July 10, 2013

CORNERSTONE MACRO

Economics, Policy & Strategy

Economic Research

Topics of the Day:

- **The U.S. Outlook Is Pretty Positive, And Middle America Remains Our Favorite "EM".**
- U.S. Employment Is Increasing at a Pretty Steady Pace.
- Mfg Employment Is Down, but the Mfg Workweek Matched Its Record High.
- Overall Mfg Employment Is Still Sluggish, But Mfg Is Helping Certain States.
- In States with Strong Mfg Employment Growth, Overall Employment Growth Has Been Strong.
- Vehicle Sales Surged to Pre-Recession Levels.
- U.S. Mfg Renaissance Is Helping to Lift U.S. Vehicle Production.
- Housing Is Likely to Continue to Be a Driver of GDP.
- U.S. Capital Spending Is Likely to Reaccelerate.
- The Federal Deficit as a Share of GDP Has Improved from -10.4% to -4.6%.
- Federal Outlays as a Share of GDP Are Declining.
- U.S. Domestic Company Profits Have Led Profit Increases.
- The S&P and EM Stock Markets Have Decoupled.
- Domestic Activity Is a Support for U.S. Mfg.
- Our Favorite "EM" Is Middle America.
- China New Normal: Export Growth Has Slowed Sharply.
- China New Normal: Import Growth Has Slowed Sharply.
- **China New Normal: Both Exports and Imports Are Down Sharply Over the Past 5 Months.**
- **Italian Recession: Banks' Bad Debt Is Rising, and IP Is In a Severe Recession.**
- Greek Depression: Greek IP Is Still in Depression Territory.

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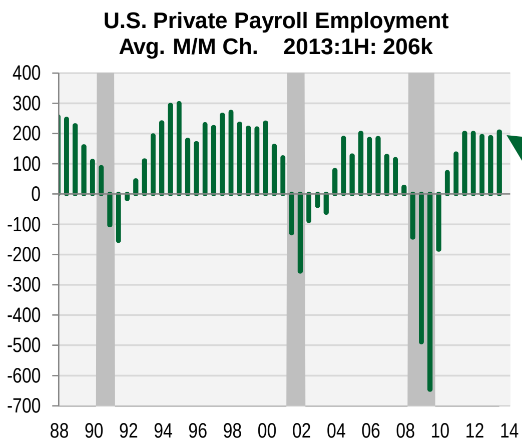
The U.S. Outlook Is Pretty Positive, And Middle America Remains Our Favorite "EM".

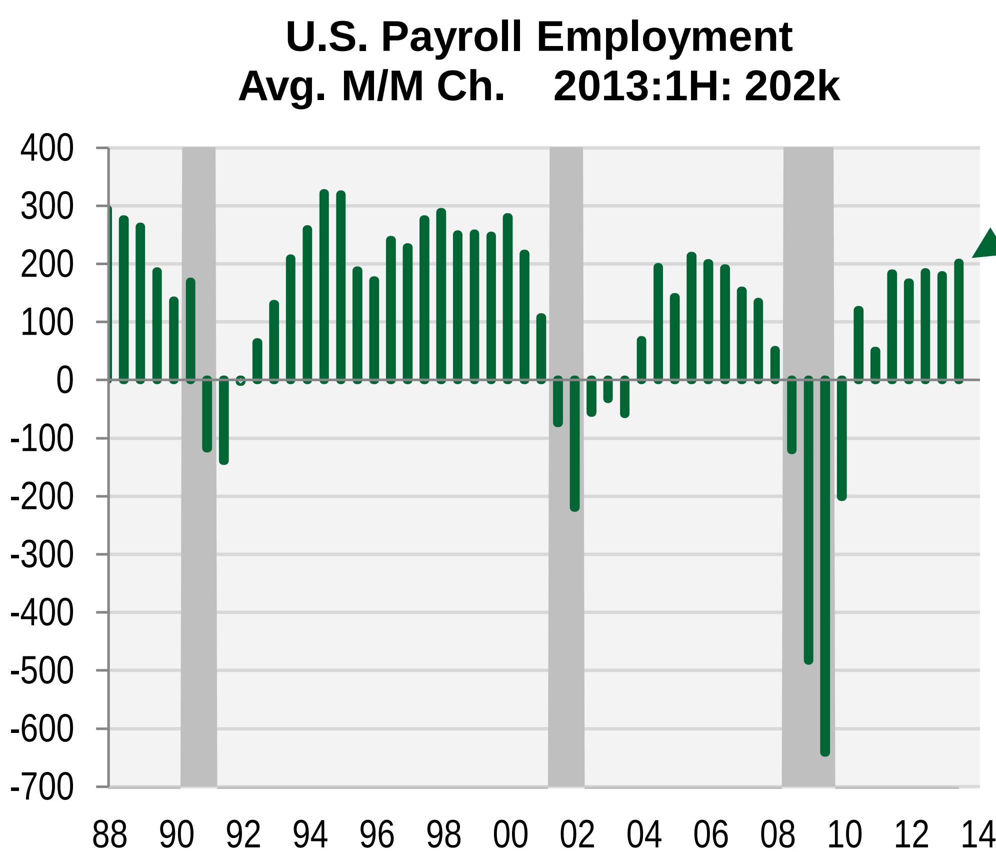
To be sure, the U.S. still faces a number of headwinds, e.g., the huge govt debt overhang and low saving rate. However, there are more tailwinds, which will make it easier to grow and, in turn, delever. Within the U.S., we remain particularly bullish on Middle America, our favorite "EM", a key beneficiary of both the Mfg and Energy Renaissances, and the associated multipliers, e.g., housing. Core positives for the U.S. include:

1) Real GDP has increased 8.1% from its trough, and is 3.0% above its 2007 peak.
2) Although the unemployment rate is a still high 7.6%, it has declined from 10.0%.
3) Private employment has increased 6.7% from its trough, and is on track to reach a record high in 8 months.
4) Inflation is very low, and is likely to remains low for the next year.
5) The budget deficit has improved from 10.2% of GDP to 5.5%.
6) The U.S. enjoys favorable demographics compared to many other DVs (and China).
7) More free trade accords are likely.
8) The U.S. is experiencing an Energy Renaissance.
9) Technology is a key driver of growth.
10) A U.S. Mfg Renaissance is starting to unfold.
11) The Mfg and Energy Renaissances make the U.S. an attractive destination for FDI.
12) A multi-year recovery in housing is unfolding.
13) A multi-year recovery in domestic capital spending is unfolding.
14) The U.S. has a very strong higher educational system.
15) The U.S. has a strong agricultural sector.

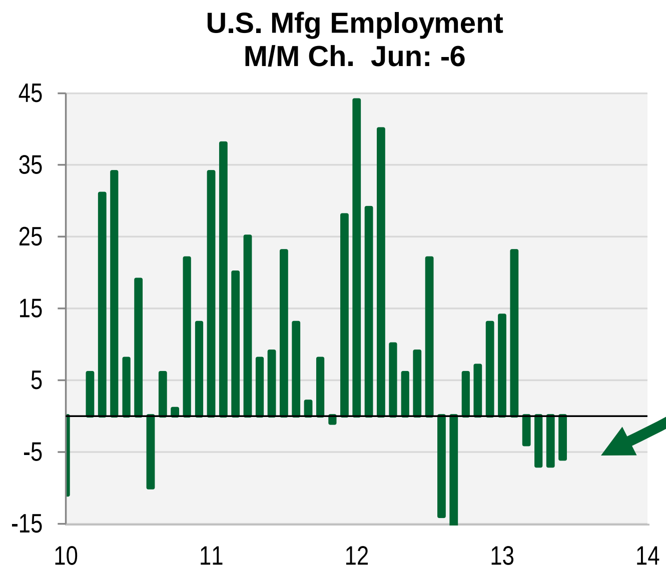
U.S. Employment Is Increasing at a Pretty Steady Pace.



