04/15/2012

Quarter in Review

The Markets

The second quarter of 2012 cooled off considerably from the double-digit gains [in the US equity market] seen in Q1. May was a terrible month with equity indices down over 5% for developed and by over 11% for emerging markets. Markets rebounded a bit in June but **equity markets were still down from 2% to 8%** for the quarter. **Bond indexes saw gains,** and **long bonds saw the most of it as they were up over 7%** while other fixed income indices were up from 60bps to 3% for TIPS for the quarter. World bonds however couldn't recover fully and ended up down 39 bps. Alternatives were mixed with **real estate up close to 4%** but **Commodities were down almost 10%**, thanks to large price declines in the energy markets.

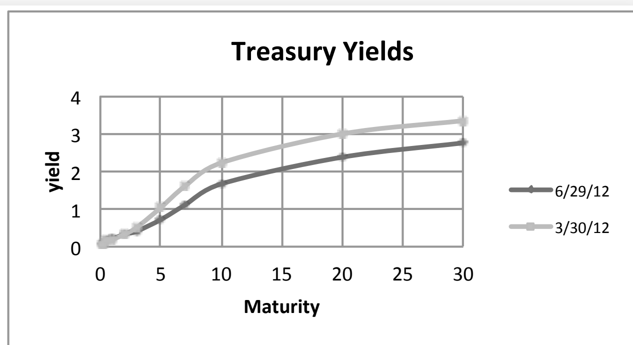
At the beginning of April I wrote about the Greek debt drama and how it seemed to have come to a conclusion, but warned about the smaller anti-austerity parties gaining momentum. As the first Greek election proved, with large wins from SYRIZA (the coalition for the radical left) and large losses from PASOK (the Panhellenic Socialist Movement), the Greek austerity measures had taken their toll on the populous. Even though SYRIZA made large gains, it was unable to form a government and the damage was done. With Alexis Tsipras (leader of SYRIZA) playing a game of chicken with the Troika (EU, ECB and IMF) regarding defaulting on Greek sovereign debt, the market went into a tailspin. The probability of Greece exiting the Euro if SYRIZA gained more seats in parliament and was able to form a government were getting higher. In the end, the New Democracy party was able win the second election and form a government. They have presented a program to sell government assets and reduce state spending, but as of today have won little in concessions on timing, and the Troika inspectors have found Greece's compliance with structural reforms completely inadequate. Therefore Greece still remains in limbo with a possible exit still in the cards. In addition the rest of Europe faces significant headwinds, which Mario Draghi (President of ECB) spoke to in Brussels on the 9th of July. Even though the ECB has a single mandate (price stability), it is playing a much greater role in shifting the political landscape as the crisis unfolds. In early March the EU member states (except for the UK and Czech Republic) signed the Fiscal Compact, requiring countries to have national budgets that are in balance or surplus, with a .01% of GDP fine a year after ratification (01/01/13). 12 member countries need to ratify and 10 have done so to date, with France, Italy and Spain having not voted yet. However this compact (and the European Stability Mechanism, ESM) is now in front of the German Constitutional Court. Their decision on the constitutionality of the law could greatly affect the ability for Germany to play "THE" role in the bailout. Their ruling should come later this month.

In the US the 2nd quarter 2012 saw our economy continuing to expand but the expansion is slowing. The Federal Reserve felt compelled to continue its duration extension program until December despite declining interest rates. The credit ratings for major US money center banks have been downgraded. Leading economic indicators were up, but the trend could reverse as the constituents are pointing to a flat or lower number this month. Jobs and the unemployment rate are simply not good and nothing close to historical recovery numbers. Production will probably be positive again this month, but new orders from the ISM gave the market a real scare. Housing seems to have seen some bright spots but the inventory levels look artificially controlled. The consumer does not like its future prospects, despite increases in disposable income. The new 500-pound Gorilla in the room is the fall elections, coupled with the debt ceiling and Bush tax cuts. All of which don't bode well for a strong recovery.

Interest Rates

The Fed's first maturity extension program finished in June 2012, and even though interest rates have declined, achieving the Fed's original objective, a new extension program has been planned for the remainder of 2012. So in addition to the $400 billion the Fed has already shifted to the back end of the curve, an additional $267 billion is planned for the remaining 6 months of 2012. The stress in the European markets may have played a larger part in the pressure on the curve (see below) but overall rates are still lower. Conforming balance 30-year mortgage rates have been on a decline from 4% to 3.66% since the end of March.

