CalPERS Trust Level Review
STATE OF THE ECONOMY

Period Ending June 30, 2015

ECONOMIC SUMMARY

US economic expansion enters its 7th year of (slow) growth

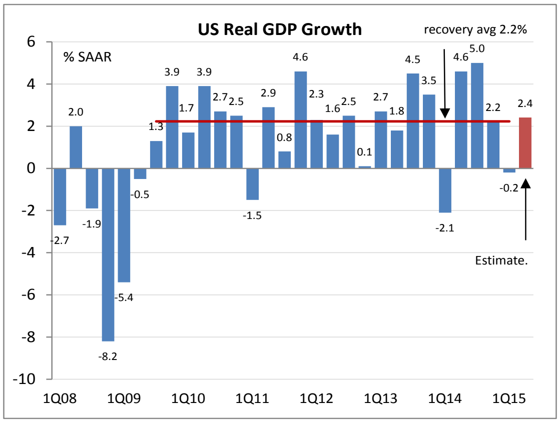
- US economic growth slowed during the past half year to little more than 1%, although we could well see upward revisions, and the second half looks to be starting considerably better.
- Despite low growth, the US unemployment rate fell by another 0.3% from December to June and is getting close to the Fed's measures of non inflationary unemployment (NAIRU). This reflects, among other things, the slow growth of the labor force … which probably puts 'potential' US growth a 2% or less going forward.
- Restrained wages and higher marginal taxes have kept household disposable income growth quite steady, and in spite of high confidence and strong balance sheets, households are still saving around 5% of their income, three points more than at a similar point in the past expansion.
- The recovery in business investment has been roughly commensurate with the cautious outlook for product demand and the rise in utilization of existing capacity. Whilst the profit share of national income is now receding a little, corporates will benefit from solid top line growth for some time to come.
- Housing is a promising driver of future growth with an improvement in household formation driving higher prices and rents, along with low vacancy rates for both rentals and owner occupied. In the past year, affordability has been fairly steady … 9% rise in house prices offset by a 44bps drop in the mortgage rate.
- Whilst the six year expansion has experienced only 2.2% yearly growth, it would have been 3% without the 1% yearly decline in government spending. State tax revenue is only 5% above the prior peak and social benefit spending is now taking larger share of their outlays.
- The US trade gap remains remarkably steady with halving of the Oil import bill offsetting a sharp deterioration in the non-Oil trade balance.

Positive	Same Trend	Negative
- Economy better than aggregate data suggests US might repeat last year's slow start/strong finish. Benchmark revisions might boost history. **- Stronger housing into the summer** Starts, sales, prices and plans-to-buy are going strong, while affordability remains OK. **- Strong household balance sheets** 1Q15 Flow of Funds Report confirmed that household fundamentals remain sound. **- Well supplied commodity markets** Across energy, bulk commodities and foodstuffs, it appears to be a buyers' market. **- Supportive public policy** Active ECB and BoJ, benign Fed and proactive PBOC are helping to see off tail risks.	**- The dollar** Benign outlook for the Fed has stemmed the advance of the dollar after nine strong months.	**- Soft first half for growth** US economy improved toward mid year but likely delivered growth in low 1's for first half. **- Capex and investment intentions** Little upside for investment based on already high GDP share, orders and surveys. **- Weak S&L spending** Significantly depressed state tax revenue vs past recoveries, yet increased social commitments. **- Tight labor markets** Available persons to fill job openings dropped below 2.7 … near the lows of the last expansion. **- Corporate debt** Rising at a quicker pace recently, although not excessive against company valuations. **- Tail risks** Numbers don't add up in Greece, whist China is struggling to effect a transition.

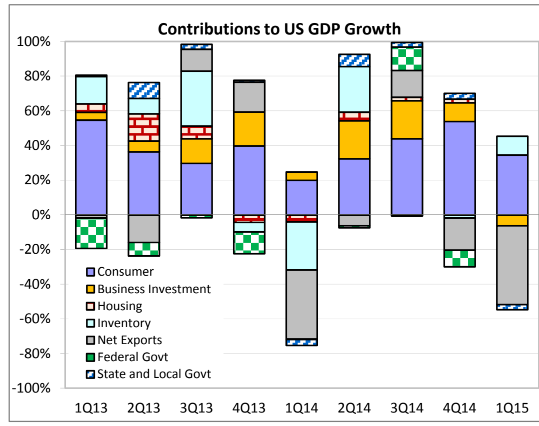
US ECONOMY IN AGGREGATE

SUMMARY

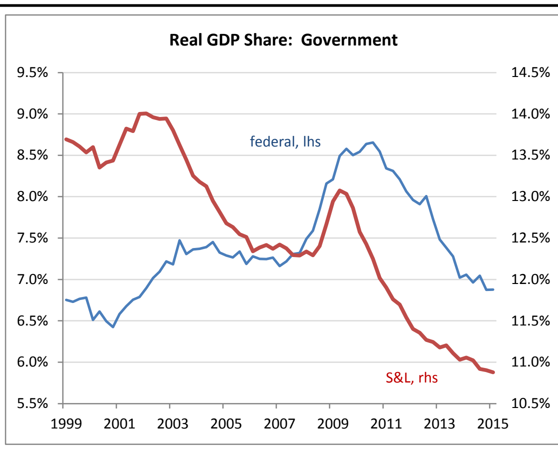
- The US economic recovery broadened in the second half of 2014. With the US still a net energy importer there should be net benefits from falling Oil prices despite offsets from lower capex and jobs in that sector.



