BBGI GROUP Global Investments
Economic Research
WEEKLY ANALYSIS

Alain Freymond – Partner - CIO
April 30, 2015

U.S. economy disappoints: time to « sell in May and go away »?

Does GDP growth have real chances of recovery in the 2nd quarter? Hopes reside in an improvement in the job market and an increase in consumption.

Key Points:

- U.S. Q1 GDP growth disappoints
- GDP growth is actually -0.5 %, excluding inventory adjustments
- The nine-month 25% increase in the U.S. dollar penalizes foreign trade and U.S. GDP
- Trade deficit recorded the biggest gap in 18 years, standing at $51.4 bn
- The Fed is now in "want and see mode"
- Further improvements on the labor market
- Job offers at their highest in 14-years
- The drop in unemployment affects labor costs
- Hopes for GDP recovery in Q2 all reside in consumption
- Short-term profit taking on fixed-income markets mark a long-term inflection point
- Positive outlook for equities

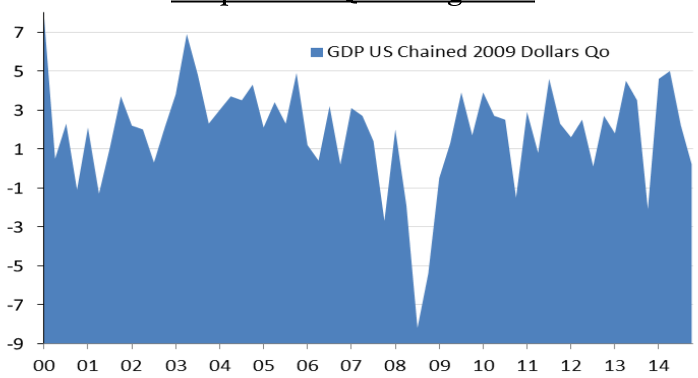
Disappointing U.S. Q1 GDP growth at +0.2%

The consensus forecast expected a +1% U.S. GDP growth in the first quarter 2015 after having gradually reduced estimates since the beginning of the year.

GDP came in at a scant +0.2%, well below expectations. The deceleration of the U.S. economy from the strong performance in the 3rd quarter 2014 is appalling. While forecasts expected a strengthening of activity in the U.S. in 2015, things eventually moved into a gradual slowdown in economic momentum. From a +5% growth of the 3rd quarter 2014, it declined to +2.2% in Q4 2014 to finish possibly even below zero for Q1 2015 after review in the coming weeks.

This is perhaps a dejà-vu for the U.S. economy, as we must recall that in 2014 Q1 growth had eventually dipped into negative territory (-2.1%) before the U.S. economy could display a clear recovery in the second quarter (+4.6%).

Drop in U.S. Q1 GDP growth



Sources: Bloomberg, BBGI Group SA

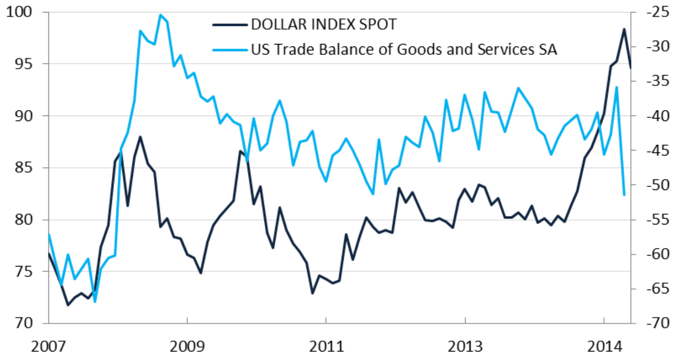
If we take a closer look, it should be noted that if consumer spending slowed sharply from a very strong +4.4% in Q4 2014 - the strongest since 2006 – it still grew +1.9% q-o-q. Specifically, services increased +2.8% and durable goods by +1.1% which supports this trend, however, growth of non-durable goods was slightly negative (-0.3%).

