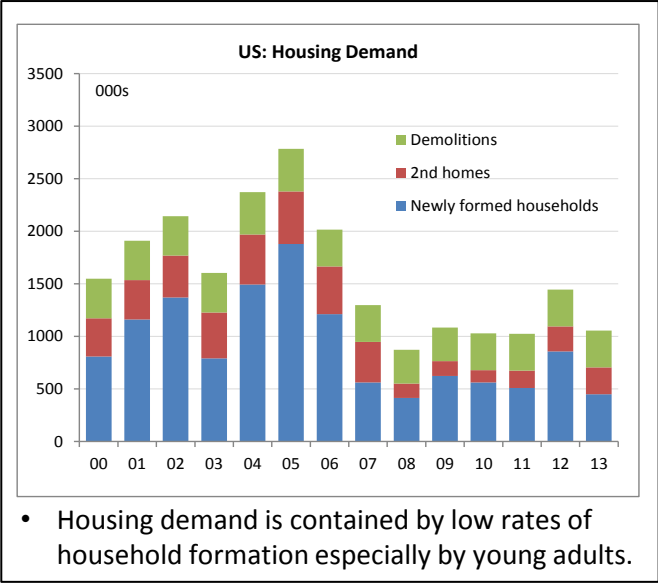
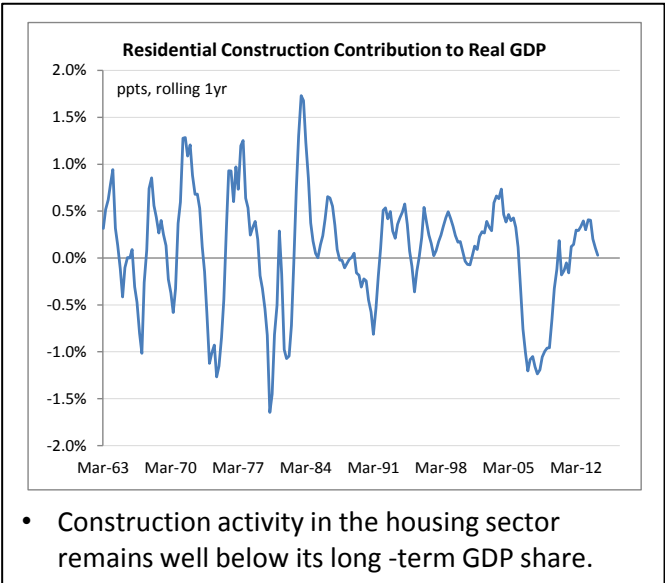
- Households have been cautious this year despite strong balance sheet improvement, solid income growth and more confidence. Some of the mystery in this lies in whether healthcare spending has really dropped



HOUSING

SUMMARY

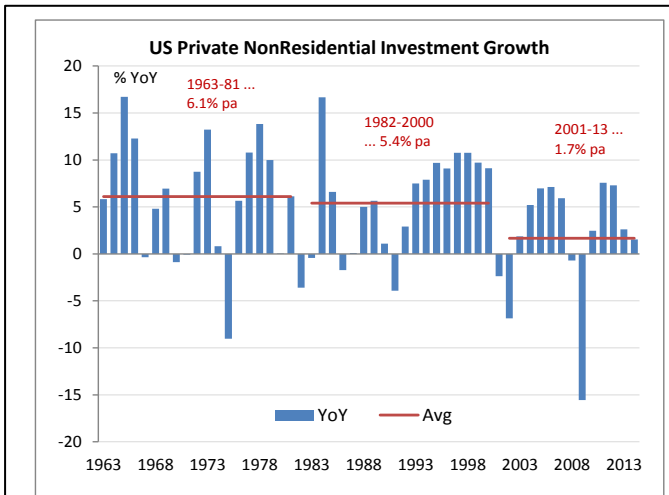
- After years of above-normal housing activity we are only just working this off and the current housing recovery is slow and measured. Focus on multis and renovations have also kept activity impact on GDP low.



