04/22/17

Quarter in Review

The Markets

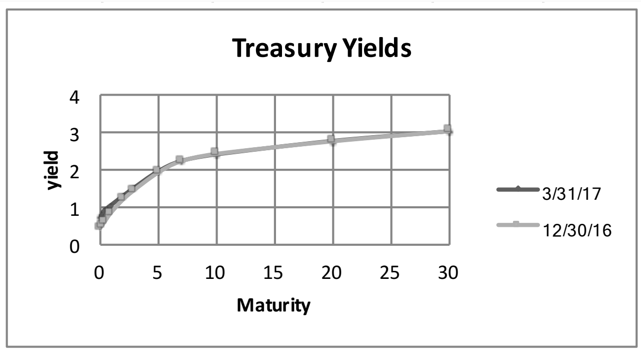
The first quarter of 2017 was a relatively benign news quarter compared to the end of 2016. The inauguration was a non-event for the markets but it looks like it will be as tough of a road for this president as it was for the last in passing legislation. The repeal and replace of the Affordable Care Act didn't even see a vote. Executive orders seem like the only way a president will be able to effectuate change going forward, and even then, a judge in some jurisdiction can block that. The supreme court does have a new judge but only after the senate had to remove the 60-vote majority. Washington now looks very similar to the Washington of 12 months ago. Across the pond, Theresa May and the Parliament triggered article 50 and have official started the process of leaving the EU. The process will no doubt be a difficult one and one in which the UK will be made an example of. I fear that the long-term effect on the British economy will be extremely harsh to its citizens, especially the younger demographic that voted to stay in. The IMF in February stated that Greece will not meet its budget surplus outlined by Europe and said that it's debt levels are unsustainable. This is something to keep an eye on in the second quarter of 2017.

The US economy in the first quarter hasn't fared very well with estimates at the time of this write up of 0.80% annualized GDP for Q1. US Securities did however do well during the quarter but like oil started to decline in the middle of March. The big winners were both non-US developed and emerging markets, up over 6% and 11% respectively. Large Cap and Growth sectors outperformed the smaller caps and value sectors, a reversal of last year's trends which saw small cap value up over 27% for the year. The Federal reserve did in fact raise its federal funds target to 0.75-1.00% on March 16th another 25 bps from December, and bonds started to feel a bit of pressure in the month of March. Overall for the quarter, long term bonds returned 1.57%, with intermediate and short-term bonds returning 0.82% and 0.57% respectively. High Yield and International Bonds returned about 2.4% for the quarter with Real Estate REITs earning only around 1%. Commodities were the big loser with oil dropping from $55 to $50 a barrel. Commodities as a whole were down about 5.7% for the quarter.

Interest Rates

In March, the Federal Reserve raised the federal funds target another 25 bps. Comparing December's rates the yield curve has bear flattened. Meaning the front end of the curve has moved up 25bps while the backend has remained in place. However, the bigger news from the minutes of the meeting released in early April was the Fed will start to decrease the size of its balance sheet starting at the end of this year or early next year. This in of itself is a tightening of monetary policy and should have a widening effect on overall yields. However, since the release of the minutes the back end of the curve has rallied (prices climbed, rates fell). Now this may be due to the fact that the US bombed Syria and also because of the escalating tensions in North Korea, or even the surprisingly combative news conference held between Tillerson and Lavrov over both issues. But the yield curve is flattening, albeit gradually.

Years	3/31/17	12/30/16	Difference
0.08	0.74	0.44	0.3
0.24	0.76	0.51	0.25
0.5	0.91	0.62	0.29
1	1.03	0.85	0.18
2	1.27	1.2	0.07
3	1.5	1.47	0.03
5	1.93	1.93	0
7	2.22	2.25	-0.03
10	2.4	2.45	-0.05
20	2.76	2.79	-0.03
30	3.02	3.06	-0.04



The Mortgage Bankers Association weekly survey showed average 30yr-Fixed Conforming Balance rates at 4.22% (with 0.35 pts) while Jumbo 30-yr Fixed Rates were 4.15 (with 0.23 pts). Average 15-Year fixed rate mortgages were at 3.5% (with 0.41 pts). Mortgage applications have decreased from a week ago, while refinancing is up. The purchase index also showed signs of slowing.

