07/29/16

Quarter in Review

The Markets

Well the Brits did it, and have voted to exit the EU. David Cameron's hubris has set in motion something I feel will be the final removal of much of British influence in the world. Scotland and Northern Ireland see this as yet another chance to remove themselves from the United Kingdom. Now to be perfectly fair, trade agreements will get done between the UK, France and Germany, their economic interdependence is simply too important. But this will already cause a weak European growth picture to become weaker. With the addition of terrorist activity after terrorist activity destabilizing the region, and Putin taking full advantage of this political and social unrest, Europe doesn't look like the place to invest for a number of years. Nor do they look like they have the ability to resolve the Syrian issue, or stem the rise of nationalism, anti-globalism… and it is spreading.

Despite terrorism, political unrest, a presidential election in the US, and almost monthly news reports or domestic violence, protest and increased volatility domestically, the securities markets have done quite well. US stocks on average weren't up that much with the Russell 3000 Index only posting 3.62% YTD, but the Mid-Cap Value index, the one I typically favor and invest for our portfolios' equities was up 8.87%, with small cap value 6.08%, the other area we allocate equity exposure to. The big winners though were in three places, Commodities, Reits and Long-Term US Bonds boasting 14.98%, 13.56% and 11.70% YTD. Given my fill of Commodities over the past several years I had no taste for them for our allocation this year. REITs have been and will be a continued favorite of mine in the portfolio as a good growth vs. value balance. But Long-Term bonds were once again a place that I wanted no part of for this year, and that was because the Federal Reserve started to raise interest rates back in December of last year. With an effective duration of 15.24 and the average credit rating a single A for the long term bond fund I use I was worried that an instantaneous one percentage point increase in interest rates in the back end of the curve meant a 15% loss of value of the one ETF. What I didn't imagine is that the yield of the back end of the curve 10-30 year bonds would go **down** 76 basis points (three quarters of a percent) from December until now. The US treasury is still the safety instrument out there. And when people get scared they put their money there. The current US 30-year treasury is only yielding 2.25% nominally as of 07/14/16. The real interest rate (less inflation) is actually negative (you are paying the government money) for TIPS bonds for both the 5 and 7yr instruments. Only if you take a 10, 20 or 30-year bond is your real interest rate actually positive at a whopping .09%, .053% and 0.7% respectively as of 06/30/16.

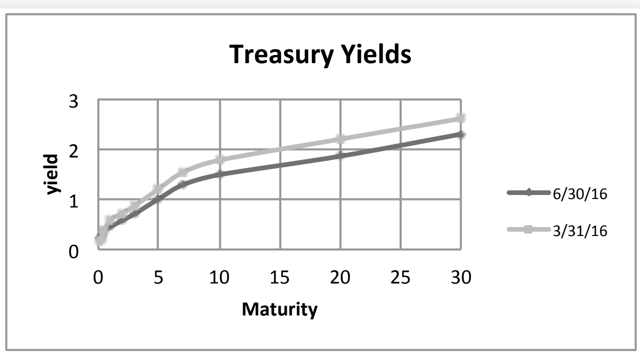
The Fed started to raise the funds rate in December, the target is still 0.25% to 0.50% and the funds rate is right in the middle at 0.37%. Since March the curve has flattened even more as the long end has rallied. Jobs stumbled in May and pushed out any future Fed tightening to September if not the end of the year. Consumer confidence has recovered somewhat in both the surveys, people feel better about their personal finances, but not as good on the economy or jobs as a whole. Inflation is above 1% two of the three monitors but there are definitely pockets (education, healthcare, rents) that are making core inflation rise above the target. Holding out of long-term bonds was the correct choice to make given the Fed's desire to start getting back to more of a normal curve. But with all the terrorist events, Brexit, and May's employment blip, people have simply poured money into Treasuries, especially the back end of the curve. I am regretting my decision.

Interest Rates

In December the Federal Reserve raised the federal funds target rate 25 bps to a range of 25 to 50 bps. It is currently hovering around 37 bps smack dab in the middle of the range. The last time the fed raised the interest rate was June 29th 2006, ten years ago! For the past six months the Fed has remained on hold as Europe has recoiled from multiple terrorist acts and the May employment report was only 11k positive jobs. CPI is has been hovering around 1.00% for the entire quarter.

Treasuries continue to rally with the 30 year dropping to a 2.3% and the 10 year dropping below 1.5%. There is little if any chance another rate hike gets done prior to the end of the year. In fact many fixed income analysts and portfolio managers have called for Treasuries to keep rallying through year-end with 10 Years ending up at 0.90%. I wish I had been in a little longer duration for the first half of this year, but feel that call to remain on hold given the Fed's December stance was the correct one.