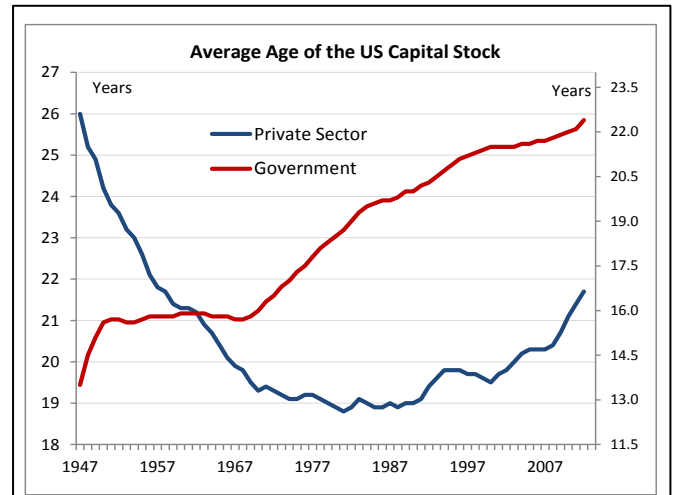
BUSINESS SECTOR

SUMMARY

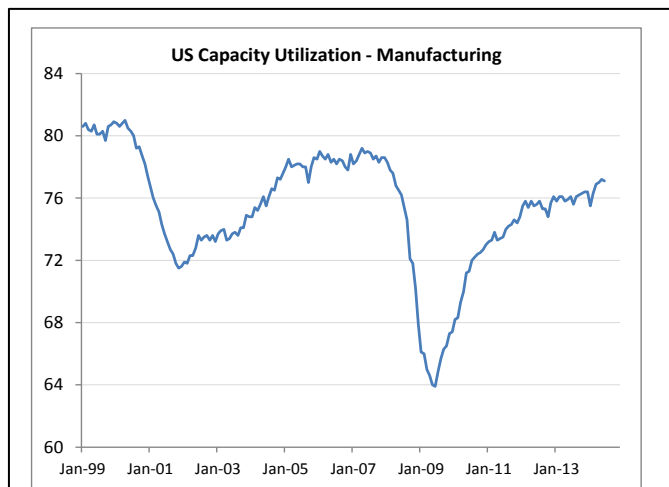
- There are some modest signs that suppressed business capex will improve later this year.



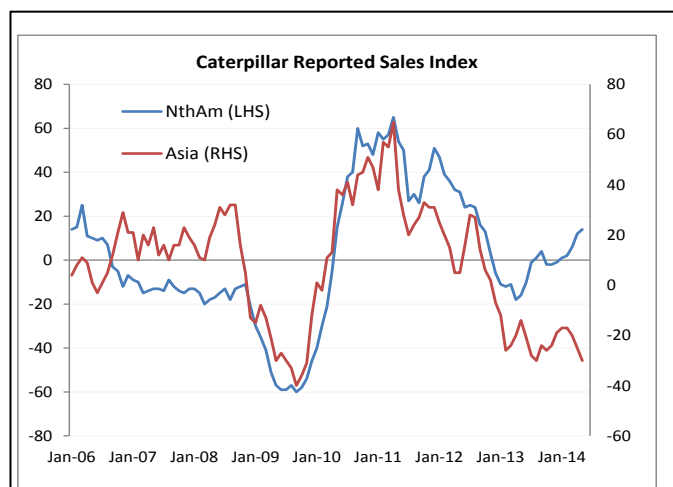
- Slowdown in business capex growth has been associated with slower 'potential' GDP growth.



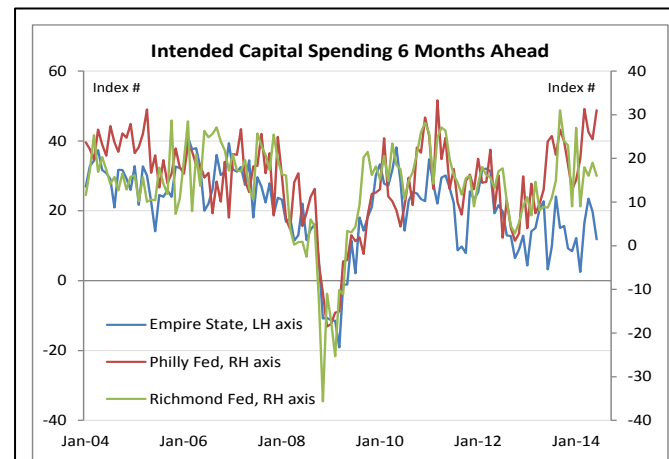
- The ageing of the capital stock has not to date triggered an uptick in investment.



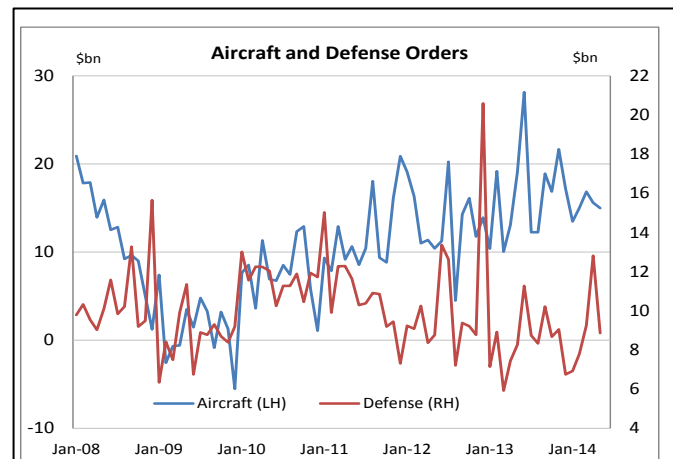
- Capacity use in some sectors portends more future capex ... esp. manufacturing and mining.



