ORCAM ALTERNATIVE PERSPECTIVES

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The US Economy is Hotter Than it Looks

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Recent economic reports have contributed to some fears about the future state of the US economy. There are now growing fears that the economy will be weaker than many believed heading into the year. As the cyclical view remains the core to my views I think it's important to maintain the proper perspective here and not fall into trap of what looks like an overreaction to some reports.

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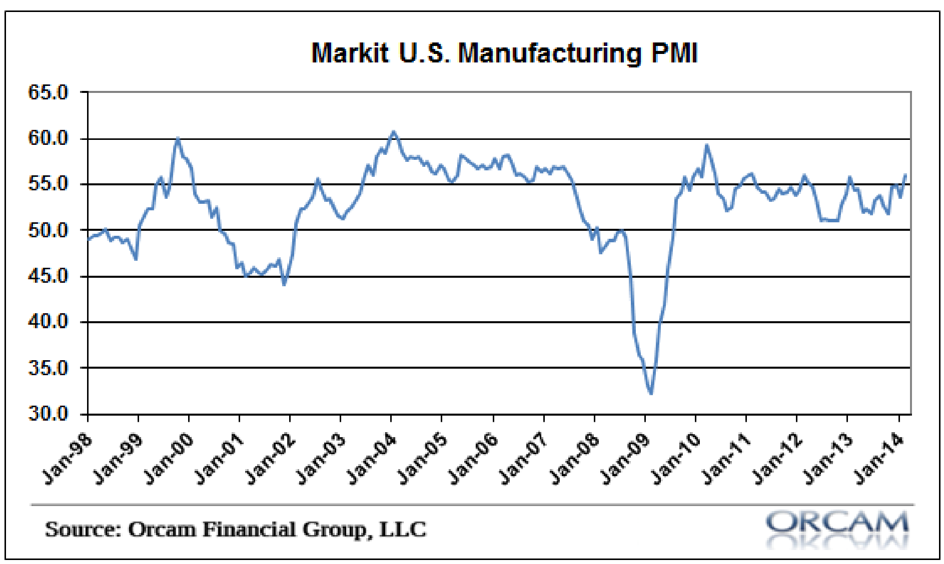
First, there has been some clear weakness in recent US economic reports:

- The last two labor reports were weaker than expected.
- Recent housing reports have been extremely weak.
- Some narrow manufacturing reports have been sluggish.

But it's not nearly as bad as some will have us believe. Today's PMI report was a clear sign that the state of affairs is better than many think. Headline PMI came in at 56.7, up from 53.7. But more importantly, employment improved to 54 from 53.2 and new orders jumped to 58.8 from 53.9.



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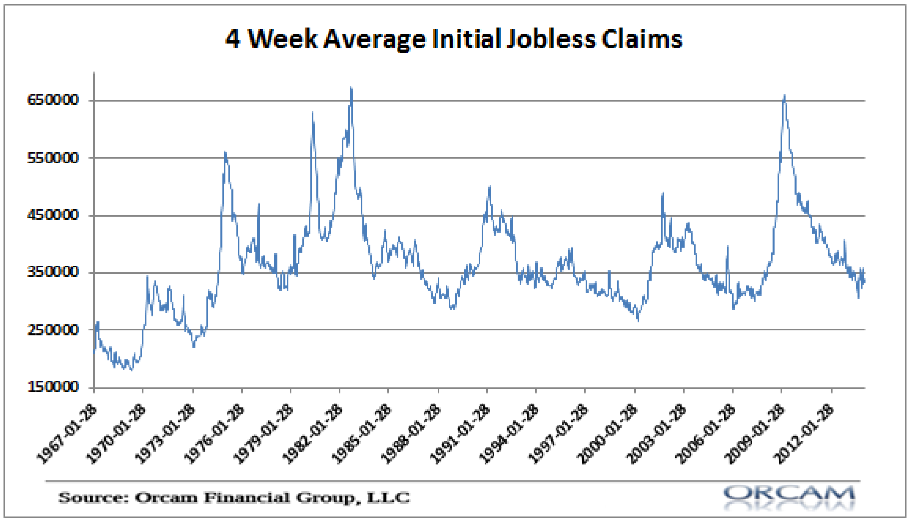
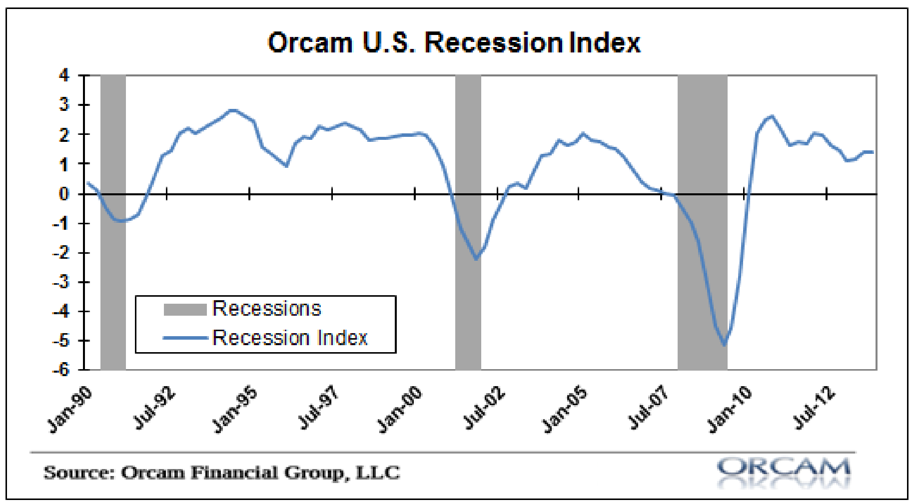


