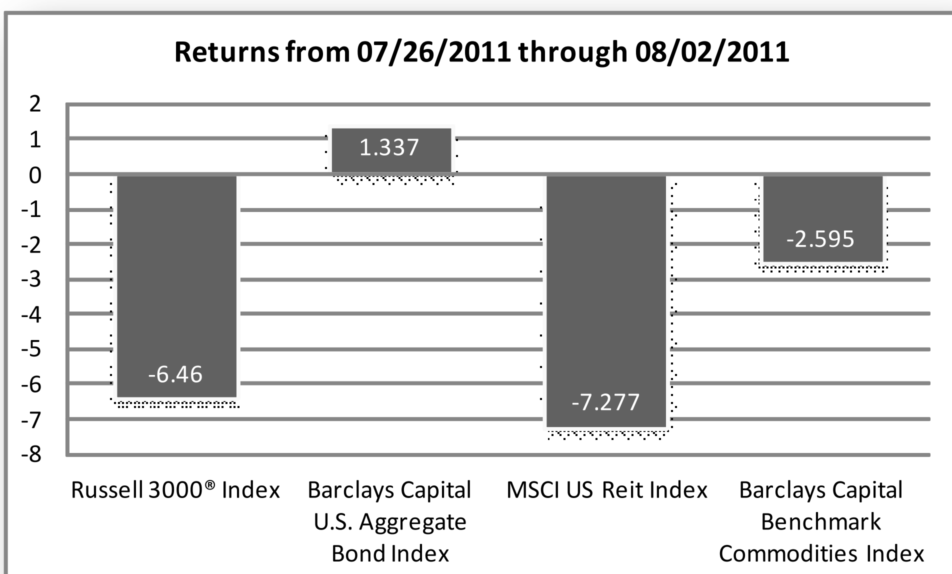
10/10/2011

Quarter in Review

The Markets

The third quarter of 2011 was worse than the second, with the biggest pressure on markets coming from the U.S debt ceiling debate and Europe's continuing struggle to find a solution to Greek and other sovereign debt issues. The U.S. economy continued its expansion, albeit at a very subdued pace, but most economic data wasn't showing major warning signs of an impending contraction. Unemployment is still a major drag with an increase less than 1% YTD for non-farm payrolls. Inflation continued its march forward with annualized CPI getting closer to 4%.

On July 26th 2011 I wrote my clients and expressed my concerns of the possible downside risk of congress not raising the debt ceiling, and recommended a 100% allocation to cash until congress acted. Fortunately congress did act, but the securities markets still took a beating. On August 2nd, 2011 I wrote again after congress raised the debt ceiling and told my clients to reinvest back in their pre-debt ceiling debate allocation. See below for performance of different sectors during that time period.



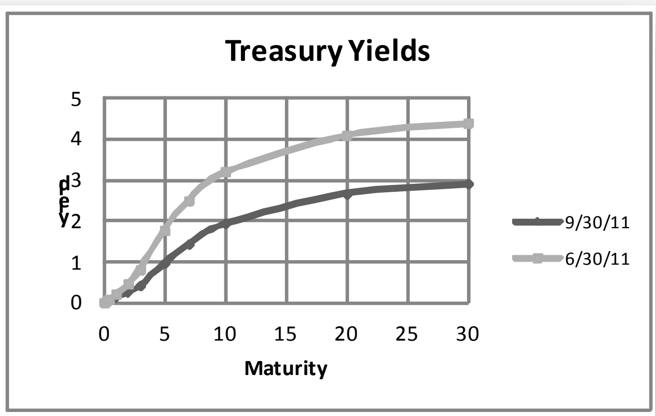
The Markets (continued)

Most portfolios benefited from being out of the market during this time but security returns for Q3 2011 were still abysmal. Portfolio allocations to bonds may have been able to reduce some of the pain, but **U.S., Developed and Emerging market stocks were DOWN anywhere from 14% to 23% during the quarter**. Again **Bonds performed much better with most sectors positive.** Being long the curve (investing in longer maturity instruments) made a world of difference though, and I continue to allocate a portion of the portfolios in this bucket. **The Barclays Capital Long Government/Corporate index was up close to 16% for the quarter.** Whereas the short end of the curve, BarCap 1-5 year Gov/Corp was only up around 1%. **High Yield bonds**, which have some equity characteristics, were **down close to 7%** for Q3. Inflation continued to pick up pace in the third quarter but the Commodities and Real Estate sectors performed worse than Q2, down 15% and 11% respectively (compared to -6.5% and +3.59% in Q2).

Interest Rates

With the fed struggling to decrease the unemployment rate, a different program was put in place to hold the long end of the curve down. They are fully aware of the structural problems in the unemployment rate that the housing market has caused. In an attempt to help hold mortgage rates down the Fed has begun its “Twist” program by selling its short dated paper and buying longer dated paper. Since the majority of the flattening occurred prior to the Fed’s announcement either the Fed has really poor information controls or they feel that the long end still needs more pressure.

