10/15/13

Quarter in Review

The Markets

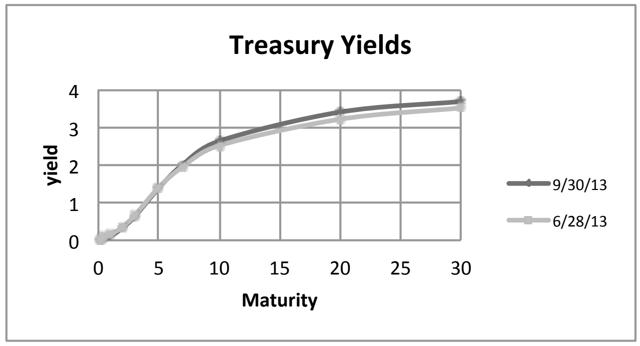
In the Third quarter of 2013 equity markets continued to extend their gain. The global market in both equity and debt performed well with developed markets up over 12% and emerging markets up over 6%. Global bond markets were also up over 4% while U.S. bonds struggled to get into positive territory but got help from the Feds refusal to taper. Real estate had a terrible August down over 6%, and down 3% for the quarter. Commodities tried to claw back a bit in Q3 but September saw another slide, leaving them up 3% for the quarter.

For all of its grandstanding about communication the Federal Reserve misled the public and the investing community in stating that it would taper its bond buying in September and not following through. The Fed can talk about economic statistics as the reason for not tapering, but it looks like the fiscal side of D.C. is the reason. The anticipation of a government shutdown and debt ceiling argument looks justified. It has caused market volatility, and divided the country even more. Even so, the US Economy continued its expansion in Q3. We had positive job growth over the quarter, housing continued to recover while treasury rates climbed and mortgage rates fell. GDP estimates for Q3 GDP held steady at 1.7% annually with September 26th data releases. The consumer is taking out a large amount of non-revolving debt, and the US Government is providing it, but we are currently sailing in somewhat of a fog as many of the US economic data providers are shuttered.

Interest Rates

As I am writing this review the vice chair of the Fed Janet Yellen has been nominated for chairman when Ben Benanke's term is up (01/31/14). A supporter of Fed's bond buying program and easy monetary policy, she is considered a "dove," compared to other members of the FOMC. Her problem as chairman will be that there are many changes to the FOMC in 2014, as many voting seats change and personnel retire. As we can see from the minutes of the September FOMC meeting there are two distinctive camps regarding the decision to not taper in September. One camp saw the economic data was consistent with a taper and believed that not tapering would have a negative effect on its credibility. In my opinion it did, and I have little faith in the Fed or our Federal government to provide anything to remove the question of their intentions going forward. Interest rates have risen in the back end of the curve and 30 year FRM mortgage rates now stand at 4.22 down about 25 basis points since the end of June.

Years	9/30/13	6/28/13	Difference
0.08	0.03	0.02	0.01
0.24	0.02	0.04	-0.02
0.5	0.04	0.1	-0.06
1	0.1	0.15	-0.05
2	0.33	0.36	-0.03
3	0.63	0.66	-0.03
5	1.39	1.41	-0.02
7	2.02	1.96	0.06
10	2.64	2.52	0.12
20	3.41	3.22	0.19
30	3.69	3.52	0.17



Leading Economic Indicators

The Conference Board's leading economic index has showed a steady increase for the entire year of 2013. As of August it now stands at 96.6, the highest point of the past two years. One of the contributors, Average weekly claims, will be revised as the most recent claims number has gone back from 308k to 374k. This is well above the four-week average of 328k in August. Although a negative for employment, this shouldn't affect the LEI that much as ISM new orders is still above 60, and other indicators were positive in September.

Jobs

At the time of this write-up **nonfarm payroll** posted… nothing, because the BLS was closed. August and July both showed 100k increases and the ADP report (an alternative private employment report) was up 166k jobs for September. A note about the ADP report, it is much more volatile than the nonfarm payroll number, however the correlation for two reports are relatively high.

The **4-week moving average** of **unemployment claims** is **325,000** as of the time of this write up. This is going to continue to get revised up as some of the data errors from California and other states start to correct. The current number is **374,000** and this is not a good trend. The ISM employment survey has been in the mid 50s for the entire quarter, and coupled with the ISM new orders index is a positive for the manufacturing sector. Overall the jobs picture looks ok but the recent claims number is somewhat alarming.

Production

The Fed will not report industrial production for the month of September on time. This is due to the fact of its dependence on data from federal agencies that remain closed. The July number was slightly negative and the August number showed a good increase. Year over year change in manufacturing employment as of August was up as was capacity utilization. With the Fed not tapering, this normally would be a negative sign for industrial production. However since I feel that the reason the Fed didn't taper was in direct response to fiscal inequities, I don't feel that production moved negative in any meaningful manner.

