04/03/2011

Quarter in Review

The Markets

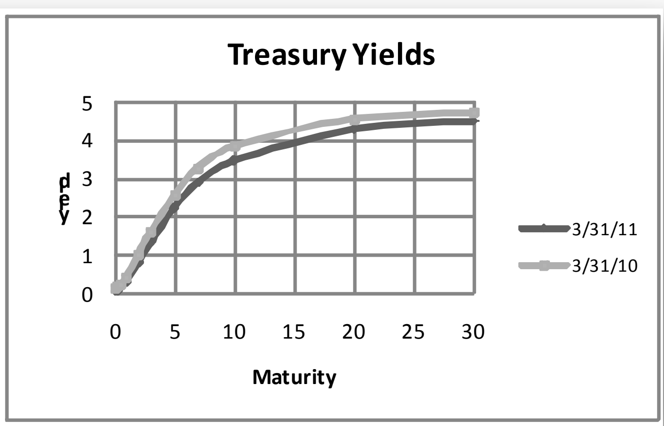
The first quarter of 2011 was not without major headlines around the world. From the earthquake and tsunami devastation in Japan, to major political changes in the Middle East, Congressional budget extensions, and sovereign downgrades in Europe, market participants had reason enough to be jittery. But for the most part the U.S. markets took it in stride, and the economy continued on its slow road back.

Stocks did well in the first quarter of 2011, especially those in the mid and small capitalization range, returning almost 8.00% in most indexes. Large cap stocks didn't do poorly either returning around 6.00%. Bonds on the other hand, couldn't keep up, with interest rates rising throughout the curve an average of 22 basis points since December. High Yield bonds though, with a beta more similar to stocks than bonds, returned close 4.00% for quarter. In the alternatives category both REITs and Commodities did very well, although REITS did suffer in March as new and existing homes sales fell dramatically (see the section below on housing).

Interest Rates

The Federal Reserve has been vigilant in trying to keep interest rates down, in an effort to keep our economy on a growth track, adding jobs, and helping the housing market recover. For the most part it has worked with interest rates still below where they were a year earlier.

Years	3/31/11	3/31/10	Difference
0.08	0.05	0.15	-0.1
0.24	0.09	0.16	-0.07
0.5	0.17	0.24	-0.07
1	0.3	0.41	-0.11
2	0.8	1.02	-0.22
3	1.29	1.6	-0.31
5	2.24	2.55	-0.31
7	2.9	3.28	-0.38
10	3.47	3.84	-0.37
20	4.29	4.55	-0.26
30	4.51	4.72	-0.21



Interest Rates (continued)

But interest rates have begun to rise since December of last year. To combat this the Fed intends to purchase another $600 million in long dated treasuries by the end of the Q2 2011. Mortgage rates are right where they were at the end of 2010, with 30 year Fixed rates near 4.86%, 15 year FRM near 4.09%, and 5/1 Adjustable rates near 3.70%.

Leading Economic Indicators

The economy continued its expansion in the first quarter of 2011. The Conference Board's leading indicators have been on a **positive trend** since July of 2010. The leading indicators are 10 economic series that have in the past provided insight into whether the economy is heading toward an expansion or a contraction. The leading indicators didn't do a great of a job of predicting this past recession and the Conference Board had a two part report talking about how why. M2 may no longer be that strong of measure, but they haven't found a better replacement. The leading indicator diffusion index can often help paint a better picture coupled with the Leading Economic Indicator number. The diffusion index measures which of the ten indicators where increasing in the previous month. Therefore if 8 out of the 10 indicators were increasing (like they were in February) then the index would be 0.8. The diffusion index has had an average of .76 since the end of the recession.

Jobs

At the time of this write up **nonfarm payroll** posted another increase of **216,000**, or 478,000 jobs gained in the first quarter of 2011. We still have a long way to make up for the over 7 million jobs lost during the recession, but positive jobs gains for the last two quarters is a good sign for the economy. **Temporary** or **part time job services** are still **positive** and holding a 12% increase year over year. Temporary jobs declines are one of the tell tale signs that the economy is cooling and could be moving into a contraction. The **4-week moving average** of unemployment claims has seemed to cross **below the 400,000** market for both February and March, another **positive** on the employment front. Lastly both the Bureau of Labor Statistics (BLS) and the Institute of Supply Management (ISM) showed positive gains in employment in the manufacturing sector of the economy for the quarter.