- Caterpillar is seeing more business growth in the US than in Asia.



- Intended capex in general is looking to improve in second half of 2014.

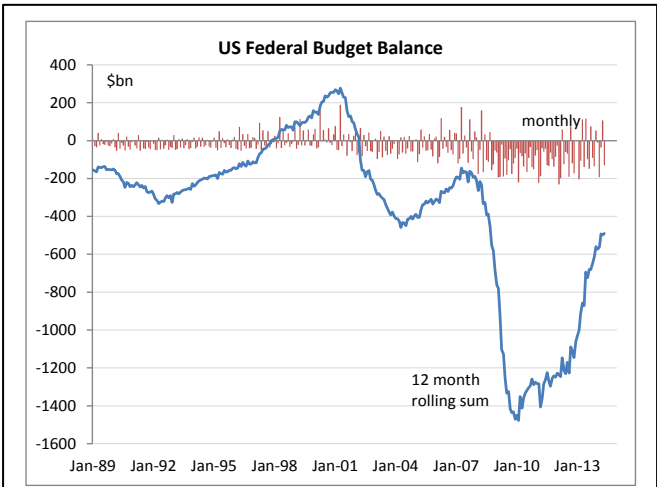


- Aircraft and defense orders are still languishing, offsetting improvement in core capex orders.

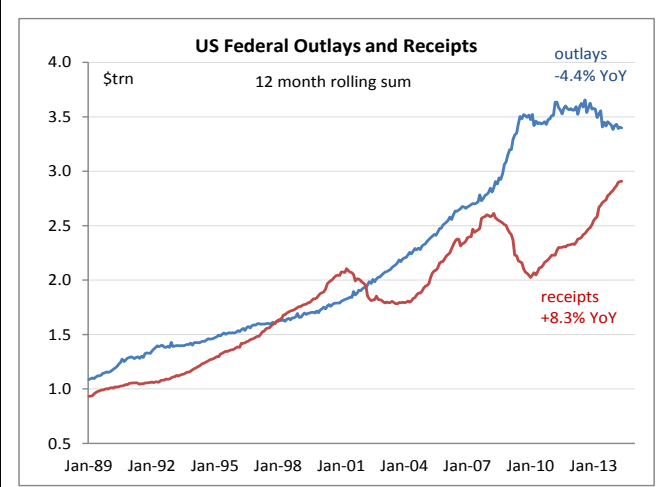
GOVERNMENT

SUMMARY

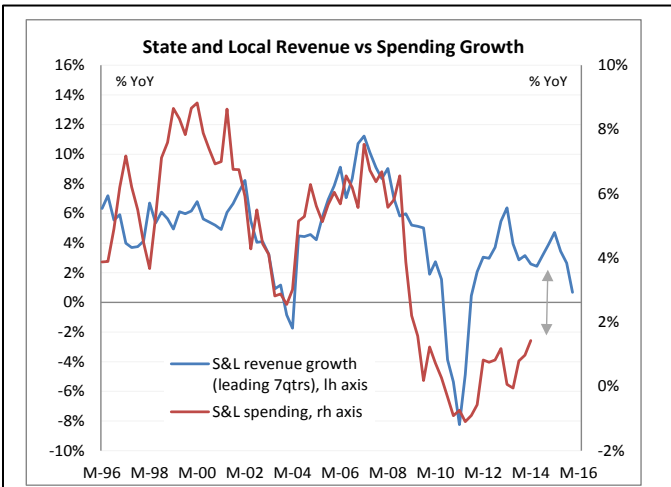
- Government is less of an economic headwind that in 2013 but corrective action against potential long-term fiscal deterioration may be required from 2016 onwards.



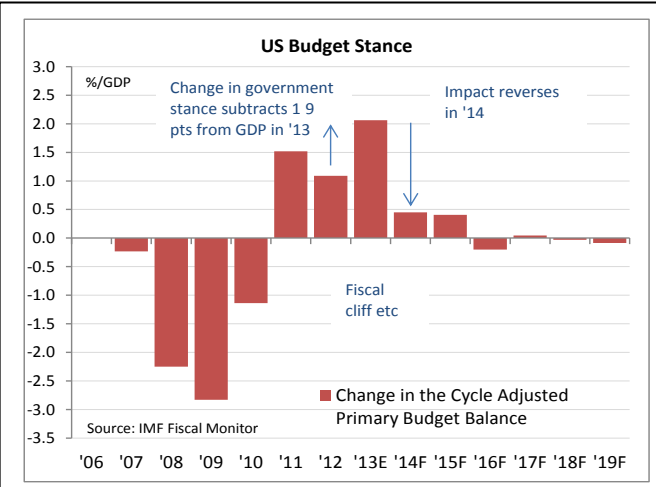
- The federal deficit has experienced a rapid decline, helping keep bond yields low.