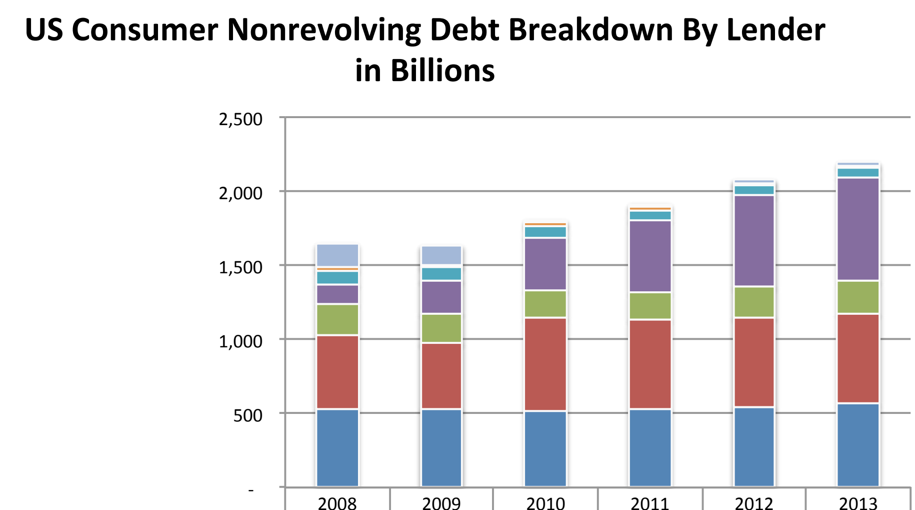
Housing

The census bureau, like other government agencies, has closed their website. Therefore I have limited data from which to form a good opinion on housing. Nonetheless existing home sales (from the National Association of Realtors) for August was up again with 5.4mm annual sales figure. I am not a huge fan of this statistic or the agency that provides this data but a continued positive trend for the market is a good sign. The S&P/Case-Shiller Home index is a notoriously late index, as it only reports it numbers with a 3 month lag. The most recent report is for June 2013 showing housing prices up over 10% year over year. Looking at the NAHB's (National Association of Home Builders) website, new home sales rose 7.9% in the month of August as reported by the HUD and Census bureau prior to the government shutdown. Again it is hard to say whether housing is still going strong, but if interest rates rise, mortgage refinances will disappear and home prices should level off or start to decline. This may have been another reason why the Federal Reserve decided not to taper.

The Consumer

Consumer confidence took a hit at the end of Q3 in 2013. With the impending government shut down and debt ceiling debates starting up the consumer confidence numbers from the Conference Board and University of Michigan both dropped across each of their respective indexes. It surprises me (a little) that after the government is crying wolf for the third time the public hasn't learned much from the DC soap opera. Although so far it looks like their sentiment isn't affecting their financial decisions as the stock markets are up 1.37% month to date as of October 14, 2013.

Personal Income and Disposable Income both increased in July and August year over year. Consumer credit also expanded for those months as well with Non-revolving credit up 8% annually over the past 11 months. I have been stressing in recent reports the amount of student loan debt our country is taking on. I believe we as the taxpayers are going to eventually pay a large portion of this debt, as graduating students will not find jobs that will enable them to pay it off. Pictures often speak a lot better than words. Please take a look at the below graph and concentrate on the **566 BILLION dollar increase (135 to 701)** that US government has lent to students over the past 5 years! As a percentage of total revolving debt the federal government has gone from providing 8% to close 32%! As much as I am not huge fan of FNMA, FHLMC and GNMA, for some of those mortgages there were actually properties that in the event of default could help to recover the value of the loans. What is the value of a university diploma on the open market these days? This data was obtained from the Fed's website (http://www.federalreserve.gov/releases/g19/current/default.htm#fn11b)



	2008	2009	2010	2011	2012	2013
Pools of securitized assets	160	131	19	16	19	18
Nonfinancial business	19	17	19	21	21	21
Nonprofit and educational institutions	95	89	78	72	67	63
Federal government	135	223	356	487	617	701
Credit unions	203	202	190	185	205	219
Finance companies	499	443	624	605	608	609
Depository institutions	535	532	521	529	542	565

What is also interesting from the same webpage is the memo section under the non-revolving data. It shows a breakdown between Student Loans borrowing and Motor Vehicle loans. In the past five and a half years, student loan growth has been growing at 9% annually, while auto loans have been just over 1.4%! I guess if you can't finance a car because you don't have a job ask Uncle Sam to finance your student loan… because there is nothing to repossess!

Inflation

As of August CPI was up 1.52% annually while PCE was only up 1.39% for July. Subdued inflation numbers will only add support to a Yellen led Federal reserve expansionary monetary policy. There are other areas of the economy though; housing, commodities and college costs that are all increasing at levels well above the 1-2% level that affect the consumer. I was recently showing a financial planning client the current total cost of an Ivy League education, which today stands around 60k per year. The average annual increase for the past 13 years has been around 4.83% per year, well above the annual CPI rate of 2.5% over the same time period. Easy money is not simply coming from the Federal Reserve in driving up asset prices; it is also coming from the Federal Direct Loan program, the Perkins Loan program Federal Family Education Loan Program driving up the cost of education.

In Closing

We are now **51 months** into an economic expansion with the **average expansion being 42 months** for the past 33 cycles. Last quarter I spoke about the Fed signaling the end to its bond buying program, and how it caused market volatility. This quarter the Fed went back on this statement and continued its program. In my opinion this hurt the Fed's credibility despite knowing their true intentions. As a portfolio manager I have continued to stay out of long bonds and have not changed my portfolio allocation going into government shut down or debt ceiling debates. We are currently exposed to the equity, fixed income (albeit shorter duration), real estate and commodity sectors for the foreseeable future. I believe we currently have around 13% chance of a contraction and will continue to monitor the key economic statistics that govern this estimate.