



Macro Update

The 30,000 Foot View

Last week's global PMI data gave us a fairly good real-time reading of the state of the global economy. All in all, I'd say things are little changed from recent months where growth has clearly returned. The GDP Weighted PMI Indicator shifted marginally lower from a reading of 51.8 to 51.3. Anything over 50 is consistent with global growth so the big picture is still modestly positive. The notable weak points remain Japan and the Eurozone where contraction is still occurring. The notable strong points remain the USA and India who look like the best houses in a pretty weak neighborhood.

Last week's data dump also included a minor upgrade to US Q4 GDP to 0.1%. This is obviously disappointing, but continues the muddle through theme that is to be expected during a de-leveraging cycle.

On the de-leveraging, the NY Fed also released their Q4 household debt report which showed the first rise in household debt since Q4 2008. This is an extraordinary statistic. To put this into perspective you can see that this has never occurred in the post-war era in the United States (see figure 2 on historical household credit trends).

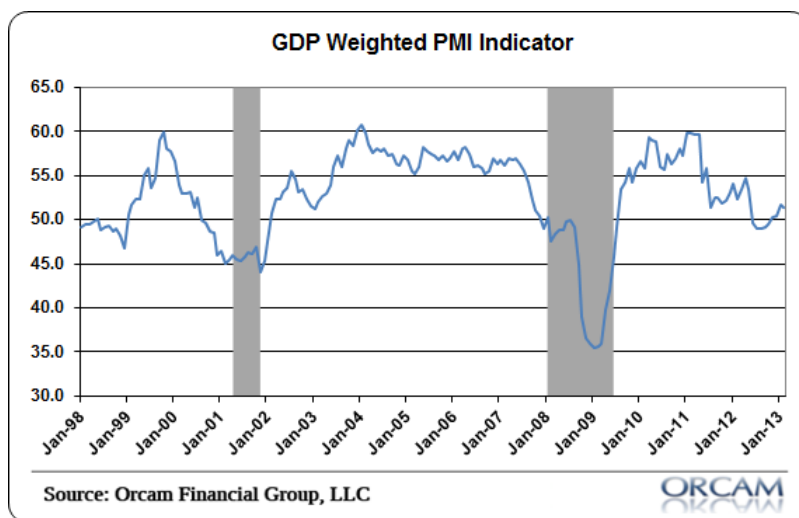
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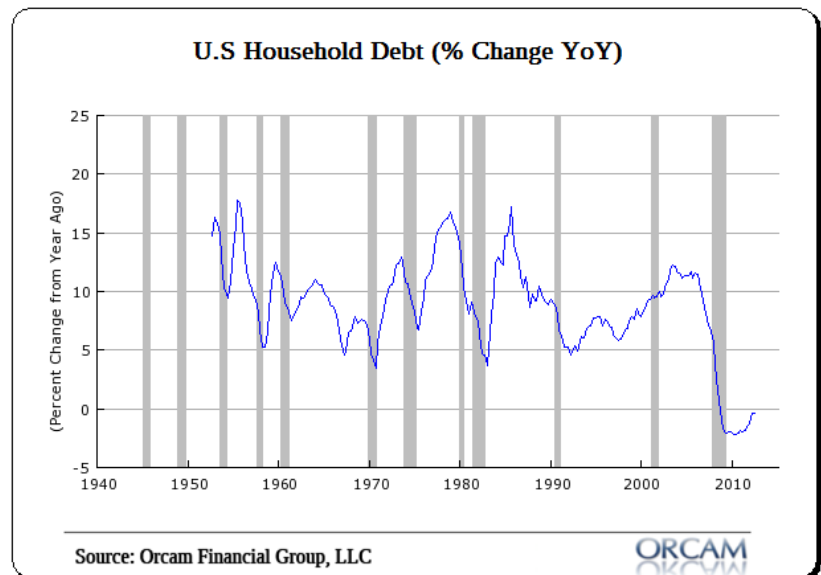
"If everyone is thinking alike, then someone isn't thinking."

-General George Patton



A big part of understanding the monetary system is about understanding how central private credit is to the money supply. In fact, private credit is the primary form of money within the system so when lending grinds to a halt it's indicative of a money supply that is no longer expanding. And that means the economy lacks investment, spending, etc. In such an environment we are highly unlikely to see strong inflationary data or strong growth until this trend starts to make it back towards that historical range of 5-10%

growth. But the good news is that we appear to be making progress. This de-leveraging cycle is all about understanding how gradual improvement will lead to gradual recovery.