Years	9/30/11	6/30/11	Difference
0.08	0.02	0.01	0.01
0.24	0.02	0.03	-0.01
0.5	0.06	0.1	-0.04
1	0.13	0.19	-0.06
2	0.25	0.45	-0.2
3	0.42	0.81	-0.39
5	0.96	1.76	-0.8
7	1.43	2.5	-1.07
10	1.92	3.18	-1.26
20	2.66	4.09	-1.43
30	2.9	4.38	-1.48



Interest rates fell an average of 139 bps (compared to 20bps in Q2) in the 10 to 30 year part of the curve in Q3. **Mortgage rates did continue to drop over the quarter**, with 30 year fixed rates down to 4.22% from 4.51% , 15 year FRM near 3.44% from 3.69%, and 5/1 Adjustable rates at 3.07% compared to 3.22%. The problem I believe is that regardless of how low interest rates are, borrowing standards are very tight (as they should be in my opinion) and that those households that could refinance already have, and those households that can't refinance or sell their home to move to a new job, haven't.

Leading Economic Indicators

The Conference Board's leading indicators renewed a positive trend for May through August. The six month diffusion index though is still bouncing around showing some months with only 4 of the 10 series trending upward. My main concern for the August positive number is that the majority of the boost came from M2 (money supply), which the Conference Board itself has said is a weaker indicator of the economy than it has been in prior years. Couple that with the diffusion index again at 4 out of 10, and this isn't a strong sign for the economy. The OECD business cycle clock still shows industrial production in the expansion quadrant as of August, but trending toward a downturn. Overall the leading indicators don't feel too strong.

Jobs

At the time of this write-up **nonfarm payroll** posted an increase of **103k for September**, and only **287k jobs gained** in the **third quarter of 2011**. This compares to **497k jobs gained in Q1 and 290k for Q2**. Using the last 12 months jobs gains rate, it will take us another 4.5 years before we are at the same pre-crisis level. The FOMC has continued to try other measures to keep interest rates accommodative, saying in early August that they would keep rates low till 2013 (spawning much critique from the investment community) and also their "Twist" program in late September. All in an attempt to help assure firms of lower interest rates and thus incentivizing them to hire. **Temporary** or **part time job services** were **positive in Q3** and the year-over-year increase has held around 8.5%. The **4-week moving average** of unemployment claims has declined slightly from Q2 but is still above the **400,000** level for the entire quarter, another **negative** on the employment front. Lastly the Institute of Supply Management (ISM) employment index continued to have a level above 50, and the trend has been positive for the past 24 months. Overall the data is not great, not terrible either, but it will take a long time to work down our unemployment rate. Is there a new natural rate of unemployment the Fed should be looking at?

Production

Industrial production posted its first negative quarter (Q2) since the end of the contraction in June of 2009. It was a very small negative at -0.06% but negative nonetheless. Q3 has been a different story, with **July and August both posting positive numbers month over month**. It would take an IP report of over negative 1% in September to have a second negative quarter in a row. This is highly unlikely as we haven't seen a negative number like that since the height of the last contraction.

Orders for durable goods are very volatile month to month, but have continued to show positive trends in 3-month and YOY ratios, with YOY changes in non-defense and non-transportation orders still 8.5% above last year's numbers.

The ISM diffusion indexes can be used as a proxy for GDP by calculating the **difference** between the new orders and inventory index (orders growing faster than inventory levels). Since 1948 the average difference has been **8.8**, Q1 2011 average was 16.8, Q2 average was 2.6, and **Q3 2011 average was NEGATIVE 1.7.** This is another area for concern given how close PMI and ISM non manufacturing are to 50. The **ISM non-manufacturing** index dropped a very tiny amount in September, but the underlying components paint a different picture for the economy. **Gains in business activity and new orders** offset a large decline in employment and supply deliveries. From an employment view this is negative, but from an output view this is very good.

Housing

The housing market might be one of the few bright spot in this quarterly update. **Year-over-year** changes in **new single family sales** have been **positive for July and August, up 8% and 6% respectively**. But this is off of a really low base, and the annual number is still around 300k or half of the long run average of new home sales. Price data from S&P/Case-Shiller has been positive over the past four months as of the Sept. 27th report. **Existing home sales**, as reported by National Association of Realtors, also rose for the months of July and August up **17% and 21% year-over-year,** on a seasonally adjusted basis to an annual rate of 5.03mm houses sold per year, and improvement over Q2.

On the building side, permits for new home construction were **up 8.7%%** in August 2011 (from August 2010). At 625k annual rate this still pales in comparison with the 50-year average around **1.4mm** per year. But it has risen above the 600k average since the contraction ended in June 2009. I agree with the S&P/Case-Shiller report in that four months of positive numbers don't necessarily mean a "sustained recovery," and caution should be taken in getting too excited about the above numbers.

