08/04/17

Quarter in Review

The Markets

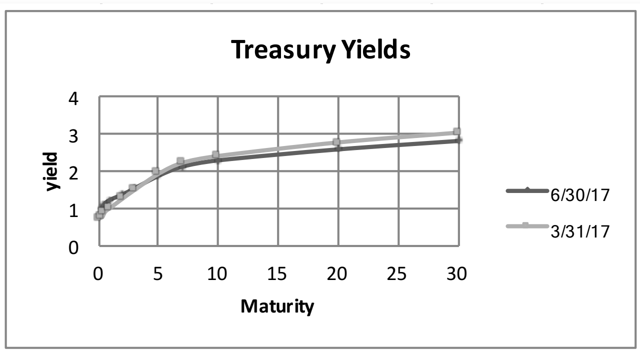
2017's second quarter was full of dramatic stories and otherwise market altering news on a global scale. From the US strike on Syria in response to chemical weapons usage, to North Korea's successful test of an ICBM, to the four separate terror attacks in the United Kingdom, the geopolitical volatility has increased dramatically. In an attempt to shore up her power Theresa May called for a snap election but wound up losing her several seats in Parliament. Brexit turned one year old and the EU looks like they are in a significant power position for this negotiation. Emmanuel Macron won the French presidential election and then increased his party's power days later in the parliamentary elections, ousting traditional politicians from their jobs, but defusing one of Europe's nationalist movements. There were also two separate Ransomware virus releases causing major problem in the medical and transportation industry. The Euro-area finance ministers released 8.5 billion Euros in new loans to Greece, staving off another possibility of default. The U.S. wasn't short of news either, from the withdrawal from the Paris Accord, to the removal of James Comey as the FBI director, and Robert Mueller investigating not only collusion ties but also the prior business dealing of the Trump campaign with Russia. The Federal Reserve raised rates again in June and will start to slowly reduce its balance sheet this Fall, although the ending target could still be three times its original size prior to the recession.

Despite an extremely volatile non-economic data, the quarter's performance across the different asset classes wasn't bad, except for Commodities which took another bath as oil lost another $5 a barrel. US equities were up with growth outperforming value and large caps out performing small caps. Again, the bigger winners though were developed and emerging market equities up over 5% and 6% for the quarter, and 11% and close to 18% respectively for the year. Having erased 2015 negative returns in 2016, let's see how they hold up for the remainder of the year. On the fixed income side the best performing segment was global bonds ex-US, up 2.21% for the quarter and 4.69% for the year. High Yield and Long-Term Bonds were up about just over one percent for the quarter. With inflation falling in May and June, TIPs underperformed and was down almost half a percent for the quarter. Real Estate continued to limp along earning 1.65% for the quarter and is up 2.65% for the year. Lastly commodities lost another 5% and are now down over 10% for the year.

Interest Rates

In June, the Federal reserve raised the federal funds target another 25 bps to 1.0-1.25%. They justified the rate increase by strength in household spending, labor markets, and general economic activity. The bigger news was how the Fed outlined its plan for reducing the balance sheet which currently stands at $4.465trn. They stated that there would be limits on the reinvestment of principal received from both Treasuries, Agency and Mortgage backed securities. Treasuries would be limited to $6bn per month, increasing by $6bn every three months with a maximum of $30bn per month going forward. For Agency and MBS this figure was limited to $4bn per month rising every three months by $4bn up to a max limit of $20bn. What does this mean? Based on estimates of the Fed's balance sheet maturity schedule this means that the Fed looks likely to reduce to balance sheet to around $3.00trn over the next three years. Or the level it was in January of 2013 (https://fred.stlouisfed.org/series/TREAST). This is a far cry from the $800bn before the financial crisis in 2008. The Fed looks poised to start this in December of 2017 along with potentially one more rate hike. But if inflation continues to fall (1.65% CPI and 1.42% yoy as of June) this could remove the December rate hike. Taking a look at break-evens, nothing across the curve has been near 2.00% since the beginning of May. The curve flattened this quarter with the back-end rallying and the front end reflecting the increase in the funds rate. The spread between 2yr and 10yr treasuries was 0.93% as of 06/30/17, similar to what it was a year ago, except that the entire curve is now wider by an average of 75bps, or close to the amount of the Fed's tightening.