Years	6/29/12	3/30/12	Difference
0.08	0.04	0.05	-0.01
0.24	0.09	0.07	0.02
0.5	0.16	0.15	0.01
1	0.21	0.19	0.02
2	0.33	0.33	0
3	0.41	0.51	-0.1
5	0.72	1.04	-0.32
7	1.11	1.61	-0.5
10	1.67	2.23	-0.56
20	2.38	3	-0.62
30	2.76	3.35	-0.59



The June FOMC minutes were definitely more subdued than the March minutes, with slowing growth, slow employment gains, and deterioration in European sovereigns and banking sectors taking center stage. The minutes laid out the plan to hold the Fed funds rate at a 0-25 bps and continue the extension program till December. Only Lacker dissented stating that he didn't see the need for further stimulus, but wouldn't be opposed if inflation dropped below the target of 2%, but with PCE and CPI at 1.52% and 1.73% annualized as of May, maybe we are

already there. I think the Fed is seriously stuck; they have yet to really cause a dent in unemployment, and as the minutes stated, and I agree, a large portion of this unemployment rate is structural. Cheap money isn't going to retrain our work force for the jobs employers are offering.

Leading Economic Indicators

The Conference Board's leading indicators were mixed for April and May. The pull back in April reversed in May and now stands at 95.8. The six-month diffusion index, which had shown only 5 of the 10 indicators trending up for both March and April, was back up to 7 of the 10 in May. The major contributors to the increase were building permits, new orders, and interest rate spread. **As the month goes on we could see a much different story** as new orders (as stated above) took a huge hit downward, and the majority of the other indices look flat or down. The only silver lining, which was a statistical anomaly, was a large decrease in weekly claims. Other than that I am expecting a lower leading indicator level reported in July.

At the end of last year the Conference board changed their leading indicators. In April the OECD changed its business cycle clock to show GDP instead of the index for industrial production (IIP). Their argument (http://www.oecd.org/dataoecd/35/27/49985449.pdf) states that industrial production for many countries was used as a proxy for GDP because of the value it represented in GDP. Now that those values for most developed countries is at or below 30% they feel it is no longer a viable proxy. The statistical argument, for most countries, is more compelling than the value argument, in that they show that IIP doesn't track the turning points with respect to GDP very well. The problem with replacing IIP with GDP is that GDP is a quarterly reported number. Also the data is presented months after the time period in question and it is frequently restated. When you look at the OECD clock, the latest US GDP data they have is March, and that is not very helpful. Not to mention their latest number for the Composite of Leading Indicators (CLI) is for April. In theory I agree with the study (albeit the US IIP still has a .92 correlation to GDP) but as an investor I need more timely information. Going forward I will just look to the Conference Board's indicators only, and although that isn't perfect at least they are only one month behind.

Jobs

At the time of this write-up **nonfarm payroll** posted an increase of **80k for May 2012 (remember anything less than 100k may not be statistically relevant)**, and **225k jobs gained** in the **second quarter of 2012**. This compares to **677k, 492k, 383k in the last three quarters**. Thus the total gained for the LTM was **1.8mm.** The unemployment rate is holding steady at 8.2% as of June. Median unemployment is back under the 20-month level while the aggregate weekly hours worked index continues its upward trend.

Temporary or **part time job services** were **positive again in Q2,** and the year-over-year increase has moved upward again to above 10% (compared to 8% in Q1). The **4-week moving average** of **unemployment claims** has unfortunately started to creep back up. But as of this write up, it had a large decline because of a smaller than expected auto retooling shutdown effect on the seasonal adjustment. It now stands at **376,500,** lower than June's average but about even with May. Lastly the Institute of Supply Management (ISM) employment index continued to have a level above 50, at 56 with an average near 57 for the quarter. Even though most of the data is positive, the jobs recovery after the 2001 and 2008 recessions are taking much longer than after 1975, 1982 and even 1991. But the trend has not reversed and it is supporting a continued expansion.

