01/16/14

Quarter in Review

The Markets

The Fourth quarter 2013 ended a remarkable year in equities. The developed world had gains of around 6%, while emerging markets were up around 2% for the quarter. Long bonds recovered some of their losses but were still down almost 9% for the year. The Barclays Aggregate Index and the Government/Credit 1-5 year indexes were down only 2% and 0.10% respectively for the year. Real Estate had a good October but lost all its gains in November ending as taper rumors started up again. Real Estate was up 2.5% for the year. Commodities had a dismal year down 6.6% as inflation remained low.

With the Bernanke era closing and the Yellen era beginning the Fed decided to taper in December reducing its purchases of Treasury bonds and Mortgage backed bonds by 10 billion. If the Fed's reduction in short term rates is any example the Fed will continue to reduce its purchases steadily by 10 billion per month until September of this year. Fed fund rate increases still look to start sometime in 2015, but that may change if inflation and GDP ramp up. Estimates have Q4 GDP around 3.4% on an annualized basis, while inflation remains near 1.5% year over year. Although the government shutdown was a terrible political move for the conservatives in congress the economy (and this investor) learned our lesson, and mostly ignored it. Markets finished a record year and medium and short-term bonds looked to be a safe haven for interest rate watchers last year and going forward. Lastly there was a budget deal struck in December, which showed improvement somewhat to the partisan politics of late. However the debt ceiling issue will once again rear its head in March when Secretary Law starts pounding the table about the hazards of a default.

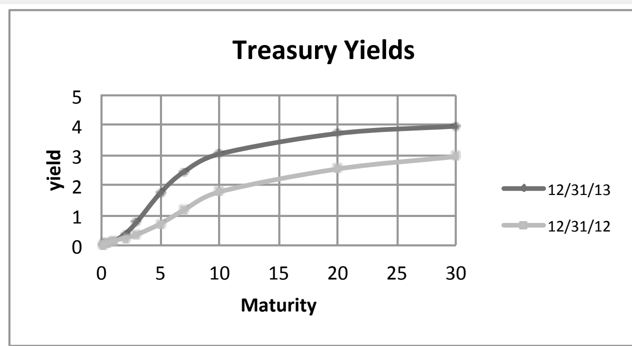
Interest Rates

On January 6th 2014 Janet Yellen was confirmed as the next chair of the Federal Reserve. Her term will begin on February 1st, 2014. With the Fed beginning its tapering in December, this allows Chairman Yellen to continue the course without coming across as departing from Bernanke's plan. Hopefully the weak employment numbers for December don't give the Fed reason to suspend the taper. The white house also nominated Stanley Fischer to the Vice Chairman position, along with Lael Brainard and Jerome Powell as Board Governors. With one remaining governor position to be filled (and potentially Jeremy Stein's as well) the make up so far looks substantially more

hawkish than the previous board. Since Stein probably not leaving until May we should see continually tapering unless something dramatic happens to the economy.

Since September interest rates in the back end of the Treasury curve have widened by about 35 bps. Since the beginning of the year they have widened by over 1.00%. The 30-year fixe rate mortgage rate is now over 4.6% and increase of 40 bps from the beginning of October. Refinancing levels have dropped off substantially and with increasing rates should not increase for 2014.

Years	12/31/13	12/31/12	Difference
0.08	0.01	0.02	-0.01
0.24	0.07	0.05	0.02
0.5	0.1	0.11	-0.01
1	0.13	0.16	-0.03
2	0.38	0.25	0.13
3	0.78	0.36	0.42
5	1.75	0.72	1.03
7	2.45	1.18	1.27
10	3.04	1.78	1.26
20	3.72	2.54	1.18
30	3.96	2.95	1.01



Leading Economic Indicators

The Conference Board’s leading economic index has showed a steady increase for the entire year of 2013. As of November it now stands at 98.3, the highest point of the past two years. Stock prices, interest rate spreads and the Conference board leading credit index contributed to another increase. Building permits and consumer expectations reduced the level, but 8 out of the 10 contributors were positive.