Investments incurred a net contraction in reaction to the fall in crude oil prices and drastic reduction of capital expenditure (CAPEX) announced in the energy sector. The -3.4% fall followed a +4.7% increase in the previous quarter. The drop in structural investments (-23%) and in the energy sector (-48.7% annualized) accounted for most of this significant decline.

At this point, we must note that this low GDP growth of +0.2% would probably have been negative (-0.5%) without the contribution of inventories. Indeed, inventories rose by $110 billion in the 1st quarter against only $80 billion by year-end 2014.

When calculating GDP, the increase in inventories investment is deducted as a positive contribution. Without this impact, U.S. Q1 GDP would have actually contracted by -0.5%.

Trade Balance Sheet
«Trade-weighted US dollar »



Sources: Bloomberg, BBGI Group SA

Rise in USD affects GDP growth and foreign trade

An almost 25% appreciation in the U.S. dollar (Trade-Weighted US Dollar Index), between June 2014 and March 2015, has pushed up imports and reduced the competitiveness of U.S. exports. In such a context, it is usual to observe a continuation of imports (+1.8%) after having exceeded a 10% rise last quarter. For their part, US exports contracted under the effect of an increasingly high U.S. dollar.

The trade deficit has rebounded from $471 to $522 billion on an annualized basis. In March, the trade deficit surged to its highest level in six years (-67 billion USD), while the ports on the west coast were back into normal activity.

This is a 43% widening and largest trade gap in 18 years.

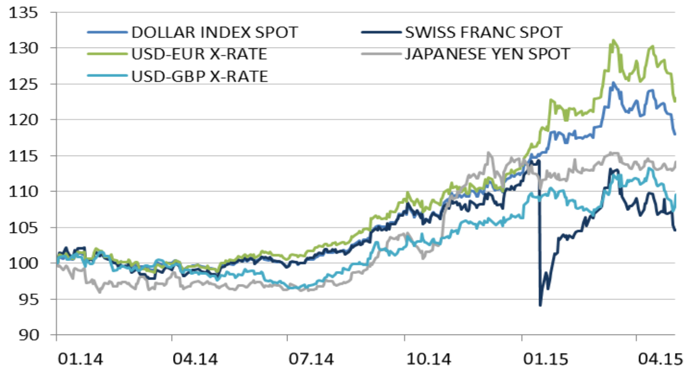
We must recall that a drag came from labor unrest on ports on the west coast. Excluding this factor, the impact could have been even greater on GDP growth rate, as it seems that imports suffered a higher blow than exports.

The rising U.S. dollar seems to have clearly had an impact on the performance of the US economy in Q1. After an increase of +25%, the combined effect of the loss of competitiveness in exports and the rise in purchasing power over imports is thus particularly negative.

Despite the recent fall in the U.S. dollar, the latter remains quite strong earlier this quarter. It will definitively take more time to curb current trends.

The pace of deteriorating foreign trade in the United States will certainly be lower in the coming months, but it is expected to continue in the 2nd quarter and further penalize GDP growth.

Trade-weighted U.S. dollar index and exchange rates

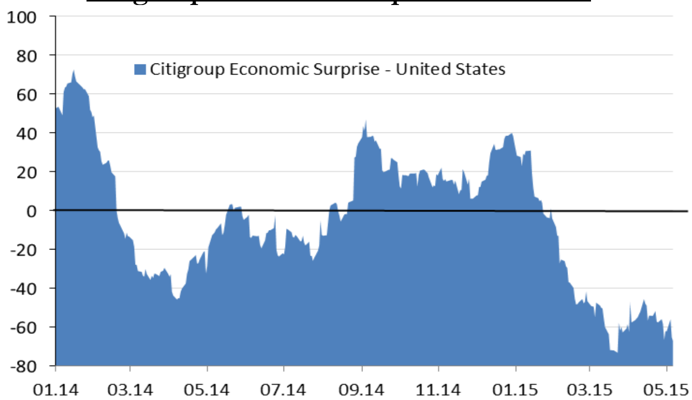


Sources: Bloomberg, BBGI Group SA

Disappointing data puts off Fed's interest rate hike perspectives

Disappointing GDP growth for the 1st quarter was among the biggest negative news since the beginning of the year.

