05/20/15

Quarter in Review

The Markets

The first quarter of 2015 saw US value large cap stocks underperform by almost a percent while EAFE value was up 4%. US mid and small caps stocks as well as emerging markets were up over 2%, while long term bonds were up almost 5%. The big winner were REITs up close to 7% while commodities once again underperformed all other sectors down almost 7%.

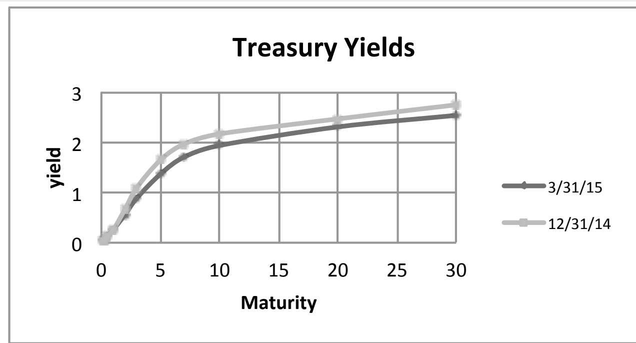
First quarter GDP was tracking 1.3% early in the quarter but the when the advance estimate came out it was close to 0.2% or essentially flat. As of the time of this write up it is now looking more like it will be a negative print of -0.8% and a very big reason the Fed has shifted its rate increase to later this year. Q2 estimates are have also started to fall from an original 3% to now more like 2.6%. However when you look at GDP over the last twelve months the economy grew about 3%. Interest rates fell again in the second quarter dropping around 20bps along the curve. The Fed continues to state that rates may begin to rise in the latter half of this year, but June looks less and less likely. Jobs in March were terrible but there was a rebound in April. If industrial production doesn't start to produce some positive numbers (negative for five months), the June jobs report will be very important to watch. Consumer confidence was good in Q1 but reversed in April along with other market indicators. Inflation is none existent when including food and energy, but core is up about 1.8%. The quarter was designated "Stagnation" because both growth and inflation were negative.

Interest Rates

The March FOMC statement reinforced the belief that an interest rate increase would start in the latter half of this year, with September the target. The increase would be gradual (1% per year) similar to those in prior years, trying not to startle the bond market. Although the first quarter GDP number was lackluster at best, the committee saw two main factors, weather and the West Coast port labor dispute, as temporary and the economy would pick back up in the following quarters. The strength of the dollar compared to other currencies has caused the Fed's estimated growth numbers to be revised lower, as well as estimates to inflation, which year over year ending March was flat. This is nowhere near the Fed's long run target.

Despite talk of interest rate increases Treasury yields continued to decline. From the 2 year to the 30 year, yields have dropped anywhere from 11 to 28 bps, as their prices have increased. This was reflected in the performance for bonds mentioned above.

Years	3/31/15	12/31/14	Difference
0.08	0.05	0.03	0.02
0.24	0.03	0.04	-0.01
0.5	0.14	0.12	0.02
1	0.26	0.25	0.01
2	0.56	0.67	-0.11
3	0.89	1.1	-0.21
5	1.37	1.65	-0.28
7	1.71	1.97	-0.26
10	1.94	2.17	-0.23
20	2.31	2.47	-0.16
30	2.54	2.75	-0.21



Leading Economic Indicators

The Conference Board's leading economic indicators (LEI) increased again in the first quarter of 2015. Unemployment claims (down almost 20k), and the yield spread (difference between 10 year treasury and fed funds rate) more than offset the decrease in building permits. However only 6 of the 10 indicators were positive this in March and the average has been only 5 of the 10 for the quarter. This is down from 2014, and rate of increase in the index is slowing down considerably. Still positive in general, but something to keep an eye on for sure.

