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Firm Inception 08/03/10

**10/15/2012**

## **Quarter in Review**

### **The Markets**

The third quarter of 2012 rebounded nicely, retracing its lost ground from Q2. The US Large and Mid Cap Equity Sectors were up over 6%, while Small Caps were up over 5%. Developed and Emerging Markets also posted over 7% gains, while Fixed Income sectors ranged from up 0.88% for Short Term debt to 4.39% for High Yield. Commodities also recovered all its losses for Q2, but Real Estate was flat for the quarter.

In July I wrote that European Sovereign debt crisis roiled markets and showed a significant weakness in a monetary union without a fiscal union. With Greek politics behind us for the most part the focus turned to the German Constitutional Court, and whether they would ratify the European Stability Mechanism (ESM) as being constitutional. In early September the court ruled that the laws that were challenged did not violate the constitution, but the court imposed a size restriction (27% of ESM) and said the government must approve it. Markets reacted favorably to the outcome, but I am still very worried about the long term political and social affects of the northern Europeans sending money south. There are large issues of sovereignty here that US Citizens don't understand. Early in our country's history there were distinct differences between colonies but there were no major civil wars between them. The earliest settlers to our country had very common threads in religious persecution, non-aristocratic backgrounds, while still having diversity in country of origin. For the most part though the thirteen colonies were British and faced many similar challenges in defending themselves, farming, trading etc. My point here is that as a nation we have had more common than dissimilar ground between our states than the European countries have had in their history. We have had less civil and intra-continental wars, and our common currency and common federal government has existed for multiples of time than that of the Euro and EU. Although some may argue over accents, New Yorkers and Texans speak a common language, and have for several hundred years. I believe because of this commonality the US is still a much more efficient nation politically and economically than the Europe Union is in totality, and this is why I am still fearful of a solution to their sovereign debt, economic and budgetary problems.

The US Economy in Q3 was almost a mirror of Q2 in that it limped along but made no decisive turns up or down. Q2 GDP was revised down to 1.3% on an annualized basis. The Federal Reserve and Chairman Bernanke felt an open ended quantitative easing policy (QE3) was necessary, buying mortgage backed securities in addition to long term treasuries. The initial market rally in mid-September was quickly reversed, with drops of 3% for equity and 5%



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for real estate investment trusts in the latter half of September. As stated last month I felt the Fed's move was compensation for a Congress and White House that once again could be unable to act to resolve the expiring tax cuts and debt ceiling issue early next year. Leading economic indicators have remained the same since Q2 but the diffusion index has fallen back to 40 as of August. Unemployment is stagnant, and despite the decline to 7.8% (which should have a revision next month), we are still barely treading water as gains just offset the net difference of people entering and leaving the workforce. Production suffered a huge setback in August (down 1.16%). Hopefully we see a positive number in September reversing this trend, but with manufacturing employment down and weekly hours flat we could see another negative report. Couple this with sub 50 numbers for June, July and August in the ISM survey, production looks like it is slowing down. (In September we did see a reversal back to 51.5 as orders rebounded, but I am still cautious). Housing continued to be the relative bright spot in the economy with the S&P Case-Shiller indices showing positive gains in July, while new and existing house sales remain steady and permits through completion reports are all up. Consumer sentiment had a large rebound this month, and with incomes rising month over month and year over year they should. Unfortunately once again the savings rate is back under 4% and consumer credit continues to expand. The election uncertainty is now back to where it was a few months ago, as the polls and the electoral college looks more evenly split. The Senate is still looking like a Democratic victory while the House will remain in the hands of the Republicans. As much as business leaders are clamoring to have congress act prior to the expiration of the tax cuts and debt ceiling, I simply believe the probability remains extremely low unless one party gains control of the entire government.

