11/10/2014

Quarter in Review

The Markets

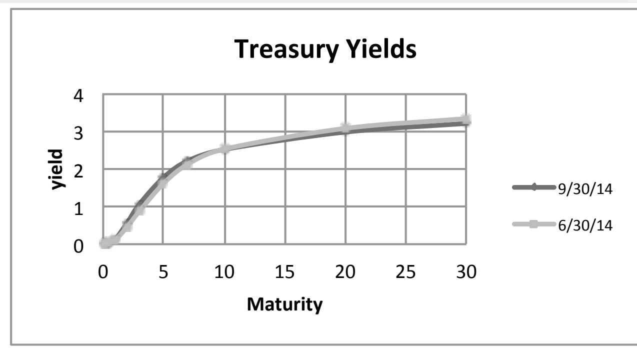
The third quarter of 2014 saw negative returns across almost every asset class but long and medium term US bonds. Small cap, non-US developed and emerging market equities were down 8%, 6%, and 3% respectively. But nothing dropped more than commodities, down almost 12% for the quarter. Despite being down 3% this quarter Real Estate is still the best performer for the year up 14%, while long-term bonds come in a close second. September was an abysmal month for performance across all risk asset classes, however October has showed a recovery back to pre September levels.

The third quarter saw the economy grow at an annualized rate of 3.5%, compared to the revised 4.6% for the second quarter. Interest rates widened a bit in the belly of the curve but saw the longer term bonds actually tighten (price increased) as equities sold off. The Fed ended its bond-buying program in October but interest rates have continued to tighten despite one of their biggest buyers leaving the market. Leading economic indicators saw an increase in September, and jobs numbers continue to show positive gains above 200,000, while unemployment claims declined. Industrial production was actually stronger than Q2, but housing is stalling, and as interest rates start to climb next year, growth will be modest at best. Consumer confidence took somewhat of a hit in September but has recovered while incomes continue to increase. Unit labor costs are rising but productivity growth is outpacing it on a quarterly basis. Inflation reversed its normalizing course this quarter and was essentially flat, producing another "Chaos" labeled economic quarter.

Interest Rates

The September FOMC minutes didn't have any groundbreaking information in them that would alter the course of the Fed. The bond-buying program was scheduled to end in October, and did, and the consensus for a rate increase held steady for June of 2015. The board still only consists of five of the seven positions, and White house nominations for the other two seats look hard pressed with the recent mid-term election results. Over the third quarter though interest rates in the front and belly of the curve did widen out a bit (Treasuries got cheaper) but the back end of the curve, long maturing treasuries continued to tighten or get richer as equities sold off in September.

Years	9/30/14	6/30/14	Difference
0.08	0.02	0.02	0
0.24	0.02	0.04	-0.02
0.5	0.03	0.07	-0.04
1	0.13	0.11	0.02
2	0.58	0.47	0.11
3	1.07	0.88	0.19
5	1.78	1.62	0.16
7	2.22	2.13	0.09
10	2.52	2.53	-0.01
20	2.98	3.08	-0.1
30	3.21	3.34	-0.13



Leading Economic Indicators

The Conference Board's leading economic indicators (LEI) increased again in the third quarter of 2014. There wasn't much of a change between July and August and both Manufacturing and ISM new order statistics dropped, along with interest rate spreads and equities. But there was increase in September supported by a drop in unemployment claims and increases in building permits. September's diffusion index, the percentage of indicators providing an addition to the LEI statistic was at 90, the highest level since May of 2010.

Jobs

At the time of this write-up **nonfarm payroll** posted an increase of 256,000 jobs for September (revised up 31k). We have gained 2.6 mm jobs over the past 12 months (ending October), and the unemployment rate now stands at 5.8% (down 0.1% from September). The household survey, the survey used to calculate the unemployment rate, added 379,000 jobs in September. The labor participation rate (Civilian labor force/Civilian non-institutional population) hasn't changed since June of this year and stands at 62.8%, which is not a good sign. Lastly the U-6 unemployment rate, which counts the total unemployed plus those marginally attached and working part time for economic reasons, was at 11.5% seasonal adjusted, down from 13.7% a year earlier. We seem to be moving in the right direction but unit labor costs have increased 2.4% in the past four quarters, and 0.3% in the third quarter of this year.

