
The Macroeconomic Outlook and Markets

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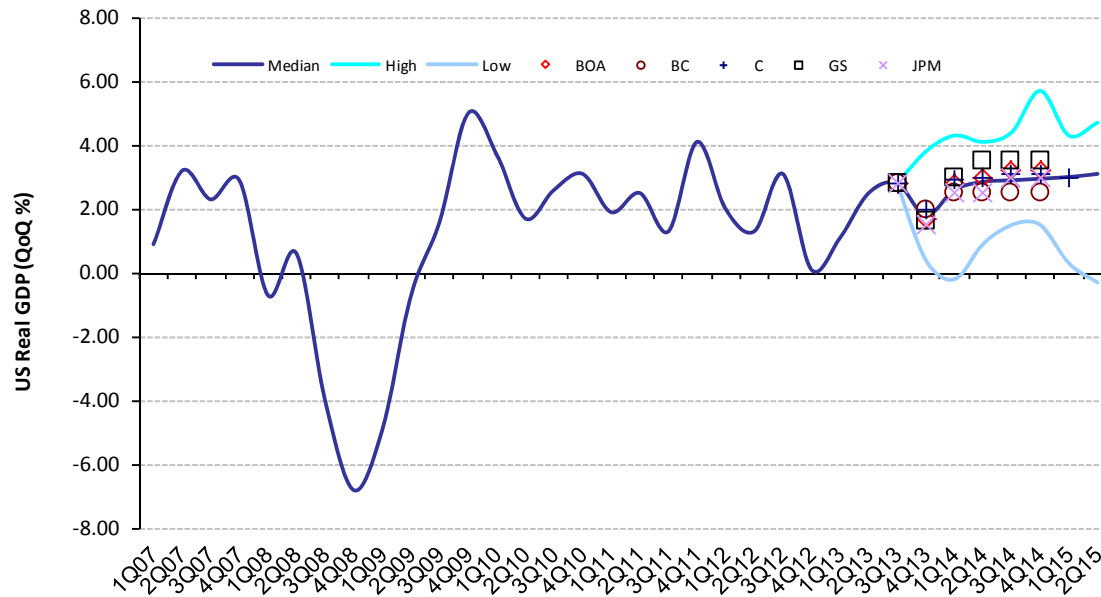
Outline

1. **GDP – Unemployment – Employment**
2. **The Fed's Balance Sheet and Inflation**
3. **US Interest Rates and Bond Markets**
4. **Equity Market Risk-Return**
5. **Global Markets**
 - *Known Knowns*
 - *Known Unknowns*
 - *Unknown Unknowns*



US Real GDP

US Real GDP QoQ Actual & Projected, 1Q07 – 2Q15



Bottom Line: Fed sees accelerating GDP growth in 2014 and 2015; yet decelerating, but above potential GDP growth in 2016

Tail Winds: Energy, technology, tapered sequester, the dollar, household net wealth (real estate and stock portfolios), foreign growth, credit availability, improved financial conditions, consumer and business sentiment, accommodative monetary policy, tapering of household deleveraging

Headwinds: Fiscal drag/fiscal debate, political and business uncertainty, healthcare, labor force participation, widening income gap, low business fixed investment, decelerating consumer spending and housing growth, increasing rates