Jobs

At the time of this write-up **nonfarm payroll** posted and increase of 74,000 jobs, which was far less than the consensus 200,000. We have gained 2.1mm jobs in 2013, and the unemployment rate now stands at 6.68%. Unfortunately the main reason for the decline is that the labor force shrank by 347,000 jobs in December. Couple this with the lowest labor force participation rate (62.8%) since 1978, this is a very disappointing job report. The stock market however has not reacted negatively to the information, showing a small loss since last Friday.

The **4-week moving average** of **unemployment claims** is **335,000** as of the time of this write up. With January’s number at **326,000** this is one of the few bright spot in the jobs data this month. The ISM employment survey has

been in the mid 50s for the past six months with manufacturing adding 80,000 in the past five months. This job report is a very good picture of the sate of employment, gains in many industries but structural problems causing many people to leave the labor force. As the economy continues to recover the question will remain whether we will be able to train and educate a workforce with new skills at an affordable price.

Production

Industrial production had a strong fourth quarter. With the revisions IP was up 1.63% compare to 0.97% in the third quarter. Year over year change in manufacturing employment was up 0.64%, with the average for the past 12 months around 0.50%. These are good numbers for the manufacturing sector, and although the service industry saw a softer Q4, manufacturing is typically a leading indicator for service. These numbers probably helped the Fed justify the December taper; lets just hope that path continues.

Housing

The census bureau is open for business this quarter and has reported and annual increase of 464,000 new homes sold per year as of November, down from October's 474,000. Existing home sales were also down in November, from 5.1mm to 4.9mm on an annualized basis. The S&P/Case-Shiller Home Price index was up 1.05% in October, and up over 13.6% on a year over year basis. With interest rates continuing to rise we should see this index start to level off as refinancing has disappeared. New home building should also start to level off, and this is reinforced by the NAHB's confidence index falling a point to 56 in January. Overall I think we should start to see a more normalized rate of return in the housing market over 2014.

The Consumer

Consumer confidence continued to decline in the first two months of Q4 as the Government shutdown became a reality. From October 1st through 16th the US government was closed, consumer confidence sank into the low 70s in both the Conference board and University of Michigan indexes. The stock market had an anemic return for the month as well. Sentiment and securities returns were both up by December though with the Conference board at 78.1 and University of Michigan at 82.5. This was right in time for the holiday season, but retail sales weren't great. In fact they only rose 4.1% year over year compared to 5.2% in 2012. Just as a comparison consumer confidence was substantially lower during December of 2012, so why did consumer put on the breaks this holiday season?

Personal Income and Disposable Income took a pretty hard hit this year. As the social security tax reverted back to 6.2 percent, the amount it assessed against increased, and high-end tax brackets increased, people simply had less income. So when the American earn less we borrow more… consumer credit also expanded for the past twelve months. Year over year it is up over 6%, with non-revolving credit leading the way.

Inflation

As of December CPI was up 1.49% annually while PCE was only up 0.87% as of November. In December we saw a rise of 0.30% with the bulk coming from energy increases up 2.1% for the month. Both core and headline CPI been trending toward 2% over the past two years. Like I said last quarter though there is plenty of inflation out there in housing, stocks and education costs, but with wages subdued the CPI will be as well. I don't know if we see a lot of wage growth this year, without productivity growth, it will be tough to justify. (http://www.federalreserve.gov/newsevents/speech/bernanke20140103a.htm)

In Closing

We are now **54 months** into an economic expansion with the **average expansion being 42 months** for the past 33 cycles. The Fed has finally started its taper and should stay on course till September barring some major economic disaster. Interest rates are rising, and this will keep me out of long bonds for the foreseeable future. Leading indicators are strong, but the employment report painted the same lethargic picture of an untrained and unmotivated work force. Production is definitely better, but the consumer showed they are still reluctant to make large purchases, and who can with stagnant wages and reduced income. Looking at the current reported economic statistics I believe there is still less than a 15% change of contraction. Therefore I may make some tweaks to the allocation but no large shifts out of risk assets.