WEALTH MANAGEMENT
# MONITOR

WEALTH MANAGEMENT GROUP

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# Economic Theme:

## What the Second Most Important Indicator Is Signaling

The single most important indicator each month is the employment report. This report from the Bureau of Labor Statistics tells us the number of jobs gained or lost, the unemployment rate, weekly and hourly earnings, duration of unemployment, and other esoteric facts that economists and investors pour over. The employment report is the granddaddy of economic releases. Our choice for second place honors would not be major releases such as the Consumer Price Index or Gross Domestic Product. While important, these indicators have value mainly as economic guideposts. Our choice for "second best indicator of the month" is the Institute of Supply Management's Non-Manufacturing Index (NMI). In addition to providing insight with regard to economic activity, NMI is also a guide to market expectations. As an economic indicator, NMI measures strength in the service sector, which accounts for about 90% of the economy. The composite index covers 17 service industries from Arts, Entertainment & Recreation to Finance & Insurance. In addition, NMI has predictive value in that it correlates highly with Personal Consumption Expenditures (PCE) with a quarter's lead time. Importantly, PCE represents 70% of GDP. Regarding market expectations, NMI tracks the change in corporate credit spreads (corporate yields minus Treasury yields) with a high degree of correlation. Corporate spreads are a key driver of performance of risky assets such as equities, commodities and high-yield debt. In summary, then, NMI can provide helpful clues as to the health of the economy and the ebullience of the stock market.

NMI was a key factor in our positive assessment of PCE growth and stock market strength during the latter part of 2010 and early 2011. In recent months, however, NMI has rolled over, and the April reading of 52.8 is at a level last seen in August 2010 when fears of a double-dip recession were incubating. For comparison purposes, NMI hit a recovery peak of 59.7 last February. While a few months do not a trend make, we do believe that NMI is suggesting that PCE growth will decelerate for at least a few quarters. To be more specific, PCE growth, which was 4.8% in April, as measured year-over-year, will likely slow to less than 4%. This rate of growth, which is in nominal terms, likely overstates strength in PCE due to high energy and food costs. For example, nominal PCE growth accelerated to 4.7% in 1Q2011 from 3.8% in 4Q2010, while real PCE growth was essentially flat quarter-to quarter. The accompanying chart shows the statistical fit between actual and predicted PCE growth from 1Q2001 through 1Q2011.

As indicated above, NMI has a strong correlation with corporate credit spreads which in turn influence risky asset price performance. Declining corporate spreads are indicative of stronger economic and earnings growth and easy money. Consequently, risky assets perform well. With NMI rolling over, corporate spreads likely bottomed at about 100 basis points in early February and seem set to rise from a recent reading of 104 basis points. In these circumstances, our upside target for the S&P 500 Index would remain 1,360. The recent closing high was 1,363.61 reached on 4/29. While this does not guarantee a bear market in equities, it does suggest that equity performance will be lackluster during the near-term.