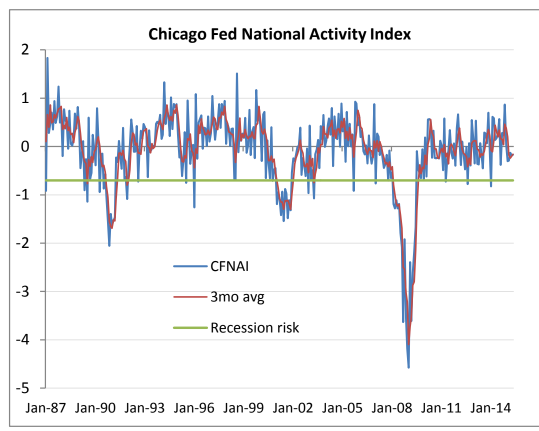
- US GDP growth remains tepid.



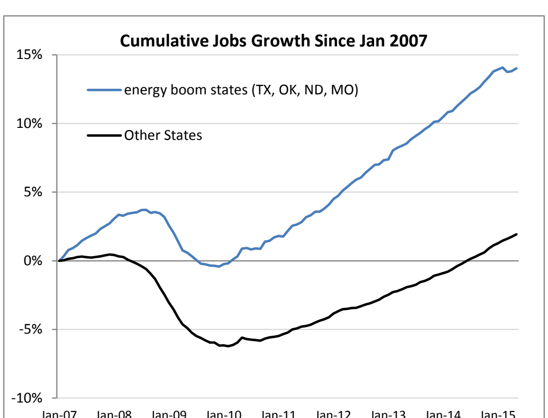
- Trade was a negative in 1Q15.



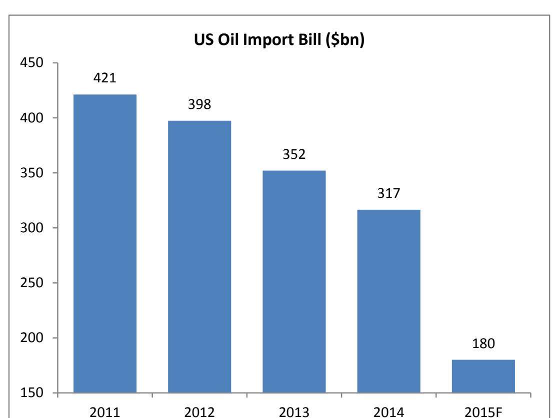
- Expansion rate 3% w/out government.



- Fed activity measure is very stable.



- Jobs in the energy boom States levels out.

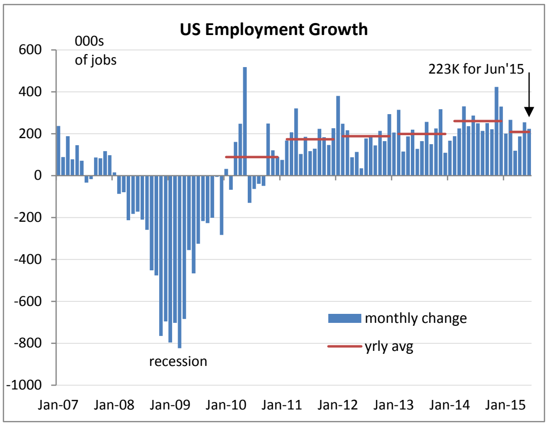


- Reduced oil import bill cushions trade.

LABOR MARKET

SUMMARY

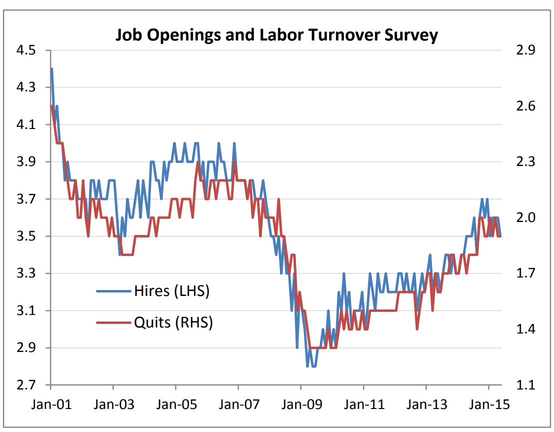
- The US labor market continues its gradual improvement, but is starting to hit some constraints in terms of available labor supply.



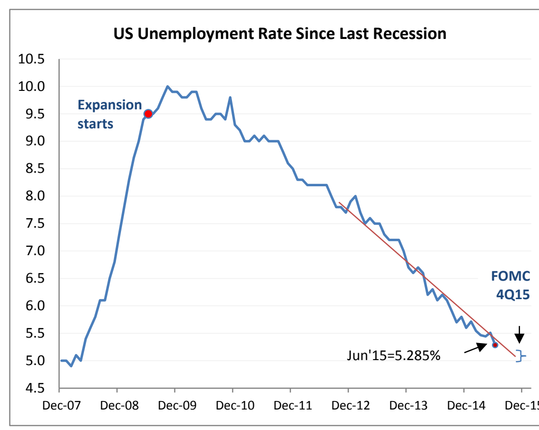
- Jobs growth softens a little this year.