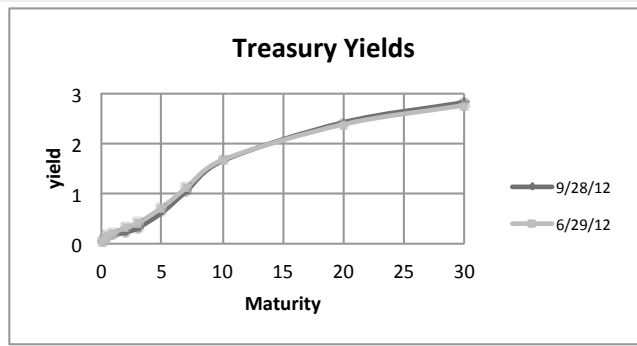
## Interest Rates

Chairman Bernanke and FOMC stated in September that their view of the political uncertainty, a poor housing market, limited credit conditions, and reduced spending in the government sector would limit GDP growth in 2013. Given an 8% unemployment rate, another quantitative easing program (QE3) was announced. The Fed would continue operation twist (QE2), buying long dated while selling short dated Treasuries (\$45 Billion per month till December). But in addition they would also start buying agency mortgage backed securities (\$45 Billion per month but with no end date, sort of). They caveat here was that they would continue to buy based on "monitoring incoming information." If the labor market didn't improve they would continue to buy. Now they didn't set a target for the labor market, but the unemployment rate would be a key indicator. In the past the "natural rate of unemployment," was around 5%, more recently the "new normal," has been argued to be much higher, maybe even 6.7%. Now at what level the Fed stops buying is a mystery and thus actually adds uncertainty to the market instead of reducing it. The other statement the Fed has made is when they would likely foresee raising interest rates, or engaging in a monetary tightening scenario. Most recently Chairman Bernanke stated that the Fed would continue its accommodative policy (keeping rates down) well into an expansionary period in the business cycle, or at least until mid-2015. What was interesting though is that in the FOMC minutes there were some calls for a different way to communicate an end to their accommodative position. Instead of stating dates, some participants



felt providing specific numerical thresholds for key economic data would be more beneficial. But of course they couldn't agree on what the threshold level would be. Interest rates changed little between quarter ends.

Years	9/28/12	6/29/12	Difference
0.08	0.06	0.04	0.02
0.24	0.1	0.09	0.01
0.5	0.14	0.16	-0.02
1	0.17	0.21	-0.04
2	0.23	0.33	-0.1
3	0.31	0.41	-0.1
5	0.62	0.72	-0.1
7	1.04	1.11	-0.07
10	1.65	1.67	-0.02
20	2.42	2.38	0.04
30	2.82	2.76	0.06



## Leading Economic Indicators

The Conference Board's leading indicators from June till August have been stuck in the 95.6 area. The bigger problem was the diffusion index's average is now below 50. In fact in June the number sank all the way to 25, meaning that only a quarter of the indicators showed increasing signs over the last six months. Looking at some of the already release data for September, the indicators look pretty mixed. The one good improvement is that the ISM new order survey, is now above 50 at 52.3. With over half of the data yet to be reported the leading indicators should once again be flat to slightly positive for the month, but things could change.

## Jobs

At the time of this write-up **nonfarm payroll** posted an increase of **114k for May 2012**, and **437k jobs gained** in the **second quarter of 2012**. The total gained for the last twelve months was **1.8mm (the same as Q2)**. The unemployment rate is now at 7.8% as of June. Median unemployment fell again from 19.8 months in June to 18.5 months in September. The aggregate weekly hours worked index continues its upward trend from 96.1 to 96.4. All in all not a bad employment report but nothing great.

So lets shift the focus quickly to the 783k jobs gained in the Household Survey this past month. A sharply greater number than the non-farm survey, and the survey where our unemployment rate is calculated from. Putting aside the conspiracy theory rhetoric (if there is anyway the POTUS can affect this number we have much greater issues) we should really start to question the validity of the Household Survey. Especially when such an important "headline" number can alter or sway the decision making of people. Putting the household survey in context for a



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second, it is survey that is comprised of approximately 60,000 eligible households in the sample (<http://www.bls.gov/news.release/empsit.tn.htm>). Each person 16 years or older are asked if they are employed, unemployed or not in the labor force. With all statistical samples there exists sample error (The possibility that the sample is not representative of the population). A “confidence” interval is given with the reported number, to give the reader the ability to judge how good the sample statistic is, the smaller the range the better the statistic. For the non-farm payroll number it is about 100,000 jobs for a 90 percent confidence interval. Meaning that there is a 90% chance the true number (or number of the entire population) lies within the range of the reported number plus or minus 100,000 jobs. Looking at last month that means that the number could have actually been anywhere from 14,000 to 214,000 jobs gained. The **Household survey at a 90% confidence** interval is much **larger at 280,000 jobs**. From pure statistical observation this means that the true value is somewhere in a range of 560,000 jobs around the reported number, over double that of non-farm payroll.

Secondly if we look back in time since the surveys started 1948, or 776 months, we can create a distribution of the monthly increases and decreases over than time period. When you do this you can see that of the 776 observations **only 12 times in history has the rate exceed 750,000 or 1.5% of the total observations**. What is even more interesting is that 2 of those 12 times have occurred in 2012. So when an increase of 873,000 jobs is reported the month before an election, and the unemployment rate calculated from it is below the rate when the POTUS entered office, people scratch their heads. Funnig thing is no one said anything when the number was a 847,000 gain in January of this year.