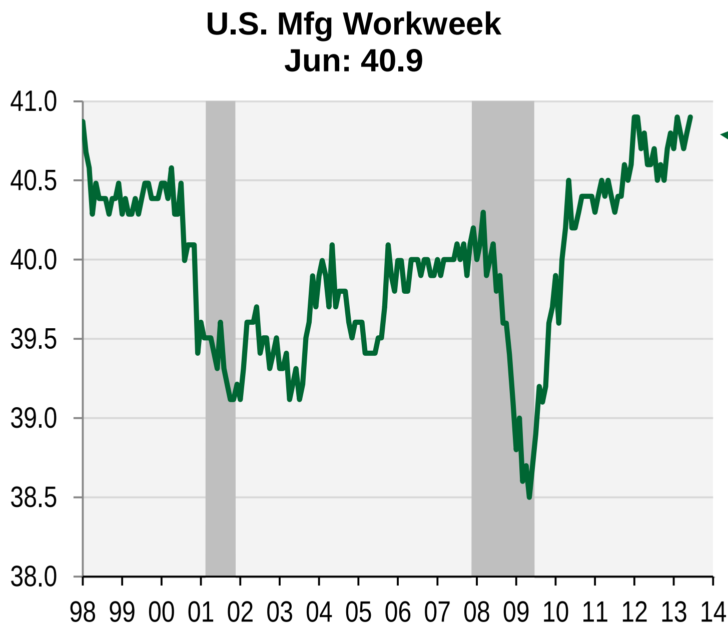
For the first 6 months of 2013, monthly payroll employment gains have averaged 202k per month, the fastest half-year gains since 2005. From 1992-1999, average monthly gains were 233k, i.e., we're almost back to "normal". And those gains are with government employment still declining. Private employment gains averaged 206k per month in 2013:1H, the fastest gain since 1999. The increase in private employment helps explain why the stock market has continued to rally in the face of higher bond yields.



Mfg Employment Is Down, But the Mfg Workweek Matched Its Record High.



Despite the relative strength in overall payroll employment, mfg employment remains weak. However, the mfg workweek in June increased, matching a record high. Looking ahead, based on the strength in the workweek, mfg employment should start to increase in 2H, helping boost overall employment.



Overall Mfg Employment Is Still Sluggish, But Mfg Is Helping Certain States.

% Change in Mfg Employment

Jan 2010 to May 2013	
1. MI	19.4%
2. SD	15.4%
3. ND	15.2%
4. WY	14.0%
5. WA	11.2%
6. IN	10.6%
7. ID	10.5%
8. KY	10.1%
9. IA	9.0%
10. OH	8.9%
11. WI	8.0%
12. UT	7.9%
13. TN	7.2%
14. SC	7.1%
15. TX	6.9%
U.S.	4.4%

Mfg employment has been strong in these 15 states. Most are either in the rust-belt, and/or energy producing states, and/or business friendly states.

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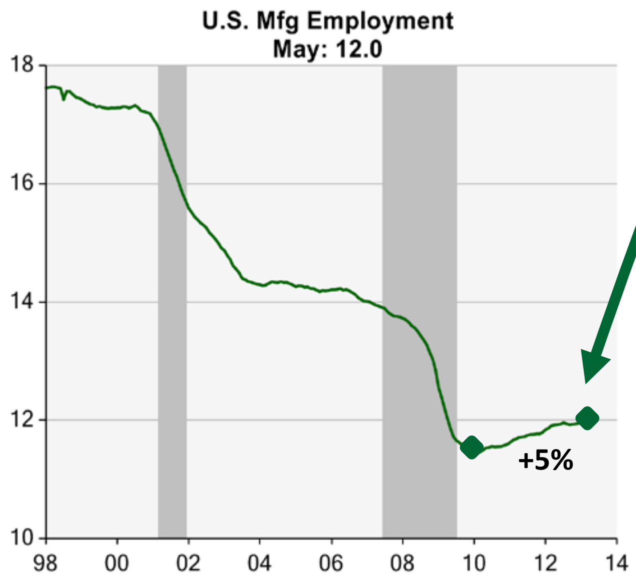
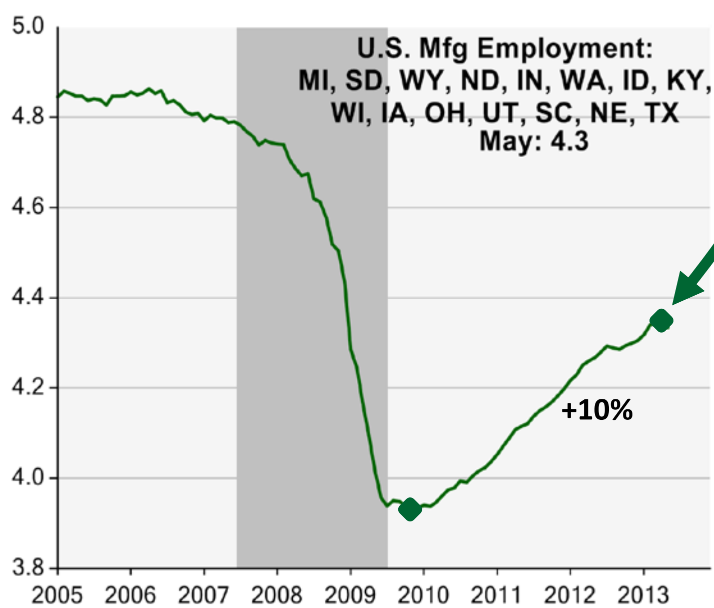
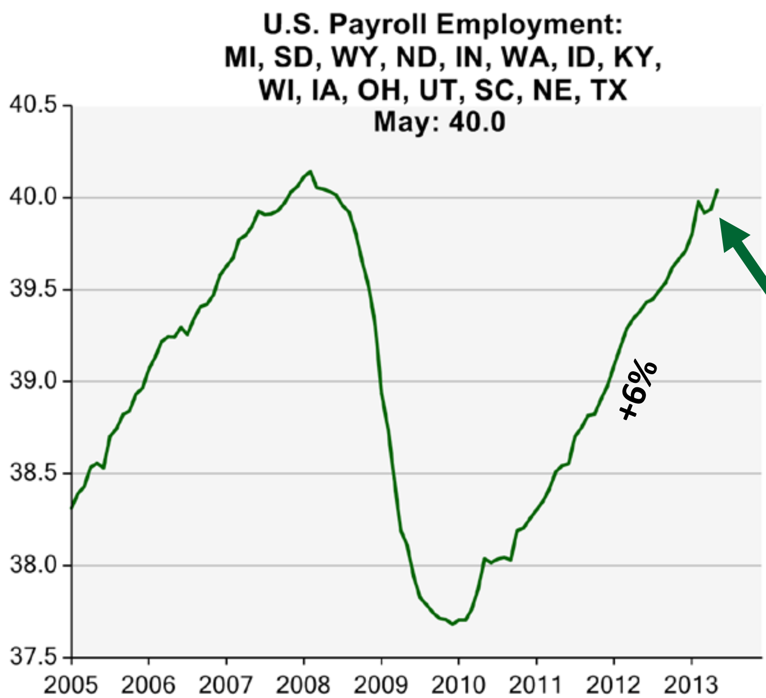


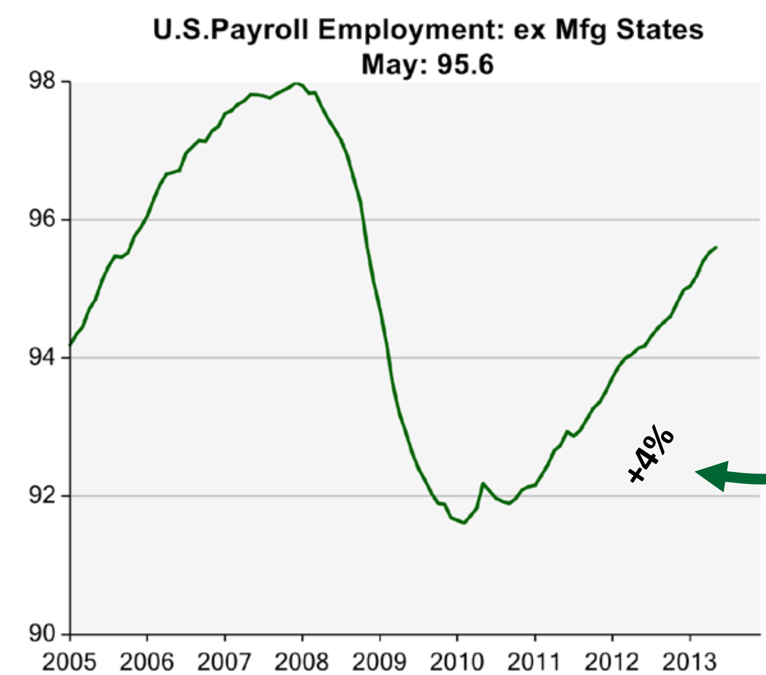
Although overall mfg employment has remained sluggish, mfg employment in mfg-oriented states has actually been quite solid. That is, the Mfg Renaissance is so far not helping boost overall employment significantly, but is strong in certain states.



