The Jerome Levy Forecasting Center

Client Bulletin

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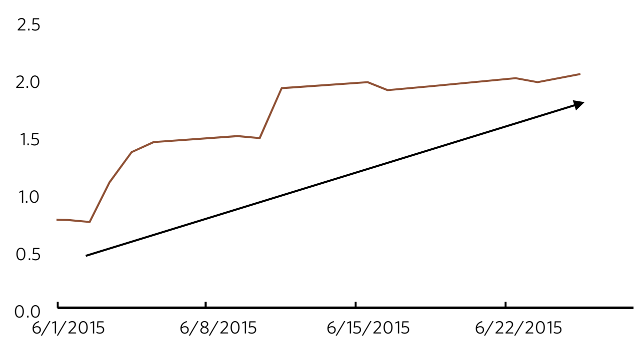
Second-Quarter Bounceback Looks a Little Bigger, But Still Likely to Disappoint

Data released in June have pointed to a stronger second-quarter bounceback in output and earnings than that suggested by previous data, but that bounceback will probably still disappoint markets considerably. The Atlanta Fed's "nowcast"—their running estimate of second-quarter real GDP growth—has doubled over the course of June (chart 1), reflecting recent better data. We, too, in the most recent issue of *The Levy Forecast®*, raised our range of forecasts for second-quarter NIPA profits (chart 2), reflecting both small upward revisions to first-quarter profits and recent data improvements. However, industrial indicators continue to point to weakness, and there are significant downside risks to the second-quarter data yet to be released, particularly to trade and inventory data which are released with a long lag. Most likely, the second-quarter bounceback in profits will be pronounced yet not up to the levels of fourth-quarter 2014. Over the coming weeks, expect downward revisions to consensus estimates for second-quarter growth and earnings.

June Data Point to Stronger Q2 Growth CHART 1

Atlanta Fed "Nowcast" for Q2 2015 Real GDP Growth

annualized % change from first quarter to second, seas. adjusted, by date of forecast



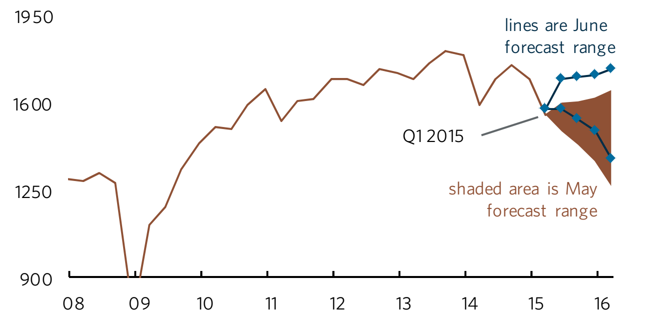
Here are some positives for profits in the second quarter:

- As we expected, the personal saving rate appears to be declining in the second quarter (chart 3) as households spend down some of their accumulated energy savings and as energy spending itself rises from depressed first-quarter levels along with the partial rebound in oil prices. The saving rate could well continue to decline in the second half of the year, providing further support to profits.

NIPA After-Tax Profits CHART 2

NIPA Profits after Tax adjusted for tax law distortions to depreciation

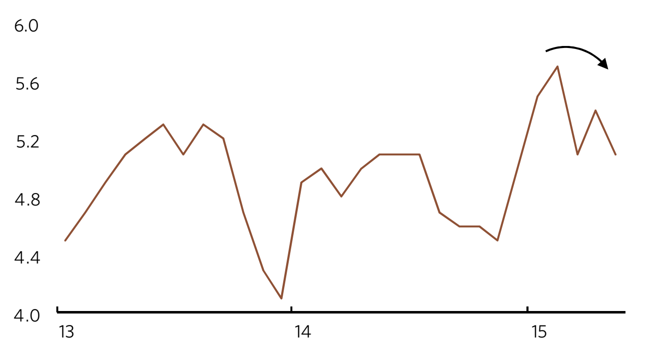
$ billions, seasonally adjusted, annual rate, forecasts through Q1 2016