Production

Industrial production for June won't be released until after this quarterly review. However the numbers for Q2 show production up close to 1% for the two months ending May. IP is a volatile number and does have a lot of revisions, for example the February number was revised up, but March reversed this number and Q1 ended up about 50bps. With manufacturing employment as well as average weekly hours for that segment up, IP should be flat or positive for June. But the bigger issue is below…

Orders for durable goods, (items whose use last three or more years) are slowing. The year over year number is the lowest growth rate since December 2009. As budget cuts in defense spending have started to take their toll, durable goods orders excluding defense and transportation orders are looked to for signs of consumer spending. Those numbers as well are starting to slow down with year over year growth in the high 6% area down from close to 14% this past December. The biggest shock this month though was from the **ISM diffusion index for new orders.** The number plummeted from **60 to 48. THIS IS A REALLY BAD MONTH OVER MONTH MOVE.** Obviously the number cannot be looked at in isolation, but if a trend starts to develop or if other data starts to trend weaker this could be a problem. The **non-manufacturing index** reported a **52 for June,** a number that has been above 50 for the past 31 months.

Housing

Year-over-year changes in **new single-family sales** have continued their positive trend since January. The twelve-month average is moving up, around 330k, with the most recent print at **369k.** Price data from S&P/Case-Shiller ending April 2012 showed **annual declines of near 2.2%** in both the 10 and 20 city composite, but also showed a **March to April increase of 1.3%**. Looking at the home price graphs for both indices, it looks like a very "controlled burn." I will try to stay away from too many conspiracy theories on inventory levels, and foreclosure pipelines, but my gut tells me that the visible housing supply is not representative. On the building side, permits for new home

construction were **784k in May, up over 25% YOY**. I am generally trying to stay positive about the housing market, but similar to consumer credit I am getting the "here we go again," feeling.

The Consumer

Consumer confidence has gone south in both the Confidence Board index and in the University of Michigan index for Q2. The Michigan Sentiment index is now at the lowest level since last December. I don't think anyone was very surprised by this, as employment and housing seem stuck, new orders are declining, and it looks like the economy is starting to slow down. Couple that with the election this fall, the debt ceiling debate and the expiration of the Bush tax cuts, the consumer's outlook shouldn't be too rosy.

Personal Income and Disposable Income both increased for the first two months of the quarter but at a slower rate than in Q1. Real personal income less transfers (removing social security, unemployment, welfare and disability payments) also increased year over year, but at only 1.89% YOY this level isn't great since it is a lagging indicator. The savings rate was up 20bps in May but at **3.9%** this is still much lower than the past 53 year average of around **7%. Total consumer credit continued to expand**, and again we have to thank Uncle Sam and student loans. The effect is simply inflationary for the price of college and, like the deduction for mortgage interest, it incentivizes the consumer to take on more debt rather than assess the real value of a college degree or the institution providing it. Revolving debt (credit cards) spiked back up this May, increasing over 9% month over month. How did that happen? There weren't any college football games for credit card companies to give away free t-shirts to 18 year olds? Seriously I really hope this is not a trend, but with our government leading the way in spending more than it makes, the example is set.

The consumer may be in a better position today but their future outlook isn't good. The looming election and other fiscal issues, coupled with a very shaky European solution has reduced purchasing, and funds flows in May were concentrated in fixed income and money market funds.

Inflation

With only PPI being reported for June prior to this report going out, CPI-U doesn't look like it will report a positive number for Q2. We would have to see an over 25bps increase to get into positive territory for the quarter. After revisions to M2, Q1 of 2012, and the last two quarters of 2011 show excess liquidity holding steady around 5.8% (that is the amount of M2 growth that exceeds nominal GDP growth). April and May saw energy prices fall more than the February and March increases. As of May gas had fallen 4% from the prior 12 months. Food was up though 2.8% from the prior twelve months and the core number was up 2.3%.

Politics

I don't normally comment on this area but feel that there are three main issues that need to be addressed and watched extremely closely over the next two quarters. The November elections, the debt ceiling and expiration of the Bush tax cuts. Alone these three issues are enough to roil markets, but together, coupled with an ever-present European debt crisis and stalling economies, these three are serious issues that need to be discussed.

