10/20/17

Quarter in Review

The Markets

In the third quarter of 2017 we again have seen a barrage of news both tragic and terrifying. North Korea followed its successful ICBM test with not one but two missiles over Japan, which drew the ire of the global community enough that the UN security council imposed new sanctions on the country. Hurricanes Harvey and Irma left Houston, western Florida, Puerto Rico and much of the Caribbean with billions of damages, loss of life and months if not years of reconstruction efforts. The destruction was briefly felt in the claims and employment data in September but should reverse in October. Politically the White House has failed to enact much of its campaign platform, struggled to define a clear global message, and lost many business leaders to several of the president's councils. The Robert Mueller investigation continues and the Senate Select Committee on Intelligence has produced almost nothing in a viable public response to the Russian interference with the 2016 election. Facebook has turned over Russian linked Ads to Congress but there is now a debate on who should release them to the public. Will journalistic integrity or source ever be part of their algorithm? More importantly does the consumer even care? Brexit looks as bad as it did 3 months ago with little or no progress being made. The EU wants a total of 100 billion Euros in the divorce and a hard landing is looking more likely for the UK, as the BOE has hinted on raising interest rates. In the US, there were no rate hike in Q3, but the Fed confirmed it will start to reduce its balance sheet in October of this year with estimates of a 1.5 trillion reduction of the balance sheet so slow that markets aren't meant to feel it. The likelihood of a rate hike in December is climbing even as Stanley Fischer, a comparatively hawkish member, resigned prior to the end of his term for personal reasons. Randal Quarles has been sworn in as his replacement on October 13, 2017 to fill his term expiring in January of 2018. This still leaves three vacant spots on the board, while Chair Yellen looks to be replaced in the new year as well. Lastly the U.K. Financial Conduct Authority will phase out the use of LIBOR by the end of 2021. Hurt by trader collusion and lack of liquidity, LIBOR has become an unviable benchmark for banks/asset managers to use as a reference rate. Banks will continue to submit rates until such time, but the ground work for its replacement is being made on a country by country basis. In the US, the Alternative Reference Rates Committee has already recommended a broad Treasuries repo rate as its replacement starting in the first half of next year. The main problem is this "overnight rate" doesn't match up well with the most widely used one and three-month securities.

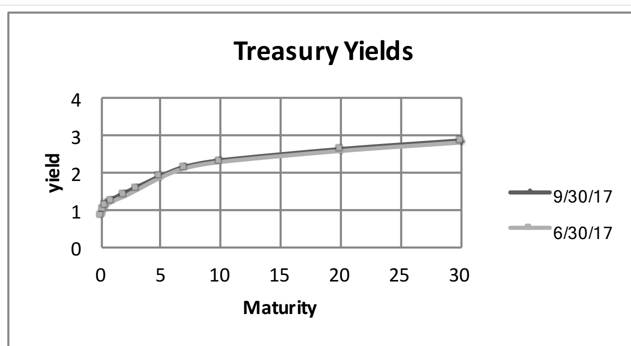
The quarter's performance was more reflective of the news this time, with the July positive, August negative, and September recovering. The biggest winner for the quarter was emerging market equities up 8.35% with the bulk of

that gain coming in July. Commodities followed up 6.5%, reversing some of its early year loses, but still down over 4% for the year. Developed Market (Non-US) rounded out the top three up almost 6% for the quarter with July and September adding equal shares. Bonds in general underperformed the equity market but did have positive returns, from 0.26% for 3-month T-bills up to 2.47% for Global Bonds.

Interest Rates

The Federal Reserve will start to reduce its balance sheet this month, but in such a planned and gradual process as to hopefully not spook the market. We won't see much in direct change to interest rates for probably a year or so, as the amounts are so small the investment world should be able to absorb it without much of a problem. The process to reduce the balance sheet should take the next four to five years to get it closer to 3 or 2.5 trillion. This would be near 13% of the total GDP. The effect on the treasury market will probably not be as large as on the mortgage market as the Fed owns close to a quarter of all outstanding mortgage backed securities. This is in comparison to a little over an eighth of the total treasury market. What will continue to move the curve would be a December increase of another 25 bps to a 1.25-1.50% target rate, and the probability is high this will happen. From June until September the yield curve has remained essentially unchanged as there hasn't been a rate increase over the same time period. The front end of the curve is up about 8 bps while the back-end up only 2 bps. Inflation since June of this year looks to have picked up in bit.

Years	9/30/17	6/30/17	Difference
0.08	0.96	0.84	0.12
0.24	1.06	1.03	0.03
0.5	1.2	1.14	0.06
1	1.31	1.24	0.07
2	1.47	1.38	0.09
3	1.62	1.55	0.07
5	1.92	1.89	0.03
7	2.16	2.14	0.02
10	2.33	2.31	0.02
20	2.63	2.61	0.02
30	2.86	2.84	0.02



The Mortgage Bankers Association weekly survey showed average 30yr-Fixed Conforming Balance rates at 4.14% (with 0.44 pts) while Jumbo 30-yr Fixed Rates were 4.13% (with 0.32 pts). Average 15-Year fixed rate mortgages were at 3.45% (with 0.43 pts). This Mortgage applications have increased 3.6% from a week ago, while refinancing was mainly flat. The purchase index was also down 2% from a week ago.