Jobs by Age Group .... Latest Qtr YoY				
Age:	Pop	L.Force	Jobs	U-rate
16-24	-0.3%	0.4%	1.7%	-1.1
25-34	1.5%	2.1%	3.0%	-0.9
35-44	0.3%	0.1%	0.8%	-0.6
45-54	-0.4%	-0.6%	0.1%	-0.7
55+	2.8%	2.8%	3.6%	-0.7
Total	1.1%	1.0%	1.9%	-0.8
Jobs by Education .... Latest Qtr YoY				
	LFPR	LF	Jobs	%LF
No HS	0.8	2.5%	3.2%	0.08
HS	-1.0	-2.5%	-1.6%	0.25
Some Coll	0.0	0.9%	2.3%	0.30
Coll+	-0.5	3.2%	3.9%	0.37

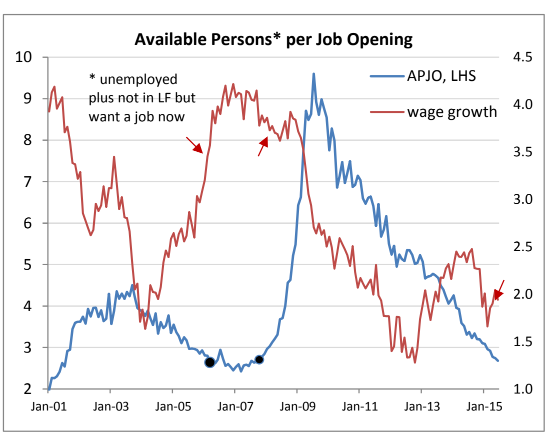
- Young and old cohorts dominating jobs.



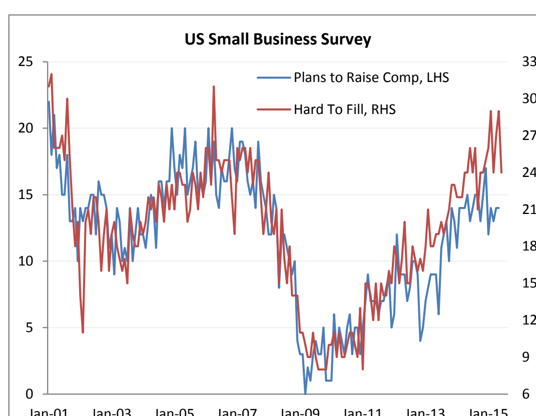
- Quits rate levels out.



- Unemployment rate falls toward NAIRU.



- Supply shortage not leading to wage surge

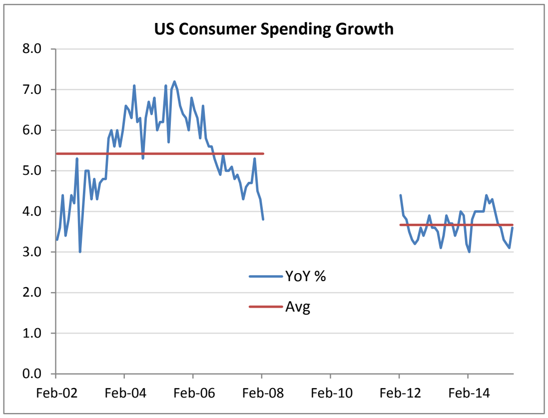


- Compensation plans heating up

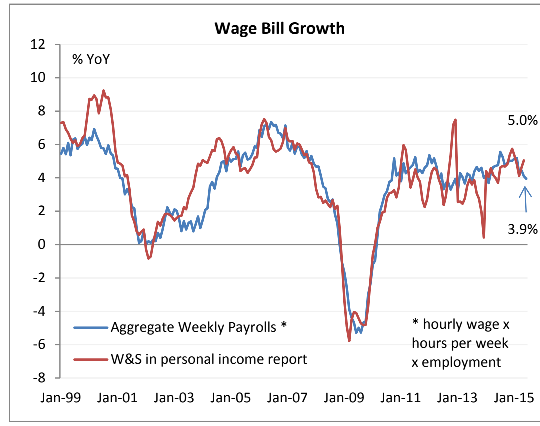
HOUSEHOLD SECTOR

SUMMARY

- Household spending has not experienced the boom or bust dynamics of the 2000s. Personal spending growth has been very stable despite improved balance sheets and high confidence.



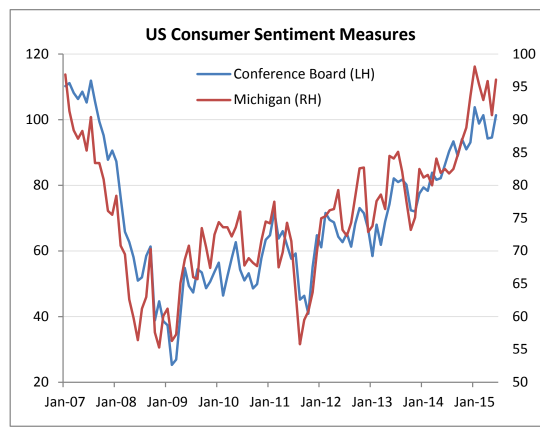
- Steadier cycle than in 2000s.