Saving Rate Declining in Second Quarter CHART 3

BEA: Personal Saving Rate as % of Disposable Personal Income

seasonally adjusted, last data point May 2015



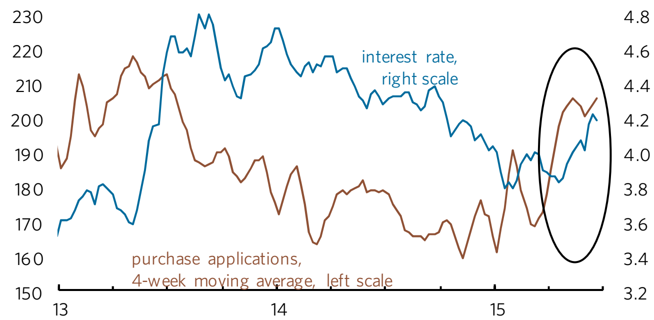
- Residential construction is boosting profits in the second quarter slightly more than we had forecast earlier in the quarter. Sales and applications for mortgages have risen despite the sharp rise in mortgage interest rates over the past few weeks (chart 4). Some individual housing markets are undoubtedly strengthening, but to some extent the latest surge reflects households spurred to buy by fears of further rises in mortgage rates.
- Nonresidential construction in the second quarter appears stronger than our earlier forecasts. We still expect a decline in the second quarter and in the rest of the year driven by energy-related construction, but some part of that decline may be offset by increases in other commercial construction as commercial real estate prices continue to rise strongly (chart 5).

Meanwhile, a number of industrial indicators continue to point to weakness. Whether the weakness evident in falling order backlogs at capital-goods manufacturers (chart 6) is primarily domestic (likely energy-related) or foreign remains to be seen. Either way, it will detract from profits.

- Port traffic data continue to support the idea that, beneath first-quarter disruptions, imports are stable but exports are falling (chart 7).
- Physical inventories show signs of being overbuilt in the first quarter, having risen while final sales declined. Weaker inventory building in the second quarter is consistent with ongoing declines in industrial production and freight activity and with reports by manufacturers of fewer supplier delivery delays (chart 8).
- Planned capital spending by U.S. manufacturers is weakening according to regional Fed surveys (chart 9). This suggests at least some part of the decline in capital goods orders through May is coming from domestic demand.

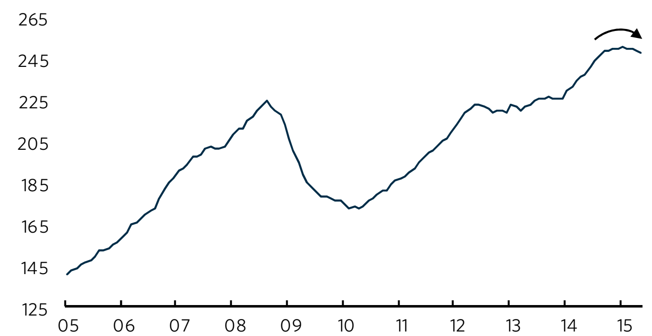
Mortgage Activity Rising Despite Higher Rates CHART 4

Mortgage Bankers' Assc.: Mortgage Applications for Purchase, index
Interest Rate on 30-Year Fixed Rate Mortgage, % per annum
last data point week ended June 19, 2015



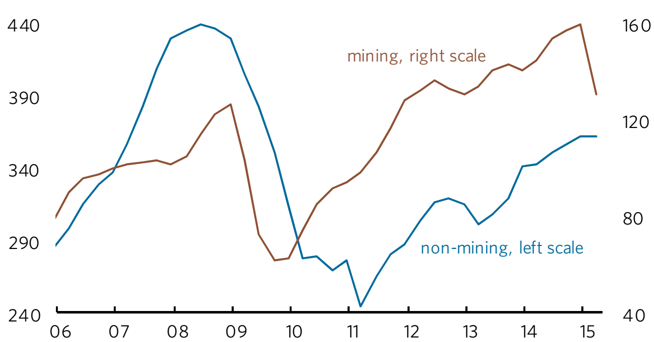
Capital Goods Order Backlog Declining CHART 6

Manufacturers' Unfilled Orders of Nondefense Capital Goods ex. Aircraft
$ billions, seasonally adjusted, last data point May 2015



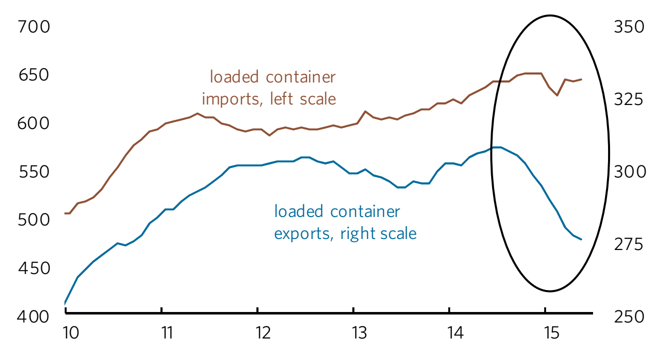
Could Non-Mining Construction Pick Up? CHART 5