Lets start with the November elections, because the latter two are governed by it. This quarter I took a hard look at the probabilities for the upcoming election and I think the following three scenarios are equally likely to occur. **Scenario 1**: President Obama Retains the White House, Democrats Control the Senate, and the Republicans control the House. The scenario means the following; we will have another debt ceiling debate and by my calculations we will hit the ceiling around November of this year, with the Treasury secretary able to extend some payments/delay debt issuance again for another two to three months. In this scenario, the Bush tax cuts likely would expire in some portion, market uncertainty and volatility would pick up, and some percentage drag to GDP would be caused because of the above affects. **Scenario 2**: Mitt Romney is elected President, the Democrats retain Control of the Senate, and the Republicans control the house. The scenario is probably as bad, as a debt ceiling debate will still happen and some form of the Bush tax cuts and payroll tax cut expires. **Scenario 3**: The Republicans control all of congress and executive office. This doesn't necessarily mean a huge upswing in stock prices either, as the debt ceiling will still have to be addressed and some agreement on increased taxes and less spending will have to achieved, but the uncertainty and political log jam that our government is in now, will be replaced with a single party in power. The question is whether tea party candidates will push for greater budget cuts and whether the constituents of more mainstream politicians can stomach it. At this juncture the data points to slim (60bps) lead by Obama in the popular vote, coupled with a 50/50 split for the Senate, and a Republican controlled House. A good piece by Alan Abramowitz (http://www.centerforpolitics.org/crystalball/) shows how to estimate the popular vote. More importantly he states that our country, and this author whole-heartedly agrees, has become increasingly polarized. He factors that into his popular vote model, which if the economist consensus of 2% GDP annualized growth for Q2 is achieved, then President Obama has a slight advantage.

Since I believe that some form of the status quo is more likely to happened than a Republican sweep, the debt ceiling and bush tax cuts are more likely going to be a problem again this fall. Our debt-ceiling limit is currently $16.4 Trillion. As of June 30 we have around $15.8 Trillion in debt, and it is increasing on average around $112 bln per month. This gives us just under 5 months before the Treasury Secretary has to start suspending debt issuance which could buy us another two to three months. Corresponding to the presidential and congressional elections, this doesn't bode well for action taken prior to elections. It wouldn't serve either party's political interests to work together here.

Lastly the payroll and Bush tax cuts are set to expire at the end of this year, including other changes to things like the AMT tax and unemployment benefits. Again neither party has an incentive to work together to reach a compromise on these issues prior to the election, which means it will be virtually impossible, and impractical to expect any major legislation to be written before the election or by a lame duck congress before these cuts are set to expire.

Last July I wrote a special comment to my clients stating that until the debt ceiling was passed I felt that the probability of loss was greater to our portfolios, than was missing the gain if the ceiling was quickly passed. For almost all portfolios managed (other than some that had annual allocation restrictions), the decision was made to sit in cash until the vote. This saved the portfolios close to 300 bps, and although the market deteriorated more after the vote, there wasn't a political or economic reason for remaining un-invested.

My investment process is based on marrying the expectation of a future economic expansion or contraction, with more granular historical observed scenarios, and investing in asset classes that outperformed during those scenarios. I take the process very seriously and only stray from it when market-moving events, that have high probabilities of occurrence and limited underlying variables, present themselves. An example of one is the debt ceiling debate last summer. The Greece and European fiscal crisis is **NOT ONE,** there were simply too many moving parts to justify being un-invested and the trigger for reinvestment wouldn't be clear either. The above political discussion lies somewhere between the two. The probability of political uncertainty remaining after the election is high. The negative effects to the economy have a wide range of possibilities. But coupled with what I see as potentially slowing US and European economies, and political stagnation this fall, I once again feel a need to potentially de-risk. Over the next two months the economic data will be very important in my decision to either once again sit in a safer asset class, or hold the line and stick with the model's recommendations.

In Closing

We are now 36 months into an economic expansion, with the average expansion being 42 months for the past 33 cycles. Equity markets have pulled back since Q1 and have been volatile in the early part of Q3. The Feds first extension program is now complete and the second one is just starting. Economic statistics as a whole haven't turned negative but are definitely slowing down. The political season is upon us and only a full Republican sweep will offer the markets some better clarity. At this time I see a probability of a contraction to be about 14%, and will not change the current allocation to the portfolios. However as the summer goes on I may look to shift to less risky assets in anticipation of market unrest caused by US and European political decisions and a general economic slowdown.