02/09/17

Quarter in Review

The Markets

This quarter's news was occupied by several stories but none quiet as shocking as the surprise election of Donald Trump as the 45th president of the United States. On election night futures sold off dramatically but paired their losses and in fact we saw gains in November and again in December in US Equities. Bonds in general sold off in both October and November before the Federal Reserve tightened 25 bps in December. OPEC finally reached an agreement to curb production as WTI bounced around between $45 and $55 a barrel. Banks started to relocate its employees as Brexit has continued its path (albeit with a parliamentary vote) to an article 50 trigger. Hurricane Matthew, a category five, cost the south-east region of the US close to $15 billion worth of damage in the beginning of the quarter, while a terrorist drove a truck into a German Christmas market killing 12 and injuring 48 just under a week before Christmas. Finally, the DOJ got an early Christmas present by reaching settlements with Deutsch Bank and Credit Suisse for $12.5 Billion on December 23rd, for their part in the selling mortgage debt in the run up to the financial crisis.

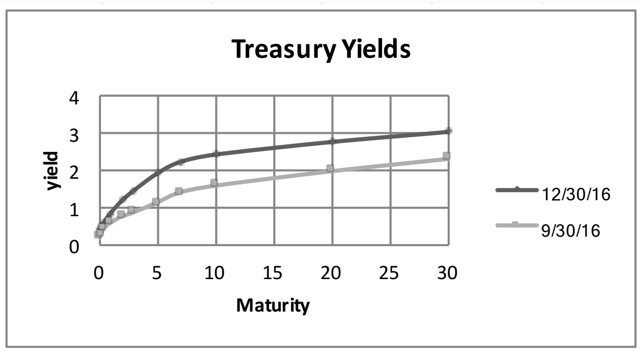
2016 was a good year for value stocks with Large, Mid, and Small cap stocks up 16%, 19.8% and 27.8% respectively. Foreign developed markets didn't have as good of a year only up 5.7% and the majority of that was made in the last quarter of the year. Emerging Market stocks had been doing really well for the first 9 months of the year but then slid after the election but still had a very good 12.9% return for year. Except for high yield which was up 17.5%, domestic bonds had a pretty subpar year up from 1.1% for short term bonds, 1.4% for intermediate and 4.21% for long term. Bond sold off dramatically in the fourth quarter with long term bond down over 7.8%. Global bonds were the worst performer down 1.7% for the year, losing more than 10.3% in the 4th quarter alone. Turning to alternatives, REITs struggled in the fourth quarter and were only up 5% for the year, while commodities returned 19.1% for the year. (Some context here, commodities were down 28% in 2015).

Interest Rates

In December, the Federal Reserve raised rates by another 25 bps, but the bond market had sold off far before the rate increase. In fact, the yields widened out from 17 to 85bps across the curve in Q4 with the back end selling off more. And that is where the curve has stayed for the past month. The main takeaway from the December commentary and then the minutes, was the change in expected rate increases in 2017 from two to three, while their outlook for inflation has become stronger. There wasn't a hike so far this year, but if inflation starts to firm more, especially wage inflation over February, then I would think that March (and not June as most economists are predicting) will be on the table for another increase. The 10-yr U.S. Treasury had a 2.45% (from 1.6%) yield as of year-end while the 30-yr U.S. Treasury was around 3.06% (up from 2.32%).

The 30-yr fixed rate mortgage has risen over the quarter and was 4.32% while 15-rates where 3.56% as of the end of December. In contrast one year ago they were 4.15% and 3.39%, not a dramatic rise but still an increase. Mortgage applications for the month of December was decreased 12% on a seasonally adjusted basis. Purchases were also down, while refinancing was up.