Leading Economic Indicators

The Conference Board's leading economic indicators (LEI) increased to 126.2, up each month in the quarter ending March 2017. More importantly in all three months, including March, 8 or 9 of the indicators were up. The only troubling indicator in my mind was that the average workweek for production workers was down. Excluding the rise in energy production we can see that IP wasn't a great number in March either. Although new orders from ISM was actually positive, both manufacturers new orders for consumer goods and capital good are always estimated in the report. With employment being lower than expected this month I am started to get a bit concerned regarding manufacturing. Unemployment claims were also a drag on the LEI this month but at 250k there is seriously nothing to complain about here. In general, the LEI is showing no signs of a slowdown in the economy.

Jobs

At the time of this write up **nonfarm payrolls** posted an increase of just 98,000 jobs for March (consensus was 180k). This was not a great number and not statistically different than zero. With that said at the current stage in the business cycle and with the unemployment rate at 4.5% we should expect a slowdown in job gains. **But how many jobs do we need to add on a monthly basis to keep the unemployment rate at this level.** The Atlanta Fed has a Jobs Calculator (https://www.frbatlanta.org/chcs/calculator.aspx?panel=1) that based on the current statistics from the CPS and CES surveys allow us to calculated that number. To keep the unemployment rate at 4.5% over the next 12 months with a 63% participation rate and a 0.083 monthly population growth, **we need a little over 121k jobs per month**. But if we want the participation rate to rise to pre-crisis levels (66%) using a long run average of 200k per month and keeping the unemployment rate at 4.5%, it would take us the next **8 years** to get there. One of the issues that remains is the amount of people that are **not in the labor force but who want a job**. The St. Louis Fed keeps track of this in their FRED database here (https://fred.stlouisfed.org/series/NILFWJN). This number has been coming down from its peak in August 2012, but it still stands at an estimated **5.78 million people**.

The ISM survey for manufacturing jobs have continued to increase to a 58.9 level for March (anything about 50 is expansionary). Each of the three months in the quarter saw positive gains in the manufacturing employment, but the year over year numbers have drastically slowed from their post-recession peaks of close to 2% growth to just 0.30% ending March 2017. The most recent industrial production numbers show positive print but Manufacturing along with Business equipment and construction were down in March. The main reason for the positive IP print this month was an 8.6% increase in the Utility sector, reverse it two-month decline. I am cautiously optimistic here, and waiting for the April jobs print.

Industrial production

As stated above Industrial production started the year on a positive note up 0.326% for the quarter, but without a strong print in March it would have been negative or flat. And that strong print came from the rebound in Utilities as March saw much more normalized weather, and heating usage. The main drag was the reduction in output by motor vehicle and parts, while consumer durables also declined. The ISM survey for manufacturers was relatively strong with only the inventory index showing signs of contraction. New orders, employment, prices, deliveries were all above the 50 level. Like the jobs numbers the IP report is mixed, overall the year over year growth rate is up 1.5% with positive readings across the board. The headline number is strong but with weakness in areas of concern.

Housing

Single-family new home sales were 592,000 units per year as of February 2017, the strongest number since July of 2016, and closer to the long run average of 651k. **Existing home sales increased** to 5,710,000 in March up from the previous month, and through the 5.3mm 12-month average. Building looks healthy with permits, under construction, completions and single family starts all up year over year. And with the delta between permits and starts turning positive it looks like the future housing activity is also positive. The S&P/Case Schiller 20 city composite index has risen 5.73% in the twelve months ending January 2017. Mortgage applications decreased by 1.8% for the week ending 04/14/2017, while refinancing was up 0.2% from the previous week. The seasonally adjust Purchase Index decreased 3% from the previous week as well. Mortgage rates have actually held pretty constant in the face of rising fed fund's rates, as the back of the yield curve has even rallied. Housing looks pretty strong from purchases, to building, to interest rates.

The Consumer

The Conference Board's consumer confidence index has risen substantially since year end to 125.6 the highest level for the last twelve months. The University of Michigan Consumer Sentiment index also ended the quarter up at a level of 96.9. However, depending on which political party you are in you view the future economy quiet differently. An overwhelming majority of republicans believe the economy with continue to expand for the next five years, but less than a quarter of Democrats believe it. The opposite is true when looking at a move into a recession with a majority of Democrats in favor while Republics are not. For this reason, among others, I take both of these sentiment indicators with a grain of salt. The new "term" for indicators like these are "soft economic data." Maybe they should have used "weak" instead.

