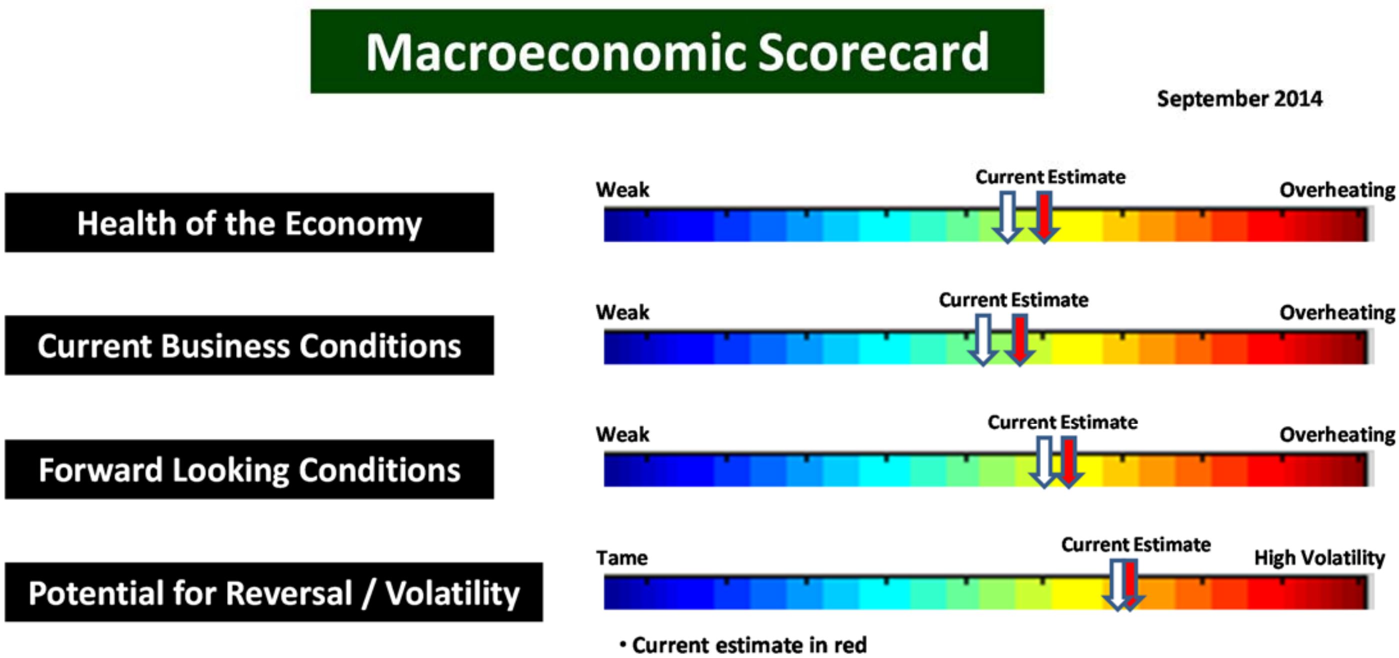
Briefing: September 2014

Armada Economic Scorecard

Attached is the latest monthly version of our economic scorecard. We realize from comments many of you make that it is difficult to go through the month with significant economic "noise" in the marketplace - and to try and cut through the chatter to determine (simply): are conditions good or bad for growth?

A couple of things to note. First, **this is a macro-economic view**. Some of you sit in a unique position in the economy and your companies will react differently to various types of economic activity. So, we are crafting this for the majority.

Second, we pulled specific economic measures because we believe they are 1) relevant, 2) reported recent enough to be useful today, and 3) **affect all business managers and the environment their companies operate in**.



Health of the Economy

We improved the current health of the economy slightly given early September recovery in retail sales, manufacturing activity, and continued strength in transportation activity. Again, as mentioned last month, most transportation networks were completely full of freight - showing that someone, somewhere is ordering a tremendous amount of merchandise - still. And, since most of our inventory to sales ratio metrics **are not** showing inventories growing any faster than sales demand, we assume that companies are keeping their days sales outstanding tight - and **reorders will continue to come through as we proceed through the peak season**.

As you will see from current supporting data in the back of today's scorecard, we still have elements of the economy that are not performing as well as they should be. **Housing, the velocity of money, household income, and job growth is still lower than a really healthy economy would create. Therefore, we have the current health of the economy "midstream" in our scorecard**. But, given the strong retail sales activity, we did inch this months' estimate up just a bit over August's.