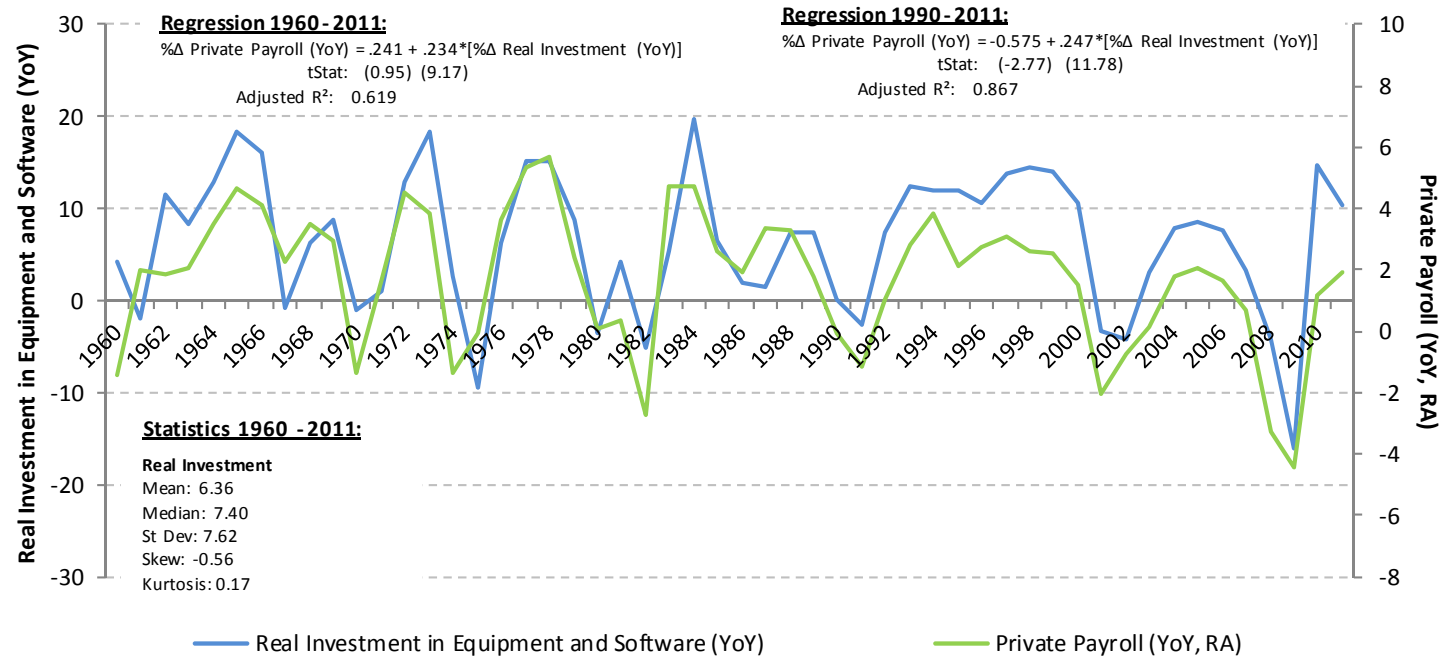
Source: Bloomberg



Investment and Unemployment

Investment activity seems to hold the key to solving the unemployment problem.

Real Investment in Equipment and Software YoY vs. Private Payroll YoY, 1960 – 2011