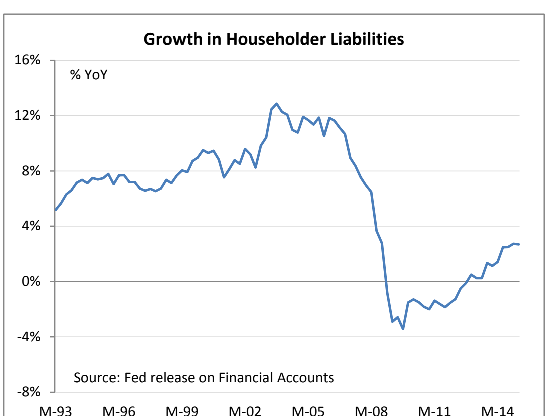
- Wages income growth quite solid …

US Personal Income and Outlays		
	Yr to May'14	Yr to May'15
Private Sector Wages	4.6%	5.7%
Total Wage	4.0%	5.0%
Proprietor income	2.5%	1.4%
Interest income	1.8%	-0.8%
Dividends	3.0%	7.5%
Benefits	4.5%	5.0%
Total Gross Income	3.7%	4.4%
Taxes	3.2%	9.6%
Disposable income	3.8%	3.8%
Savings Ratio	-0.1 ppt	0.0 ppt
Spending	3.9%	3.7%

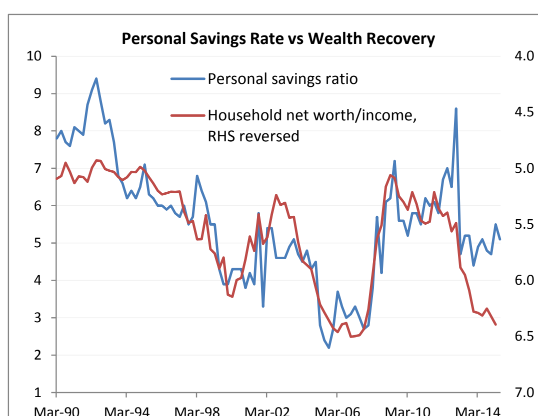
- But disposable income held back by taxes.



- Confidence is strong.



- Very modest return of leverage.

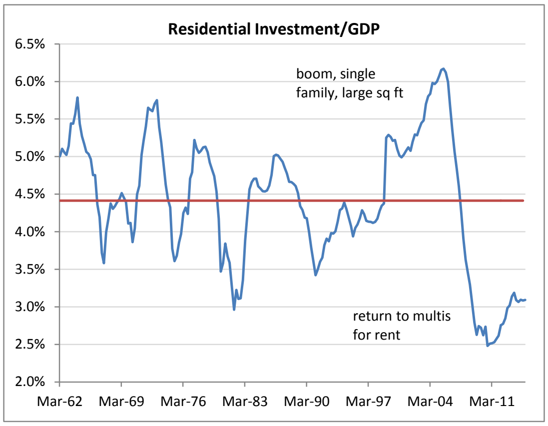


- Within a high savings mentality.

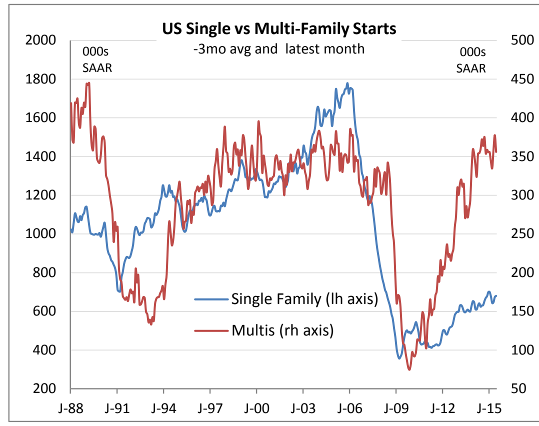
HOUSING

SUMMARY

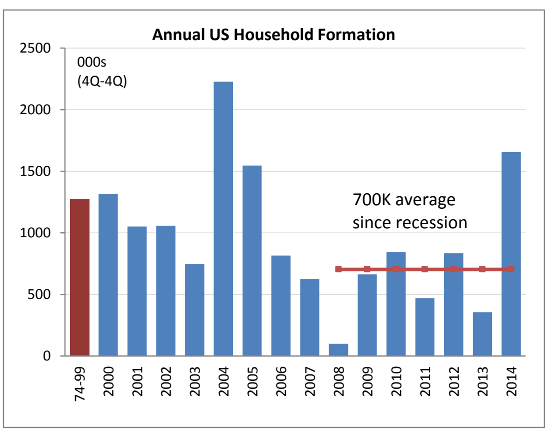
- Fundamentals of the housing market remain promising … reduced vacancies, willingness to buy and an emergent supply response.