BEA: Private Fixed Investment in Nonresidential Structures
$ billions, seasonally adjusted, annual rate, last data point Q1 2015



Imports Stable But Exports Falling CHART 7

Containerized Ocean Trade at Los Angeles and Long Beach Ports
thousands of TEUs, 12-month moving average, last data point May 2015



- Meanwhile, reports from abroad continue to suggest falling demand for capital goods from China and the other emerging markets. Brazil and Russia are contracting, and global trade flows remain weak. Moreover, reports from European capital goods producers (who, unlike U.S. producers, have been helped by the stronger dollar) suggest rampant overcapacity is finally beginning to squelch China's appetite for imported machinery.

Yet-to-be-released trade and inventory data for May and June could have a large impact on both GDP estimates and profits. In the past few months, these series have been swung around by the port disruptions and their aftermath and by oil price moves, making trends difficult to discern. As mentioned earlier, we continue to perceive downside risks for both exports and inventory growth. Trade data for May and June will also provide some indication of the extent to which domestic and foreign demand weakness, respectively, caused the decline in equipment orders. The broad pattern of industrial activity declines suggests some of both.

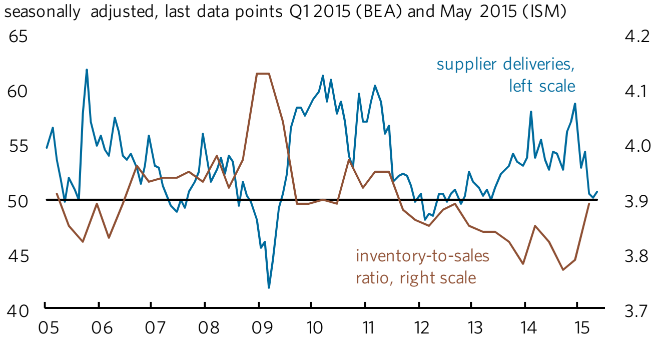
Many market commentators continue to suggest that 2015 will follow last year's pattern of first-quarter weakness and second-quarter strength. However, the scale of the bounceback will be much less in 2015 than in the previous year for two reasons.

First, the spring quarter of 2014 represented catchup activity for four extremely weather-disrupted months starting with December of 2013. By contrast, in 2015 weather disruptions were mainly confined to February (and to the Northeast), and foreign trade was delayed to varying degrees mainly during January and February. Second, in 2014 the underlying trend of U.S. economic activity was solid and fairly steady. In 2015, the trend is weakening, with profits most likely declining and the pace of expansion deteriorating.

Markets may well see some more encouraging U.S. economic indicators as the data for the second quarter are reported this summer, but the overall condition of the economy—and earnings—will in all probability disappoint markets. The most important factor in determining the fate of the U.S. expansion through 2016 will be the condition of the global economy, especially China and the other emerging market economies.

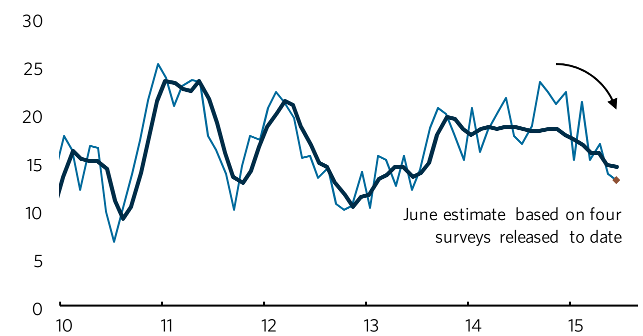
Deliveries Index Corroborates Overstocking CHART 8

BEA: Ratio of Real Nonfarm Inventories to Final Sales of Goods & Services
ISM Manufacturing Survey: Supplier Deliveries Index, (>50 = slower)
seasonally adjusted, last data points Q1 2015 (BEA) and May 2015 (ISM)



Capex Plans Weaken CHART 9

Regional Fed Manufacturing Surveys: Expected Capex 6 Months Ahead
index, % reporting increase less % reporting decrease, dark line is 3-month avg.



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