Citigroup Economic Surprise index USA



Sources: Bloomberg, BBGI Group SA

The relative weakness of the U.S. economy did not go unnoticed by the Federal Reserve. Changes to monetary policy, expected by some to occur in June, are now very unlikely to materialize.

With such weak growth, the Fed should remain cautious and maintain its monetary policy unchanged until September.

Its room for maneuver is now reduced. For some time, it will only have to comment and hope that its assessment of the situation proves to be correct, leading to acceleration in economic recovery.

The Federal Reserve considers the growth prospects as moderate and the job market as steadily improving despite the economic slowdown. It expects a gradual decrease of the negative effects of transitory factors and the hope of a recovery in consumption, supported by a progressive household disposable income.

The U.S. economy is gradually breaking free of the Fed's support, but still does not benefit from the positive effect of the decline in crude oil prices and of the improving consumer confidence. A fairly large number of recently published data has had the tendency of being below expectations; employment data is perhaps shedding some light on the "air pocket" which is surrounding the U.S. economy in the short-term. We believe that this "air pocket" should be temporary until the U.S. economic dynamic cannot be reinitiated.

Improving employment market is a real support to consumption growth

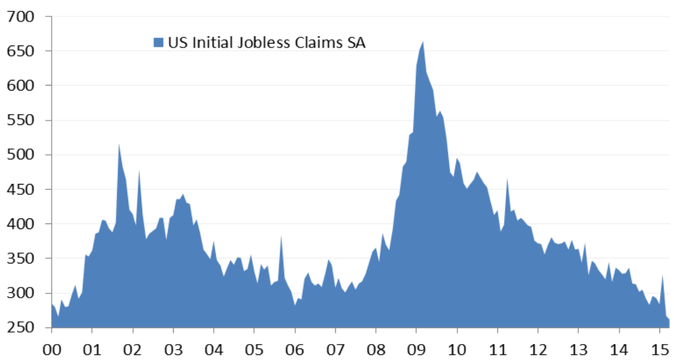
The unemployment rate continued to trend downward and now stands at 5.5%. The level is now closer to December 31st, 2007 (5%) and has already recorded an almost 50% decline compared to the 10% peak in 2009.

At the end of the quarter, the job market had a few sources of satisfaction which surely will reassure the Federal Reserve over its own interpretation of temporary economic slowdown in the 1st quarter.

The number of Americans initially applying for unemployment aid fell to the lowest level in 15 years, and on April 25 stood at 262,000 claims according to the U.S. Labor Department.

In the meantime, job openings climbed to a 14-year high (5.13 million), thus justifying the Fed's view of constant and sustained progress in the job market.

Applications for Unemployment Aid USA



Sources: Bloomberg, BBGI Group SA

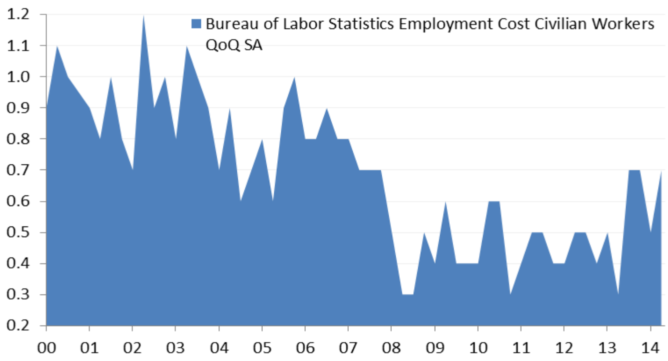
Although some disappointment persists in job creation statistics which remain below expectations as the U.S. economy only added 126,000 new jobs in March. We should still see job creation resume in the coming months.

Parallel to an improvement in the employment segment, we can observe a significant change in the cost of labor.

The rise in labor costs for civilian workers (Employment Cost Index) which increased by +0.7% and has reached its highest level since 2008. Unit labor costs, a gauge of compensation costs, rose at a 5% annualized rate in the 1st quarter, suggesting that the unemployment drop to 5.5% is starting to affect wage conditions.