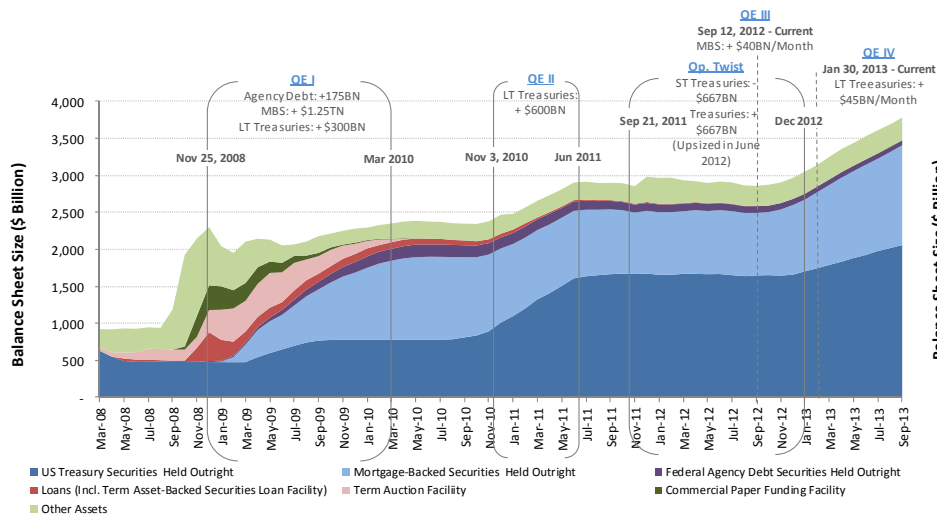


Source: Bloomberg

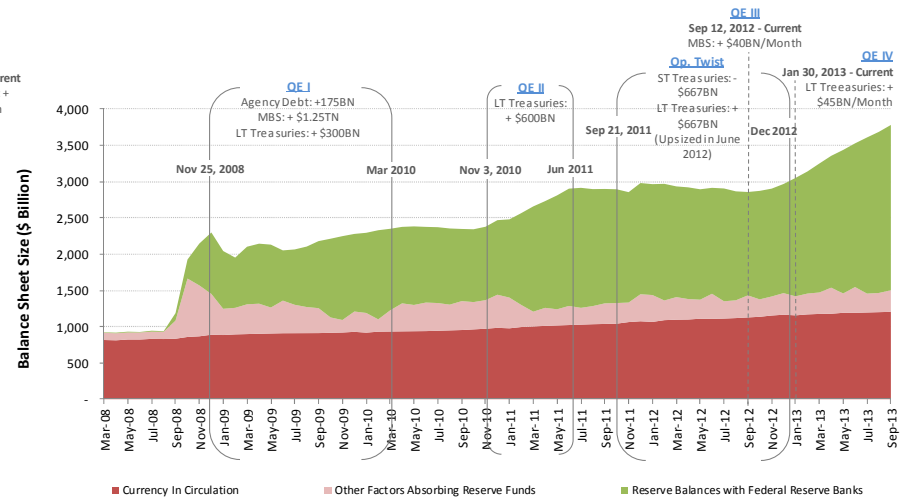


The Fed's Balance Sheet and Inflation

Federal Reserve Assets, Mar 2008 – Sep 2013



Federal Reserve Liabilities, Mar 2008 – Sep 2013



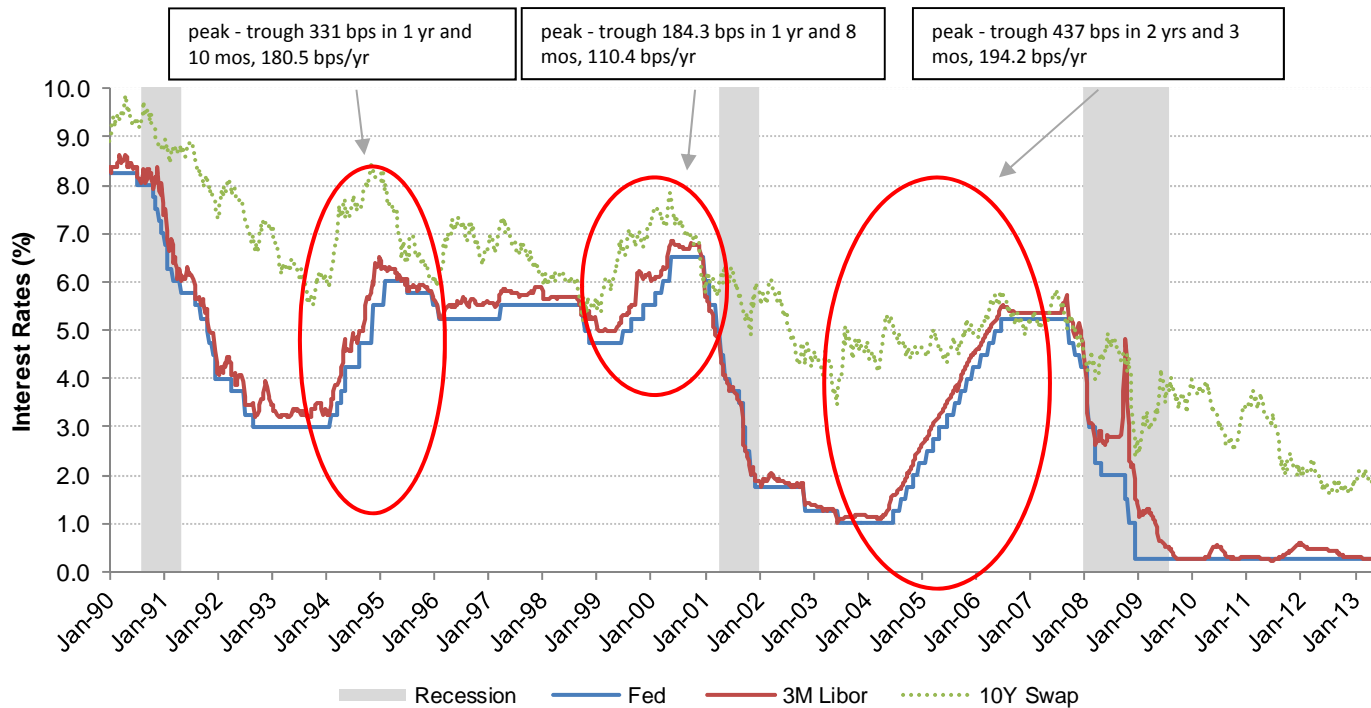
- ◆ Despite the ballooning of the Fed's balance sheet, inflation remains tame at less than 2%, with long-run expectations not exceeding this target by more than 50 bps. The question remains whether this expectation will be borne out