The **4-week moving average** of **unemployment claims** is **281,250** as of the time of this write up. Claims continue to drop, another sign of a tightening labor market. The ISM manufacturing report on business showed an employment number increasing in July and August but then falling back to 54.6 by September (numbers over 50 are expansionary). The FOMC statement in October has taken a more hawkish tone as the labor market continues to

firm, but it doesn't look like they are going to start raising short term rates or unwind their massive four trillion bond portfolio any time soon as inflation (and unit labor costs for that matter) remain in check.

Production

Industrial production

Industrial production grew at 1.08% in Q3 up from a revised 0.82% in Q2. Manufacturing Employment continued to rise on a year-over-year basis, up 1.42% October 2013 to October 2014. These are consistent gains but on a historical basis the percentage of manufactured jobs to total non-farm payroll is at an **all-time low, 8.72%.** This compares to an average rate of 21% in the 1970s, 16% in the 1980s and a 13% in the 1990s. Think we are moving away from manufacturing in this country? Third quarter productivity also rose, up 2.0% annualized with output increasing 4.4% and hours worked up 2.3%. While capacity utilization remains slightly below the long run 80.6% average, there doesn't seem to be a slow down in production or cause for concern in this area.

Housing

Single-family new homes sales were 467,000 units per year as of September 2014, above the September 2013 number again but not close to the long run average of over 600k per year. **Existing home sales** were up again over the five million mark, while mortgage applications continued to decline. The S&P/Case Shiller index fell again in the month of August, the fourth month in a row. Year over year the index is up 5.6% percent with 12 of the 20 MSAs (Metropolitan Statistical Area) reporting a decrease. Housing is slowing and the specter of interest rate increases in 2015 will not help.

The Consumer

Consumer confidence was somewhat shaken in the end of September with the measure dropping in the conference boards survey, while gaining in the Michigan survey. Personal income year over year has remained at a 4% growth rate since April of 2014, while real personal income less transfers remains near 2% year over year. Disposable income is still growing but at a sub 4% year over year basis as of September. Savings is back over 7% but levels continue to rise in both the revolving and non-revolving debt space. As consumers ramp up credit card debt this is may be a sign they are more comfortable with their future prospects. Although this wouldn't agree with the above confidence report, October confidence numbers did rebound.

Inflation

CPI slowed again this quarter actually ending down 0.03% or essentially flat. Over the last twelve months there has only been a 1.7% increase in CPI. The PCE (Personal Consumption Expenditures) were only up 1.43% year over year ending September and the GDP deflator only showed a 1.43% increase. This pull back gave the Fed more ammunition as to why it is waiting to increase the funds rate, but employment numbers are getting closer to target. It has been well documented that the Fed is typically late in increasing the funds rate during the cycle. With commodity prices plummeting this past quarter, a typically good inflation hedge, I am wondering if inflation will eventually rear its head or will the funds increase in June next year actually slow an economy that isn't really heating up.

In Closing

We are now **63 months** into an economic expansion with the **average expansion being 42 months** for the past 33 cycles. With none of the major economic statistics pointing to a recession only the length of the expansion is driving a 13% chance of contraction. The quarter was a tough one for risk assets despite the general strength in the economy. The advance estimate for Q3 GDP was 3.5% but as more data is coming out it is looking closer to 3%. Looking at real GDP year over year ending September the economy grew by 2.35%. Looking at the current reported economic statistics I believe there is still less than a 13% change of contraction. I rebalanced the portfolios this quarter shifting some of the years gains from US intermediate and short term bonds, mid-cap stocks and real estate, into international bonds, high yield debt and commodities, keeping portfolios inline with targets.