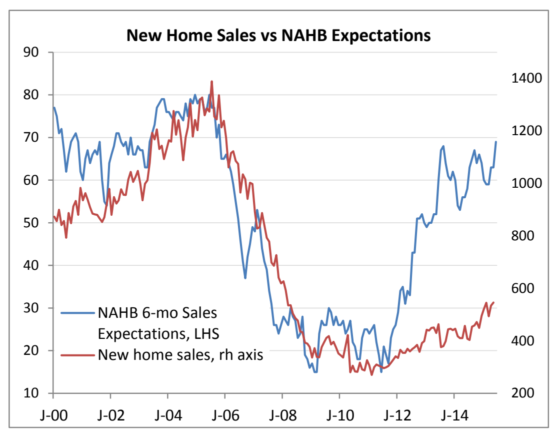
- Housing construction recovery is slow.



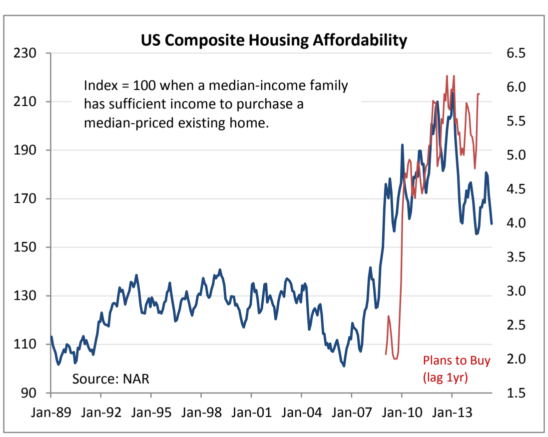
- Multis are leading the way.



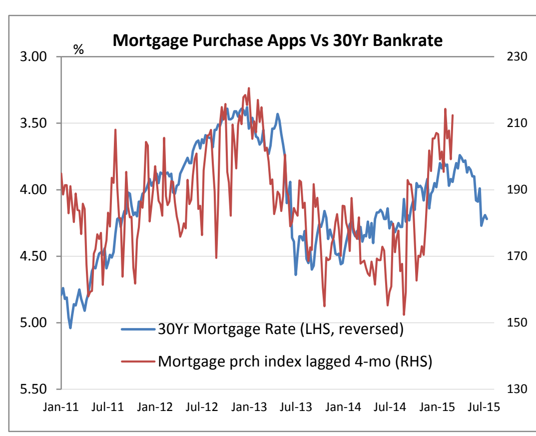
- Household formation jumped recently.



- Sales constrained by absent supply.



- Affordability has held up pretty well.

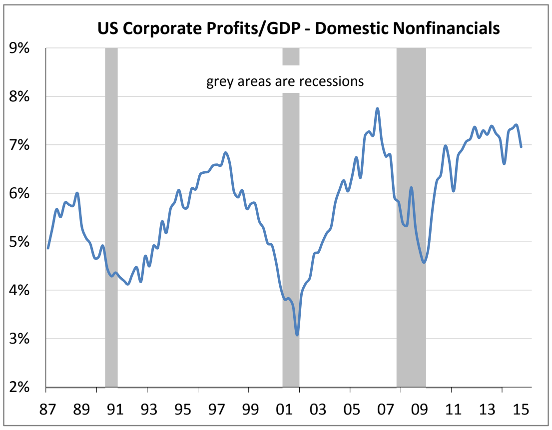


- But will higher rates discourage buyers?

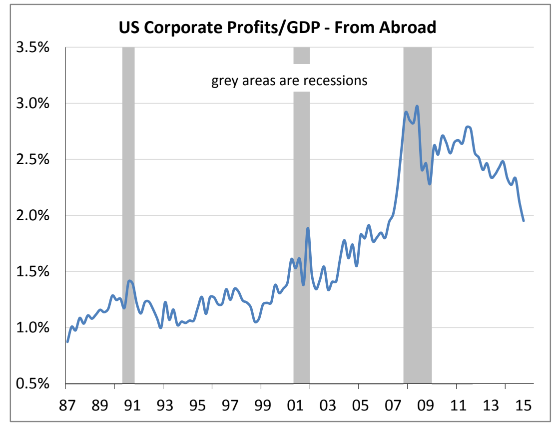
BUSINESS SECTOR

SUMMARY

- In a slow growth recovery, business investment has recovered, but has not gotten ahead of demand growth. Corporate debt issuance has accelerated but remains within reasonable boundaries.

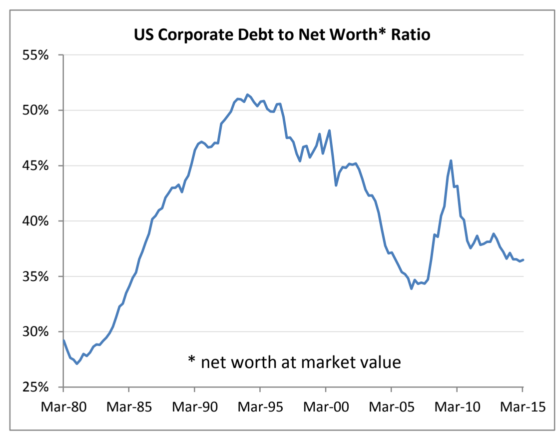


- Domestic profit share remains very high.