Source: Bloomberg.

Velocity of Interest Rates

3M Libor and Fed Funds Target Rate vs. 10Y Swap, 1990 - 2013



- ◆ Short-term rates may increase rapidly as the economy recovers
- ◆ Following the Fed's tightening cycle in 2004, short-term rates increased approximately 440 bps in 27 months

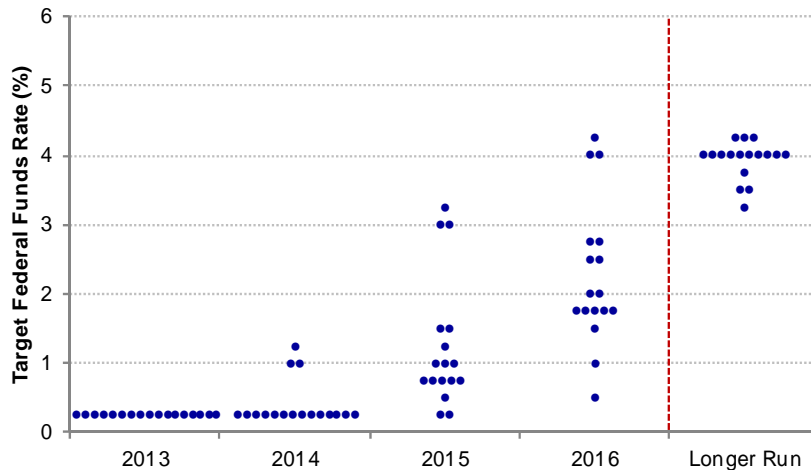


Note: Peak to trough LIBOR

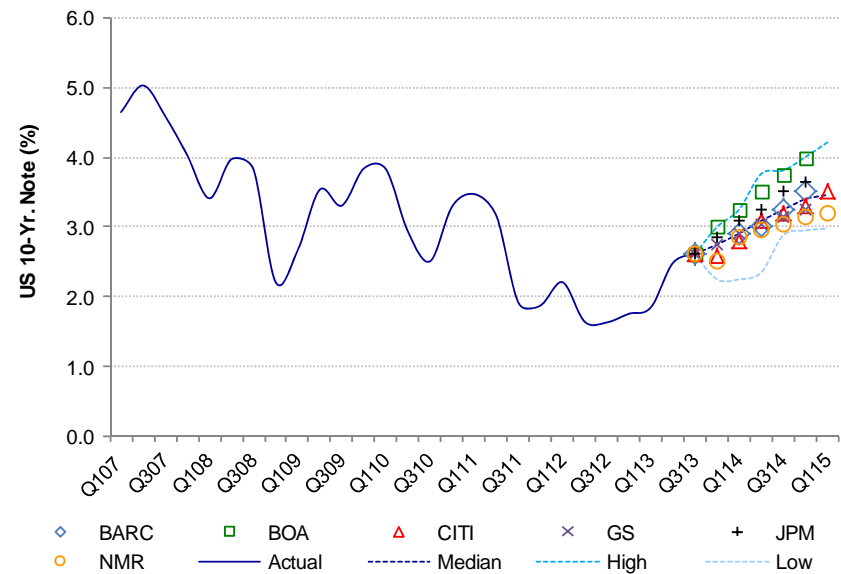
Source: Bloomberg.