Years	6/30/17	3/31/17	Difference
0.08	0.84	0.74	0.1
0.24	1.03	0.76	0.27
0.5	1.14	0.91	0.23
1	1.24	1.03	0.21
2	1.38	1.27	0.11
3	1.55	1.5	0.05
5	1.89	1.93	-0.04
7	2.14	2.22	-0.08
10	2.31	2.4	-0.09
20	2.61	2.76	-0.15
30	2.84	3.02	-0.18



The Mortgage Bankers Association weekly survey showed average 30yr-Fixed Conforming Balance rates at 4.17% (with 0.36 pts) while Jumbo 30-yr Fixed Rates were 4.11 (with 0.25 pts). Average 15-Year fixed rate mortgages were at 3.45% (with 0.44 pts). Mortgage applications have decreased 2.8 % from a week ago, while refinancing was also down 4%. The purchase index was also down 2% from a week ago but up 9% from 2016.

Leading Economic Indicators

The Conference Board's leading economic indicators (LEI) increased to 127.8, up each month in the quarter ending June 2017. The revisions to the prior quarter showed that on average 7 or 8 of the indicators positively contributed to the rise in the index. This was weaker than prior, and that average continued in Q2. My fear of the average work week hours for the production workers proved overblown as the revisions showed it was hovering around 42. But as I stated above the yield curve flattening has seen the spread between the fed funds rate and the ten-year decline and therefore the contribution to the LEI decline as well. The large increase in ISM new orders and the rebound in building permits more than offset the increase in weekly initial unemployment claims. Again, the LEI isn't showing a slowdown in the economy for this quarter.

Jobs

At the time of this write up **nonfarm payrolls** posted an increase of 231,000 jobs for June (consensus was 180k). The April and May numbers were also revised higher up 207k and 145k respectively. Last quarter I spoke about the amount of jobs needed to keep the unemployment rate at 4.5% at a 63% participation rate. Since that number was 121K and average of the above three numbers was above that, **the unemployment rate fell to 4.4%** as June 2017. Other positives from the BLS report was that the median duration of unemployment is below 10 months at 9.6, the first time it has been under 10 since the middle of the recession. Temporary help services were up 4.74% year over year in June. This indicator typically leads recession as temporary workers are laid off first.

The ISM survey for manufacturing jobs have continued to increase to a 55.2 level for June (anything about 50 is expansionary). Manufacturing employment in the BLS survey showed an increase in April, but essentially flat for May. Year over year manufacturing employment is up, and also much better than Q4 of 2016. Overall the Q2 2017 jobs numbers were positive, and the Fed used them partially as justification for rate increase.

Industrial production

Q2 Industrial production numbers were stronger, up 1.29% vs. Q1 up only 0.05% (essentially flat). With inflation dramatically slowing for the quarter, it was still labeled a "growth" quarter vs. chaos. This quarter however mining was the largest contributor to IP. Additionally, mining was up 9.9% year over year the (but 9% below its peak in December 2014), with the next highest sector being Construction up 3.1% since 2016. The report stated "advances in in oil and gas extraction, in coal mining and in drilling support activities" (https://www.federalreserve.gov/releases/G17/Current/g17.pdf) caused the gain. The ISM survey for manufacturers finished the quarter up 57.8, and it hasn't been below 50 since August of 2016. New orders were up over 60 and deliveries were a solid 55. If I was looking for a dark cloud IP is definitely not it.

Housing

Single-family new home sales were 610,000 units per year as of June 2017, the strongest number since July of 2016, and closer to the long run average of 651k. Year over year this number is pretty volatile but it has been a pretty good predictor of upcoming recessions, albeit it turns negative 12 to 24 months prior. It went double digit negative in the beginning of 2006, well before the recession in 2008-2009. But for the most part its signals have been around a 12 months prior. Now July's print will have to be pretty large not to show a negative y-o-y number, but I am sure anything in high 500k annual rate should be fine. **Existing home sales increased** to 5,520,000 in June about as close to the last twelve data points average as you could get.

The S&P/Case Schiller 20 city composite index has risen 5.70% in the twelve months ending May 2017. Mortgage applications decreased by 2.8% for the week ending 07/28/2017, while refinancing was down 4.0% from the previous week. Mortgage rates have declined this year about 20 bps, but refinancing is at a nine year low. Overall though the housing markets looks relatively strong, from new home and existing sales, to construction and even Schiller. The back end shouldn't widen out that much when the treasury starts to wind down its balance sheet, but I will be watching for the knock-on effects to the construction sector as a whole.

