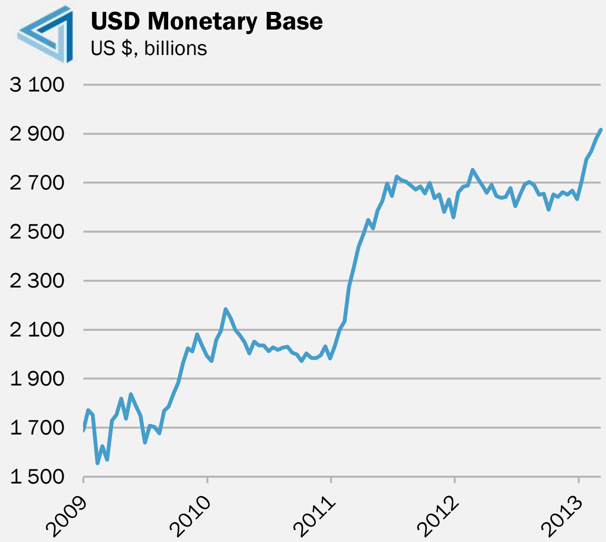
Business Cycle Monitor

US – ECONOMY REMAINS IN CYCLICAL UPSWING PHASE

UNITED STATES

Highlights

- **In line with our view in 2012, US economy remains in cyclical upswing phase and this has reflected in new record highs for the DJIA as well as strengthening economic data.**
- **Broad money growth has accelerated strongly in recent months reaching a peak of 13% annualised in January before slowing to 10% in February.**
- **The monetary base has increased $300 billion in past three months as the Fed expands the QE programme.**
- **Required reserves have climbed 16% from July 2012, confirming broad money and credit growth.**
- **Asset price inflation is strong at present. Next phase of cycle to be characterised by accelerating consumer price inflation.**
- **Risk to bond market is to downside and for long bond yields to rise above 2% in coming months. Stock market momentum remains higher toward end 2013, although short-term correction should not be ruled out.**



Source: St Louis Federal Reserve, ETM Analytics (Pty) Ltd

BUSINESS CYCLE ANALYSIS

In November 2012 we maintained our bullish view of the US economy, writing that "the ETM Business Cycle Index is slightly above neutral territory at 0.072, positioning the US economy in a cyclical upswing phase of the business cycle." Since then, and particularly in the first quarter of 2013, US economic data has surprised consensus strongly to the topside, validating our increasingly bullish cyclical view of the US economy.

The Dow Jones Industrial average has rallied to fresh record highs, beating the pre-GFC highs in the first week of March. Nonfarm payrolls data released in early March showed that an estimated 236k jobs were created in February, while consensus expected a gain of only 160k jobs. Services and manufacturing PMI's have also beaten consensus estimates in recent months, indicating the general outperformance of the US economy relative to expectations.

The cyclical upswing follows a healthy acceleration of credit and broad money growth in recent months. Unadjusted M2 money supply growth accelerated to a peak of 13% annualised in early January, but has since tapered off to growth of 10% in the week to February 25. This acceleration of money growth in late 2012 is now boosting economic activity and has sent the Dow to new records.

The Federal Reserve has its foot firmly on the monetary easing pedal, and has embarked on a new round of QE to the value of $85 billion per month. After the US monetary base was unchanged around $2.6 trillion in the 19 months from June 2011 to December 2012, the latest round of QE has seen the monetary base burst higher, climbing $300 billion in two months to $2.9 trillion as of March 6, 2013.

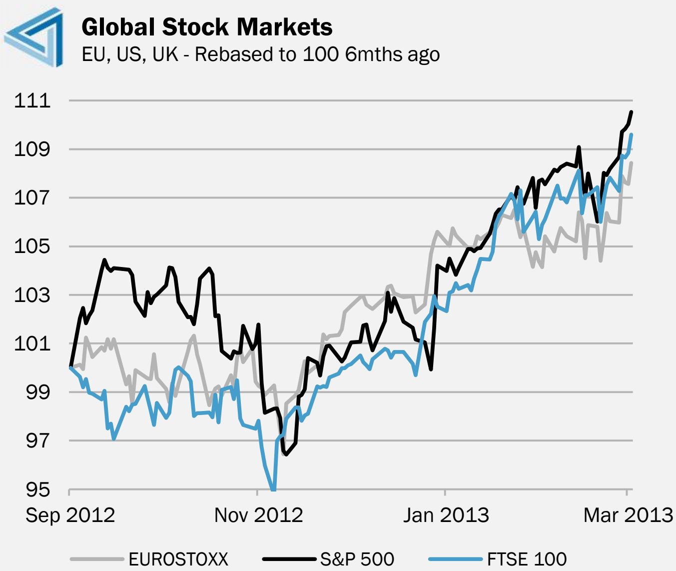
Of course, the monetary base does not tell the full story of underlying monetary developments, seeing as banks could simply be leaving this cash locked up on deposit with the Fed, limiting the impact QE has on the general economy. Required reserves – the reserves held by banks at the Fed as backing for newly created bank deposits i.e. money supply – has climbed more than 16% since July 25, 2012 to March 6, 2013, showing that banks are writing new loan assets. The recent acceleration of credit and money growth is therefore a very real one and is impacting the economic structure.