Production

Industrial production has continued to post quarter after quarter positive increases since September of 2009. Orders for durable goods for the quarter and year over year ending February have both been positive. This means that demand for capital intensive items have increased. Also, as stated above, manufacturers continue to hire feeling better about their future prospects. The Institute of Supply Management's March 2011 Report on Business showed manufacturers are reporting increases in new orders while inventory levels are declining.

The ISM uses diffusion indexes on a scale of 1-100 to present the results from their survey from over 300 purchasing and supply executives. Values greater than 50 indicate an increase in the area in question like new orders, prices, or inventory. The **difference** between the new orders and inventory index is often used as a proxy for GDP (orders growing faster than inventory levels). Since 1948 the average difference has been **8.8**, and for the past three months it has been in a range from **15.4 to 19.2**, another good sign for the economy.

Housing

The housing market continued to struggle this past quarter with the change in single family **new home sales** still **negative** year over year as of February 2011. It has been negative year over year since 2006. **Existing home sales**, as reported by National Association of Realtors, fell as well, **down 9.6%** on a seasonally adjusted basis to an annual rate of 4.88mm houses sold per year in February compared to January.

On the building side, permits for new homes continued on its negative year over year trend, **down over 17%** from February 2010. The 50 year average for permits is around **1.4mm** per year, the average since the National Bureau of Economic Research (NBER) said the economic contraction ended, June 2009, has only been around **600 permits** per year. In fact all stages of home building, from permits, to house starts, to under construction and completed have remained significantly muted since the end of the contraction. This means that all other parts of the economy tied to housing production are struggling as well. The ISM survey quoted a respondent from the fabricated metal products sector stating "The building side of our business is mired with little hope of a rebound anytime soon."

Overall housing is still a major drag on our economy, despite record affordability levels; there are simply not enough buyers for the inventory, at current credit conditions. Home price appreciation should remain flat for the foreseeable future. Flat housing prices will also contribute to the frictional unemployment portion of the unemployment rate, as underwater homeowners can't move to find jobs in other areas of the country.

The Consumer

Consumer confidence took a big hit this past month. As gas and food prices have ticked up considerably in March we have seen both the Conference Board's and the University of Michigan confidence index **drop substantially.** (63.4 from 72 and 67.5 from 77.5 respectively). The expectations indexes from both of these providers have also dropped significantly, with few respondents thinking they would see an increase in salary in 2011.

Personal Income, Disposable Income and Personal Consumption Expenditures however have been on a **steady rise for over a year now**. With **savings rates around 6**% as reported by the Bureau of Economic Analysis (BEA), consumers are using the above increases to pay down debt, with total **consumer credit down 1.43%** year over year in February 2011 (mostly in revolving debt, e.g. credit cards). However with increases in disposable income consumers have also been purchasing larger ticket items. **Durable goods expenditures are up almost 12%** year over year as of February 2011. This is supported by the evidence in the above production paragraph on durable goods orders.

Overall the consumer looks to be in a much better shape than a year ago. Income is increasing, jobs are trickling back in, debt is being paid down, and although confidence took a hit from fuel and food prices this past month, increases to durable goods purchases mean the consumer feels better about their current and future financial position.

Inflation

There are many measures of inflation, from the difference between real and nominal GDP (GDP Deflator), to the Price Index for Personal Consumption Expenditures (PCE), to the Producer Price Index (PPI) and finally the Consumer Price Index (CPI). Each of these measures has shown inflation in 2010 to be quite subdued, under 2% on an annualized basis. There are signs that this could be reversing as seen in the first quarter of 2011. Industrial production, although positive and expanding will probably not expand at a rate faster than the quarters inflation increases as measured by CPI. January and February have already posted month over month **CPI increases of 0.40 and 0.55%.** Producers of goods are also feeling inflation, with **PPI up 0.76 and 1.62%** month over month in January and February, while the **ISM Price index stands at 85** (50 year average around 63). At some point producers' margins will not be able to take any more contraction and the consumer will feel more inflation.

In Closing

We are now 21 months into an economic expansion, with the average expansion being 42 months for the past 33 cycles. Employment has and will take longer to recover, housing will remain a drag on GDP, but production and consumption levels are up and increasing. Inflationary pressures are rearing their heads, but none of the measures the NBER looks at in judging when an expansion could end have shown a consistent negative trend. My view is the likelihood for the expansion to continue is very high, and if industrial production and personal income less transfers post positive values for March, the case for a continued expansion is stronger.