08/11/15

Quarter in Review

The Markets

Well thank you Greece, thank you for destroying the quarter of performance! At some point in our lives I wonder if Europe will realize that you guys are never going to pay them back. Second quarter performance saw June remove most gains, if any remained, from the majority of the segments. US large cap stocks finished mostly flat, while the mid and small cap sectors were down over a percent. Long-term bonds were the penultimate performer down over 7% with Real Estate being the worst, down over 10% for the quarter. This is mostly because the Fed looks to increase the Fed Funds rate in the third or fourth quarter this year. Commodities did have a somewhat muted comeback but that was mainly felt in the month of April. Supply levels across the space have continued to keep a cap on prices and this segment continued to underperform in July.

Second quarter GDP current estimates are around 2.9% annualized. This is after the advance estimate was 2.3%, released by the bureau of economic analysis, and the increase in the consensus estimate is mainly because of construction spending and factory orders. Interest rates have begun to rise as the Fed target to raise rates in September is growing closer and the economic outlook remains good. The average increase in jobs in Q2 was 226,000 per month, a slower trend than 2014, but still a good number. Industrial production finally reversed its downward trend in June, but the five negative months prior was making me nervous about the economy. Consumer confidence was shaken by the slower economic growth, as many noted the problems with Greece and China. Inflation as well has started to come back with most sectors increasing for the quarter and the annual number turning positive again. Housing prices and education costs continue to increase and climb at rates much higher than those in the CPI-U. The energy sector continues to lag and so do the prices of securities that invest in that area.

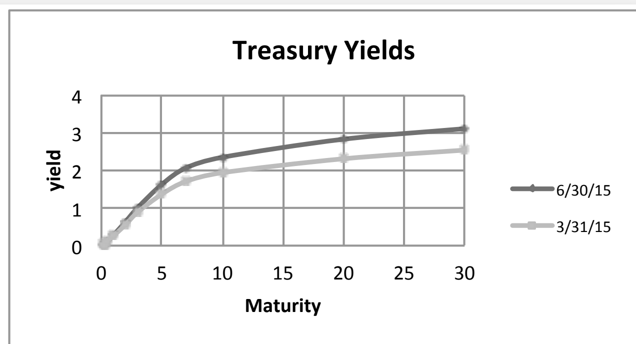
Interest Rates

In July the FOMC stated that the economy had been “expanding moderately in recent months.” It also said that the labor market continued to improve, however inflation continued to run well below their 2% target. They believed that this was temporary and a return to the 2% annual inflation would come. All of this continued to lay the groundwork for a rise in the federal funds rate in either the third or fourth quarter of this year. Even with the

Greek/EU debt conversation déjà vu, the Fed looks poised to raise rates. They did point out that business fixed investment and exports remained soft, which a very strong dollar may have something to do with.

Finally we saw some weakness in the back end of the curve that accompanied the Fed rate talk, even despite the flight to quality, which was sparked by a Greek default possibility. The back end of the curve, 10, 20 and 30-year maturity treasury yields increased about 50 bps from March. And with an average duration of the Barclay's Long Government Credit index being close to 15, this explains a 7% loss for the quarter for the segment.

Years	6/30/15	3/31/15	Difference
0.08	0.02	0.05	-0.03
0.24	0.01	0.03	-0.02
0.5	0.11	0.14	-0.03
1	0.28	0.26	0.02
2	0.64	0.56	0.08
3	1.01	0.89	0.12
5	1.63	1.37	0.26
7	2.07	1.71	0.36
10	2.35	1.94	0.41
20	2.83	2.31	0.52
30	3.11	2.54	0.57



Leading Economic Indicators

The Conference Board's leading economic indicators (LEI) increased again in the second quarter of 2015. Housing permits up 300k and interest rate spreads (widening 30bps) were the main drivers in the increase. Coupling the increase with 7 or more of the 10 indicators being positive in April, May and June, makes this is a better trend than Q1. This turnaround is positive for the economy and another data point the Fed is watching.

Jobs

At the time of this write up **nonfarm payroll** posted a revised increase of 231,000 jobs for June. We have gained 2.9mm jobs over the past 12 months (ending June). The unemployment rate is currently 5.3%; another tenth off from the March number. The median duration of unemployment has been steady at 11.3 months; this is less by two months from the beginning of the year. The average **Weekly Unemployment claims at 274,750** is well below the 48-year average of 361,136, and the trend downward has continued for the first half of this year. The employment report in general for the month of July was very positive and barring a disaster for August should give the ammunition to start raising the funds rate in September. Lastly the ISM survey for manufacturing jobs showed

continual hiring in the sector as the diffusion index was above 50 for the past three months ending July. Non-Manufacturing PMI reported a 60.3, the highest level since January 2008. This was reinforced by the 193k jobs expanding in the non-farm payroll report.

Industrial production

Industrial production finally pulled out of the nosedive in June, and was **up 0.23% for the month.** The overall quarter was still negative, but a positive monthly number reduced the probability of a contraction substantially. Following the stagnant first quarter, the second quarter's industrial production numbers helped to produced a "recession" time period. However the current Q2 GDP estimate is 2.9% annualized, up substantially from the 2.3% advance estimate. With gains in manufacturing employment, while average weekly hours remained stable, another positive (albeit weak) IP number is expected in July.

Housing

Single-family new home sales were 482,000 units per year as of June 2015. **Existing home sales** increased again to 5,490,000 in the month of June. Mortgage rates continued to climb over the quarter with 30 year fixed rates at 4.29% as of the time of this write up, after hovering around 4% for the month of July. The S&P/Case Shiller index has risen 4.99% in the twelve months ending May 2015 for the 20-City Index. This is out pacing other consumer inflation numbers to include the average increase of college tuition as of 2014, which was 3.7% for private four-year institutions.

The Consumer

Consumer confidence took a hit in both the Conference Board and the Michigan surveys. With impending rate increases, the uncertainty of Greece, and Chinese stock market declines, confidence seemed to be a bit shaken. In general most expectations, from business conditions to job openings, saw declines for the month of July. But this actually wasn't the main reason the Michigan survey declined; it was because the rate of economic growth, a slow GDP pace. With inflation near zero and income levels up near 1.8%, consumers balance sheets should be getting better if debt levels are held. Unfortunately personal savings rates are now 4.8% well below the 50+ year average of 8%. Total consumer debt increased, and the gains were from both revolving (up 3.5% year over year) and non-revolving debt (up 7.69% year over year).

Inflation

CPI reversed a two-quarter negative trend up 0.87%, enough to get the annualized number in the black for the first time this year. The increase was from food, gasoline, electricity, rents, transportation, and medical care. Fuel oil, apparel, and used cars and truck prices were down for June. On a 12-month basis though energy is still down over 15%, and estimates from the EIA (U.S. Energy Information Administration) don't show supply and demand levels closing near demand until Q1 of 2016.

In Closing

We are now **72 months** into an economic expansion with the **average expansion being 42 months** for the past 33 cycles. Industrial production reversed its trend and the decision to stay in risk assets was the correct one. With CPI being up .18% year over year, and supply levels still outpacing consumption in global energy liquids, I exited the commodity segment in early June. The commodity security I used before lost another 9% since that sale. Global bonds, a good portfolio diversifier hurt our portfolios with Greece deciding to have a referendum on whether to accept the bail out terms. The portfolios are invested almost entirely in the U.S., spread across mid and small cap equity, medium and short duration bonds and some real estate exposure. I still think there is a 25% chance of a contraction, and the markets have been quite volatile during the summer months. I have already made the allocation shift and will continue to hold most positions until an increased chance of contraction or the Fed ends its rate hike period.