Short and Long-Term Interest Rates

FOMC Outlook on Pace of Policy Firming



10-Year Treasury Rate Actual & Projected, Q107 – Q115

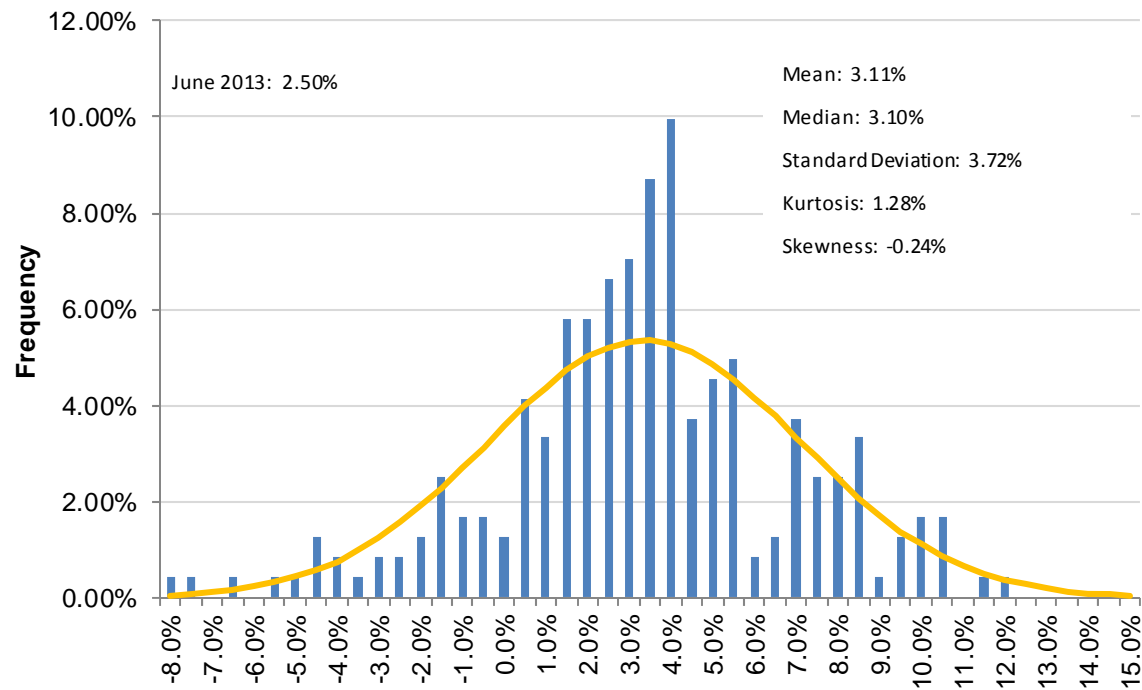


- ◆ In steady state, fed-funds rate = 2% real rate + 2% inflation = 4%
 - Similarly, 10-year treasury rate = nominal GDP growth = 3% real rate + 2% inflation = 5%
 - And 30-year treasury rate = 10-year treasury rate + term premium (25-50 bps)
- ◆ Even the Fed does not seem to know whether the markets respond to flows or stock (witness the response to talk of tapering in May/June 2013)