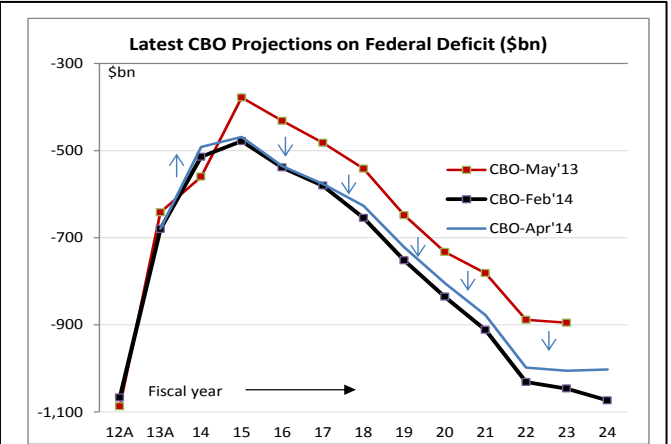
- The 'fiscal cliff' had the predictable effect of raising revenue, cutting outlays.



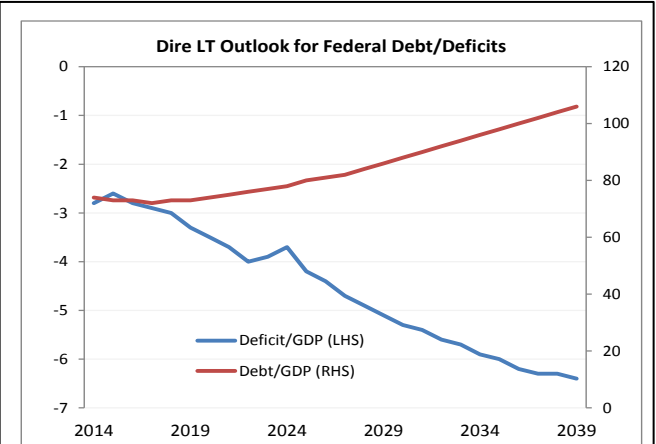
- State and local governments have been conservative despite their revenues improving



- Government becomes less of a drag on growth from this year onwards.



- However federal deficit improvement is projected to peak in 2015.

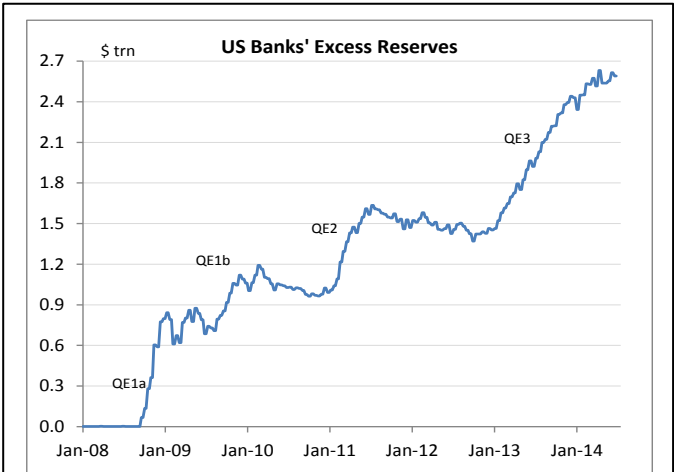


- And the 25-year picture calls for considerable corrective policy action soon .

