JUNE 30, 2014

WEEKLY INVESTMENT COMMENTARY

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Hot/Cold Economic Data Mean Lukewarm Outlook for Consumer Sectors

Data Paint a Mixed Picture

Last week was distinguished by several U.S. economic data releases that painted a mixed picture and left markets essentially flat. The Dow Jones Industrial Average slipped 0.41% to 16,851, while the S&P 500 Index inched up 0.08% to 1,960. The tech-heavy Nasdaq Composite Index fared slightly better, adding 0.89% to close the week at 4,397. Meanwhile, the yield on the 10-year Treasury fell from 2.62% to 2.53%, as its price correspondingly rose.

To be sure, the economy does appear to be recovering from the softness seen in the first quarter of the year. But the data remain mixed, and that has resulted in a number of consequences: lower bond yields, a weaker dollar and, for stocks, continued underperformance by consumer-related companies.

The Consumption Drag

Last week's big surprise was how much the U.S. economy contracted in the first quarter. Revised gross domestic product (GDP) numbers indicated the U.S. economy shrank at an annualized pace of nearly 3% in the first quarter, much worse than originally anticipated. Meanwhile, personal consumption rose just 1%. The numbers were distorted by a brutal winter and a downward revision of health care spending, which in turn could indicate behavioral changes due to the Affordable Care Act. Regardless of the distortions, the key takeaway is that even if the economy rebounds strongly from here, growth will once again be 2%, or probably less, for 2014.

On the bright side, GDP is a number that reflects what has passed and, thankfully, recent data have been more encouraging. Bookings for non-military capital goods (excluding aircraft) rose 0.7% in May after a 1.1% drop in April, while new home sales increased 18.6%, the biggest one-month increase since January 1992.

The one segment of the economy that still appears to be lagging is the biggest: household consumption. In May, personal spending again disappointed, up just 0.2%, versus expectations for a 0.4% increase.

There are several explanations as to why personal spending remains anemic. First, consumers are still struggling in an environment in which they are trying to pay down their debts and credit availability is limited. Debt helped power consumption for four consecutive decades and, without it, consumers have relatively shallow pockets. Second, the savings rate appears to have stabilized at around 4%. While consumers could theoretically spend more by saving less, at this level, the savings rate probably won't go down much more.

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Finally, as we have stated on many occasions, most households are not experiencing much, if any, growth in real income. After inflation, disposable income is up just 1.9% year-over-year, roughly 1.5 percentage points below the long-term average. Unless wages accelerate or consumers decide to dip further into already meager savings, spending is likely to remain subdued.

Consumer Stocks Still Weak

The implications of slower spending were visible last week. The mixed data had the predictable effect of pushing both interest rates and the dollar lower. The 10-year Treasury yield traded close to 2.50%, the lowest level since early June, while the dollar slid to a one-month low. While we still expect both yields and the dollar to rise, last week was a good reminder of why the increase in yields will be slow and erratic. Until the economy demonstrates more consistent growth, yields are likely to remain low.

But there is a third implication of last week's data: continued weakness in consumer-related stocks, particularly discretionary companies. Despite what is shaping up to be a decent year for U.S. stocks overall, consumer discretionary companies continue to lag and, in fact, are flat year-to-date versus a gain of around 6% for the broader market.

Last week's data may paint a mixed picture, but going forward, we do expect consumption to remain muted. As such, we'd stay cautious on this segment of the market.

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1728A-AC-0614 / USR-4147

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