Source: Bloomberg, Federal Reserve

GDP Growth, Jun 1953 – Jun 2013

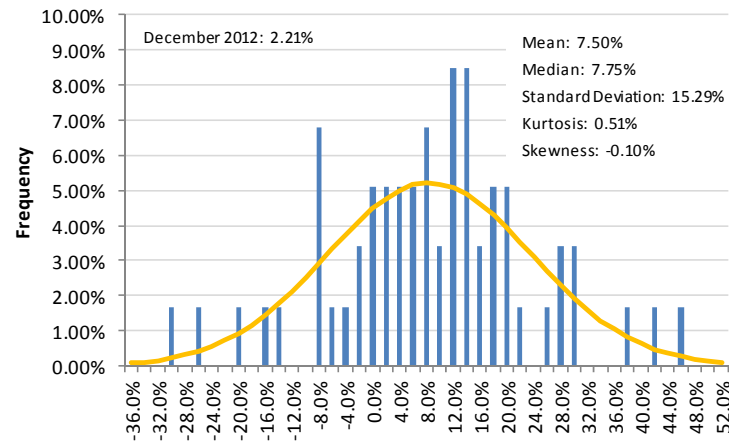


Note: All GDP data are quarterly.

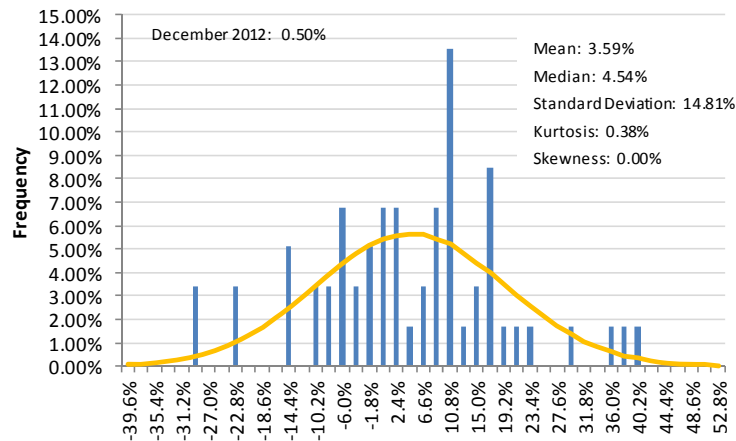
Source: Bloomberg.

S&P 500 Earnings

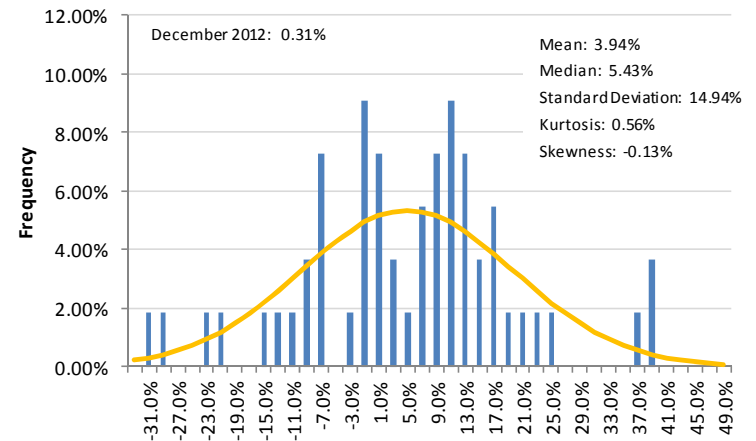
S&P 500 Nominal Earnings YoY, Dec 1954 – Dec 2012