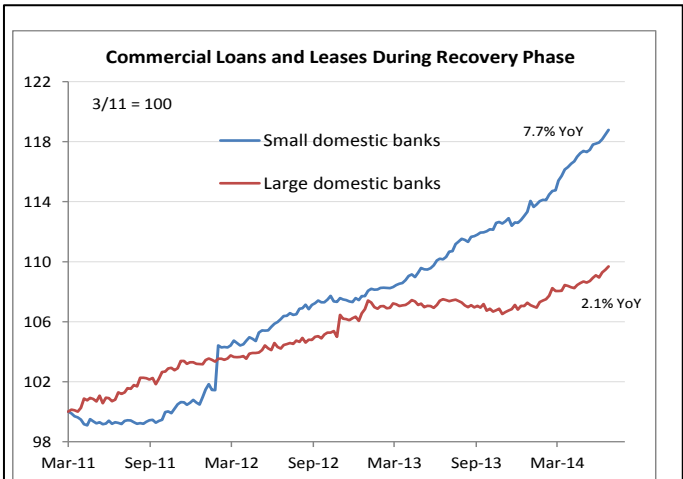
CREDIT AND INFLATION

SUMMARY

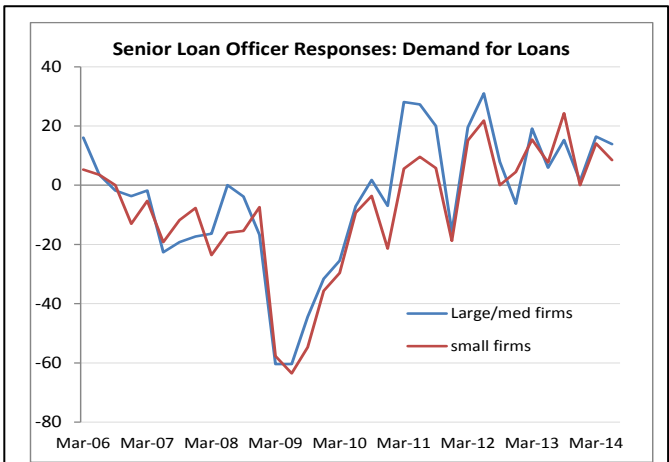
- Credit growth is perking up as well as many inflation indicators, representing a risk later this year if the Fed gets behind the inflation curve.



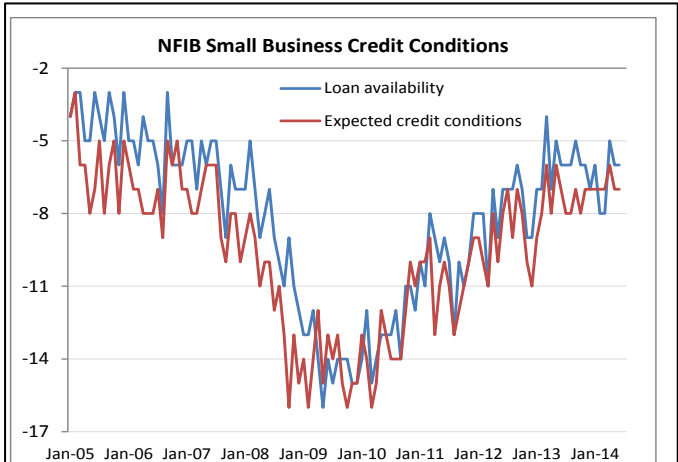
- Less QE and more bank lending has arrested the growth of banks' excess reserves.



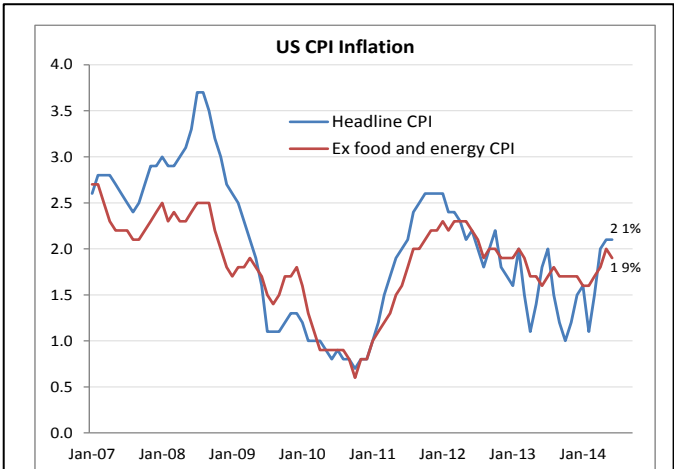
- Lending growth has been strongest for smaller regional banks.



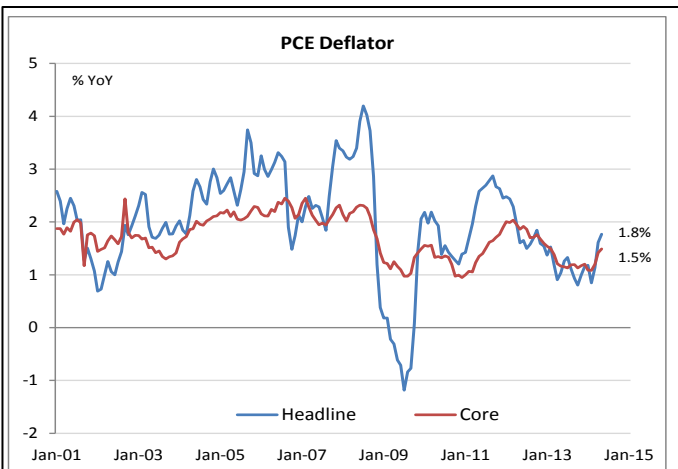
- Demand for loans has improved .



- As have borrowing conditions for small business.



- US CPI inflation has ticked higher ... food rents, healthcare and airfares have contributed.