The Sequester Risk

The markets have largely shrugged off the sequester risk thus far. And to be fair, \$85B in cuts over the course of the year isn't going to torpedo the US economy. But with growth so weak it's impossible to conclude that this is a positive short-term economic outcome. Remember, in a balance sheet recession government spending plays an unusually important role because the private sector is not borrowing and spending at a historical rate. So these cuts will certainly not help given the weak state of the private sector. In a budget of almost \$1T this isn't going to singlehandedly cause recession, but it's not a move in the right direction.

That said, many of the cuts won't even begin to take notice until the year moves on. In late March the US government will begin to furlough current workers and then the Summer months will see the biggest hits as Medicare payments and education payments will take effect. So we might not see substantial impact here immediately, but will likely see the negative impact in Q2 and Q3 primarily. The bottom line is, this isn't the end of the world, but it's certainly not a good thing.

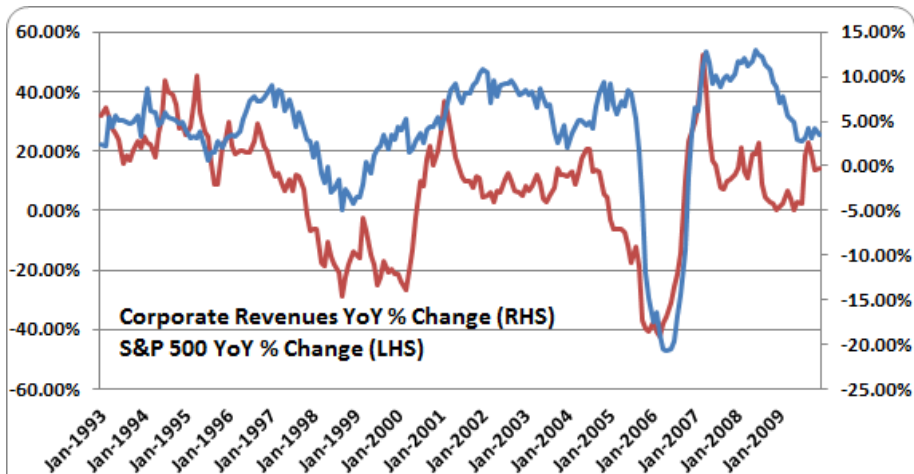
The Strategic View of the Markets

Although we're in a muddle through environment we remain in a modestly positive macro environment. That is, government spending is supporting a weak recovery and private investment and credit are beginning to crawl back at a pace that is supportive of slow growth. Most importantly, the overall combination of large US budget deficits and recovering private credit means that corporate profits are recovering. So we're continuing to see a modest amount of growth in corporate revenues which is supporting bottom line growth as corporate margins remain healthy. This data has been trending

lower, however, so it will be important to keep an eye out here.

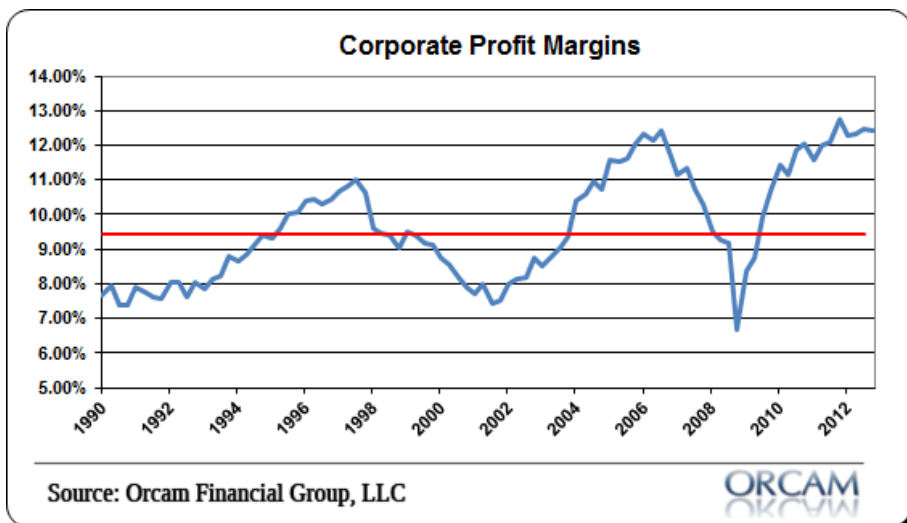
Historically, the S&P 500 has not performed well when corporate revenues turn negative on a year over year basis. In fact, the longest running negative stretches for the S&P 500 in the last 20 years both occurred during substantial revenue weakness. This shouldn't be surprising, but it should be something to be aware of.

For now, I am still bullish from a strategic (longer-term) perspective even though we've turned tactically (short-term bearish). I'll have more thoughts on the tactical view early this week.



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