Orlando's Outlook: Another 'soft-patch' forecast

As of 01-20-2012

Bottom Line *The U.S. economy was clearly gaining momentum as we headed into year-end 2011, marked by strengthening trends in employment, manufacturing and consumer spending. There's little question, however, that in the early stages of 2012, three exogenous economic headwinds threaten this positive development: the likely PIIGS-driven recession in the euro zone; possible fiscal drag from ongoing policy dysfunction in Washington; and the prospect of a hard landing among critically important emerging-market economies, particularly in China. To be sure, we believe that these events will likely slow U.S. economic growth over the next several quarters from its comparatively robust fourth-quarter level. But we do not believe that these pressures will be sufficiently powerful to drag the U.S. back into recession.*

The fixed-income and equity investment professionals who comprise Federated's Macro Economic policy committee met last week to put a wrap on calendar 2011 and peer into our crystal ball to study this year's disparate domestic and global economic and geopolitical developments and their potential impact on the investment world. And for a third consecutive year, this committee foresees a first-half soft patch, prompting the following revisions to our model for Gross Domestic Product (GDP) for the end of 2011 and for 2012:

- We increased our fourth-quarter 2011 forecast for GDP growth from 2.8% to 3.0%, compared with the current consensus estimate of 3.1%, as it appears that the third-quarter's inventory liquidation has morphed into the commencement of an inventory re-stocking cycle during the fourth quarter, which should boost GDP. The Commerce Department will flash its fourth-quarter GDP estimate next Friday, January 27.
- We left unchanged our full-year 2011 forecast at a gain of 1.7%, which is right in line with consensus.
- The triple economic headwinds from Europe, Washington and China that we discussed above, however, could have a negative impact on economic growth during at least the first half of calendar 2012. But given the accelerating and offsetting domestic strength from manufacturing and consumer spending, we are actually ticking up our first-quarter 2012 estimate of 2.3% to 2.4%, compared with a consensus estimate of 2.0%; second-quarter growth goes from 2.4% to 2.5%, versus a 2.1% consensus; third-quarter growth is raised from 2.6% to 2.7%, versus a 2.3% consensus estimate; and we increased our estimate for fourth-quarter growth from 2.6% to 2.9%, compared with a consensus growth estimate of 2.7%.
- Those quarterly changes raise our full-year 2012 GDP forecast slightly, from a gain of 2.4% to 2.5%, versus the current consensus estimate of 2.2%.

Shift the 'soft-patch' forecast into 2012 Our temporary soft-patch thesis for last year proved accurate, with a quarterly GDP growth-rate progression of 0.4%, 1.3%, 1.8%, and a projected fourth-quarter 3.0%, respectively, over the course of calendar 2011, rather than the more dire double-dip recession forecast to which the bears had clung. So we're tempting fate and planning on a successful three-peat, by renewing our soft-patch forecast for 2012.

The Macro Policy Committee also made the following observations:

Tepid fourth-quarter corporate results Going into the fourth-quarter earnings season, investors had legitimate concerns about: slower European and emerging-market economic growth; fourth-quarter dollar strength versus the euro, reversing recent currency translation gains for U.S.-based multinational companies; and peak margins and low unit-labor costs. Consequently, December was an active confessional season for corporate America, as a preponderance of profit downgrades sparked very muted expectations for fourth-quarter results. So it's no surprise that with the fourth-quarter earnings season now about 20% complete to date, S&P 500 companies (including financials) have reported average year-over-year gains of only 2.7% for revenues, with an average decline of 2.6% for profits. Moreover, only 44% of these companies beat consensus revenue estimates, with actual revenues roughly in line with consensus estimates, while only 60% of them beat consensus profit estimates, by an average of 1.6%.

Inflation easing The decline in food and energy commodity prices over the last several months has taken the edge off of inflationary concerns. For all of 2011, nominal wholesale and consumer prices rose by 4.8% and 3.0%, respectively, which represent the largest annual gains since 2007. But we ended the year with core year-over-year inflation at 3.0% and 2.2%, respectively, as nominal price increases have moderated in recent months due to the decline in oil and agricultural prices. The core Personal Consumption Expenditure (PCE) index—the Federal Reserve's preferred measure of inflation—was up by only 1.7% year-over-year through November, which is still within the Fed's 1.0% to 2.0% target range. However, the committee remains concerned about the potential stickiness of owners-equivalent rent as a key inflation component.

Fed on hold We believe that the Federal Reserve will likely remain on hold with its near-zero fed funds rate into at least mid 2013, and likely into mid 2014. We think the Fed board as currently constructed likely remains dovish and

accommodative, with the potential for a larger Fed balance sheet by year end, if the economy underperforms. But we still do not see any economic justification for more quantitative easing (QE), i.e., a massive QE3-type program, in 2012, particularly in the midst of an election year, when the Fed usually attempts to position itself apolitically.

Employment cycle continues to improve Initial weekly jobless claims, an important leading economic and employment indicator, plunged to 352,000 for the week ended January 14, 2012, which represents their lowest reading since April 2008. Weekly claims have now been consistently below the critical 400,000 level for much of the past two months, which suggests that the average monthly gain of 142,000 in nonfarm jobs that we've seen over the past six months—in which we've enjoyed six consecutive positive months for the first time since 2006—should continue. In addition, the December ADP report, with posted a very strong gain of 325,000 jobs, has now averaged 166,000 jobs in each of the past six months, while the household employment survey, which added 176,000 jobs in December, has averaged 282,000 jobs in each of the past five months. Importantly, most of these ADP and household-survey jobs are in small- and medium-sized companies, so we should see a continued pickup in the establishment nonfarm and private payrolls with a lag. The unemployment and labor-impairment rates have dropped sharply to 8.5% and 15.2%, respectively, though December.

