01/13/2012

Quarter in Review (Q4 / 2011)

The Markets

The fourth quarter of 2011 (mainly October) reversed what was looking like a dismal year for most sectors. That is except for **The Barclays Capital Long Government/Corporate index** that, as of the end of Q3, was up over 19% for the year, and then finished up 22.5% for 2011. The same economic and political themes continued into Q4, with Europe's sovereign debt concerns and US political stalemates, whipsawing markets from headline to headline. *At the time of this write up, S&P cut the ratings of 9 of the 15 Eurozone countries (17 total) it put on watch in December. One of those countries was France which lost it's triple A rating and is now AA+ rated. Like the US downgrade before, this wasn't that unexpected but it could cause a problem for the European Financial Stability Facility (EFSF) when issuing new debt (ratings partly dependent on underlying country contributors).* With continued breakdown in talks between Greece and the holders of its debt and a stalling European economy, the 4th Quarter was a tough one for International Equity. Despite a very good recovery in October (9.65%) the **international develop markets** couldn't dig out of the hole and **finished 2011 down 11.75%**. **Emerging markets** was the only sector that was worse, **down over 18% for 2011.**

In the US there were significant revisions to industrial production figures in 2nd and 3rd quarters that actually changed economic categorization of those quarters. Instead of a recession and inflation type quarters they were more like inflation and growth type quarters. Regardless, equity returns were still lack luster with **large caps** being the only sector within US equities with positive results. The biggest winners this year were **bonds, both domestic and international**. Returns ranged from **3.13% to 22.50%** for all of the debt sectors TCM allocates client money to.

Lastly the alternative sectors finished positive for the quarter and year. **REITs were up over 8%** for the year and the **broad basket commodities** index up just over **2.5%.**

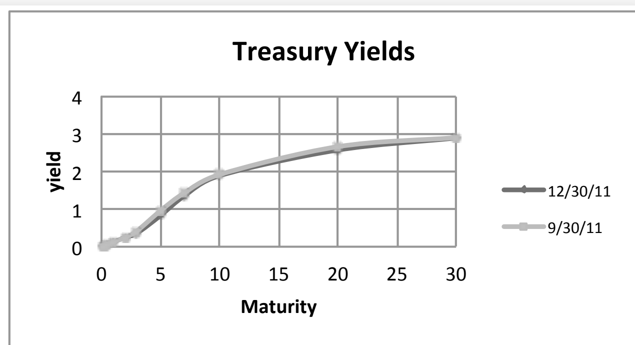
An interesting economic note is that despite the possibility of negative inflation in December (similar to October and November), and therefore also for the quarter, industrial production has been positive and would have to have a drastic decline in December to have it turn negative for the quarter as well. "So what," you say! Well this is a rare occurrence. It has only happened 5% of the time in the last 70 years, and only twice in the last 50 years, that IP was positive for the quarter while inflation was negative. The significance of this

occurrence applies to TCM's allocation process. Most chaotic periods have shown long maturity bonds to outperform other markets. This past quarter we saw equities; high yield and real estate perform the best. Since there are so few periods of economic "chaos," this will affect the allocation but only slightly. TCM continues to update its allocation process as more return data becomes available as time passes.

Interest Rates

The Fed, as part of its maturity extension program, purchased over 75% of all 6-30 year bond issuance since October 2011. The System Open Market Account (SOMA) holdings have increased their holdings in the longer duration buckets. In the 6-8yr to over 40%, in the 8-10yr to 20%, and in the 20-30yr to 20% of the total bonds outstanding. Likewise they substantially reduced their 0.25-3yr bucket to only 10% of the total outstanding. The question is whether their efforts or the problems in Europe were responsible for the almost zero change in rates (see the graph below). Rates had widened out again in October (as equities rallied) and in November, but they came right back in by 20bps in December, adding another 3% in price return for a sector whose duration is over 14.

Years	12/30/11	9/30/11	Difference
0.08	0.01	0.02	-0.01
0.24	0.02	0.02	0
0.5	0.06	0.06	0
1	0.12	0.13	-0.01
2	0.25	0.25	0
3	0.36	0.42	-0.06
5	0.83	0.96	-0.13
7	1.35	1.43	-0.08
10	1.89	1.92	-0.03
20	2.57	2.66	-0.09
30	2.89	2.9	-0.01



The December FOMC minutes concentrated on their communication transparency. As of the first meeting in 2012 the committee will start to give more information about their projections for GDP, unemployment and inflation. They will also provide a discussion of when they will begin tightening, and what factors are driving these forward-looking rate changes. Bernanke has obviously reversed Greenspan's policy of obfuscating the Fed's message to the market. We will see if this reduces volatility over the long run, as the market will have to determine how the individual members messages work into the overall policy.