In States with Strong Mfg Employment Growth, Overall Employment Growth Has Been Strong.



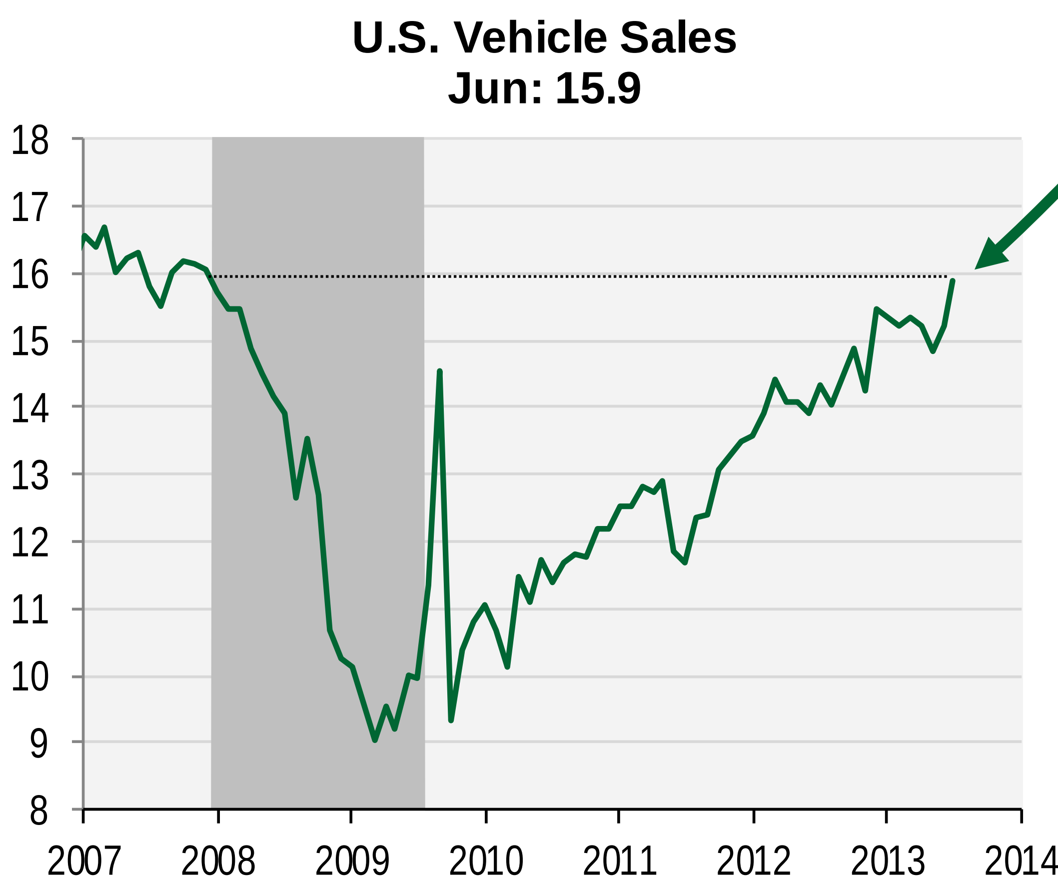
In states with rapid mfg employment growth, overall employment is near its prior peak.



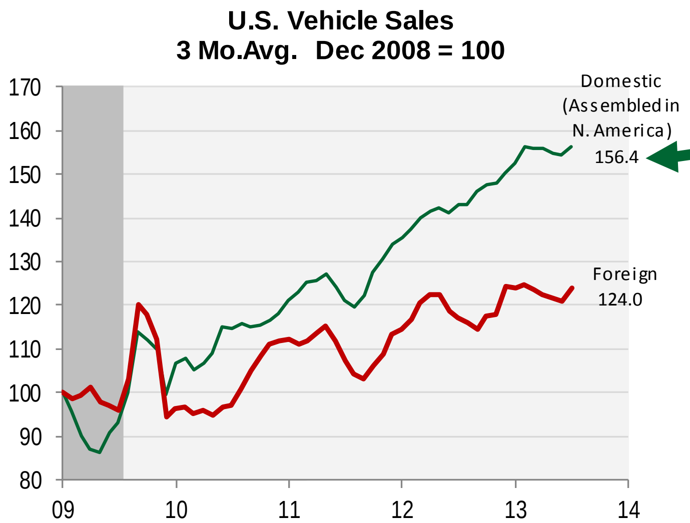
Overall employment ex these states has grown at a slower rate and is well below its prior peak.

Vehicle Sales Surged to Pre-Recession Levels.

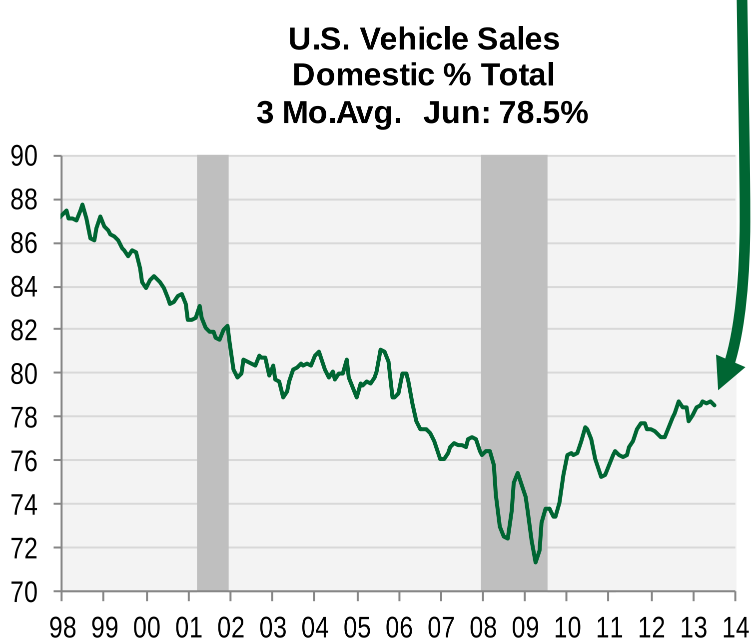
Vehicle sales in June surged to 15.9m, the highest level since Nov 2007, i.e., just before the recession began. Specific supports for vehicle sales include very low interest rates for new auto loans (especially relative to credit card interest rates), and the housing recovery/ Mfg & Energy Renaissances, which are all boosting truck sales.



U.S. Mfg Renaissance Is Helping to Lift U.S. Vehicle Production.