Housing back from the dead? The improvement in jobs over the past six months has brought with it an added bonus—tentative signs of life from the housing industry for the first time since peaking in 2005. While it's clearly too early to tell for sure, continued strength in employment would provide a critically positive fundamental backdrop for the housing market, in addition to low housing prices and interest rates, record affordability, and improving household formations. To that point, the housing-market index, a leading indicator published by the National Association of Home Builders, surprisingly spiked to 25 in January, its highest level since June 2007. By comparison, the index was at 14 in September 2011 and hit a record low of 8 in January 2009.

Inventory-restocking cycle boosts manufacturing After liquidating inventories in the third quarter because they were concerned about the prospect of a double-dip recession, strong end-market demand sparked the commencement of an inventory restocking cycle in the fourth quarter, which is likely to boost GDP. Factory orders and business and wholesale inventories have risen sharply during October and November. Industrial production jumped by 0.4% in December, while capacity utilization has leapt to 78.1%. The trade balance fell by 16% from June through October, due to an increase in exports to record levels with Japan back on track. Auto sales have surged by 18% from their June trough to annualized December levels of 13.5 million total vehicles. The important Empire, Chicago and Philly Fed regional indices have risen sharply in recent months, supporting the improvement we've seen with the national ISM manufacturing and service indices to 53.9 and 56.2, respectively, in December. Finally, the important Leading Economic Indicators (LEI) posted surprisingly strong readings of 0.5% and 0.9% in November and October, respectively.

Confidence rebound boosts consumer spending Importantly, the steady improvement in the job market has sparked a sharp rebound in consumer confidence. Michigan consumer confidence surged to 74.0 in January, versus a near cycle low of 55.7 in August, while the Conference Board's consumer confidence index leapt to 64.5 in December from 40.9 in October. As a result, retail sales during the important Back-to-School (BTS) season and during October were strong, and the Christmas season got off to a strong November start with record Black Friday and Cyber Monday results. While December's flash report was softer than we expected amidst a promotional environment, we do anticipate an upside revision because of record online and gift-card sales. Finally, the personal savings rate hit 3.5% in November from 3.6% in October, compared with a 15-year cycle high of 7.2% in June 2009.

Europe making slow, gradual progress European Central Bank (ECB) President Mario Draghi cut benchmark interest rates twice to 1.00%, before pausing recently. The new technocratic unity governments in Italy and Greece appear to be working, Spain elected a new conservative government and Ireland's austerity measures are taking root, encouraging the bond market to lower their benchmark interest rates in successful recent offerings. The troika (EU, ECB, and the IMF) has installed a plan for bank recapitalizations, a 50% haircut on Greek debt and a 1.4 trillion euro backstop. The ECB and the Federal Reserve recently orchestrated a coordinated global liquidity intervention with the central banks of Canada, England, Japan and Switzerland, and the ECB recently offered 489 billion euros in three-year loans at their benchmark 1% interest rate to 523 participating euro-area banks. Over the balance of this year, we'd like to see more progress towards a stronger fiscal union in Europe, the creation of a euro bond, and fiscal policy plans to promote stronger economic growth to offset the forced austerity measures, among other initiatives.

Washington a zero until the election With the Super Committee's well-publicized failure last year, we're watching to see how Congress and the Obama administration handle the fiscal stimulus that will expire at the end of February and the current debt-ceiling Kabuki dance. Regrettably, we have no confidence that Washington as presently constructed is capable of making the hard decisions necessary to grow revenues and change the demographically unsustainable trajectory of entitlement spending. Consequently, the November 2012 presidential election will take on increasing importance, and we expect little between now and then. But a favorable election outcome may help to spark a year-end rally.

Philip J. Orlando, CFA
Chief Market Strategist, Equity, Senior Portfolio Manager

Also by Philip J. Orlando

Orlando's Outlook: Early 'January Barometer' flashes green
Jan 13, 2012

Orlando's Outlook: Labor market, much like broader economy, ends 2011 on high note
Jan 06, 2012

Orlando's Outlook: Equity corrections prompt increase in Federated's stock allocation
Mar 25, 2011

Recent Global Equity

Weekly Update: All we need is a return of investor confidence
Jan 20, 2012 :: Linda A. Duessel

Market Memo: The pain trade in Europe may not be what you think
Jan 19, 2012 :: Audrey H. Kaplan, Ihab L. Salib

Weekly Update: At the end of the day, the markets trade on earnings
Jan 13, 2012 :: Linda A. Duessel

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.

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

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

PIIGS is the acronym for European Union members Portugal, Ireland, Italy, Greece and Spain.

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

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 Conference Board's Composite Index of Leading Economic Indicators is used to predict the direction of the economy's movements in the months to come.

The Conference Board's Consumer Confidence Index measures how optimistic or pessimistic consumers are about the economy.

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

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

The National Association of Home Builders/Wells Fargo Housing Opportunity Index reflects the percentage of households with median incomes that could afford new homes at median prices.

The Philadelphia Manufacturing Index is gauges the level of activity and expectations for the future among manufacturers in Greater Philadelphia 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.

Federated Global Investment Management Corp.

78394

Copyright © 2012 Federated Investors, Inc.

Federated®

Federated Investors Tower
1001 Liberty Avenue
Pittsburgh, PA 15222-3779
Telephone: 412-288-1900