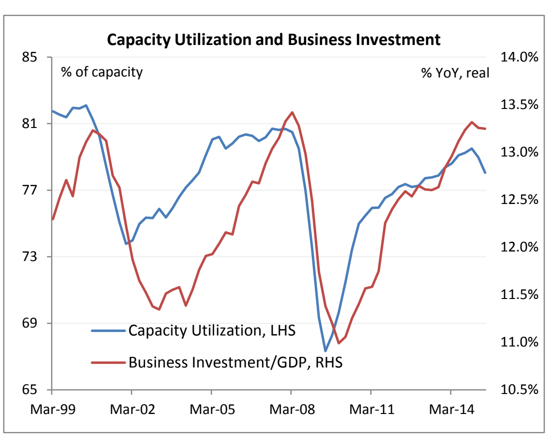


- While foreign earnings drop as $ rises.

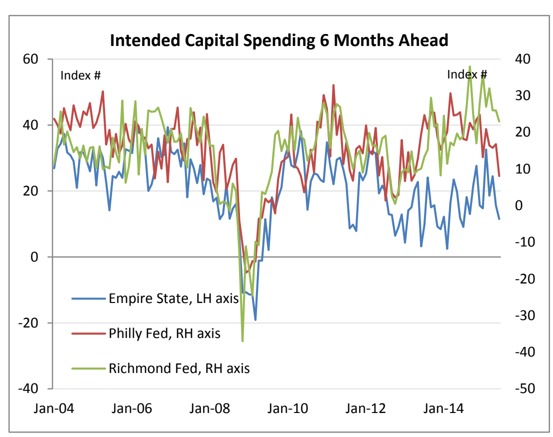
- Corporate leverage has picked up ….



- … but still low vs valuations.



- Capacity use and investment are toppish.

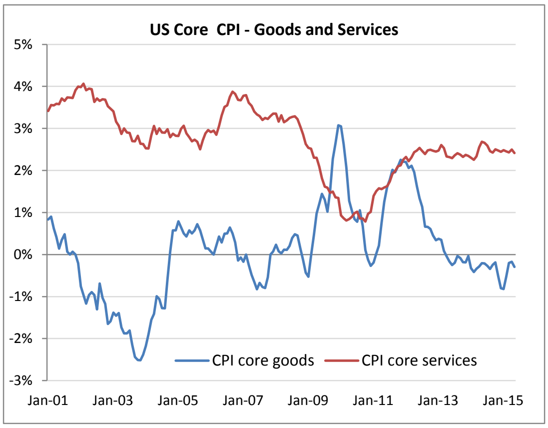


- Capex intentions are moderately strong

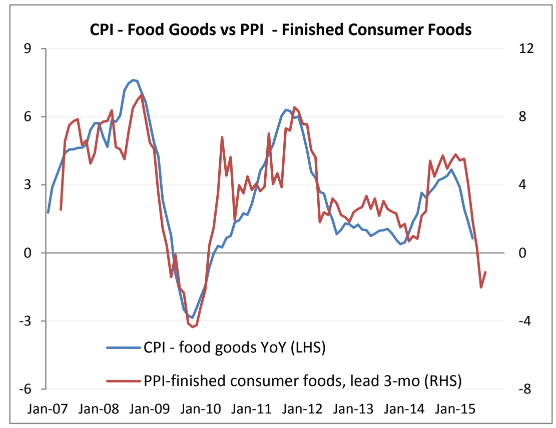
INFLATION AND CREDIT

SUMMARY

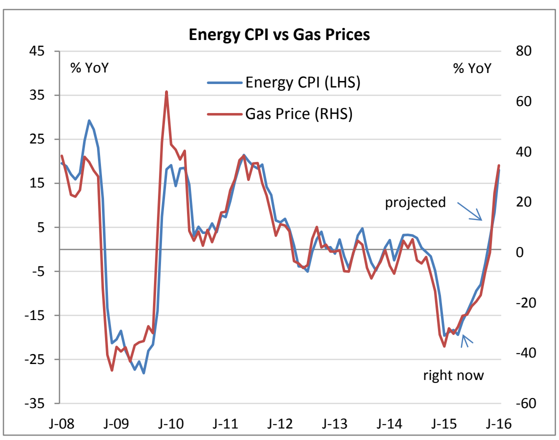
- US CPI inflation was zero during the year to June. Energy, food and currency impacts will be less helpful in the year ahead while tight labor and housing markets might also add to inflation.



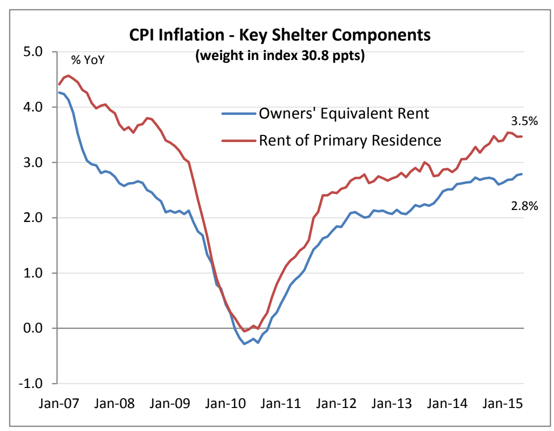
- Steady services, goods held down by $.