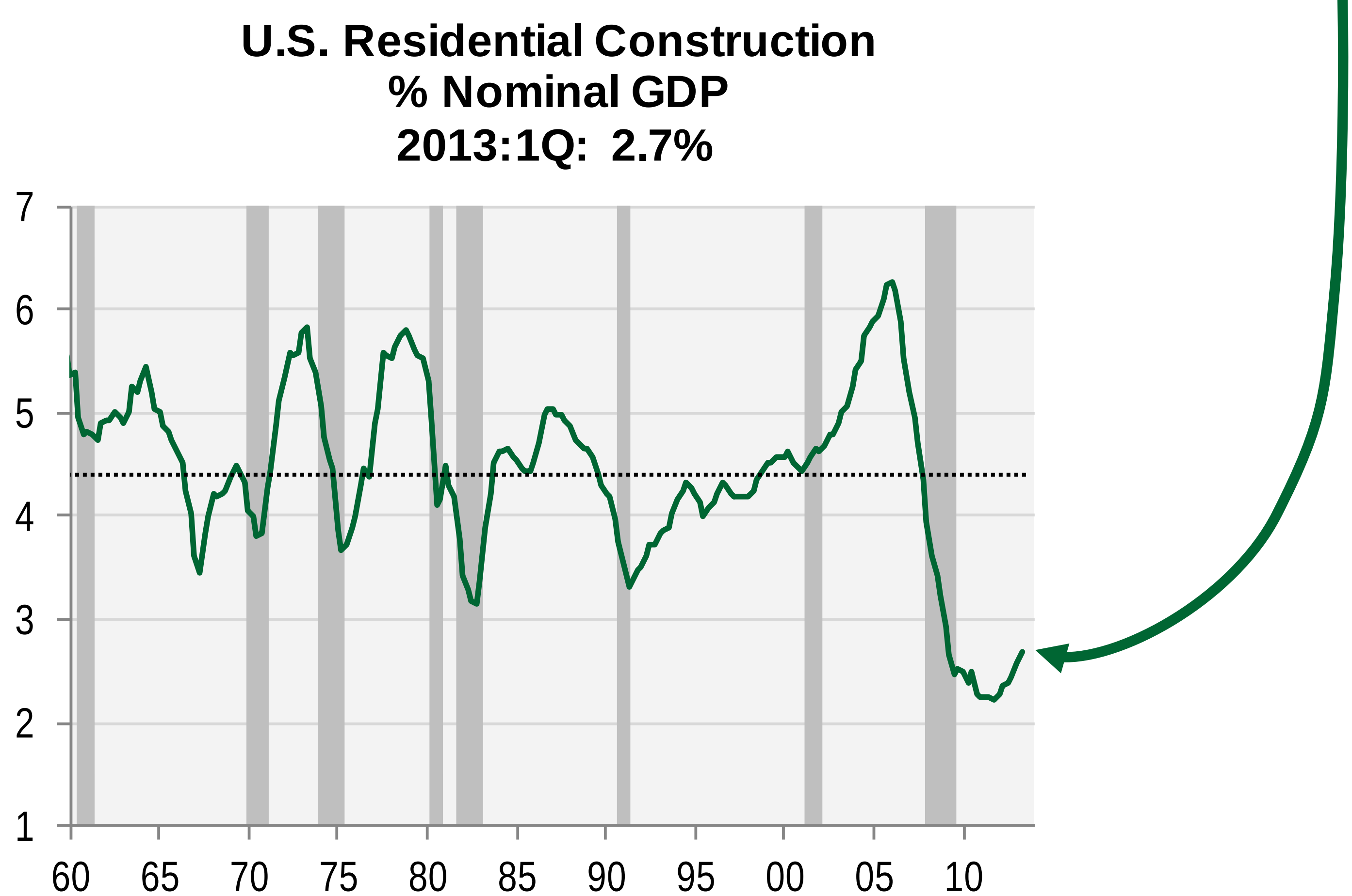
Since Dec 2008, U.S. "domestic" vehicle sales (i.e., vehicles assembled in N. America) have increased 56%, while sales of imported vehicles have increased just 24%. Consequently, sales of vehicles produced in N. America have increased from 71% of total sales to nearly 80%. In the near term, the weak yen may lift U.S. purchases of vehicles produced in Japan. However, cheap energy (e.g., low nat gas prices), low transportation costs, and restrained labor costs are all long-term supports for increased vehicle production in the U.S. And vehicles produced in the U.S. are increasingly being exported to destinations outside N. America.



- **Honda says it expects to export more vehicles from N. America - with nearly all of them coming from its U.S. factories - than it brings in from Japan by the end of 2014.**
  WSJ, July 2

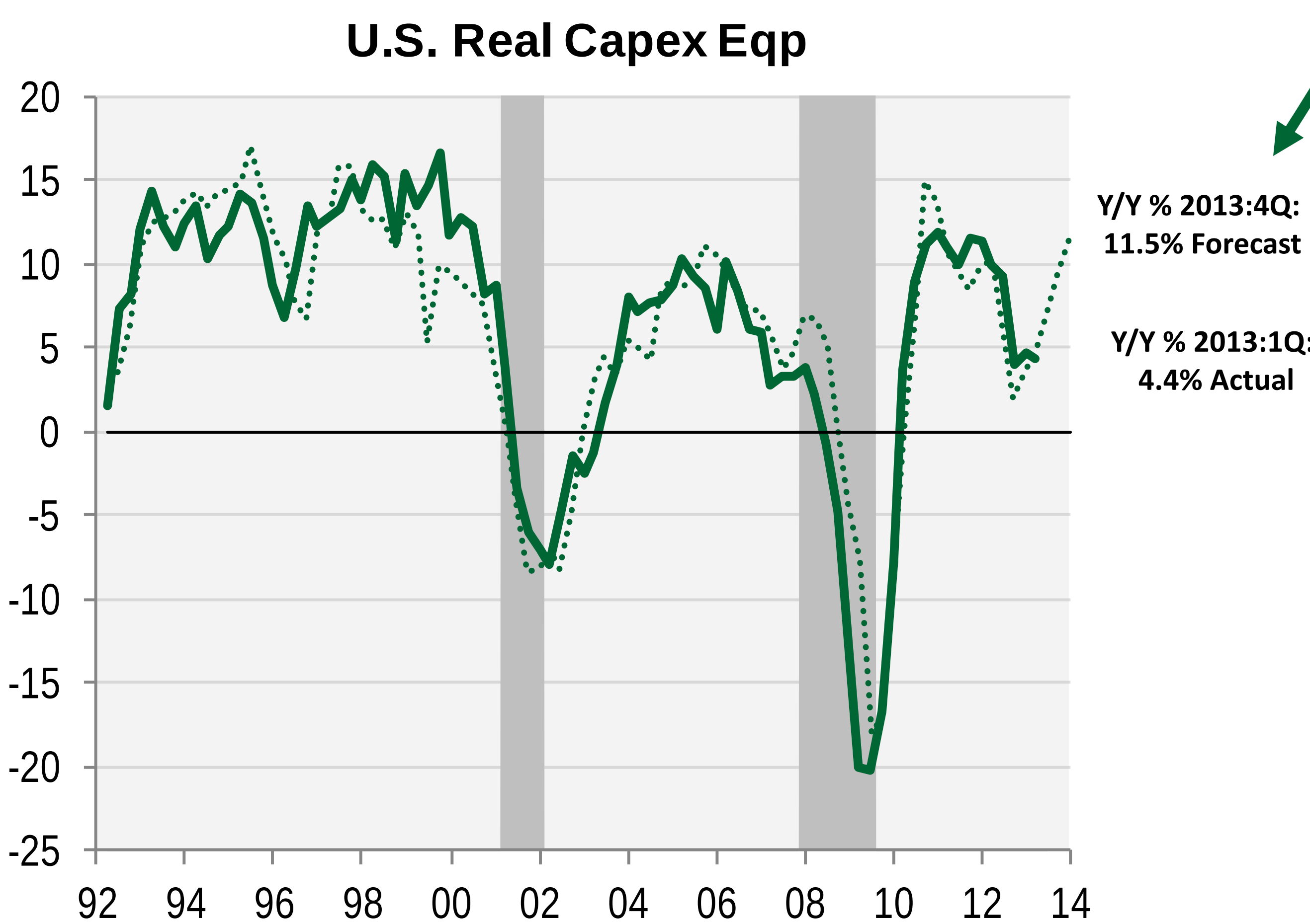
Housing Is Likely to Continue to Be a Driver of GDP.

We recently lowered our housing starts forecast for 2013:4Q to 1.1m vs our prior estimate of 1.3m, in part reflecting the recent surge in mtg rates. However, houses remain highly affordable, and purchasing a house remains attractive relative to renting. We remain bullish on housing, and believe housing will be a key driver of growth for the next 3 - 5 years. Residential construction as a % of nominal GDP is just 2.7%, well below the historical average of 4.4%.



U.S. Capital Spending Is Likely to Reaccelerate.

Our leading indicator for capital spending on equipment forecasts growth to accelerate to 11.5% by 4Q of 2013 vs 4.0% in 1Q. The reacceleration is being driven by the decline in U.S. energy prices, the decline in global short rates, and increased willingness by U.S. banks to make C&I loans. The Manufacturing and Energy Renaissances are also supports.