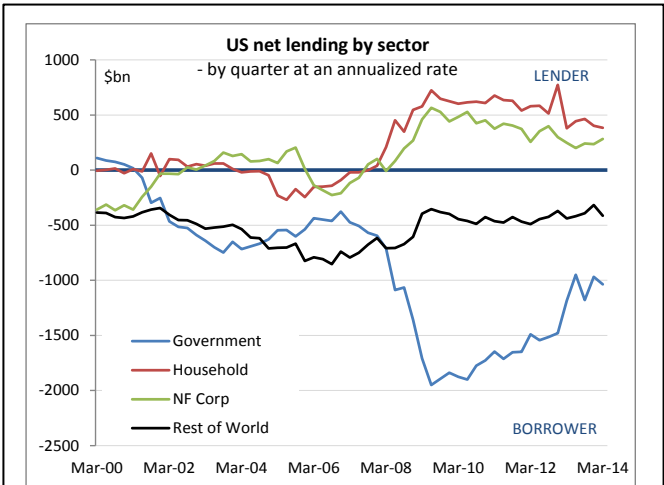


- The Federal Reserve's preferred inflation measure is still below 2% but rising.

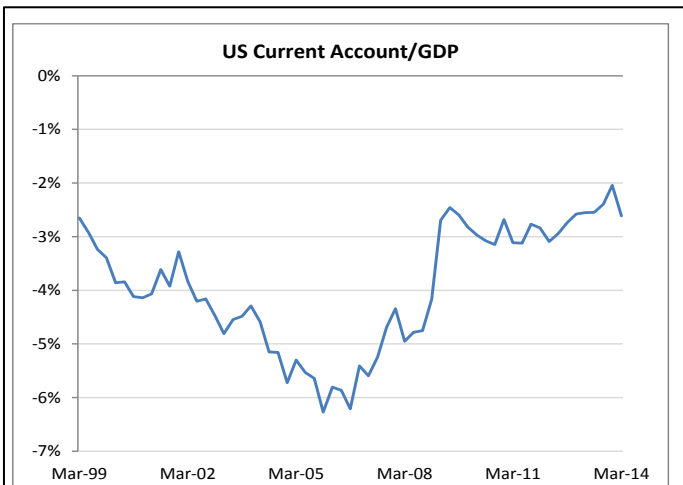
INTERNATIONAL

SUMMARY

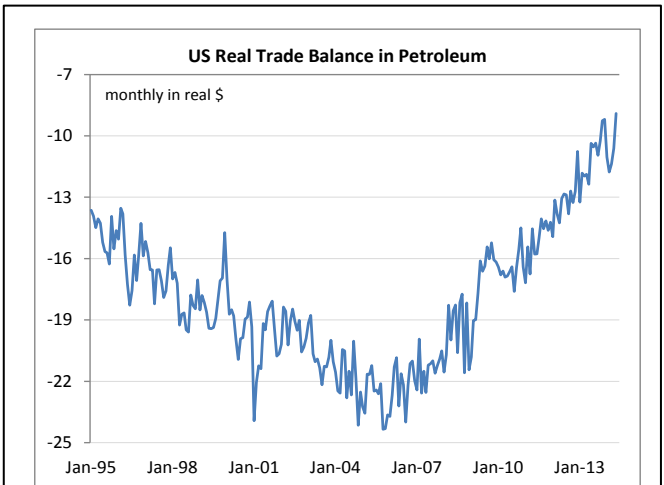
- The US current account deficit has been halved based on reduced internal borrowing and gas self sufficiency.
- Cyclically, there is hope for better trade performance in the second half of this year.



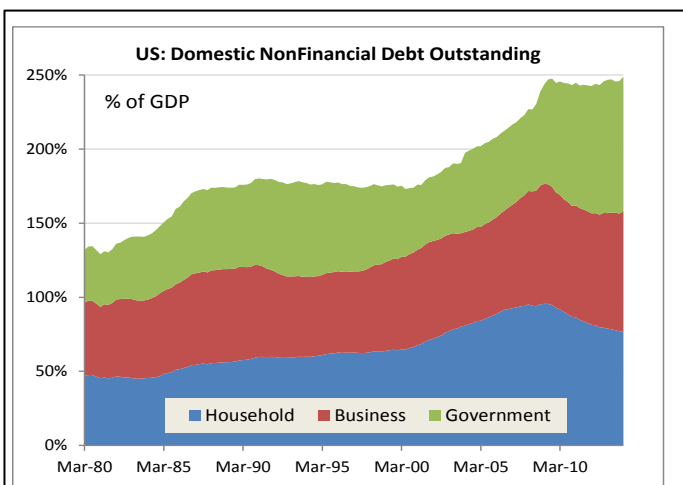
- There is less borrowing by the government and net savings by households/corporates .