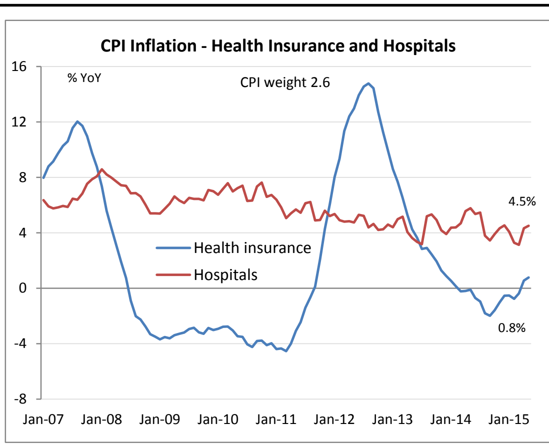
- Food inflation has fallen toward zero.



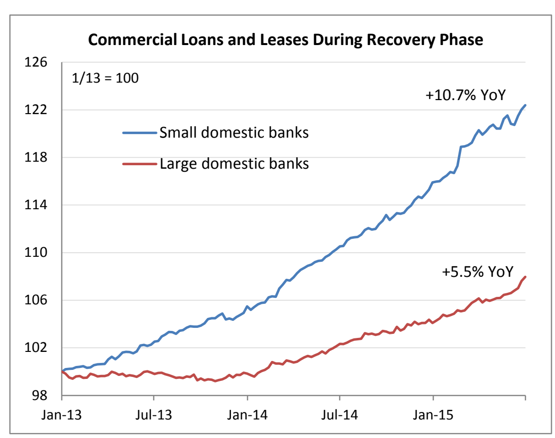
- But energy CPI about to get less negative.



- And housing inflation still rising.



- Health inflation is a wild card.

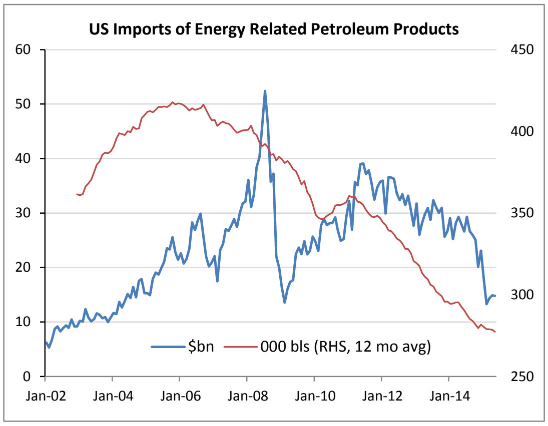


- Credit growth has strengthened.

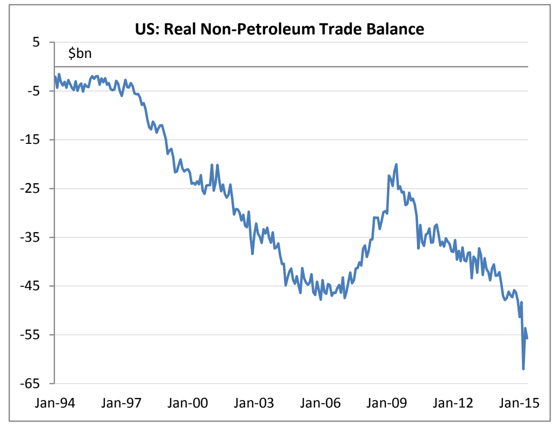
INTERNATIONAL

SUMMARY

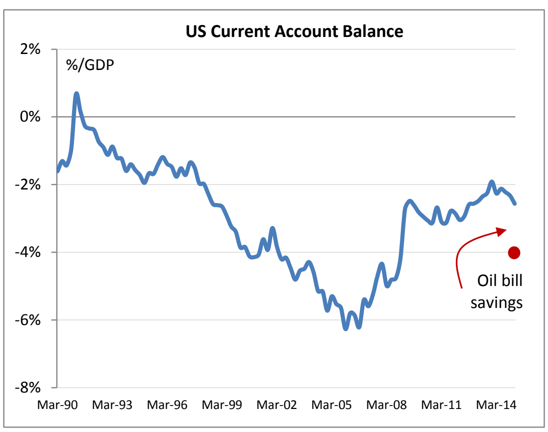
- Despite an aggressive deterioration in the US' non-oil trade balance, the windfall decline in the US' oil import bill has kept the external deficit manageable. QE has supported markets but by less than in 2011, 2013.



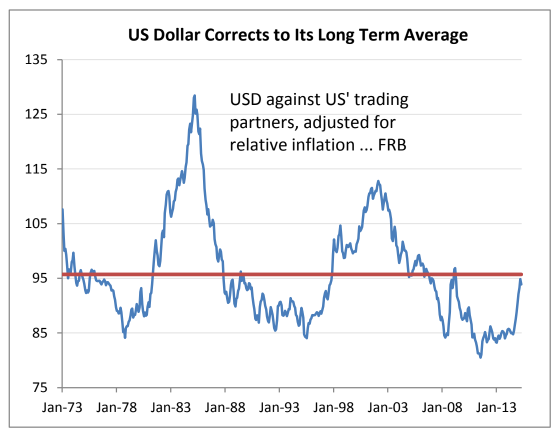
- More Oil independence a boon for trade.