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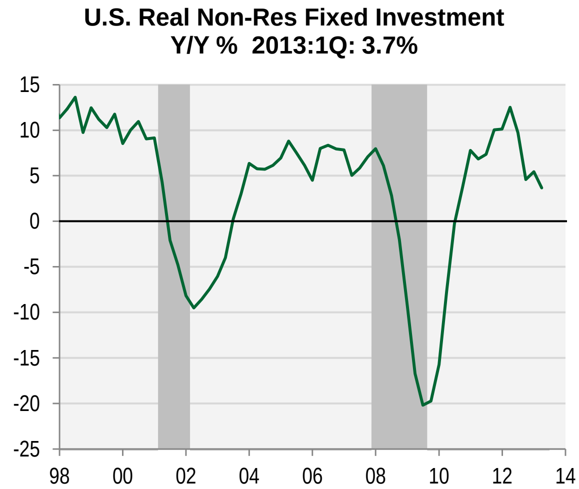
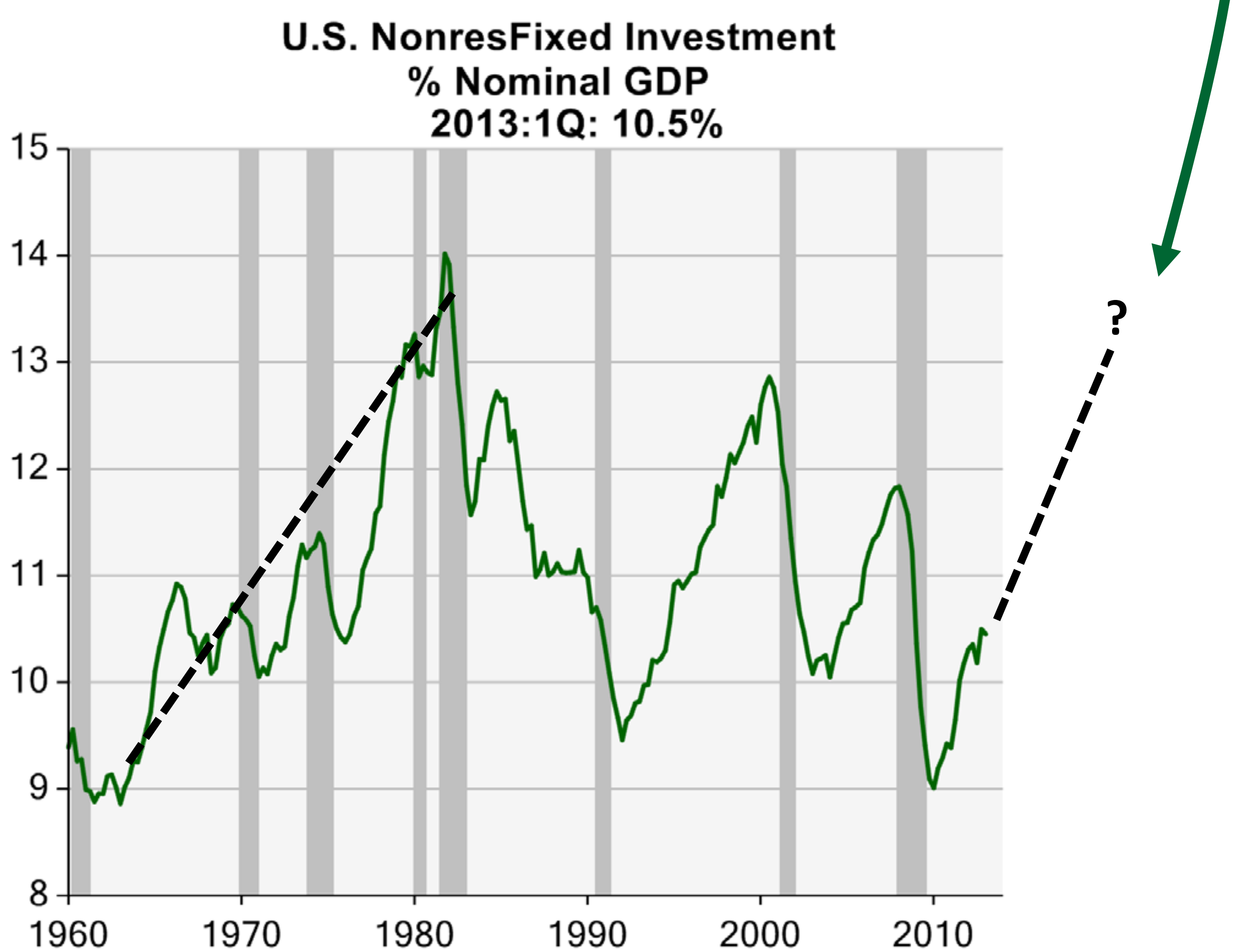


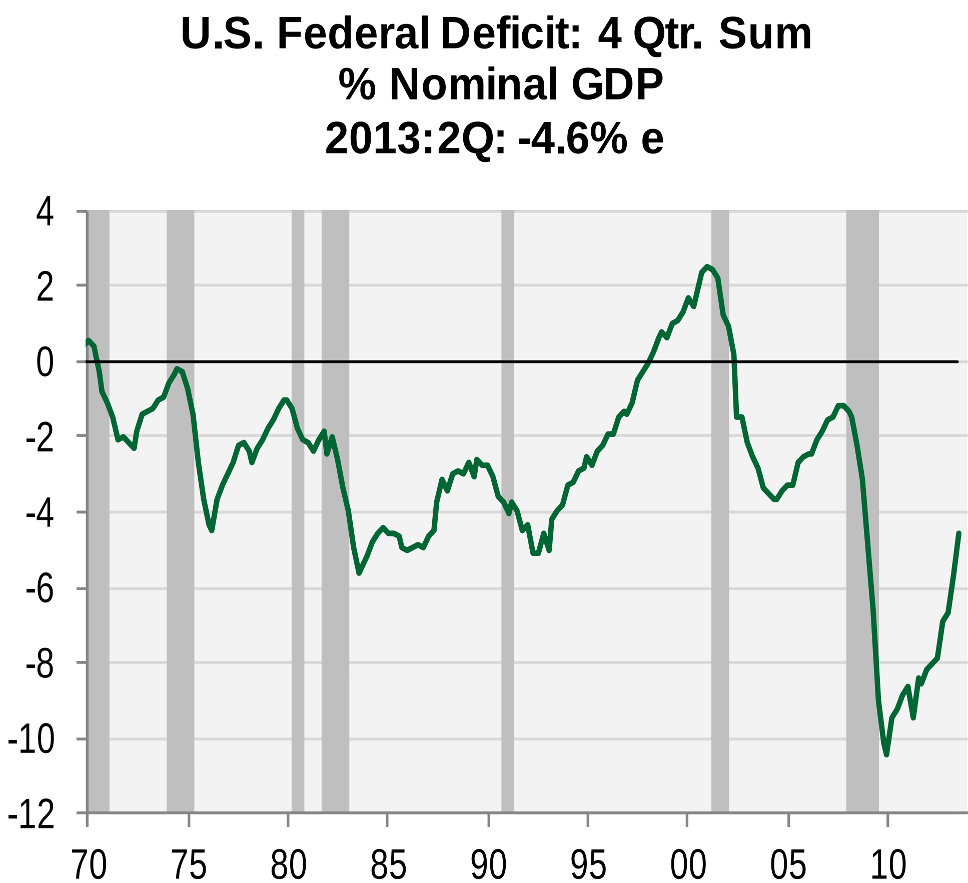
Because of the Mfg and Energy Renaissances, we think capex will be a core driver of growth over the next 3 -5 years.



The Federal Deficit as a Share of GDP Has Improved from -10.4% to -4.6%.

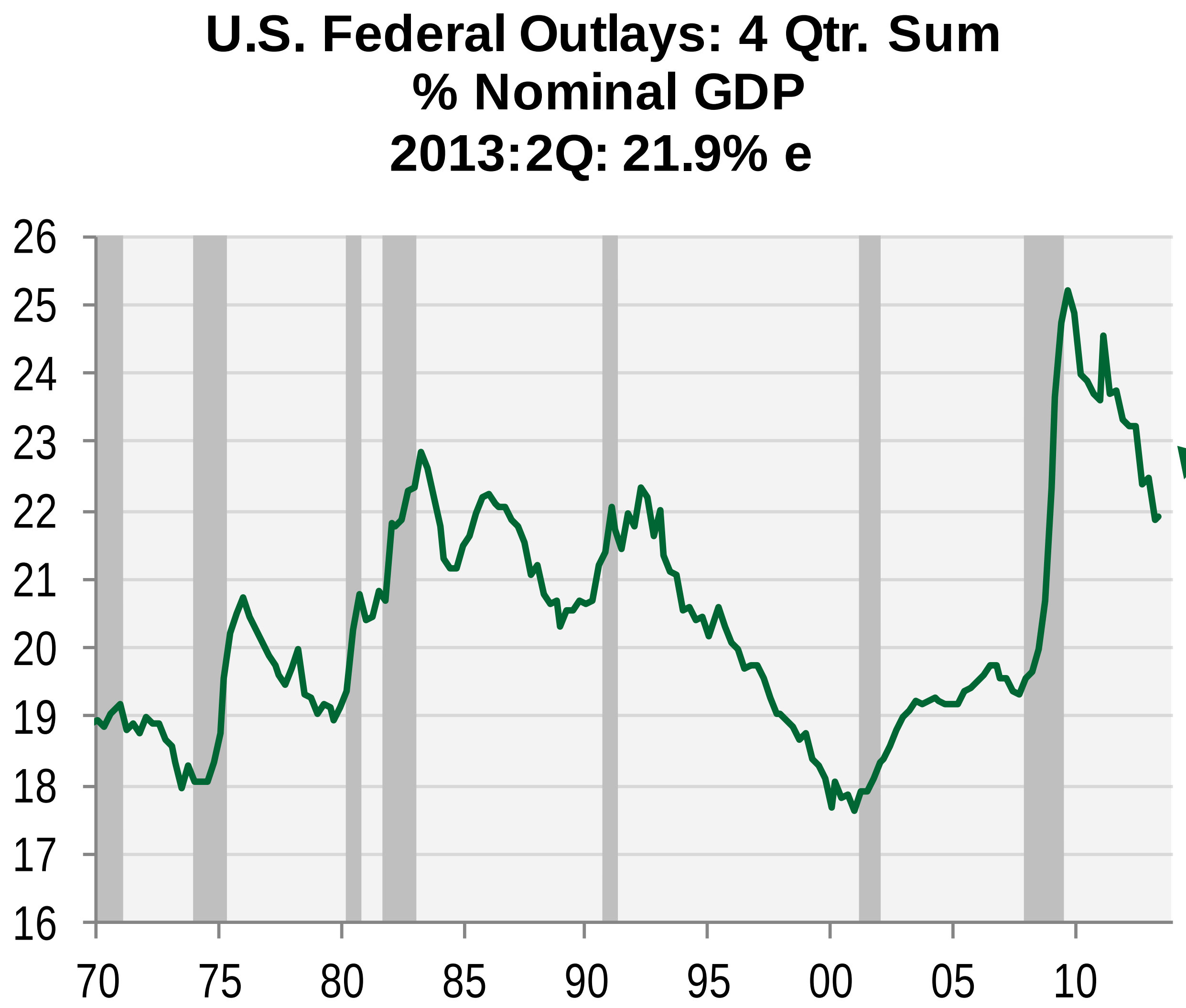
The deficit has declined to less than $1 trillion, and is on track to improve to -4.6% in 2Q as a share of GDP from -10.4%. CBO projects it improves to -4.0% in fiscal year 2013 and to -3.4% in FY 2014. As our Strategy Team has highlighted, the improving deficit is good for P/Es.

