08/10/14

Quarter in Review

The Markets

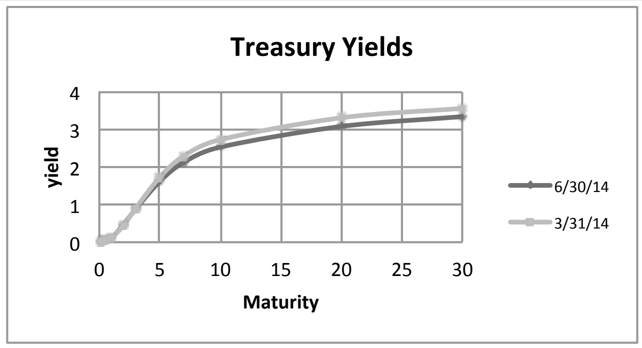
The second quarter of 2014 saw positive returns for all of the asset classes I follow. Large and Medium cap US and International equities were up 5 to 6% for the quarter. Small cap US stocks were up about half that because of April's -2.57% return. Long bonds continued their run up close to 5% for the quarter, now up over 11% for the year despite the Fed's continual tapering and early rate hike rumors. The best return this year though has been in real estate which is up close to 17% YTD. In comparison Commodities have lagged almost every class except for short-term bonds, as they are only up 3.84% for the year.

The second quarter saw the economy grow at an annualized rate of 4% compared to the contraction of 2.1% in Q1 of 2014. Economic data was mixed though with jobs, leading economic indicators, and production all positive while housing showed signs of slowing down and inflation has definitely started to pick up. Despite gains in job growth Chairman Yellen's testimony said that the Fed will remain accommodative, but could change as they approach the inflation and unemployment targets. The Fed's bond-buying program will end in October 2014. Jobs are consistently gaining 200,000 per month now, and the headline unemployment number is 6.1% as of this write up, but labor participation is still a problem. Interest rates declined again in the second quarter but housing returns and mortgage applications are definitely cooling. The consumer is starting to borrow (both revolving and non-revolving) and spend more, while labor costs are starting to rise. This may be leading to pick up in inflation as CPI now stands at 2.08% year over year ending June.

Interest Rates

The Fed nominees were appointed in the second quarter with Stanley Fischer (Hawk) and Lael Brainard (Centrist) becoming the Vice Chair and Governor. Jerome Powell was also confirmed for a new term ending 01/31/28. Jeremy Stein resigned his position on 05/28/2014 to return teaching at Harvard University. With Stein's departure the Board looks little changed in position, with only one true hawk (Fischer) among the five. Chairman Yellen's stance is still accommodative but made it known in her semiannual monetary policy report to Congress the Fed could hike the Fed Funds earlier if employment and inflation drew closer to targets. Consensus has a June 2015 estimate for the first rate hike. As of the time of this write up we are just starting to see some sell off in the treasury segment, but for the first half of this year treasuries (from 10 to 30 year maturities) have had strong performance as yields have continued to decline. 30 year fixed rate conventional mortgages have been hovering near 4.25% for sometime now.

Years	6/30/14	3/31/14	Difference
0.08	0.02	0.03	-0.01
0.24	0.04	0.05	-0.01
0.5	0.07	0.07	0
1	0.11	0.13	-0.02
2	0.47	0.44	0.03
3	0.88	0.9	-0.02
5	1.62	1.73	-0.11
7	2.13	2.3	-0.17
10	2.53	2.73	-0.2
20	3.08	3.31	-0.23
30	3.34	3.56	-0.22



Leading Economic Indicators

The Conference Board's leading economic index increased in each month of the second quarter 2014. Most of the components have been increasing throughout the year, with building permits, average workweek and average weekly claims being the negative drags. The conference board computes manufacturer's new orders because the numbers aren't released in time. Both total and nondefense capital goods excluding aircraft were close to zero, and thus could go either way upon revision. In general though the LEI looks pretty healthy and I don't expect a large revision or downturn in the latter half of the year all else equal.