Current Business Conditions

Much of our observations from the August report remain intact. There has been little change in the current "real" conditions over the past four weeks. Housing rebounded a bit in August, but remains well below levels that we should be seeing. We should be building about 1.5 million units a year at this time, and we are just over 1.093 million. Automotive remains very strong and general manufacturing is still growing at a rapid rate. Retail sales are still in-line with most expectations - especially those projected by the NRF. And, news on the inflation front has actually improved as core energy and food prices have started to ease in the last few weeks. **The biggest concern for most businesses remains the health of the average US consumer and their household discretionary income and the rising price of transportation costs**. Transportation prices continue to surge with most producer price indexes hitting at or near all-time highs for all modes and supply chain compression remains cause for concern - producer and consumer prices will remain higher as a result for some time to come. We are just now starting to hear that job creation is improving in the middle class - albeit very slowly. Growing job openings at many fast food establishments and general merchandise retailers are due to a cyclical change in employment. Some workers who accepted part time work in these companies over the past several years or had "settled" for a position in one of these companies are finding more permanent employment elsewhere (because jobs are opening up in the middle-income sector) - causing the loss of workers in these lower paying positions. The job openings in these minimum wage position industries are not due to a surge in demand - **it's a worker supply problem** - which changes the dynamic. As of metrics released in September, there are currently more than 4.7 million job openings in the US.

Forward Looking Conditions

The global economic environment remains more complex than normal. There are growing concerns that the situation in Ukraine will cause economic challenges for Europe - and indirectly for Asia and the United States. Sanctions being imposed by the EU and US on Russia are seeing retaliation by Russia. Those retaliatory actions are starting out as reductions in energy supply to Europe. This is expected to be an unusually cold and harsh winter - much like we saw last year. The demands for heating supplies will be significant. Already, Poland has seen its natural gas supplies cut by 40% - which will cause significant energy inflation pressures across the Eurozone - and possibly push some of the weaker economies back into recession territory.

The Chinese economy has also begun to show signs of stress. Ballooning credit risks are being offset by weaker economic growth. If China's GDP slips below 7.4% this year, it will see its unemployment rate increase. As that happens, companies will start to default on bond payments much faster than the current handful that have been reported thus far. If Europe struggles, more than 25% of China's exports go to the Eurozone. Therefore, it would pull China down with it. As China weakens, the US would get hit from a weaker Asian demand and a drop in European activity. That would create some significant volatility - but it might not be felt until 2015. There is likely enough momentum in the US economy today and strong enough self-reliance that the US can weather a weaker global trade environment for some time. But, it would catch us early in 2015 at the latest.

Potential for Reversal / Volatility

We have significantly increased the potential for economic volatility in our outlook for the second half of the year. There are just too many potentially impactful events that could pull economic activity down.

The Obama Administration has essentially declared war on the Islamic State (ISIS/ISIL), which could involve air strikes in Syria that both Assad in Syria and Russia has said would violate international law. That makes for a situation that is not only volatile and with great risk on the ground, but could spell trouble in international relations between superpowers. New estimates suggest that IS has at least 32,000 troops, far more than the 10,000 originally estimated. This will be a long, and costly campaign that could end in "boots on the ground" in the Middle East once again. It could also spur an attack on American soil - although intelligence officials say that there is currently no risk of that happening.

Ebola also continues to be a large unknown. Ebola infections have gone "exponential" in Africa. There are no beds available in containment units in at least three countries in Africa - Liberia being the worst. The number of dead is now above 2,400, higher than the totals of all prior years combined. Officials say that the estimate of the number of infections is far underreported, at currently 4,200. If at some point the virus were to become airborne (and there are variations currently in the monkey and primate population that are airborne), we would be dealing with an entirely different global health situation. The fact that this mutation of the virus has now quadrupled the number of infections of all previous years shows that the virus is finding a way to multiple in humans quicker (which means an easier method of transmission). If the outbreak hits the United States, and it could by accident or through a terrorist act, it will have a negative drag on economic and business environments.

Lastly, and as mentioned last month, if the situation in Ukraine were to impact the flow of energy to Europe, it would potentially send Europe into a recession - which would pull Asia down with it - and eventually the US. We know that this is already happening (at least on a temporary basis in Poland - energy supplies already cut by up to 40%). Given that many European countries are currently operating at or near economic recession levels, it won't take much to push them over the edge.