- **The budget deficit is projected to shrink to -4.0% of GDP in FY 2013 and to -3.4% of GDP in FY 2014.**
  CBO, May 14



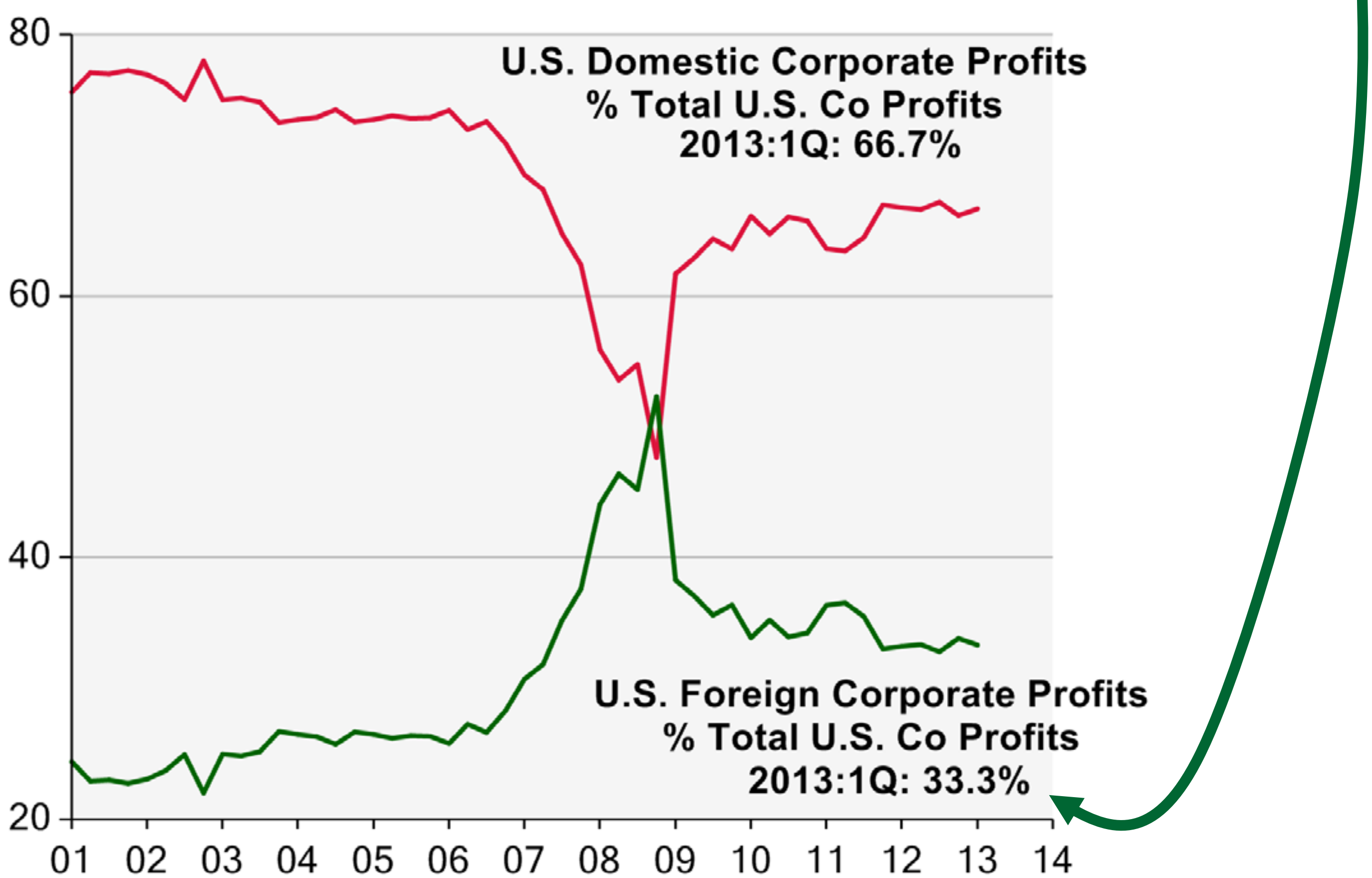
Federal Outlays as a Share of GDP Are Declining.

Outlays as a share of GDP are on track to decline to roughly 22% of GDP, well below their peak of 25% but above the long-term average of 20%. CBO estimates they'll decline to 21.5% in FY 2013.



U.S. Domestic Company Profits Have Led Profit Increases.

Although foreign earnings account for 40% of total earnings in the S&P 500, foreign earnings in the broader NIPA profits series make up a smaller 33% of the total. In addition, domestic profits accounted for 85% of the increase in profits from the recession low (see next page). So, although the slowdown in some EMs is a headwind, domestic growth is key.