The Consumer

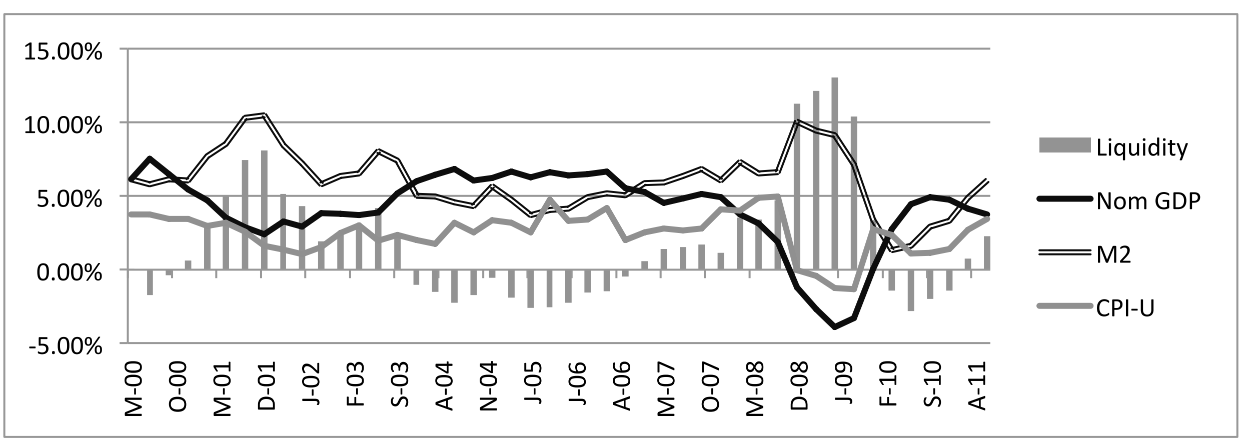
Consumer confidence was down from Q2 to Q3 in both the Confidence Board and University of Michigan surveys. From 57.6 to 45.4 for the Confidence Board, and 71.5 to 59.4 for University of Michigan. Readings below 80 for these two indexes are not a great sign for the economy. However they have lagged recoveries before, for example the University of Michigan sentiment index lagged the 1991 recovery. This was partially attributed to the effects from the job market at the time, which is a lagging indicator. No wonder the consumer isn't feeling great; the median duration of unemployment has been over 20 months since the end of the contraction.

Personal Income and Disposable Income **declined** in the month of August. Real personal income less transfers (which removes income for which no current services are performed, like social security, Medicare, and unemployment) **also declined in** both July and August. **Savings rates** have continued to fall, now **4.5%** of income. **Total consumer credit continued to expand**, year-over-year in August (but actually contracted from July to August). **Revolving credit** (credit cards and other consumer loans) contracted in both July and August and **Non-revolving credit**, auto loans for example, had its first contraction in August since June 2010. Large increases in durable goods orders in July saw small offsets in August.

Overall the consumer looks better than this time last year and seems to feel more comfortable buying larger ticket durable goods, but income is starting to flatten out, the employment situation doesn't look like it is improving much and inflation is eating into purchasing power.

Inflation

The FOMC's September 21st statement said that "Inflation appears to have moderated since earlier in the year…" I look at the CPI-U, PCE Price Index, and the GDP Deflator, which all have different ways to calculate inflation but all are pointing to a pickup. As of June 2011, their year-over-year rates were 3.43%, 2.63%, and 2.59% respectively. **As of August 2011 CPI-U and PCE were 3.76% and 2.86%** (GDP deflator is a quarterly number). These numbers are greater than the Fed's own **target of 1.5-2%,** even if the Fed only was looking at PCE. I believe that they are comfortable because of the amount of **excess liquidity** in the market as measured by the **difference between Nominal GDP growth and money supply growth**. It has actually been negative for all of 2010 and just turned positive in 2011. But now that it is positive we have seen inflation start to pick up.



Inflation (continued)

My concern for inflation is that the economic landscape is as bad now for Bernanke and Obama as it was for Volcker and Reagan in the 1980s. Whether Bernanke will have the will to raise interest rates to combat inflation in the face of an unemployment rate that hasn't been below 9% since May 2009 is the question.

In Closing

We are now 27 months into an economic expansion, with the average expansion being 42 months for the past 33 cycles. Interest rates have fallen substantially in the back end, employment gains are very slow, and housing looks like it may be bottoming out a second time. The consumer looks like they are in a better position than they were a year ago, but that may not translate into strong holiday shopping numbers. Already firms have reduced their planned hiring for the shopping season. With income levels starting to level out, increased inflation will eat into the consumer budget. With all that said, I am still not seeing any consistent negative trends in year-over-year numbers for the main economic indicators I follow, and thus no reason to change the current portfolios allocation to a more defensive posture.