Leading Economic Indicators

The Conference Board's leading indicators continued its positive trend in October and November. The six-

month diffusion index has again righted the ship with 8 of the 10 series trending upward in October and 7 in December. Unlike the third quarter where M2 was the main cause, increases across most of the components for the November number is good sign. Looking at those components that have already reported for December (Manufacturing Weekly Hours, claims, ISM Supplier Deliveries, stock prices, M2, interest rate spread and Michigan expectations) the LEI for December should be positive again. The OECD business cycle clock still shows industrial production in the expansion quadrant as of November and trending higher. The composite leading indicators from the OECD are in the downturn quadrant but have reversed its trend and coming back toward expansion. Overall the leading indicators are far better than during the third quarter and the increases across components feel better than increases in Q3.

Jobs

At the time of this write-up **nonfarm payroll** posted an increase of **200k for December**, and **412k jobs were gained** in the **fourth quarter of 2011**. This compares to **497k, 290k and 441k jobs gained in Q1, Q2 and Q3 (revised up from 287k) respectively**. Thus the total for 2011 gained was **1.6mm.** We have also taken a bite out of the unemployment rate down to 8.5% for December. San Francisco Fed President Williams still believes that we will remain over 8% for 2012 and be around 7% at the end of 2014. The rough math means that we will only be seeing another 800k jobs gained per year for the next three years if he is correct.

The FOMC measures to keep interest rates accommodative may be partially the reason firms have felt the confidence to start hiring again. Regardless, payroll numbers look statistically significant, and we can only hope they haven't been politicized. **Temporary** or **part time job services** were **positive in Q4 but not by much,** and the year-over-year increase has declined to 6.8% from the mid 8s. The **4-week moving average** of **unemployment claims** has broken through the **400,000** level for what seems to be both November and December. The 400,000 claims level is a benchmark for whether more people are in fact finding jobs and thus discontinuing their "unemployment claims." As the number falls and stays below 400,000 the consensus is that people are finding jobs, and the economy is thus doing better. In fact December's number looks like a large reduction even adjusted for the temporary seasonal hiring. Lastly, the Institute of Supply Management (ISM) employment index continued to have a level above 50, an average of 53 for the prior two quarters. Overall the data is better than Q3 and we seem to be heading in the right direction.

Production

As stated above, Industrial production had large revisions for Q2 and Q3 that were very positive. Because of this, however, the November delta was negative. Now for the first two months of the quarter, IP gained a small amount, 0.44%. Given the fact that manufacturing employment and average weekly hours for manufacturing both posted increases as of the employment report, IP should be positive for December.

Unfortunately this is not always the case, but the quarterly number becomes easier to predict once the first two months of the quarter are in. Therefore, as stated above, unless inflation has a real big turnaround we will see the third Chaos (growth positive, inflation negative) quarter in the past 50 years.

Orders for durable goods continue to show good growth in the fourth quarter. Orders for Non-defense, non-defense excluding aircraft durable goods and even consumer goods and materials are showing growth above last year's numbers.

The ISM diffusion indexes also showed signs of improvement with the **PMI index still above 50**, with the price index and supplier index both below 50. The supplier index below fifty indicates an inability to meet orders on time, or more orders than can be handled, and lower input prices obviously help margins. The **difference** between the new orders and inventory index (used as a proxy for GDP) was back up to **8.2**, near the longer run average of **8.8.** Unlike Q3 this is reinforcing the point for stronger production in the country. The **ISM non-manufacturing** index dropped again in Q4 to 52.6. **The overall trend is positive, given** a number greater than 50, but there are signs of weakness, in employment and inventory.

Housing

I have always been a little suspect of the Existing-Home sales numbers coming out of National Association of Realtors for the obvious incentive issue, but the "Periodic Benchmark revisions," were simply far overdue. Having a downward revision of 1, 2 or even 5% is acceptable but continuing to publish data year over year that should have been 11 to 16% lower boarders on gross negligence! The presentation slides from NAR (*December 21, 2011)* are very revealing and if you hadn't had a chance to look at them, you should. They have stated that the Department of Commerce needs to lower the GDP component of home sales!!!! **Existing home sales are NOT counted in GDP. New homes sales are.** I am not an economist and simply monitor data, but this can't be acceptable to any consumer of this data, especially during the worst housing market the US has seen in a long time. The revised data does show an increase of 4% from October to November, and a YTD increase of 12.2% but I am very disappointed with NAR and may not give this number much, if any, weight to decision making in the future.