S&P 500 Real Earnings YoY (HCPI Adjusted), Dec 1954 – Dec 2012

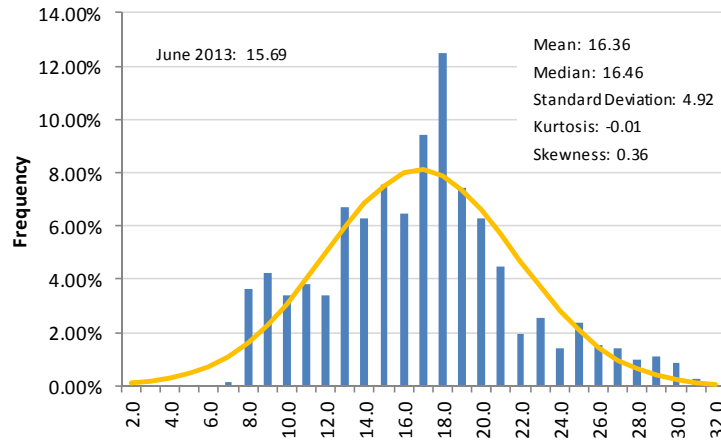


S&P 500 Real Earnings YoY (CCPI Adjusted), Dec 1958 – Dec 2012

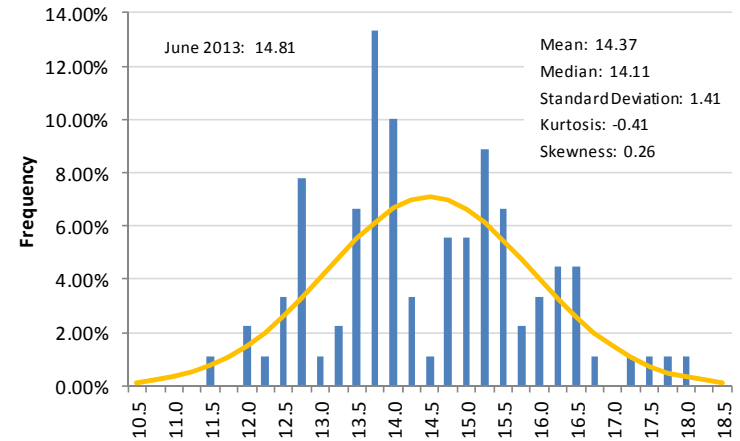


S&P 500 P/E Multiples

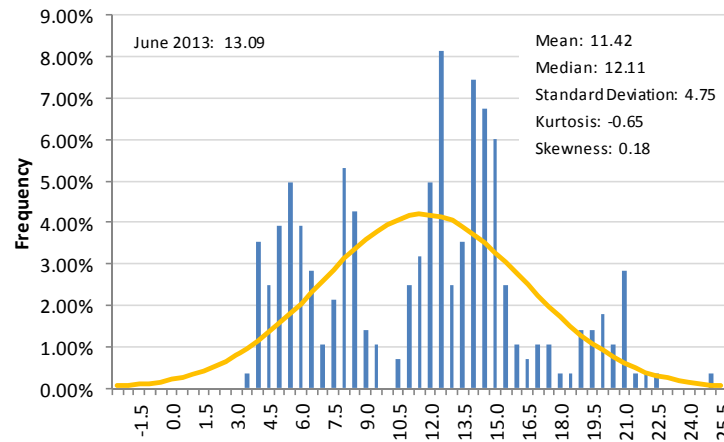
Trailing P/E, Jan 1954 – Jun 2013



Current P/E, Jan 2006 – Jun 2013



Next Year P/E, Jan 2006 – Jun 2013



Equity Sector Allocation Based on Macroeconomics

Economic Base Case:

- ◆ GDP accelerates, real and nominal interest rates rise, inflation remains tepid

Investment Implications:

- ◆ Because of GDP growth, cyclicals, technology (especially information technology), consumer discretionary and industrials are likely to do well
- ◆ On the other hand, because of rising rates and tepid sector growth, staples, telecoms and utilities are likely to underperform



International Equities

Forward P/E Multiples (12/3/2013):

Index	P/E
ASX	12.49
BOVESPA	10.13
EUROSTOXX	12.32
HANG SENG	10.53
MEXICAN BOLSA	17.61
NIKKEI	17.74
S&P 500	14.62

- ◆ International is the land of known unknowns and unknown unknowns. Need to remember that about one third of S&P 500 earnings derive from international operations
- ◆ Shifting Sands: TIMPs (Turkey, Indonesia, Mexico, Philippines) versus BRICs



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