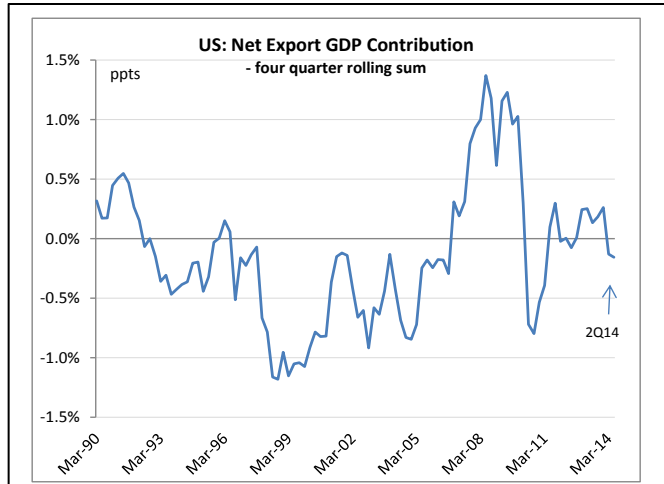
- Less borrowing has translated into a less unfriendly external deficit for the US.



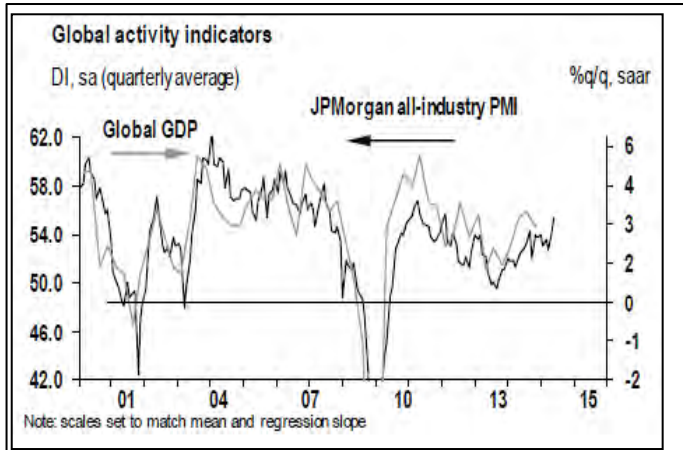
- Increased self sufficiency in energy has helped too.



- The stabilization of US internal debt has reduced the risk of a run on dollar assets.



- A better growth contribution from trade requires a more robust global trade picture.

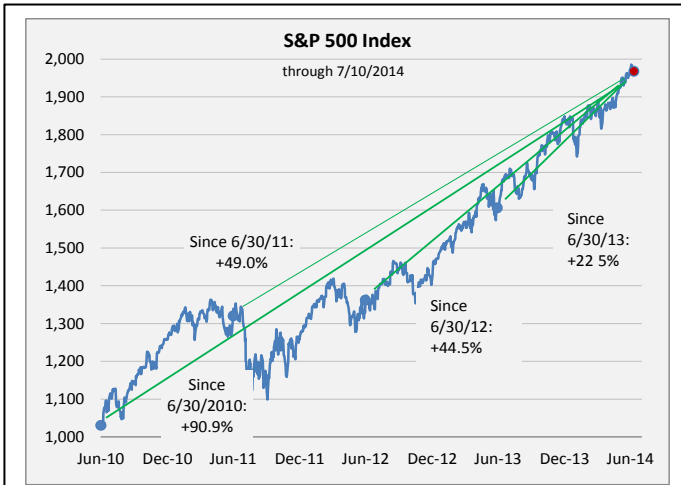


- There is some reasonable hope that global activity has a better 2nd half than 1st half.

