11/02/16

Quarter in Review

The Markets

This quarter had ton of negative market moving headlines but was still able to put in the best returns of the year except for real estate and commodities. Non-US developed markets snapped back in July following the Brexit vote up more than 8% for the quarter, erasing the YTD loss. Mark Carney and the Bank of England cut interest rates (and provided other stimulus) for the first time in seven years in August, in a preemptive strike to counter the effects of the vote. The US markets saw volatility return with Federal Reserve Governors speeches striking both dovish and hawkish tones. Chair Yellen's own hawkish comments from the Jackson Hole Summit were reversed by Lael Brainard's speech only days before the September FOMC meeting and announcement. The Fed ended up not raising interest rates and the US Equity markets produced quarterly returns from 2 to 5% across the cap-structure. At the end of August the European Commission ruled that Ireland granted Apple illegal tax benefits worth $14.5 billion while half way through September the US Department of Justice announced it was seeking $14 billion in fines from Deutsche Bank for their part in the mortgage back securities complaint. John Stumpf the CEO of Wells Fargo resigned his position in the wake of his bank opening 2 million fake accounts. Also as oil has been stuck in the $40s for sometime an OPEC meeting in Algiers spawned the discussion of curbing output. The dollar amount Saudi Arabia has discussed cutting on a yearly basis was close to the same amount, $17.5 billion, in newly issued debt by the county in October. But as has been observed in the past OPEC often cheats on its production targets and we shouldn't look for real curbs anytime soon. With oil reserves just starting to decline, the IEA reports that the market may remain in oversupply through the first half of next year. Lastly on July 15th a coup d'état was attempted in Turkey resulting in over 300 people being killed, over 40,000 people being detained, and the Turkish President Erdoğan accusing the head of the US Central Command with "siding with the coup plotters." Turkey's sovereign debt was cut to junk at the end of September by Moody's citing rising risks to their external financing and weakening credit fundamentals.

Year to date US equities have returned anywhere 8% to 13.5%. Emerging market equities have done the best up 17% for large cap firms (perspective: they were down 14% in 2015). Long bonds have started to show some chinks in their armor down 1% in September (up more than 13% YTD), as the Fed continues to speak about raising interest rates. High Yield debt is the second best performer after EM equity up over 15% YTD (they were down 8% in 2015). Rounding out the sectors both real estate (11.92% YTD) and Commodities (13.1% YTD) both did well. This compares to a 5.58% and **negative** 27.95% return in 2015 respectively.

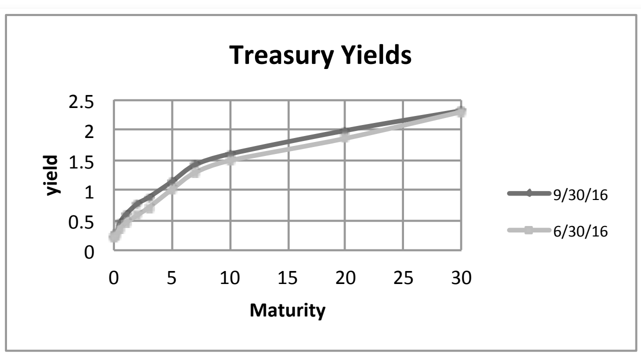
The Fed kept rates the same in September with three Fed govenors decenting, but a move in November is probably zero. The interest rate curve has started to move out despite the Fed being on hold. Job growth is looking like it is tapping out, with back to back months of sub 200,000 gains in the Non-farm payroll survey. Consumer confidence is waining and down in both the Conference Board and University of Michigan surveys for September. Inflation is ticking up but nothing above the Fed's target of 2.00% in any of the observed indicators. I am pleased with the portfolio returns year to date and we should experience some volatility until the elections outcome is clear. But I will not take my eyes off the indicators this time, and instead let what happens in the beltway stay in the beltway.

Interest Rates

In September the Federal Reserve decided, once again, that they didn't want to raise rates. This time was somewhat different in that 3 of the 10 governors dissented in favor of raising rates by 25 bps. There are only two meetings left in the year, and despite much protestation from the chair about being politically independent, the likelihood of a rate increase before the election is zero. So the only date left in the year will be the December meeting. The minutes of the September meeting point to a disagreement in the remaining slack in the labor market as justification for the hold on the rate increase. In fact in her most recent speech chair Yellen showed signs that letting inflation heat up a bit wasn't a bad thing for the economy, and thus didn't see it as a reason to raise rates sooner than later. Many economists believe that trying to "catch" inflation once it occurs is very difficult and that the Fed has tended to be late to the party in the past.

For the first time in a while Treasuries have sold off, widening 12bps on average from the 2 to the 30-year, this quarter. The 10-year stood at 1.6% (from 1.49 in June) while the 30-year remained pegged close to its 2.3% yield in June. At the end of last quarter most analysts expected the ten-year treasury to continue to rally finishing the year at only 0.90%.

Years	9/30/16	6/30/16	Difference
0.08	0.2	0.2	0
0.24	0.29	0.26	0.03
0.5	0.45	0.36	0.09
1	0.59	0.45	0.14
2	0.77	0.58	0.19
3	0.88	0.71	0.17
5	1.14	1.01	0.13
7	1.42	1.29	0.13
10	1.6	1.49	0.11
20	1.99	1.86	0.13
30	2.32	2.3	0.02



Leading Economic Indicators

The Conference Board's leading economic indicators (LEI) increased by 0.57% for the three-month period ending September 2016 (the exact same as the quarter before). The third quarter didn't have as many positive indicators as the second quarter, as a good amount of them were either at zero or slightly below (subtracting from the overall index). Those were, ISM new orders, Manufacturers new orders, S&P 500, Leading Credit Index and average consumer expectations for business conditions. Even though housing starts have fallen off building permits have ticked up, which probably won't work into GDP until Q1 or Q2 of next year. Along with permits average weekly unemployment claims also added the most to the LEI. Lastly the interest rate spread between 10-year treasuries and federal funds added to the index. My problem with the LEI report this month is those items that are positive are running out of steam, claims are at a 43 year low, the Fed will probably raise rates in December, and building permits don't always turn into starts. LEI was a positive number just not positive in all the right areas.