Jobs

At the time of this write-up **nonfarm payroll** posted an increase of 298,000 jobs for June. This was a surprise to most. We have gained 2.3 mm jobs over the past 12 months, and the unemployment rate now stands at 6.1% (a decrease of 0.6% since March). The household survey, the survey used to calculate the unemployment rate, added 407,000 jobs in June. Although a good number, please note that the labor participation rate (Civilian labor force/Civilian non-institutional population) was 63.5% in **June 2013** and now stands at 62.8%. Secondly the labor force was 155,822,000 people in June 2013 and now stands at 155,694,000. This means that even though the total civilian population is bigger, less people are being counted "in" the labor pool.

The **4-week moving average** of **unemployment claims** is **297,500** as of the time of this write up. Claims have not been this low since February 2006. The ISM employment survey rebounded a bit since the first quarter and currently stands at 52.8 for June unchanged from May. We have now recovered and surpassed prerecession jobs. Like most others, the Federal Reserve was surprised by the June nonfarm payroll number, and has since changed its wording in Chairman Yellen's report to congress on when an increase to the federal funds rate could occur. The easy money party may be ending soon if jobs numbers and inflation rates continue toward the Fed's targets.

Production

Industrial production had a good Q2 at 0.73% compared to a revised 1.58% for Q1. Manufacturing Employment has started to pick up on a year-over-year basis, up 1.18% most recently from June 2013 to June 2014. We haven't seen numbers above one percent since March of last year. But we aren't narrowing the gap to prerecession numbers enough to make a substantial dent. Average weekly hours of production works are above 42 for the past three months. We haven't seen numbers like that since WWII. Fewer workers but more hours, while capacity utilization is still below 80%, mean we aren't utilizing our physical capital as much as the human.

Housing

Single-family new homes sales are still above 400,000 a year but compared to last year at the same time we are down over 10% on a year-over-year basis. Year to date we are down close to 5%. Interest rates declined again over the second quarter, but again we are declining in new home sales. **Existing home sales** as well are down on a year-over-year basis, and just got above 5 million homes sold per year since November of 2013. Mortgage applications in almost every category are showing decline in month-to-month and year-over-year figures. With most borrowers having already refinanced, and others having little incentive to refinance (current mortgage rates equal to their existing rates), we should continue to see declines in these applications as mortgage rates increase.

The Consumer

Consumer confidence in both the Conference Board and Michigan surveys is up compared to Q1. Personal income, consumption and income less transfers are all up year-over year. Personal consumption on durable goods has been above 6% annualized now for the past four months. Savings rates have been hovering around 5% annualized for the entire year. Debt levels though continue to rise, and unlike before also revolving, or credit card debt, has increased over 2% on a year-over-year basis in both April and May. These are all signs of a consumer that is more confident in their financial prospects.

Inflation

If the Fed were still using CPI as its measure of inflation then now would be a good time to start applying the brakes. CPI as of June increased 2.08% on a year-over-year basis with PCE up 1.60%. The average month over month change for the quarter was 0.29% or 3.5% annually! The GDP Deflator as well is showing inflation up 1.99% on year-over-year basis. With unemployment also near the Fed's target, it is a question why the Fed isn't going to start raising the Funds rate until June of next year.

In Closing

We are now **60 months** into an economic expansion with the **average expansion being 42 months** for the past 33 cycles. The Fed's taper hasn't affected interest rates, but world events have. The continued problems in the Ukraine, Gaza, Libya, Syria, and Iraq to name a few, seem to have kept a decent bid for US Treasuries, even longer dated ones. The employment picture looks better, albeit with a workforce participation rate that isn't great; there have been 200k increases to non-farm payroll in every month since February. GDP revisions to Q1 showed a terrible quarter but most recent estimates to Q2 GDP are very positive. Looking at the current reported economic statistics I believe there is still less than a 13% change of contraction. Having rerun most portfolios asset allocations, there were no major changes made to the portfolios.