Year-over-year changes in **new single-family sales** have been **positive for October and November, up 9% for both months**. Again this is off of a lower base but annual sales are now at 2005 levels. Last quarter I wrote that price data from S&P/Case-Shiller had been positive over the past four months. In the August through September though it resumed its decline and was down another 1.67%. Price data for the last twelve months has been terrible. In fact all of the post recession price gains that the Composite 20 index made up to May 2010 have been reversed and we are down 34% from May 2006 to October 2011 (down 3.4% YTD to Oct).

On the building side, permits for new home construction were **up 16.04%** in November 2011 (from November 2010). Permits look stuck though at a new 600k annual rate that has been in place since the recession ended. And lets hope for the sake of supply it stays there. With shadow inventory still near 1.8mm homes and Homeowner vacancy rates still around 2.4% as of Q3, housing will continue to drag on the economy.

The Consumer

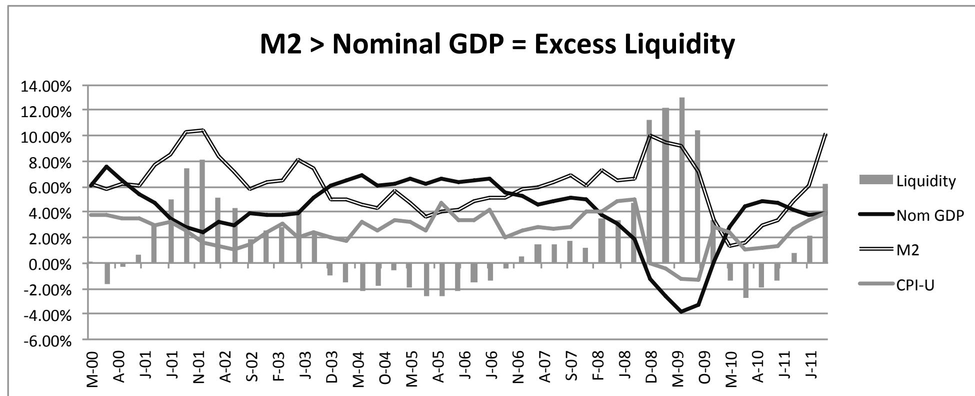
Consumer confidence at both the Confidence Board and University of Michigan made a significant comeback in Q4, from 46.4 to 64.5 and from 59.4 to 69.9 respectively. Although still far off prerecession values, reversing the Q3 trend downward is a good sign.

One of the big concerns for Atlanta Fed President Lockhart is whether the recent increase in consumer spending can be sustained without an increase in income. Personal Income and Disposable Income **both increased for the first two months of the quarter at an average of 3.8% and 2.52% y-o-y**. With inflation flat or negative this was an actual boost for the consumer. **Total consumer credit continued to expand**, for October and November as **Revolving credit** (credit cards and other consumer loans) has finally broken into positive territory year-over-year. **Non-revolving credit** (auto loans) also expanded greatly in November as well.

Overall the consumer looks better than this time last year and seems to feel more comfortable buying larger ticket durable goods; income is increasing, the employment situation looks better than it did in Q3, and inflation has abating for the time being.

Inflation

Looking back at Bernanke's comments about inflation in June of last year he was comfortable in the pick up of inflation spawned by commodity prices because he didn't see it persisting. Throughout the year I was very concerned about inflation because until the fourth quarter we were seeing increases year-over-year up to September. And then the fourth quarter came and prices cooled off and went negative. Mia culpa Ben. A warm start to winter and build-ups of fuel and grain inventories didn't help prices in the commodity sector. Most economists are calling for more of the same in Decembers PPI and CPI numbers. We are still seeing year-over-year increases in prices of 3.41% (CPI) and 2.54%(PCE) in November. Taking a look again at the excess liquidity graph below, we can see the Fed may have achieved part of its mission albeit at a slow pace.



Inflation (continued)

My concern for inflation has been belayed for now as OPEC hasn't changed its output levels and the recent USDA report saw excess stocks push agriculture prices down further. The European embargo of Iranian oil may be pushed off for several months to build up inventories.

In Closing

We are now 30 months into an economic expansion in the US, with the average expansion being 42 months for the past 33 cycles. Interest rates have vacillated a small amount but remained the same relative to Q3. The consumer is in a better position than they were a year ago, but although retailers gave positive reports on holiday shopping, retail sales for December were much softer than anticipated. Income levels have started to increase again, and inflation has now abated, helping the consumer balance sheet. There are still many obstacles to the US recovery, many of which are outside the monetary or fiscal policies we can affect. During an election year we will see whether policies are put in place to benefit our economy or the politicians chance of election… I am not holding my breath.