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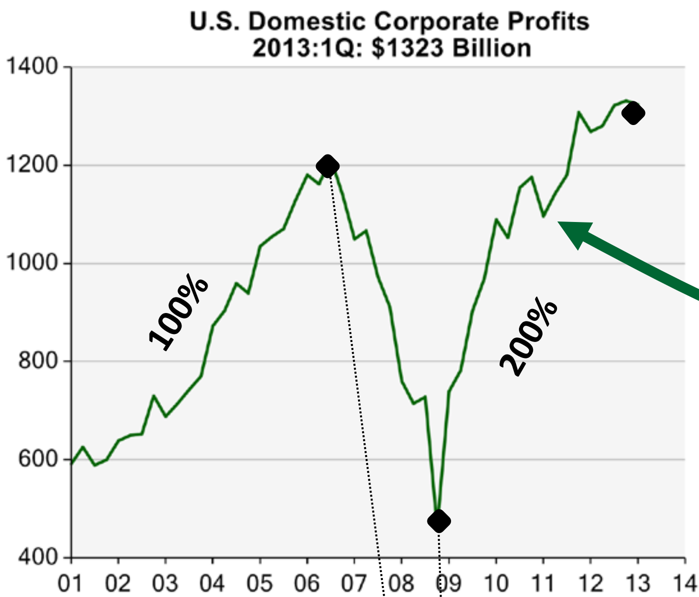
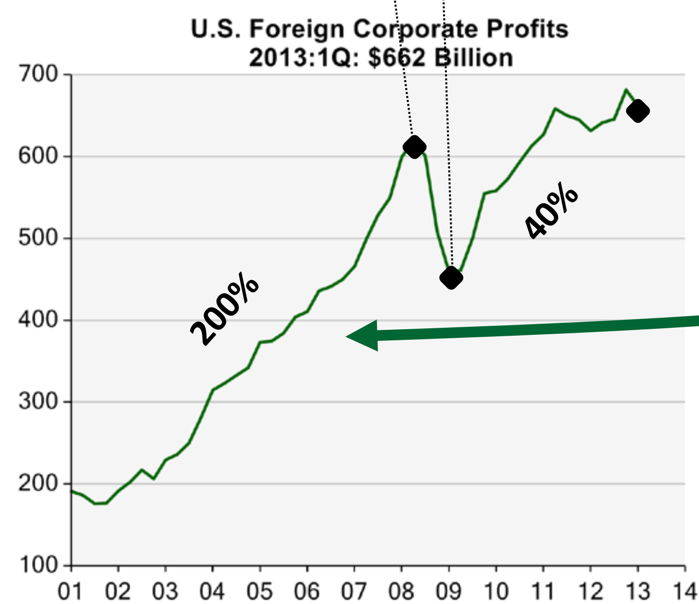
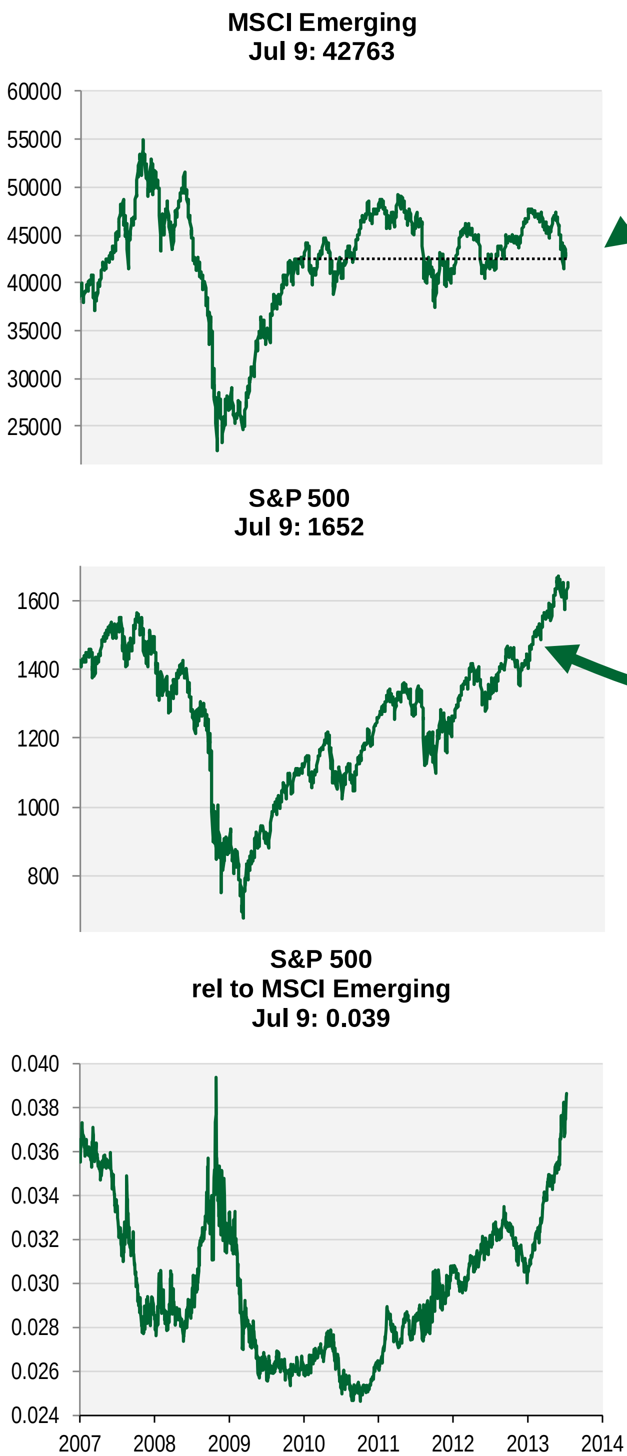


From 2001 – 2007, foreign profits led the increase in U.S. company profits, but from 2009 forward, U.S. domestic profits have led the increase in profits. We believe this trend will continue.

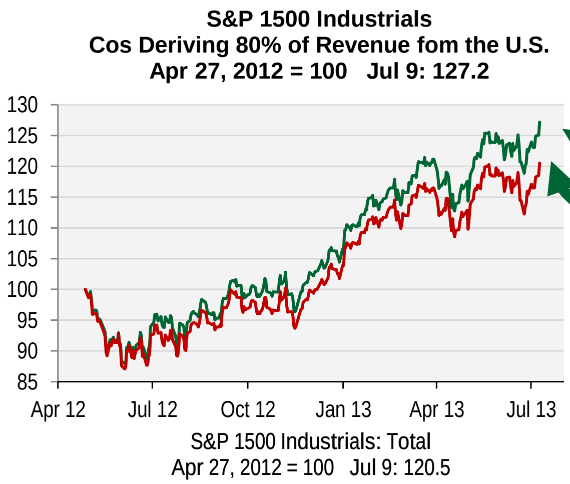


The S&P and EM Stock Markets Have Decoupled.

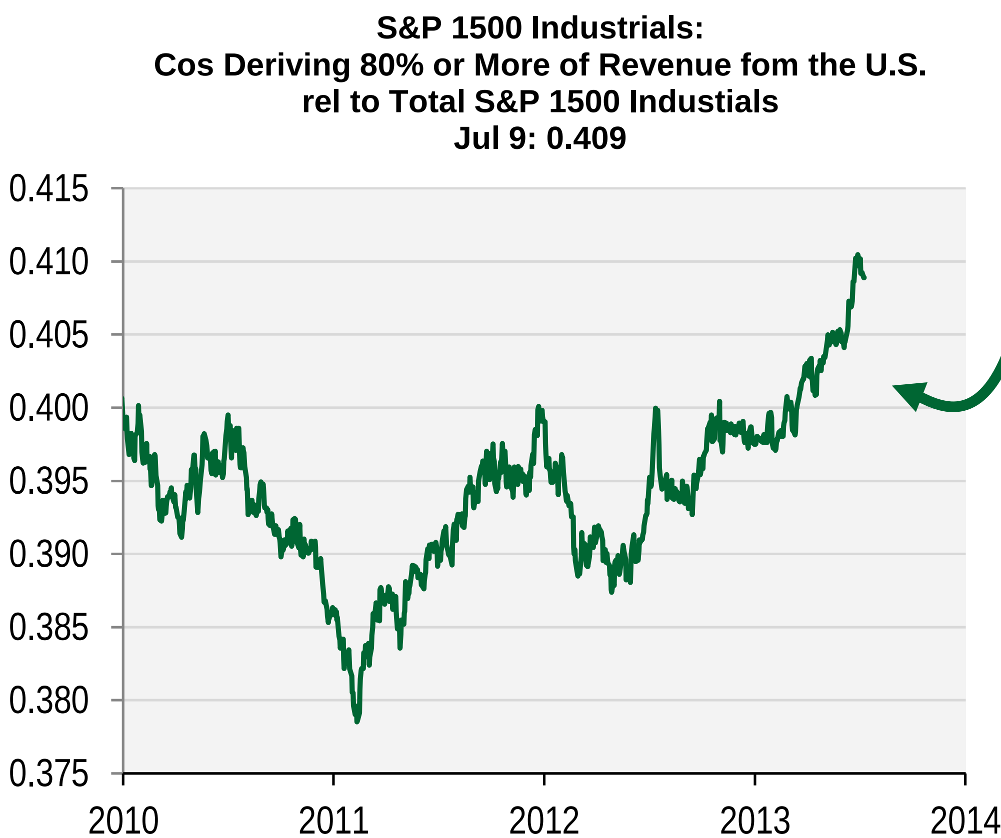


The MSCI Emerging Index has been weak and remains well below its 2007 peak. Although EMs are still experiencing faster GDP growth than the U.S., rapid wage increases in many EMs have restrained earnings growth. In contrast, the S&P has been in a rising trend and has moved above its 2007 peak. (We believe this is not a temporary decoupling). Supports for the U.S. market include low/slowing inflation, restrained wages, the improving federal deficit, the Mfg Renaissance, and the Energy Renaissance. The housing recovery is also a support.

Domestic Activity Is a Support for U.S. Mfg.