Years	6/30/16	3/31/16	Difference
0.08	0.2	0.18	0.02
0.24	0.26	0.21	0.05
0.5	0.36	0.39	-0.03
1	0.45	0.59	-0.14
2	0.58	0.73	-0.15
3	0.71	0.87	-0.16
5	1.01	1.21	-0.2
7	1.29	1.54	-0.25
10	1.49	1.78	-0.29
20	1.86	2.2	-0.34
30	2.3	2.61	-0.31



Leading Economic Indicators

The Conference Board's leading economic indicators (LEI) increased by 0.57% for the three-month period ending June 2016. Every indicator other that average workweek of production workers in manufacturing was positive or flat for June. This was a rebound from May were most indicators were negative. For the quarter manufacturing new orders was still negative despite ISM and Industrial production numbers both turning positive. As per above the 10-Treasury spread to fed funds continued to tighten as treasuries rallied, a positive for LEI.

Jobs

At the time of this write up **nonfarm payroll** posted an increase of 287,000 jobs for June. We have gained 2.5mm jobs over the past 12 months (ending June). The unemployment rate 4.9% is holding firm, up a tenth, down a tenth, but for the most part we are holding just under 5%. The **Weekly Unemployment claims stand at 266,000** but higher than the four-week average of 254,000. It the 61th consecutive week below 300,000, the longest streak since 1973. The median duration of unemployment is 10.3 months the lowest level in 92 months from half way through the most recent recession. So people are able to find jobs quicker once they have lost their jobs. Going into the Jackson Hole Economic Symposium, many economists are looking to Yellen's speech for clues of an early rate hike in September. If July and August payroll numbers are strong and inflation isn't dropping the Fed may actually have to raise its target. Lastly the ISM survey for manufacturing jobs increased above 50 to 50.4 for the first time in eight months. This is a positive sign for sure, but manufacturing still feels week and the strong dollar isn't helping. The Challenger and Gray report on Job cuts showed 132,834 jobs cuts reported for Q2, this is below the long run quarter average of 156,780, but still on track from a 600,000-year.

Industrial production

Industrial production pulled out of the nosedive and showed positive numbers for both June and the quarter. It was up 0.60% for June and 0.75% for the quarter, despite four consecutive months of negative year over year % change in manufacturing employment. The ISM survey backs this view as the total index, and new orders were both up ending June, except for inventory. Q2 2016 GDP came out today at 1.2%, less than half of the consensus of 2.5%. This a really bad miss for what economists and investment houses thought about the economy.

Housing

Single-family new home sales were 592,000 units per year as of June 2016. **Existing home sales increased** to 5,570,000 in the month of February. 30 year fixed rate mortgages have once again fallen back below their January lows to 3.63% while 15 year FRMs are near 2.91% at the time of this write up. The S&P/Case Schiller 20 city composite index has risen 5.24% in the twelve months ending May 2016. However both April and May showed a slowing as data turned negative. Mortgage applications decreased substantially 11.2 percent for the week ending 07/22/2016, with refinancing down as well over 15% from the previous week.

The Consumer

Consumer confidence climbed back to levels not seen since January of this year. At 97.4 for June this level has stemmed a decline in confidence (and is holding as July's number is at 97.3 despite BREXIT). The Michigan survey has continued to climb this year with the most recent Sentiment Index at 93.5 up from 91.7 in January. Consumers still feel good about their personal finances and buying conditions. The survey does show a less rosy economic and job creation view by consumers, and with today's GDP number this what substantiated. Real personal income less transfers was up 1.62% year over year. This data point has steadily been declining since May of last year. A slowing of this data point shows that although people are earning more on an inflation-adjusted basis, the growth rate is slowing. Since inflation is relatively tame that means that earnings increase are also slowing year over year.

Inflation

CPI stands at 1.05% helped by a gain in energy of 1.2 % and 1.3% in May and June respectively, but given where oil prices are today that could be short lived. Food at home (groceries vs. restaurants) was down 1.3% for the past 12 months, while restaurants are up 2.6%. Energy for the last twelve months is still down 9.4%. Taking food and energy out of the equation, core CPI, is up 2.3%. Normally not a number that holds much water with me, but have you tried to buy a house lately! As of the July 26, 2016 report from the U.S. Energy Information Administration (EIA) it looks like new rigs are coming online and thus increasing the supply while the demand side of the equation is staying relatively flat. Thus the pressure on oil prices lately. The GDP deflator (the different between nominal and real GDP) shows inflation up around 1.2%, in line with CPI, and far from the feds target. Thus we could be on hold for a while. PCE continues to show weakness though with the year over year number up only 0.88% and it has been below 1% for the past five months.

In Closing

We are now **84 months** into an economic expansion with the **average expansion being 42 months** for the past 33 cycles. Industrial production has made a recovery, but GDP hasn't accelerated as anticipated, up only 1.2% annualized for the second quarter. Employment figures have rebounded, but May was as close to negative as they come (statistically not significantly different from zero) and the three months ending June have not been a strong quarter. Real personal income less transfers was only up 1.62% year over year. The UK took one step closer to insignificance with its vote to exit the EU, but I don't know if Scotland will realize the magnitude of it's relationship with England to resist the knee jerk reaction to leave the UK for an EU that won't give it much. I am currently running the new allocations and fund choices. I am probably on hold until after Jackson Hole and passed the September possibility of a rate hike. After that it is looking for a better entry point potentially after the election in November. The portfolios have done very well this year I am not looking to get cute into year-end.