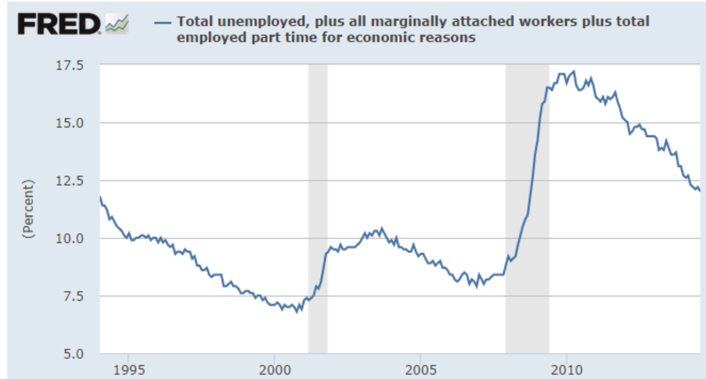
We already see these impacts in the drop in Asian export prices and a weakening outlook for Germany. **Companies are dropping export prices to increase sales volume in the US**. But, especially as Asian automakers drop their prices, it will start to take a toll on US automakers (arguably one of the strongest US growth sectors). It is an intricate and intertwined set of global markets - a ripple in one is felt across all of them.

With these conditions evident in the global environment, **potential for volatility is high and we have adjusted our volatility index higher for September**.

Potential Areas to Watch

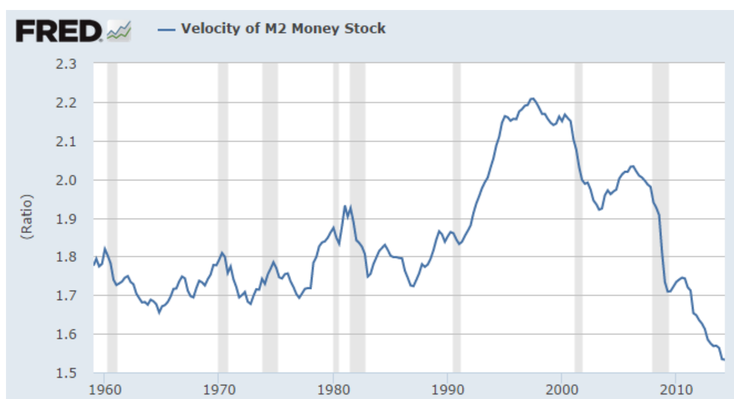
Real Unemployment. The U6 rate improved in September, dropping from 12.2% in July to 12.0% in August. The U3 rate also improved in the month (from 6.2% to 6.1%). The Labor Force Participation Rate fell in August to its lowest level since 1979, falling from 62.9% to 62.8%, this could have helped account for the slight improvement in the unemployment rate.

As you know, we watch the U6 rate because it is all-encompassing. We mentioned in our commentary that some changes in the job market were occurring. More than 10,000 Baby Boomers a day are reaching retirement age (whether they retire or not) and many are coming from mid-market jobs. That opens up a lot of opportunities on a monthly basis and we are starting to see "job hopping". People who have jobs are moving to better paying positions - which causes a lot of change in household income, relocation needs, etc. It may not be purely new job creation, **but it is a positive trend that will begin to help improve the U6 rate over time**.

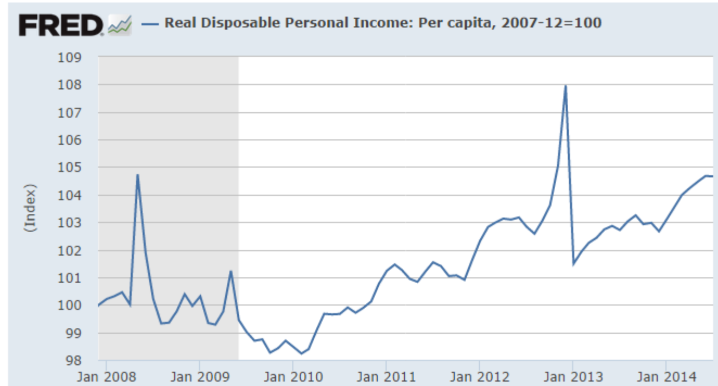


This is a very small portion of the employment story. We should get better news over the next four weeks as seasonal hiring starts. The data item to keep an eye on is the average hourly earnings rate. Growth rates are still well below where it was at the beginning of the recession. If inflation is growing at nearly 2% and earnings are growing at about 2%, there is no real growth here in household income. Some of this is due to the percentage of part time jobs in the national labor report - which we see in the high U6 rate. Until that turns around and we see wage growth more significant than this, we won't get the real strength at a consumer level to help turn around housing and other critical metrics.