Years	12/30/16	9/30/16	Difference
0.08	0.44	0.2	0.24
0.24	0.51	0.29	0.22
0.5	0.62	0.45	0.17
1	0.85	0.59	0.26
2	1.2	0.77	0.43
3	1.47	0.88	0.59
5	1.93	1.14	0.79
7	2.25	1.42	0.83
10	2.45	1.6	0.85
20	2.79	1.99	0.8
30	3.06	2.32	0.74



Leading Economic Indicators

The Conference Board's leading economic indicators (LEI) increased by 0.73% (up 1.05% for the year) for the three-month period ending December 2016. The fourth quarter saw eight of the ten indicators add to the total indicator. The only indicators that reduced measure was unemployment insurance and manufacturers' new orders. Stock prices (S&P500) added the most to the index as it was up 3.82% for the quarter. ISM New orders added the second most to the index with a 60.3, a value confirmed in January of 2017 at 60.4. Unemployment insurance claims subtracted the most from the LEI, but it has been bouncing between positive and negative amounts since June. At 258,250 these amounts are at the lowest levels since the early 1970s. Overall the LEI was a very positive indicator ending the year.

Jobs

At the time of this write up **nonfarm payrolls** posted an increase of 157,000 jobs for December. We have gained 2.2mm jobs over the past 12 months (ending December). The average jobs gain in 2016 was 186,000 per month vs. 228,000 in 2015. Remember that anything near 150,000 per month borders on statistically insignificant (might not be different than zero). The unemployment rate stood at 4.7% a decline from the past year. The **Weekly Unemployment claims stood at 258,250** with the four-week average exactly the same. The median duration of unemployment is 10.2 months returned to its June level after significant upticks in July and August. The labor force participation rate was 62.7 essentially the average for the year, and slightly below the long-term average. The labor force participation rate started its decline at the turn of the century, and many papers have been written as to the cause (age of the work force, a lot of people retiring, etc.) But the 2008 financial crisis kicked it into overdrive and the concern was whether the fall could be arrested. It seems that as of December 2013 we have been very close to 63 percent participation rate. Take a look at the long run graph from the St. Louis Fed here, (https://fred.stlouisfed.org/series/civpart) , that shows a steady increase from the early 1960s until 2000. Although 63 is nowhere near the peak near 67, I believe the decline has subsided.

Lastly the ISM survey for manufacturing jobs have steadily increased above 50 to 52.8 for December. This is a positive sign for sure, as manufacturing lost jobs in 2016 as a whole. The Challenger and Gray report on Job cuts showed 91,303 jobs cuts reported for Q4, the lowest job cut level since June of 2000. This brings the total job cuts for 2016 to 530,915.

Industrial production

Industrial production finished the year on a positive note up 0.36% for the quarter and up 0.51% for the year. However, the year over year change in manufacturing employment has been declining since august of this year. Manufacturing added almost 100k jobs in 2015 but lost 18k in 2016. The ISM survey coincides with this as it shows that employment only rose above 50 in the last quarter of the year, a signal that firms were hiring. New Orders though have also been steadily climbing since September and stood at 60.3 at the end of December. If any of the push to get the US back in the manufacturing sector is successful, we won't see it work into the data until the latter half of 2017 if at all.

Housing

Single-family new home sales were 536,000 units per year as of December 2016. But this was a substantial decline from November and not expected by the market. In fact, it played a role in GDP being sub 2% for the quarter. Are rising mortgage rates having anything to do with this, or the talk of losing the mortgage deductibility affecting it? We had a mild beginning to the winter, and although December is not a typical home buying time these numbers are seasonally adjusted. Since 1963 the average annual rate of new home sales was 648, since 2000 it has been 702. So, we are off the from these numbers but well above the post-recession mark. **Existing home sales increased** to 5,490,000 annually in the month of December above the last twelve-month average which is now firmly in the 5.5mm area. This number actually beat analysts' expectations, but only the brokers fee is added to GDP, so a substantially smaller amount than new build. The S&P/Case Schiller 20 city composite index has risen 5.3% in the twelve months ending November 2016, with all 20 cities reporting increases in home prices. Mortgage applications decreased substantially by 12% for the week ending 12/30/2016, while refinancing was down 22% from the previous two week.