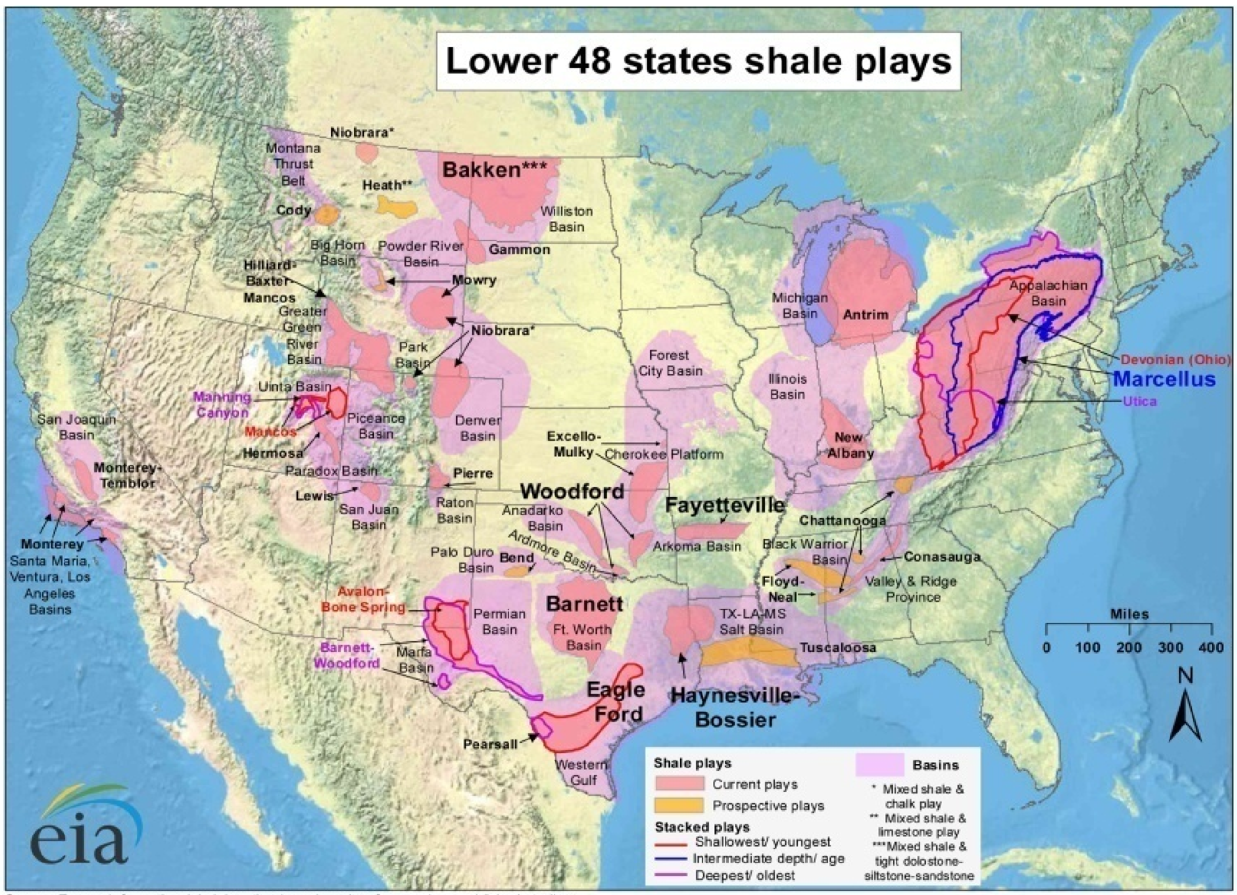


Over roughly a year, cos in the S&P 1500 Industrials that derive 80% or more of their revenue from the U.S. have increased 23%, while S&P 1500 Industrials overall have increased 16%.



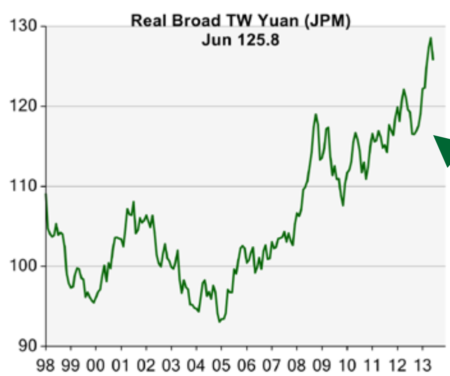
Our Favorite "EM" Is Middle America.

➢ **Bakken Boom Cutting West Coast Imports of Crude**
Bloomberg, June 21



Source: Energy Information Administration based on data from various published studies.
Updated: May 9, 2011

China New Normal: Export Growth Has Slowed Sharply.



From 1998 to 2004, Chinese export growth accelerated from roughly -5% to 35%, i.e., exports were a major boost to domestic growth. Now, they've slowed to just 8%. The rising yuan, sharply higher wages, and generally more difficult business conditions are all at work.

China New Normal: Import Growth Has Slowed Sharply.

From 1999 to 2004, Chinese import growth accelerated from roughly 0% to 40%. Now, they've slowed to just 3%. Reasons include a slowdown in capital spending and a slowdown in retail sales, i.e., a broad-based economic slowdown.

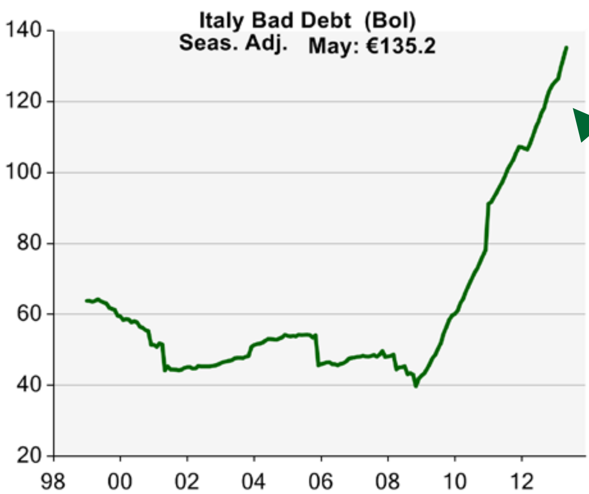
- **China Auto Group Says More Cities About to Restrict Auto Sales**
  Bloomberg, July 10

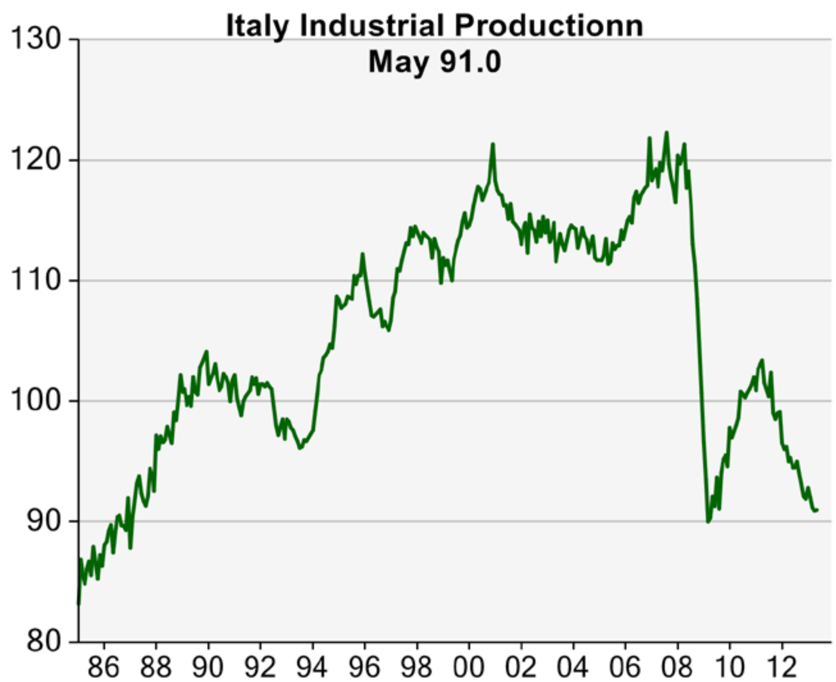
China New Normal: Both Exports and Imports Are Down Sharply Over the Past 5 Months.

Italian Recession:
Banks' Bad Debt Is Rising, and IP Is In a Severe Recession.

- **Italy's Credit Rating Cut to BBB by S&P. Outlook stays negative.**
  Bloomberg, July 10

Italian industrial production remains in recession territory, and is at the same level first reached in 1987. At the same time, bad debt continues to rise, and ratings are being lowered.





Greek Depression:
Greek IP Is Still in Depression Territory.

While there were a few signs recently showing Greek economic activity has stopped decelerating, e.g., mfg PMI, Greek industrial production is still in depression territory.

Even though there are signs the Eurozone recession is moderating, today's weak reports for French IP, Italian bad debt and Greek IP add to evidence that the overall Eurozone economy is still in recession.