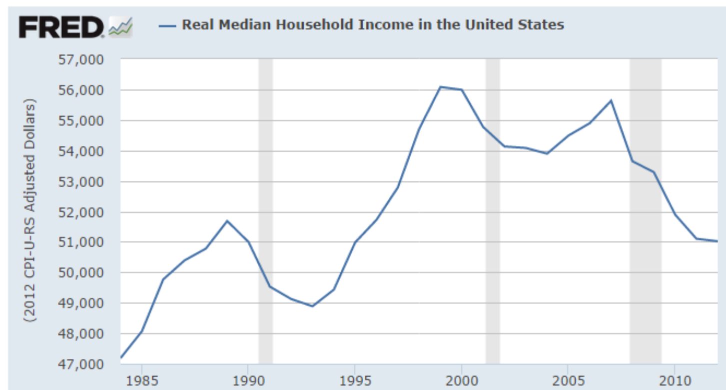
How Long Can Cash Stay Idle? We continue to see the velocity of M2 money at the historically lowest levels. The ratio essentially recovered the .002 in August that it gave up in July. The ratio is currently at 1.533, just slightly off of the all-time low of 1.531 hit in July. As mentioned last month, the Dallas Fed shows that banks are sitting on record reserves in both their required and excess reserves accounts (approaching $4 trillion). The movement of money in the country is critical to the health and growth of the economy. Until this number starts to trail back upward, we can say that business sentiment, consumer sentiment, lending, investment, and general economic growth is **not where it needs to be**. The velocity of M2 is still trending in the wrong direction. But, as mentioned last month, once it starts, it can rebound very quickly. With European economic fears tied to Russia and Ukraine permeating through the economy, the movement of money will continue to remain sluggish as investors seek safe haven investments. Companies need about a 2 year "runway" in order to put their strategic plans in place and to start spending and investing in growth. And, as long as Congress continues to float major negative legislation in energy, labor, or taxation - it will continue to create uncertainty and spending will remain conservative. Again, we need to see movement in this figure before we believe that any significant growth can be sustained.



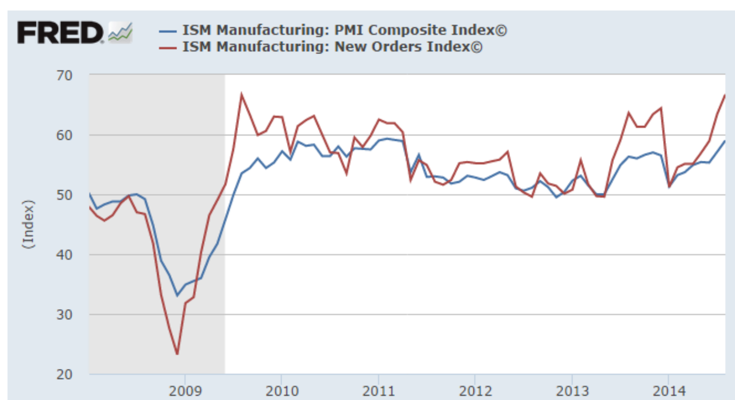
Disposable Income Slipped in July. For most businesses, disposable income is the most important economic factor - from a customer perspective. Whether B2B or B2C, your sales are directly or indirectly driven by consumer spending. We look at disposable income per capita and shifted our look for the third month in a row to an index - indexed to December of 2007. These figures are adjusted for inflation and show that we have seen a slight slippage in the last month in disposable personal income (slipped to $37,553 from $37,558). In reality, that's not much of a slip. And, over the past several years - the real disposable income has actually improved.

