05/05/2013

Quarter in Review

The Markets

The first quarter of 2013 was great for U.S. stocks, from small to large capitalization. The Russell Midcap Value index was up over 14% over the period with large and small cap value up 12% and 11% respectively. International developed markets were also up albeit just over 4%, while emerging market stocks were down almost 2%. U.S. Bond markets were up as well but not close to the pace of their equity counterparts. In the alternatives sector real estate continued its upward trend returning over 8%, but commodities fell off again, down over 1%.

I wrote in December that I still feared a market disruption could be caused by many political problems both domestically and abroad. The Senate and house had just passed a bill that added to our deficit and the debt ceiling issue was still an open subject. I truly didn't see resolution to either problem and thought the markets would punish Washington for their lack of conviction. I was wrong. I have learned a great number of lessons over the past 16 years in the investment world and this past quarter taught me many more. I am glad that these lessons didn't take my clients too far off their goals, but being defensively positioned during the first two months of the quarter didn't allow us to reap the benefits of price increases in the equity markets.

Lesson number one: Don't fight the Fed. Having traded on a bond desk for many years this is one of the first lessons I ever learned. The Fed Chairman did not waver from his bond buying program or his goal to keep interest rates down well into an expansion. The bond purchases have continued, pouring cash into the banks and forcing reinvestment into risk assets.

Lesson number two: Washington can cry wolf only so many times. The "Sequester" was touted as a major disaster waiting to happen. However with the Fed injecting $85 Billion PER MONTH by buying bonds, how bad could an $85 billion budget cut on an ANNUAL basis be? Although I truly believe that our economy was hurt by the tax increases, the market has virtually ignored the problems in Washington and rewarded those holding riskier assets.

Lesson number three: Trust your investment program. I developed an investment program when I began Tilden Capital Management, LLC in 2010. I back tested it, spoke with many seasoned professionals about its merits and understood the goals I wanted to achieve with it and how it would match well with my target client base. I do not blindly follow my program and I am always trying to improve the process, however in September I felt that the

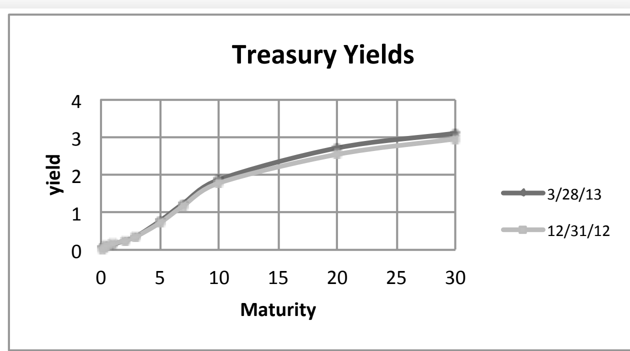
model may not incorporate the political vicissitude that was and is Washington D.C. Given that markets did not react as I expected then to, going forward I will not waver again from trusting the program I developed.

The US Economy in Q1 continued its expansion. Another 618k jobs were created, housing continued to recover and interest rates remained very low. The Federal Reserve has continued to buy bonds to maintain downward pressure on interest rates in the back end of the curve. Industrial production and manufacturing look positive, but orders are pretty flat. The consumer's balance sheet is better and their confidence looks better as well. I still feel this is all artificial and hope the real economy will please stand up.

Interest Rates

The March FOMC minutes pointed out that the fiscal budget cuts would restrict growth and reduce annual GDP by 1.5% for 2013. With inflation low and unemployment still in the mid 7% the Fed felt their bond purchase program did not need to be altered. This gives long bond prices support until such time the Fed changes course which, as of now, looks like somewhere between late 2013 and mid 2014. I have exposure to long bonds in many accounts and am very aware of the risks that rate increases (coupled with less Fed bond buying) pose. As of now I am comfortable with the Feds ability to continue to purchase bonds and keep the back end down. Quarter to date, as seen below, we had a little bear steepener (when long term rates rise more than short rates), but rates remained relatively unchanged for the period. As of the end of March 30 year fix mortgage rates are still in the mid 3% and continue to fall.

Years	3/28/13	12/31/12	Difference
0.08	0.04	0.02	0.02
0.24	0.07	0.05	0.02
0.5	0.11	0.11	0
1	0.14	0.16	-0.02
2	0.25	0.25	0
3	0.36	0.36	0
5	0.77	0.72	0.05
7	1.24	1.18	0.06
10	1.87	1.78	0.09
20	2.71	2.54	0.17
30	3.1	2.95	0.15



Leading Economic Indicators

The Conference Board leading economic index showed a steady increase for the first two months of the year, while dropping slightly in March. It mainly benefited from the increase in stock prices (S&P 500), the Leading Credit Index, and the interest rate spread between fed funds and the 10-year. However in the March report there were some signs of weakening in average hours worked for production workers, building permits, and ISM new orders. With many of the April numbers reported already I believe we will probably see another uptick in April as revisions have been made to the non-farm payroll numbers for Q1 and unemployment is down another tenth of a percent.