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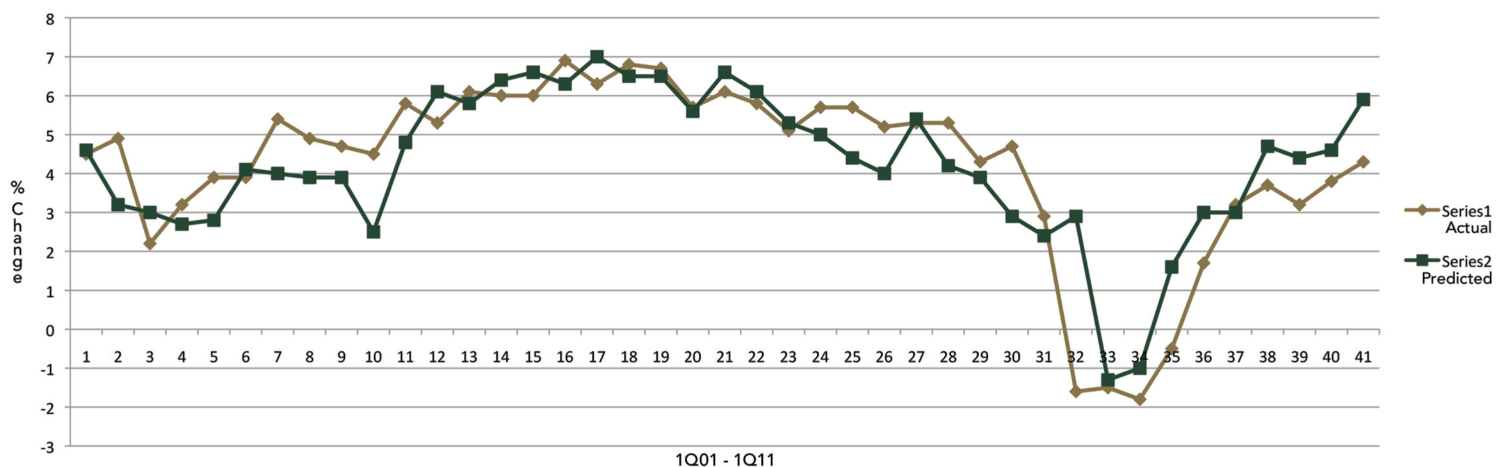
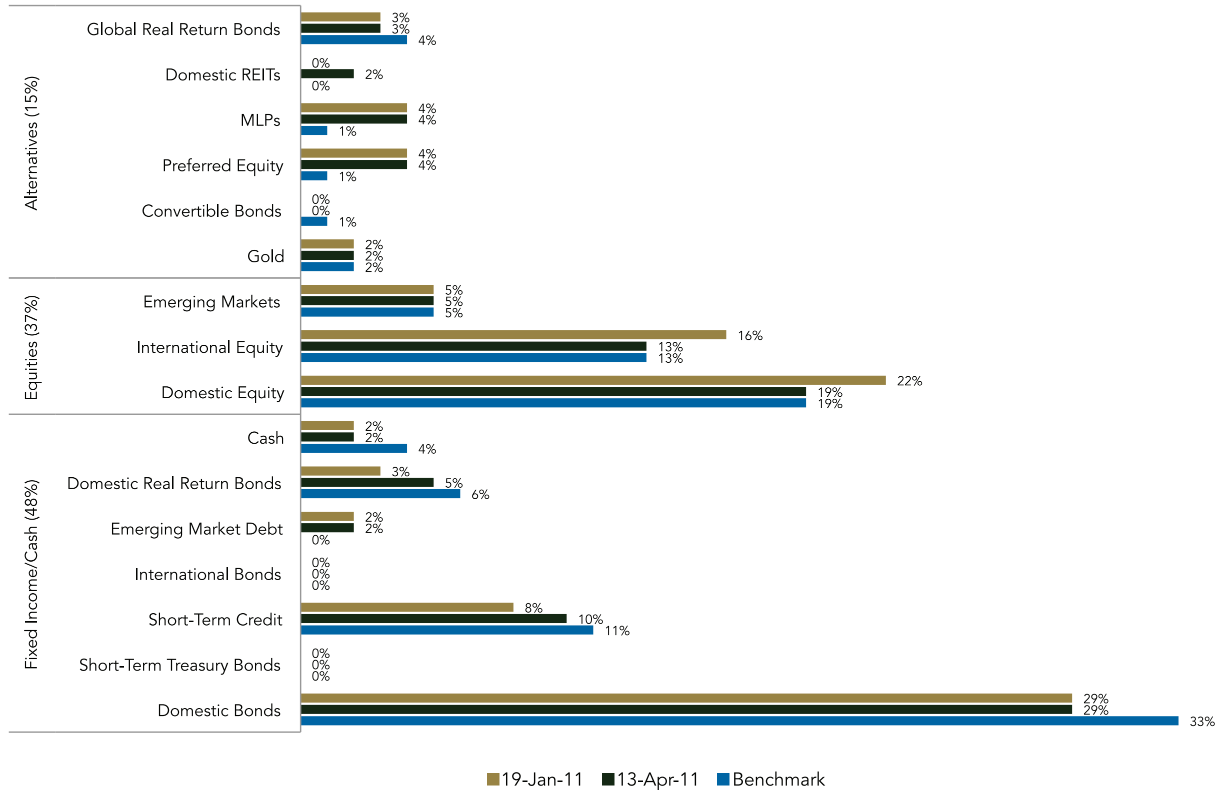
## PCE - ACTUAL VS. PREDICTED



## ASSET ALLOCATION RECOMMENDATION

As our valuation price targets have been met, we remain neutral all three equity asset classes. While bonds have rallied in response to signs of slower economic growth and buying support by the Fed, we continue to underweight the domestic bond asset class. By virtue of QE2, the Fed has been buying about 70% of Treasury supply, and these purchases are scheduled to end June 30. Further, the 10-year Treasury is facing technical resistance at the 3.06% yield level. Emerging market debt has benefited from strong investor support, and we continue to overweight that asset class. In the alternative category, we are overweight preferred equity, MLPs and domestic REITs.




| MARKET CLOSES | | |
|---|---|---|
| **S&P 500 Index**: 1,331.1 | **Dow Jones Industrial Average**: 12,441.6 | **10-Year Treasury Yield**: 3.07% |

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