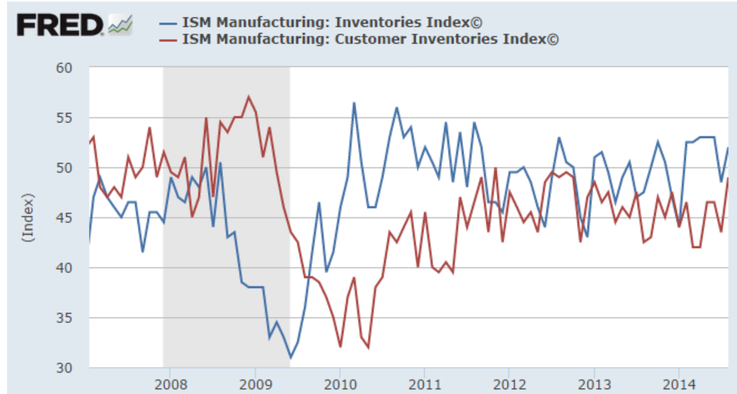


Consumers have dropped a significant amount of their household debt - especially for the millions that are no longer in a home mortgage. That destroyed household wealth, but that's not what we are measuring. We are looking at the ability for consumers to purchase goods and services today. So, one piece of the equation is the Real Median Household Income, and it explains part of the problem. The chart at right shows the metric, and as you can see, real income today is about $51,017 (adjusted for inflation) whereas it was $56,000 prior to the recession. This is one of the reasons why our core metrics are weaker than many would like them to be, and why some of our economic scores are not reflecting a 5% quarterly GDP rate as we probably saw in Q2 (when all of the revisions are accounted for).

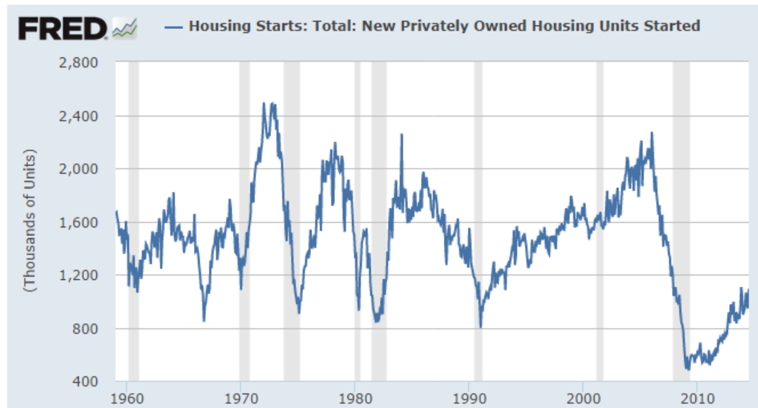


Manufacturing and Services Strong. The ISM Repot on Business for August showed that manufacturing and services activity both continued to improve. The manufacturing composite hit 59.0 in August, up 1.9 points from the 57.1 posted in July. New orders were also increasing strongly - hitting 64.5 which was 3.3 points higher than the 61.2 posted last month. The New Order index strength is good as we mentioned last month because typically new orders transpire into finished goods activity in 4-6 weeks. Again, like last month, nearly every category in the report was positive. If there was something to keep an eye on, it might be inventories. We saw inventories climb to a level that could start to suggest an overstock situation for some manufacturers. Inventories at manufacturers were up 3.5 points to 52.0. A reading over 50 suggests that inventories may be outstripping demand slightly. Customer's inventories also jumped significantly to 49.0, a rise of 5.5 points. That is dangerously close to an overstock situation for customers of manufacturers...which would also suggest some future weakness in new orders if this inventory doesn't sell.





The manufacturing sector accounts for approximately 19% of total GDP, the services sector accounts for about 70% of economic activity. Even in the services sector of the economy (including retail), we saw the ISM index come in strong. The composite for the services sector was up .9 points in August. New orders however slipped a little bit, falling 1.1 points to 63.8 in August. Employment, business activity, supplier deliveries, and backlog of orders were all positive. Prices, export orders, imports, and inventory sentiment all slipped in the month.



<u>Housing Dives</u>. We saw the rate of new home starts recover in July (recover being a relative word). Housing starts hit 1.093 million, up from 945,000 hit in June. As you can see from the chart at right, we are still at the trough levels of every previous recession dating back to the 1950's. We should be building about 1.5 million new units a year at this time - in order to prove that economic recovery is real and sustainable. Alan Greenspan pointed out this week that every previous recession was construction-led. This one has been led by business spending and automotive manufacturing. As we mentioned last month, housing has a very strong economic multiplier - up to 7 to 1 by some estimates including direct and indirect impacts. One dollar of spending creates about $7 of economic activity. We need the housing sector to rebound before we can get real, solid, sustainable economic growth. Current housing volume is being driven by multi-family units. If we begin to get an overstock situation in the multi-family unit sector - we will see housing plummet further.

Note: These are <u>just a few</u> of the hundreds of metrics that we pay attention to. And, there are many different ways to slice and dice the data in the charts that we presented. Our aim is to make this simple and to give you an idea of what major macro data points we and others are watching for changes in the economy. The metrics we present here could change from month-to-month depending on changing market conditions.