The Consumers

The Conference Board's consumer confidence index stood at 117.3 as of June 2017, off the march high but it rebounded in July to 121.1. The University of Michigan Consumer Sentiment index ended the quarter at a level of 95.1, also off its high and trending downward. The underlying data points in the survey saw some really positive numbers though. With 51% of respondents reported improvement in their finances, the highest figure since 2000! Net income references also were the highest in a decade. Inflation expectations rose slightly to 2.6% over the next year and 2.5% over the next five. Finally, 62% of homeowners selling their homes responded that they had gains in their homes.

Personal income and outlays showed increases across the board for the quarter, but the rate of increase is slowing year over year. Revisions to March numbers also showed a less rosy picture than had previously been thought. Real Personal Consumption Expenditures on Durable Goods were up 5.29% since June of 2016. Real Personal Income Less Transfers was up 1.08% year over year, and this number is well below the long run 3% average. This is in stark contrast to the consumer sentiment surveys. But overall the quarter wasn't bad, it just didn't show the increases like those from Q4 2016 and Q1 2017. The Personal Consumption portion of GDP was up 2.62% year over year.

Lastly consumer credit expanded at a 5.77% annual rate ending May 2017. Revolving and Non-Revolving consumer credit are now expanding at 6.06% and 5.66% year over year.

Inflation

As of June, CPI was up 1.65% over the past twelve months, a stark contrast from the 2.38% in March. May was negative and June was flat, which doesn't seem to be altering the Feds current tightening path or the reduction plan for its balance sheet. The largest contributors to the decline came from energy, with both gasoline and fuel oil down around 6% in May and around 3% in June. Looking at the past twelve month the biggest decline was in the used cars and trucks down over 4%. Most sectors excluding gasoline, clothing, and food at home saw increases of anywhere from 2 to 12% for the past year. PCE was up 1.42% for the past twelve months ending June less that CPI. The GDP deflator was up only 1.6% for the same time period. The Fed and the street will definitely be watching this number as it seems job growth isn't slowing toward its full employment equilibrium. Lastly TIPS break evens were 1.63% for the 5yr and 1.85% for the 30yr. All the inflation numbers are below the Fed's target.

In Closing

We are now **96 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 continued to flatten, while the front end widens and the back end comes in. I don't believe that the Fed starting to wind down the balance sheet will add much pressure to the back end, as the market knows exactly their plan, method and time period, and there hasn't been a reaction. The LEI showed the economy is still expanding, and employment numbers were strong if not unusually strong given the unemployment rate and the length of this expansion. Labor force participation rates have been hovering at 63% for the past five years now and although those "not in the labor force but who want a job now" has continued to decline, was that because they no longer want a job or because they found one? Industrial production had a great quarter up 1.29%, a definite improvement from Q1, and strengthens the possibility of the expansion continuing. The increase was across all major market groups, but mining was definitely the standout this quarter and contributed the majority of the increase by the three industry groups. This has reversed my view from last quarter that manufacturing was slowing down, and coupled with M3 report from the Census bureau and real manufacturing and trade sales data, I don't see the slowdown that I was seeing in Q1. Housing also had a pretty good quarter with an increase in annual rate of new home sales and existing home sales above 5mm annually since November of 2015. If there was on grey cloud in this quarter it could be in the consumer, in that they didn't look as good as Q1 but nothing has turned negative. We saw increases in Q2 in personal income, disposable personal income, expenditures, durable goods and real personal income less transfers. They just weren't as big of increases as we saw in Q1. So, does this bleed into Q3 GDP, yes I think it might. One of the points in the Michigan survey made this month that stuck with me is was that households with income in the top third reported less favorable buying attitudes. And since they account for over half of all spending this gives me and maybe GDP reason to pause. Lastly inflation doesn't look great across all the indicators, it looks like it is stalling around 1.5 and Yellen and the Fed don't seem affected especially given that jobs keep printing 200k a month.

So, does all the talk of bond and stock market bubbles and stagflation concern me? Not yet, the underlying fundamentals of the economy look fine if not strong. I will always be concerned of the knock-on effects of defaulting student loans, and the ability of the next generation to remove the noose around their necks. It *will* decrease their ability to buy houses, and cars and other durable items, and that could have a dampening affect over the long run. I continue to hold my US equity exposure in the mid and small cap spaces. I am shorter duration in anticipation of continue rate hikes and the reduction in the Fed's balance sheet. The quarter was designated as growth as IP far outpaced inflation. I trued up the portfolios in July, only to exchange the mid cap value fund for all taxable and IRA accounts and the large cap value fund for those accounts with a 6% target rate of return.