Jobs

At the time of this write-up **nonfarm payroll** posted a revised increase of 85,000 jobs for March. We have gained 3.0mm jobs over the past 12 months (ending March), and the unemployment rate now stands at 5.4% (down 0.2% from December). The March number looks like a hiccup in an otherwise steady 200k job increase for the past 31 months ending the April. The household number, albeit a much more volatile index, has been all over the map but still positive since April 2014. The median duration of unemployment continues to fall, and for the first time in almost 7 years is under the 12-month mark. The Job Openings and Labor Turnover report (also known as the JOLTS) confirms the 3mm in jobs gained over the last 12 months, but the numbers are starting to flatten out on unadjusted basis with the hire and separations annual rates almost equal at 3.6 and 3.5% respectively. This means that despite 5 million jobs available there were 5 million hires and 5.1 million separations (quits and layoffs). The trend for annual rates is getting smaller, a slow down of hires and separations. If these nullify each other while job openings remain stable the unemployment rate will stop falling.

The **4-week moving average** of **unemployment claims** is currently **283,750**, a decrease compared to fourth quarter's number. Claims have started to decline again and while the BLS employment diffusion index is at 57 (down from 60.5 in December) the ISM survey index finally crossed the 50 mark at 48.3. Anything below a 50 on a diffusion index is a contractionary sign. No wonder the Fed is holding off increasing the funds rates till later this year. With Q1 GDP turning negative, and employment slowing, we will need a rebound in Q2 for the Fed to justify increasing rates in Q4.

Industrial production

Industrial production **fell by -0.64%** in Q1 and Q4 was revised down slightly to 1.11%. This is a second sign of a slowing economy and along with negative inflation was the reason Q1 was titled a **Stagnation** period. Manufacturing employment has remained flat for the past three months ending April along with the weekly average hours of production workers. Unless we see a strong rebound over the next several months this could be a good sign that we have begun to slow down. As of the time of this write up April's IP number was also negative (**The fifth straight month**). If any of the major indicators are revised negative next month I may look to become more defensive in the allocation.

Housing

Single-family new homes sales were 481,000 units per year as of March 2015. **Existing home sales** increased back above the five million mark, while mortgage applications continued to decline. Jumbo mortgage rates as of the time of the write up are to **3.99%.** The S&P/Case Shiller index has risen 5% in the twelve months ending February 2015 for the 20-City Index with all of the 20 MSAs (Metropolitan Statistical Area) reporting an increase. I don't see a large increase in home sales any time soon. Rates are low, the consumer balance sheet is largely rebuilt and the affordability index is pretty high, so why are people buying. Unbelievably I think the consumer may have learned something from the last housing bubble, in that the "American dream," of owning your own home isn't actually that great, and can easily lead to bankruptcy and years of digging out of financial catastrophe. So I believe that people are more cautious about putting large portions of their wealth in houses and banks are definitely more cautious about lending. Maybe half a million new homes a year is the new equilibrium.

The Consumer

Consumer confidence continued to make gains in Q1 of 2015 with both the Conference board and Michigan surveys showing increases. But in April those trends reversed along with GDP and other negative US economic data. Personal income as a total, along with disposable and consumption expenditures remain positive year over year, but the growth rates are starting to slow, and still nowhere near prerecession growth levels. The confidence

numbers though weren't backed upped by weakness in car buying, or major household purchases, which leaves us with increases in fuel. Therefore this could be an anomaly, and we should carefully watch the next number for any form of a trend.

Inflation

CPI slowed again this quarter ending down -0.23%, while producer inflation PPI reversed its trend in March but has since turned back negative in April. Over the last twelve months CPI has essentially been flat -0.02%. The Fed has time after time said that the main reason has been commodity prices and that those were only temporary. In fact when looking at core inflation (ex food and energy), something I rarely do, inflation is actually up 1.8% for the last 12 months ending March. But with Industrial production negative and total CPI negative we are in a period of stagnation, and if CPI reverses and IP doesn't then we are in for a recession period.

In Closing

We are now **69 months** into an economic expansion with the **average expansion being 42 months** for the past 33 cycles. This is the first time that industrial production has been negative 5 months in a row without a contraction. But it was the only indicator in the entire quarter that was negative. If there are revisions to payroll, or if real manufacturing and trade sales reports a negative number for March, I will be looking to rebalance the portfolios to a much more defensive position. I haven't done so already because one indicator, albeit negative for five months now, isn't enough to rebalance the portfolios, I am now seeing a possibility of contraction for Q1 at 24%, the highest level seen since the beginning of the 2008 recession. The equity markets haven't reacted negatively and it seems like most traders are watching the Fed closely. If the economy starts to stall though the Fed has no place to go.