Jobs

At the time of this write up **nonfarm payroll** posted an increase of 156,000 jobs for September. We have gained 2.5mm jobs over the past 12 months (ending June). The average jobs gains in 2016 are 177,000 per month vs. 228,000 in 2015. The pace is slowing; as it should the closer we are to full employment. However remember that anything near 150,000 per month borders on statistically insignificant (might not be different than zero). The unemployment rate ticked up to 5.0% but we are have been hovering here for the last twelve months. The **Weekly Unemployment claims stand at 260,000** while the four-week average of 251,750. The median duration of unemployment is 10.3 months returned to its June level after significant upticks in July and August.

The ISM survey for manufacturing jobs declined again below 50 and stayed there they entire quarter, signaling yet again a contraction in manufacturing employment. This reinforces the slowing of new hires as we are at or approaching full employement. The Challenger and Gray report on Job cuts showed 121,858 jobs cuts reported in Q3, a good number confirming the low unemployment claims. Overall I feel that we are getting close to the tail end of the large employment gains for the economy, despite the Fed's argument of continual slack in the employment market.

Industrial production

Industrial production had a flat quarter as July's increase was erased by the decrease in August, and September was essentially flat. We haven't seen the long stretches of negative numbes though that was almost all of 2015, but this isn't a banner year for IP. The average increase in IP from 2011 to 2014 was around 2.5%, whereas in 2015 we were down 2.32%. YTD IP is only up around 0.17%, and with the ISM survey below 50 and the Manufacturing

Employment portion of the labor report showing a contraction for the past 7 months, this doesn't bode well for the sector. Q3 GDP however did post a quality gain of 0.71% or 2.9% (annualized). But looking at this number over the past 12 months the increase has only been 1.5%.

Housing

Single-family new home sales were 593,000 units per year as of September 2016 (average being 651,000 since 1963). **Existing home sales stand** at 5,470,000 in the month of September. 30-year fixed rate mortgages have climbed back up to 3.74% and 15 year FRMs are near 3.38% at the time of this write up. The S&P/Case Schiller 20 city composite index of home prices has risen 5.13% in the twelve months ending August 2016. Mortgage applications decreased 4.1 for the week ending 10/21/2016, with refinancing down as well over 2% from the previous week.

The Consumer

Consumer confidence slipped in both the Conference board's and University of Michigan's survery for the month of September. This is after having climbed in September in both and also in August in the Conference board's survery. It seems like consumers are a bit less positive about their future income gains, but don't think the economy is heading into a recession anytime soon. Looking over the last twelve months Personal Income is up 3.22%, while Real Personal income Less transfers was up 1.89% (slightly under the average gain since the end of the recession). The personal savings rate has declined for the past four months, and the personal consumption portion of Real GDP is up 2.58% for the past twelve months. By themselves these are pretty good numbers, but when combined with the other above indicators we are starting to see signs of a slow down. This could be a lull or it could be the beginning of a recessionary period. Nothing has turned negative across the main indicators but things are definitely cooling off.

Inflation

CPI stands at 1.48%, up from 1.05% three months earlier. (This is the rate of increase over the past twelve months). PCE, the indicator the Fed cherishes most, is also at 1.25% up from 0.91% over the same time period. Inflation seems to picking up a bit. Fed Chair Yellen's recent comments that it wouldn't hurt the economy to run a little hot, means that Fed thinks that raising interest rates at a measured level is enough to fight the negative effects of inflation. And since the CPI hasn't hit 2.00% since June of 2014 and CPE hasn't hit it since April of 2012, I don't see them in any rush to increase. I was very surprised that the Fed head-faked in September though (two years in a row by the way) but based on their dual mandate (there is really a third but I will leave that for another write up) they have reached full employment but not their inflation target. So I believe it will take another quarter or two to get there, which is not what is being forecasted by some economists. In fact the view is that inflation will hit targets a lot sooner if not this month. If that does happen then there may be the case for shifting some of the longer duration bond investment into the commodity sector. But that allocation would be measured to small if any.

In Closing

We are now **87 months** into an economic expansion with the **average expansion being 42 months** for the past 33 cycles. Real GDP has recovered somewhat and stands at 1.5% for the past twelve months, with a strong initial report for Q3 of 2016. Industrial production was essentially flat for the quarter, while job gains have slowed substantially from 2015 to 2016. Over the past month I have run the new allocation choices and realigned the portfolios to their original targets away from the drift. Hopefully there will be a clear outcome from the election one way or another, nothing is contested or hanging chads this time. Yes Florida I am looking at you. But the truth is that we are very long in the expansion period, not the longest on record (120 months ending March 2001) but the second longest. The Fed is trying to raise interest rates, albeit slowly as to not spook the markets, but the interest rate curve is starting to creep out. I will keep the allocation where it is until I start to see more indicators turn flat or negative before I adjust to a more conservative stance. As for now I will be voting for Darth Vadar, because atleast he is an evil that I know.