If these developments are negative for company margins, they are a strong argument for a stronger recovery in consumption.

Employment Cost Index



Sources: Bloomberg, BBGI Group SA

The U.S. dollar continues to benefit from positive fundamentals and a favorable interest rate differential despite a generalized rise in long-term interest rates in different currencies.

The recent correction in the U.S. dollar reflects investors' weariness and their disappointment in a non-confirmation of a strengthening of the United States' economy. This is probably also the result of improved economic conditions in Europe and Japan. In one of our previous Weekly Analysis, we mentioned that the U.S. dollar was in a phase of downward momentum, and will be followed by a new rising pause. If the latter were to remain at current levels or appreciate, we must emphasize that we would probably observe a further deterioration of the trade balance and a negative impact on GDP growth.

The hope of a significant rebound in GDP in the 2nd quarter 2015, in our opinion mainly resides in improving consumer confidence and domestic demand.

But in the short term, we must admit that investors are skeptical as illustrated by the falling USD, the general rise in interest rates, rising oil prices and the correction in some equity markets.

Among what could be defined as certainties, the Fed should not raise interest rates before its September meeting. The few recent data is a bit more reassuring and should not change its cautious trend.

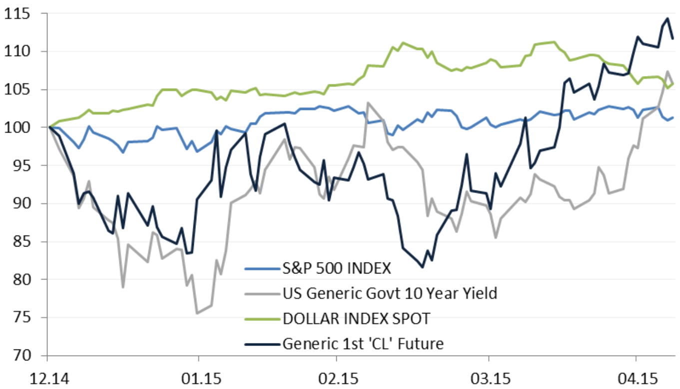
Thus, does U.S. growth have a real chance of recovery or will we witness a weak 2nd quarter?

"Sell in May and go away?"

Initially, the flow of disappointing economic data weighed on the U.S. bond market. Long-term interest rates have consequently slipped below 2%, while in Europe the German Bund rate approached 0%. More recently, soaring crude oil prices echoed the decline of the U.S. dollar within the complete indifference of the equity market. We still observed a growing correlation between fixed-income markets and the evolution of oil prices.

Is the almost 40 basis points sharp rise in interest rates in the United States, United Kingdom and even more prompt in Europe and also in Switzerland is only a temporary return of volatility? Or is it triggered by generalized profit taking or is it the beginning of a trend reversal which has often been drawn into play and is taking time to materialize?

S&P500, USD, 10-year Government bonds and Oil



Sources: Bloomberg, BBGI Group SA

We believe that this short-term movement, especially on fixed-income markets where yields were close to zero are actually the explicit sign of massive profits. In the U.S., the rise in long-term interest rates mirrors the return of slightly more positive expectations for both growth and inflation. Improving labor market and consumer confidence should lead to a strengthening consumption in the second half of 2015.

The U.S. equity market does not seem to be too concerned on the rise in long-term interest rates, not more than by the risk of contracting corporate profit margins or falling profits of multinational companies.

The Fed's next interest rate hike will probably be limited and maybe even below the frequently mentioned 25 basis point.

Will the long-standing saying "sell in May and go away" be the winning strategy in the coming months?

Recent changes to fixed-income markets have probably marked the reversal point of the long-term trend. However, in the current context of weak economic activity, we do not believe that the actual interest rate increase is set to continue. Therefore, equity markets should soon benefit from a return of investors and resume the uptrend for some time.

BBGI Group SA
Rue Sigismond Thalberg no 2
1201 Geneva -Switzerland
T: +41225959611 F: +41225959612
info@bbgi.ch - www.bbgi.ch