Again I have no interest, and neither should anyone in the finance or business community, in discrediting the agencies that provide these statistics. Proving foul play could be catastrophic for our ability to borrow and fund our national debt. But I do think it is time to take a serious look at this statistic and whether a better one should be developed or found.

**Temporary or part time job services increased from Q2 to Q3, but fell between August and September.** The year-over-year increase has fallen back again to 8.22%. The **4-week moving average of unemployment claims** hasn't moved that much; **375,500** from **376,500 in Q2**. Lastly the Institute of Supply Management (ISM) employment index continued to have a level above 50, with an average near 53 for the quarter (falling from last quarter).

I am still not convinced that our employment situation is positive. We continue to see frictional and structural unemployment, as 3.6 million job openings were reported in the Bureau of Labor Statistics job openings and labor turnover survey in early October. The biggest problem though as recently reported in a Boston Consulting Group survey, is not that there is such a large skill gap preventing people from getting hired, but a reluctance of firms to hire in the current period. I feel that firms will hire when they feel firm economic and regulatory footing underneath them, and not until then.



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## Production

Industrial production for September won't be released until after this quarterly review. However the numbers for Q3 show production down over 0.6% for the two months ending August. **The bigger problem was that IP was down 1.16% in August.** Now there have been large negative numbers in history followed by a large upswing, but with ISM orders down for the last 3 out of 4 months, I am a little concerned. Interestingly equities still performed well for a quarter that could be designated recessionary.

**Orders for durable goods**, (items whose use last three or more years) had a **terrible August, down 13.24% month over month**, the highest month over month decline since January 2009, six months from the end of the recession. The 3-month average and year over year numbers are now in negative territory. The **ISM diffusion index for new orders** continued its lower trend in both July and August at 48 and 47.1 respectively. Luckily the index moved back up above 50 in September but I am still concerned given the slow down in manufacturing hiring. The **non-manufacturing index** reported a **55 for September**, which is a positive sign for service industry hiring.

Production has slowed both in the US and throughout the other developed countries in the world.

## 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 348k annual sales, with the most recent print at **373k**. Price data from S&P/Case-Shiller Home Price Indices ending July 2012 showed **annual INCREASES (yes I wrote that correctly) of 1.5%** in both the 10 and 20 city composite. On the building side, permits for new home construction were **803k in August, still over 25% YOY gain**. My fears last quarter seem to be short lived, and the housing sector looks to be slowly recovering.

## The Consumer

Consumer confidence has rebounded considerably from Q2. The Michigan Sentiment index is now at 83.1, a dramatic increase from the August 78.3 report. With housing looking like it found a bottom, employment creeping but positive, personal income increasing slowly, and consumer credit expanding, maybe people feel better about their personal balance sheets than they did in Q2. I still don't think though that anyone has fully calculated the ramifications of the fiscal cliff and the debt ceiling debate in the next few months. As the effects haven't been felt



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yet, people's views remain positive, but when tax increases, and higher medical costs are felt the sentiment should reverse the positive course.

**Personal Income and Disposable Income both increased** for July and August. Real personal income less transfers (removing social security, unemployment, welfare and disability payments) also increased year over year. The only negative trend has been the savings rate, which when trying to get the economy going is a good thing, but at 3.7% I feel we are not saving enough and instead starting to borrow more. To argue this point **Total consumer credit continued to expand**, at a rate of 5.54% year over year. Revolving debt increase almost one percent in August while **non-revolving debt expanded at 7.81% year over year**.

The consumer feels better and with recent increases in core retail sales, they seem to be spending, probably helping the real GDP growth rate for Q3.

## Inflation

With only **PPI** being reported for **September (up 1.12%)** prior to this report going out, CPI-U looks like it will report a positive number for Q3. Inflation has been subdued lately although PPI has reported over 1% increases month over month for August and September. CPI may follow PPIs direction but not necessarily its magnitude, however gasoline has seen a recent increase. The Federal Reserve has stated unequivocally that they will continue to provide easy money to help the employment situation, and with the PCE Price Index (the inflation measure they use) increasing 1.49% year over year, they must feel there aren't any signs of inflation heating up.

## In Closing

We are now 39 months into an economic expansion, with the average expansion being 42 months for the past 33 cycles. Equity markets have regained their strength heading into the election but seem to be cautious in the early part of October. The Federal Reserve program QE1 is complete, QE2 will continue till December and QE3 has just begun. IP was negative last month, and another negative print coupled with an employment revision next month and low durable goods orders, point to a continued slow down. It isn't enough to increase my probability of a contraction greater than 15%, however for all of my clients I have placed their portfolios into a much more defensive position until the political uncertainty, fiscal cliff and debt ceiling, and European Sovereign debt issues have come closer to a resolution.