Probably the best indicators in the bunch this time around are the consumer's Income and Outlay statistics. They all showed signs of increases year over year, with Real Personal Consumption Expenditures on Durable Goods up 7.59% since February of 2016. Real Personal Income Less Transfers was up 2.56% year over year. Although growth in this statistic stalled in 2013, it has been consistently above 2% since January 2014. The savings rate currently stands at 5.6%, up from December but holding pretty steady.

Lastly consumer credit expanded at a 6.31% annual rate ending February 2017. Revolving and Non-Revolving consumer credit are now expanding at similar 6% rates. The 300-lb. gorilla in the room though is that of the 1.4 trillion dollars of student debt the US Government, or we the people, own **1.08 Trillion** of it **with 11.2% of it being**

delinquent. However, in the New York Fed's Quarterly Report on Household Debt and Credit (https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/HHDC_2016Q4.pdf) it states that t**his number is about half** of the total delinquency. Said another way there is over **242 Billion dollars** of student loans that are delinquent. See footnote 2 on page two for an explanation.

To put this in perspective for all those "bankers are evil" people, the total amount of the financial crisis bailout was **623.4 Billion**. Of which Banks and Financial Institutions received **245 Billion**. **To date the treasury has received 703.3 Billion back!** (https://projects.propublica.org/bailout/) How much of the above delinquent student loans do you think are going to come back in? Maybe if the US Government didn't provide a trillion dollars in loans, then the price of education might to start moderate.

Inflation

As of March, CPI was up 2.38% over the past twelve months. March was the first month the index was down since February of last year. This was driven by a decline in gasoline along with wireless telephone services. Food at home, groceries, was up for the month, but down 0.9% for that past twelve months. However, food away from home, restaurants, saw a 2.4% increase year over year. Energy in general drove the bus year over year up 10.9%. Core inflation, those items excluding food and energy was also up 2.0% year over year. Used cars were down 4.7% while shelter, transportation services, and medical saw and average increase at or about 3.4% year over year. PCE, the indicator the Federal reserve prefers was up 2.12% ending February. As of the end of March, TIPS breakevens across the maturity spectrum ranged from 1.77 to 2.08% (http://www.bondeconomics.com/2014/05/primer-what-is-breakeven-inflation.html). We will have to wait till April 28th to take a look at the GDP deflator and the US employment cost index (ECI) but I am confident that inflation near the Fed's target has been confirmed.

In Closing

We are now **93 months** into an economic expansion with the **average expansion being 42 months** (and the longest being 120 months) for the past 33 cycles. The yield curve has started to flatten a bit, given the front ends reaction to the Fed's March Increase of the Fund Rate target. The back end has held tight despite the minutes of the Fed's meeting talking about unwinding the four trillion of treasuries and mortgage backed securities on its balance sheet. The leading indicators were up again and it was 8 or more of the indicators up each month for the quarter. Employment numbers slowed and missed the consensus view, but as the expansion ages, and the unemployment rate declines this is to be expected. The issue that we face is what labor force participation rate are willing to stomach going forward and how we decrease the number of those not included in the labor but who want a job. Industrial production had a positive quarter, but mainly because March was strong, and within March Utilities had a big month. Manufacturing is slowing down, especially in the auto industry. They were producing at probably unsustainable levels and this may be a retracement back to a more realistic long-term production level. But we should be watching IP closely as it had a tough 2016, and is an important gauge of the economy. Consumer confidence is at all-time highs, but very politically biased. However, consumer income and purchases remain strong even for durable goods. Consumer credit is expanding at a 6% rate in both revolving and non-revolving segments. But I grow increasingly concerned about the level of student debt not only held Federally but also because of the belief by many students that someone else should pay for their education (https://www.washingtonpost.com/news/get-there/wp/2015/03/30/a-revolt-is-growing-as-more-people-refuse-to-pay-back-student-loans/?utm_term=.d1b66e8b8225). At what point in time do we take responsibility for our own actions?

Inflation looks to be holding and it is broad based. The Fed might actually be getting in front of it this time… just kidding. The portfolios continues to have a heavy waiting to small and midcap stocks. The large caps and foreign stocks were the definite winners of the quarter though. The move out of Real Estate was correct, and I am very thankful for not getting into commodities, despite inflationary pressures. The quarter can be designated an inflationary quarter as CPI was increasing at a faster rate than IP, and if GDP projections are correct this will mirror IP. I will continue to hold off allocating to long term bonds until the fed is done raising interest rates, but if the market starts to falter I will definitely pair back the equity holdings, and long bonds will be where I park a portion of the money.