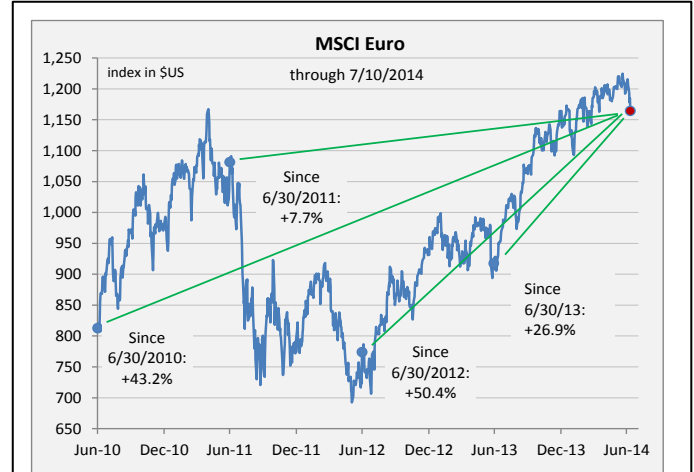
FINANCIAL MARKETS

SUMMARY

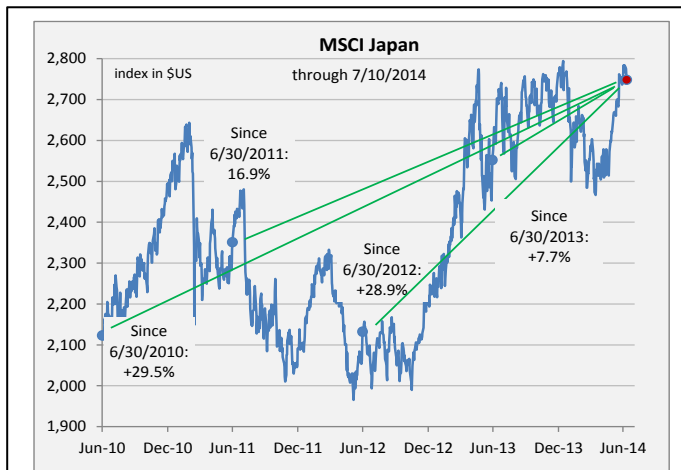
- Most stock markets have had a very good June to June year, emerging market stocks less than others.
- The US 10-year bond yield fell in the first half on less supply and more foreign demand.



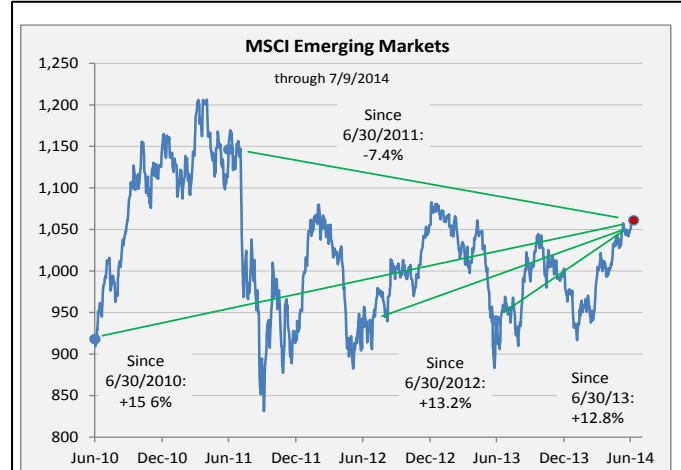
- Three straight years of strong US stock market gains.



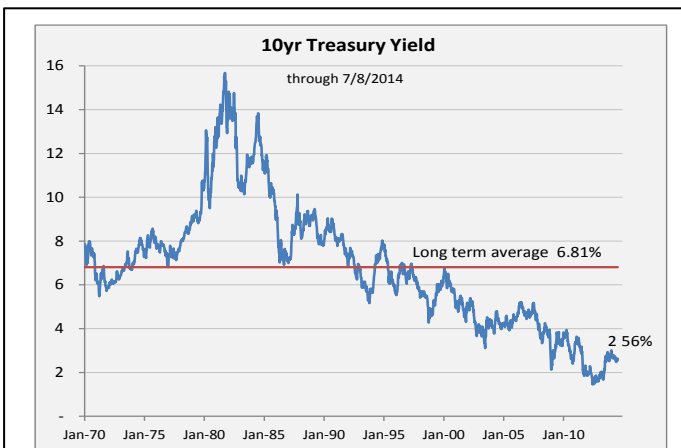
- European stocks supported by stronger euro and more accommodative European Central Bank



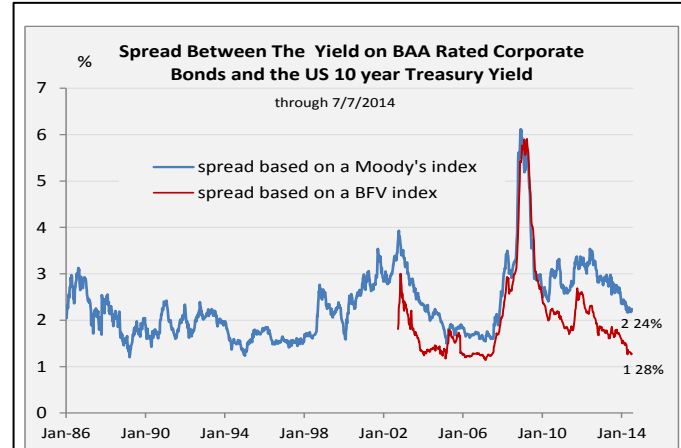
- From Japan, more confidence in Abenomics and risk taking by local retail investors.



- Weak inflows to emergin markets has suppressed participation in global equity market rally.



- Private demand for Treasuries and lower federal deficit have swamped the QE reduction.



- Corporate spreads are in close to the last cycle's narrows.