The Fed's new easing programme is therefore having the desired effects: banks are creating new loans and deposits in the economy and that is stimulating economic activity. Fed data shows that credit is flowing mainly to the corporate sector at present. Commercial and industrial loan growth climbed to 14% y/y in December, while consumer credit loan growth remains muted at 2%. This suggests that economic activity is picking up in the capital goods sectors, and that resources will be bid away from the consumer sectors in the short-term.

The shape of the yield curve also reflects an economy in a cyclical upswing phase. The US 2-10 Treasury yield curve has, since reaching lows of 120bps in July 2012, climbed to near one year highs of 180bps in early March. This is also indicative of an economy where fiat-fractional money supply is flowing onto credit markets, driving short-term interest rates lower relative to long-term rates, encouraging a cyclical upswing phase of the economy as businesses finance relatively high yielding long-term investments with low interest rate short-term loans.

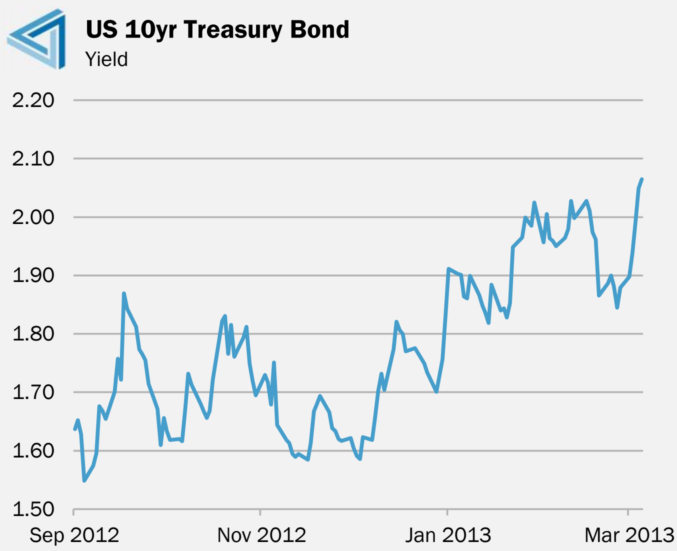
Looking ahead, although money growth has slowed marginally in recent weeks, it hasn't slowed enough to pressure the cyclical upswing. The cyclical turning point would be reached once consumer price inflation accelerates to levels more in line with the broad money growth rate, but we are still far from this point. The MIT billion prices project shows a consumer price inflation rate of 1.7% y/y at present, up from lows of 1.1% in July 2012. The 'official' inflation rate was 1.6% y/y in January. Meanwhile, money growth is running at just below 7% y/y, which means the monetary space is still strongly positive and should sustain the cyclical economic boom for some time longer.

In terms of the consumer price inflation outlook, the S&P 500 has gained 11.5% y/y in mid-March, while the Dow is up 11.3% y/y. Asset price inflation is far exceeding consumer price inflation in the past year. This indicates that pipeline consumer price inflation pressures are to the upside, and that following the increase of broad money supply and credit in recent months, demand to hold cash balances should begin to fall and translate to accelerating consumer price inflation later in the year.



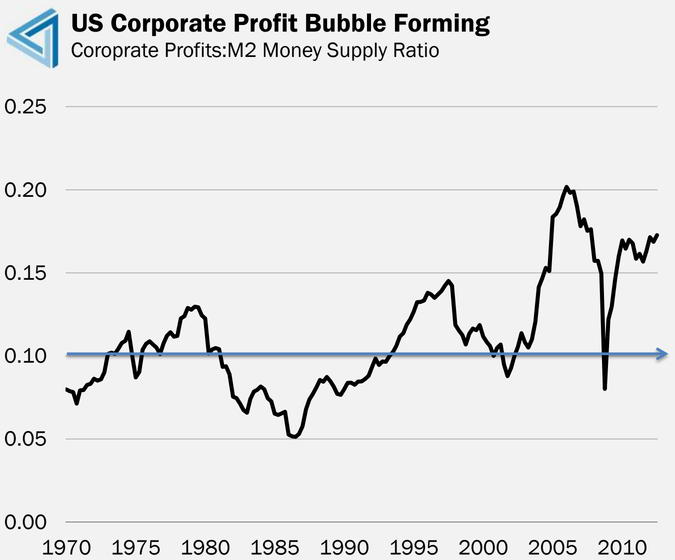
Source: Reuters, ETM Analytics (Pty) Ltd

In the meanwhile, the monetary manipulated cyclical upswing of the US economy remains firmly in play, until such a time that broad money growth slows, and price inflation accelerates. From now until then, however, corporate profit and earnings should be in a rising trend, which will tend to pull money market and bond market yields higher. We believe this will start to exert a curve flattening bias across the term structure of interest rates, although we fully expect the Fed to maintain its zero rate policy which will artificially steepen the official sovereign yield curve. The risk to bonds is to the downside in the remainder of 2013. The 10yr yield could rise well above 2%.



Source: Reuters, ETM Analytics (Pty) Ltd

Equity markets should continue to gain toward year-end on the loose monetary policy environment that is boosting earnings and capital values, although one must be aware that this bull market is forming another major equity bubble. Below we show a chart of US corporate earnings relative to M2 money supply. We can see clearly how the late '90's boom was not allowed to liquidate fully as the ratio was prevented from falling sufficiently below 0.10. The same was true after the 2008/09 crash in earnings. Ultimately the system is being 'rescued' by massive money pumping to prop up an unsustainable earnings structure.



Source: Datastream; ETM Analytics

This earnings structure can remain supported for a while longer and will drive the bull market higher, but it must eventually collapse.

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