Jobs

At the time of this write-up **nonfarm payroll** posted an increase of **165k for April 2013**, and **618k jobs gained** in the **first quarter of 2013**. The total gain for the last twelve months was **2.1mm an increase of 300k compared to last year.** The unemployment rate is now at 7.5% as of April, down 0.3% from September. Median unemployment fell again from 18 months in June to 17.5 months in April. The aggregate weekly hours worked index continues its upward trend from 97.5 in December to 97.9 in April. The employment numbers look better than in Q4 but there have been major revisions over the past few months and if this report were written in April instead of May, my outlook may have been somewhat different.

Temporary or **part time job services increased in every month in 2013.** The question here is whether this job market is expanding or rather reacting to Obamacare, shifting full time jobs into the part time bucket. The **4-week moving average** of **unemployment claims** declined by 16k from December to April, **342,250 from 359,000 in Q4.** The ISM survey this month wasn't great and saw a decline in both the headline number and in employment. Manufacturers are hiring but the levels are right around the 50. (With expansion above 50 and contraction below it.)

The JOLTS report (http://www.bls.gov/news.release/pdf/jolts.pdf) increased to 3.9 million job openings, an increase by 300k jobs from January to February. The hire rate was 3.3%, higher than the separation rate. I still believe that unemployment rate is too high and the Fed will continue to buy bonds until this number is well below 7%.

Production

Industrial production for March showed another increase, which for the quarter showed a total increase of 1.39%. Employment in manufacturing was up throughout the quarter but the April employment report is showing the number of workers and hours worked has leveled off. December did see another quarter designated as Chaos, but Q1 is again a Growth quarter, with IP greater than inflation.

For the past four months **Orders for durable goods,** (items whose use last three or more years) have been very volatile (3.6% Dec, -3.8% Jan, 4.3% Feb, -5.9% Mar) while the most recent print of the I**SM new orders** index has remained about 50 for Q1 The total **non-manufacturing index** reported a **53.1 for April,** which was the lowest print in the past five months. The trends here look better than Q4, but the flattening of jobs in manufacturing may mean we are slowing down again.

Housing

Second bubble? Year-over-year changes in **new single-family home sales** have continued their upward trend with the twelve-month average moving up to 385k from Q4's 360k. The most recent print was 417k. Price data from S&P/Case-Shiller Home Price Indices ending February 2013 showed an **annual increase of 9.3% (up 5% more than in Q4)** in the 20-city composite. On the building side, permits for new home construction in the **900k are since November, declining to a 17% YOY gain**. We have a long way to go to a second housing bubble but builders are back and prices are climbing. This will help the consumer's balance sheet and can be seen in the most recent durable goods purchases.

The Consumer

Consumer confidence rebounded in the first quarter of 2013. The Washington distraction in December and the affects of the budget cut and tax increases obviously weighed heavily on the consumer minds. When the reality final hit, the consumer's confidence slipped in January but as stock prices in January and February climbed so did the consumers confidence. Now with real estate prices also increasing, while unemployment falls, the consumer should continue to feel upbeat.

Personal Income and Disposable Income both increased during Q1. Real personal income less transfers (removing social security, unemployment, welfare and disability payments) was up but the savings began its decline again down to its lowest level since December 2007, now at 2.7% as of March 2013. Consumer credit is expanding over 6% year over year, with the non-revolving debt (auto and student loans) expanding at 8.5% year over year as of

March. This is going to be the next bubble for us, and student loans won't get paid back because the job market isn't expanding enough to absorb the graduating student body. This will still not be a catalyst for curbing our lending in this area by the US government because we all know if you don't have a house and a college education, and boat load of debt to go with it, you simply aren't American!

Inflation

As of March CPI was up 1.48%, PCE was up 0.97% and the GDP Deflator was up 1.2% year over year. With unemployment starting to decline, the Fed has no intent of taking their foot off the gas. They have banks increasing their capitalization rates and inflation is nowhere in sight despite M2 approaching 11 trillion while the monetary base has increased by 15% since last year. When the labor market starts to tighten more and firms have to bid higher for the incremental employee, we should start to see inflation pick up.

In Closing

We are now **46 months** into an economic expansion with the **average expansion being 42 months** for the past 33 cycles. Having gone through the political issues in December and seeing nothing negative happen to Equities I learned some important lessons this past quarter. Don't fight the Fed, Washington is a carnival not even a circus, and my investment program is sound, tested over multiple market cycles, and straying from it didn't help my clients. I will always lean to the conservative side when making decisions with my client's money. After all I am helping them to retire and put their kids through college and not to speculate with their money. But as each of my clients have total return goals, I can't sit on the sidelines with their money waiting for Godot.

The next key market turn/road sign will be when the Fed start signaling that they will stop buying the long bond and mortgages at their current pace. When this time comes I will look to rotate to shorter duration bond index securities if available. For now the economy looks to be on pace, but will real GDP grow at a pace to take over as the Fed exits its buying program?