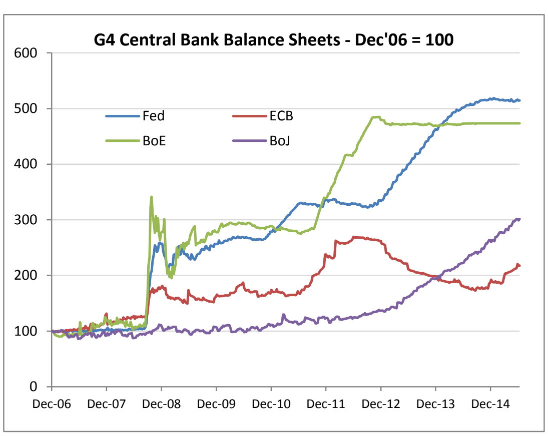
- But offset by wider deficit for non-petrol.



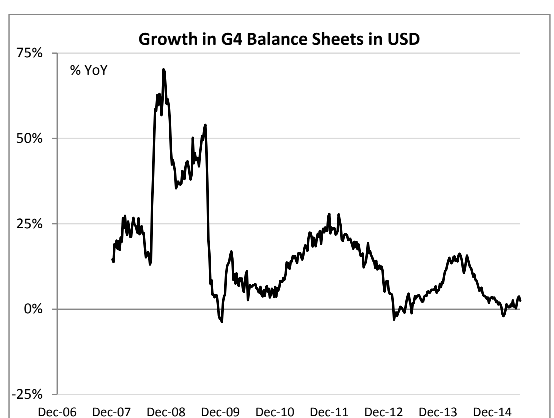
- US' external gap steadies.



- USD adjusts up to its long term average.



- Japan and ECB step up asset purchases



- But USD expansion is lower vs past QE.

RISK TABLE

SUMMARY

- Risks to asset markets originating domestically are low.
- Despite the recent Greek crisis, European economy has some momentum into mid year and Japan appears to be following the central bank's mildly optimistic path.

UNITED STATES		10yr avg	Jan	Feb	Mar	Apr	May	Jun	Trend
Tight labor market causes wage inflation, Fed response									
Wage growth	YoY	2.8	2.0	1.7	1.9	1.9	2.0	1.9	
Underemployment	%	12.5	11.3	11.0	10.9	10.8	10.8	10.5	
Avail. per opening	Ratio	4.76	3.09	2.96	2.93	2.78	2.75	*2.68*	
Overreaching US economic sectors									
Savings ratio	%	4.8	5.5	5.7	5.1	5.4	5.1		
Loans and Leases	YoY	5.1	8.2	8.2	8.2	8.0	7.8	7.8	
Federal deficit	$,12m	-746	-495	-494	-510	-460	-412		
US profit squeeze									
Wage bill	YoY	3.6	5.2	5.2	4.3	4.5	4.1	3.9	
Quits	Rate	1.8	2.0	1.9	2.0	1.9	1.9		
PPI	YoY	2.9	-3.0	-3.4	-3.2	-4.4	-3.0		
US slows to 'stall speed'									
Leading index - 6m	saar	0.4	4.8	4.3	3.9	4.0	4.4		
Chicago Fed NAI	3-mo	-0.35	0.2	-0.18	-0.24	-0.20	-0.16		
Durables orders	YoY	3.2	-1.2	-4.1	-3.7	-2.1	-3.6		
GLOBAL									
Sharp global slowdown									
DM PMI	Lvl	n.a.	53.5	54.6	55.9	55.1	54.4	54.1	
EM PMI	Lvl	n.a.	51.3	51.8	51.5	51.2	50.6	49.6	
Difference	Lvl	n.a.	2.2	2.8	4.4	3.9	3.8	4.5	
Chinese credit event									
China PPI	YoY	1.4	-4.3	-4.8	-4.6	-4.6	-4.6	-4.8	
TSF growth	YoY	19.8	13.7	14.0	12.9	12.4	12.2		
Res floor space sold	YoY	14.8	--	-11.7	-7.6	-3.7	7.8		
Exports	YoY	15.6	-3.2	48.3	-15.0	-6.4	-2.5	2.8	
Abenomics 'fail'									
Core-core CPI	YoY	-0.4	1.7	1.7	1.7	0.0	0.1	0.2	
Real earnings	YoY	-0.7	-2.3	-2.3	-2.7	-0.1	-0.1		
Real exports	YoY	0.4	11.1	-2.1	3.2	1.8	-3.7		
European deflation									
PMI	Lvl	n.a.	52.6	53.3	54.0	53.9	53.6	54.2	
Core CPI	YoY	1.3	0.6	0.7	0.6	0.6	0.9	0.8	
M3 money growth	YoY	4.7	5.3	5.4	6.1	6.7	6.3		