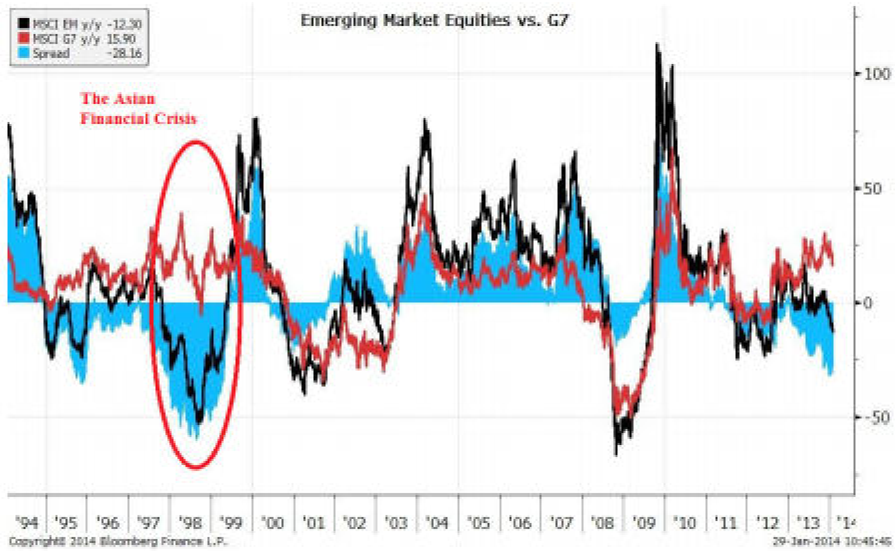
One of the better real-time economic indicators, initial jobless claims, continues to tell a similar story. The latest reading of 336K is consistent with continued economic improvement. This brought the 4-week moving average to 339K. In 2013 the 4-week moving average was 344K for the full year. Therefore, the recent trends remain in the right direction.

The latest update to the Orcam US Recession Index also confirms this cyclical view. Recent data brings the index to a reading that is slightly improved and consistent with continued US economic expansion. This continues to lead me to believe that the odds of a recession in the USA are extremely low. Therefore, the risk of a tail risk event in corporate profits and the broader market remains a low risk event.



Of course, this doesn't mean there aren't other potential tail risks that exist. The US economy is a good house in what's looking more and more like a bad global neighborhood. And while the latest US PMI report was quite strong, the latest Chinese PMI report was quite weak. This is a continuing worry due to the weakness in emerging markets and the potential for crisis. As China's economy softens an important source of demand increases the risk of economic contagion in emerging markets. The longer this weakness continues the greater the risk of contagion.

I would continue to maintain a bullish cyclical perspective in the USA and developed economies while remaining underweight emerging markets. We can't predict precisely what will occur in the coming years, but we can manage the potential risks that exist. And it's my view that emerging markets remain an excessive risk in a world where we need not expose ourselves. The playbook here is emerging markets and the 1997 Asian Financial Crisis. As you can see at the chart to the right, developed economies substantially outperformed emerging market stocks during this period. The US stock market is likely to outperform emerging markets in the case of further economic deterioration in emerging markets. In the event of a major tail risk event we would expect this outperformance to appear somewhat similar.



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