The Consumer

The Conference Board's consumer confidence index finished the year at 113.3 the highest level for the year. It finished a quarter of continual increases in this index. The University of Michigan also end the quarter up at a level of 111.9 boosted mainly on unrealized political promises made by the newly elected administration. However, most people had a favorable view of their finances with large increase in anticipated income. The consumer's Income and Outlay statistics all showed signs of increase year over year, with Real Personal Consumption Expenditures on Durable Goods up 8.14% since December 2015. Real Personal Income Less Transfers was up, but only 1.91% year over year. This number was consistently in the 2% range for the entire year. Another sign the consumer is gaining confidence (or just repeating the same mistake it always makes) is the decline in savings rate. The savings rate currently stands at 5.4%. Lastly consumer credit expanded at a 6.25% annual rate. Although both revolving and non-revolving credit continue to expand, revolving credit, for the first time since the recession, was growing at a rate higher the non-revolving. With that said, total consumer debt is 1.1 trillion dollars more than at the end of the recession and 97% of it come from non-revolving debt.

Inflation

As of December, CPI was up 2.10% since driven by the shelter and gasoline segments of the index. Gasoline was up 3.0% for December and 2.7% in November on a seasonally adjusted basis. The 2.1% has significance in that it was greater than the average increase for the past ten years. The food segment of the index declined 5.4% for 2016 mainly reduced by food at home or the grocery stores staples of meats, poultry, fish, and eggs. This was countered by increases in the energy portion of the index, up 5.4%, but this after declining the past two years. Thus, with this offset we could look to the index for all items less food and energy, and it was up 2.2 percent for 2016, with rents being the primary driver of this increase up 3.6% for the year. Analyst estimate reaching 2.8% in 2017 if certain tariffs are put in place, and or demand continues to rise. I will be keeping a close eye on wage growth numbers this year. The US employment cost index (ECI) finished the year up 2.2%, and the consensus is that this will pick up as the unemployment rate falls and labor markets firm. The ECI has been stuck around 2 to 2.5% for the private sector for the past 6 years as the public-sector rate has steadily been increasing since its trough at the end of 2011.

The GDP deflator (the different between nominal and real GDP) shows inflation up around 1.57%, trailing CPI, but closer to the fed's target. PCE was in-line with the deflator up 1.62% for the year. Although the Fed's main indicator is PCE, I think they will not easily ignore a 2.2% rise in core CPI.

In Closing

We are now **90 months** into an economic expansion with the **average expansion being 42 months** (and the longest being 120 months) for the past 33 cycles. Interest rates have steepened in the back end of the treasury curve by close to 85 bps, while mortgage rates finished the year only about 15 bps wider than the end of 2015. The leading indicators were up mostly because of the rise in the stock market and new order from manufacturers. Employment numbers showed signs of slowing though, especially in the manufacturing sector, adding only 16k in Q4 and losing 18k in all of 2016. Industrial production ended on a positive note up 0.51% for 2016, and much better than 2015, but it still feels soft to me. At a 561k average in new home sales for 2016, just over 5mm in existing home sales, and 5.3% home price appreciation (ending November) housing doesn't look bad, just not the strong driver of an economy hoping to expand at a rate great than 2%. The consumer is confident, saving less and borrowing more, and expecting wages to increase in 2017, while core-inflation is above 2% with rents driving the bus. My thoughts are this expansion looks a little long in the tooth. None of the major NBER indicators are flashing red and my expectation of a contraction is down around a 16% chance. But the Fed is raising rates, inflation is starting to show, people are confident, and that makes me pause. I have shifted the portfolios out of REITS as of the beginning of the year, specifically defending against their volatility (justified or not) to increases in interest rates, and shifted more into small cap value, while still holding a good portion of mid-value as well. I will also continue to hold medium term and short term bonds, and will look to shift to long term only after the Fed stops raising rates. If the Fed isn't fast enough and inflation starts to really pick up I may add a small portion of a balanced commodity fund to the mix but I don't anticipate doing this. I will continue to stay away from either developed or emerging market equities as their risk/return profiles continue to lag those of the US.