Leading Economic Indicators

The Conference Board's leading economic indicators (LEI) increased to 128.6 for the quarter ending September 2017. As only 6 of the 10 factors contributed positively this month, the measure was down two tenths from August. Average production workers work week, weekly claims, manufacturers new orders nondefense capital goods (estimated) and building permits all contributed negatively this month. Claims should see a reversal in October as those workers displaced by Hurricane Harvey and Irma get back to work. ISM's new order index was up and contributed the most to index, so I am interested to see the actual manufacturers new order results and whether they are in fact a negative contributor to the index. The LEI is still showing a continued expansion.

Jobs

At the time of this write up **nonfarm payrolls** posted a decrease of 33,000 jobs for September (consensus was 80k). The Household survey (a much more volatile survey) was up 906,000 jobs. Couple this and the labor force participation rate of 63.1 and the **unemployment rate fell to 4.2%** as of September 2017. The negative print caught markets a bit off guard as many pundits didn't think the hurricanes affected the payroll report that much. But looking at the securities markets there was almost no reaction and markets have climbed higher since. Look for a rebound in October payrolls as can already be seen in the most recent reduction in claims data.

The ISM survey for manufacturing jobs have continued to increase to a 60.3 level for September (anything about 50 is expansionary). Manufacturing employment in the BLS survey was up about 29k jobs in Q3. Year over year manufacturing employment is up about 117k jobs. Overall the Q3 2017 jobs numbers were positive, and will help the Fed to justify another increase in December.

Industrial production

Q3 Industrial production numbers were weaker, down 0.58%, but up 0.84% year to date. This is in comparison to a 1.28% second quarter, and a 0.70% YTD through September of 2016. Since the quarter was negative and inflation was positive this quarter was labeled a "recession" period. The Federal Reserve, which produces this data, pointed out that without the hurricanes industrial production would have been up about 50 bps on a seasonally adjusted annual rate. Not great either but better than negative print. The silver lining in the report showed both mining and utilities were up as well as durable goods. The weakness came from the chemical materials space in areas most affected by the hurricanes. The ISM index was up to 60.8 as of September with all sub-indexes above 50 as well other than customer inventories. This means that in each case the manufacturing index was growing, and in most cases faster than the previous month, and the trend has been for almost an entire year now.

Housing

Single-family new home sales were 560,000 units per year as of August 2017, and have been declining since the July high of 614k. The three-month trend is definitely slowing and I will be watching this closer in the months ahead as it is a pretty good leading indicator, but it is a bit volatile. Year over year ending both August and September were negative (-7.5% and 1.23%), but we need double digits and multiple months of them before this presents any warning signs. Couple this with the first year over year negative print for permits, the cracks might just be showing. **Existing home sales increased** to 5,390,000 on an annual basis in September from the August print, but far less than the beginning of the year and a noticeable slow down. Year over year now existing home sales is only up 0.19%.

The S&P/Case Schiller 20 city composite index has risen 5.99% in the twelve months ending July 2017. With only three cities seeing price declines. A decline in inventory in existing homes and a slowdown in new building should help to buoy the market in the face of the Fed raising interest rates and maturing bonds on its balance sheet.

The Consumers

The Conference Board's consumer confidence index stood at 119.8 as of September 2017. It has been hovering around 120 for the past three months. The preliminary University of Michigan Consumer Sentiment index was at 95.3, also off its high of 98.2 last December and trending downward. Concerns about the hurricanes helped to reduce confidence in the national economy but was balanced out by their views of their own financial situations. Home prices, as mentioned above, along with increases in income levels have made the consumer feel better. This can be seen in the savings rate **decline from 4.1% in February of this year to 3.6% in September**.

Personal income and outlays showed increases across the board for the quarter, but the rate of increase is slowing year over year. Real Personal Consumption Expenditures on Durable Goods were up 5.80% since August of 2016, while Real Personal Income Less Transfers was up 1.34over the same time period. Unlike last quarter this supports the consumer confidence surveys above.

Lastly consumer credit expanded at a 5.49% annual rate ending July 2017. Revolving and Non-Revolving consumer credit are now expanding at 5.49% and 5.52% year over year. In general, the consumer looks and sounds pretty good. Houston and Florida have seemed to start to recover as claims data have ticked down recently but the devastation to Puerto Rico will surely cause investors to take long hard look at investing in debt instruments from that municipality for several years.

Inflation

As of September, CPI was up 2.23% over the past twelve months, a rebound back to March levels from the 1.65% of June. The rebound in energy prices over September helped to boost the number. Food also increased but at a much smaller amount. The areas for concern in the report lie with core goods: new and used cars down 1% and 3.7% the past twelve months, commodities less food and energy were down 1% and apparel was off 0.2%. The **service portion of the index increased with shelter up 3.2%, transportation 3.9% and Medical care services up 1.7%** over the last twelve months. Core inflation was up 1.7% since September 2016 and probably enough to keep the Fed on track for a December hike. The question is whether this is sustainable, and I believe from the above indicators it is. The Fed's rate increases and reduction in balance sheet should continue following a slow path barring Taylor becoming the next Fed Chair, but even then, I don't believe he will try to increase rates to follow his rule to the letter. Lastly TIPS break evens were 1.68% for the 5yr and 1.92% for the 30yr. PCE and the GDP deflator will come out over the next several weeks and we will have to see if they are in line with CPI.

In Closing

We are now **99 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 remained almost exactly the same as it was in June as the Fed has not increased interest rates nor started to reduce its balance sheet yet. The LEI is showing a continual expansion, employment has taken a pause because of the hurricanes, but a rebound is expected in October. Industrial production was also effected by the hurricanes, but a rebound in September showed that it was short lived and not necessarily cause for concern. Both new and existing home sales have cooled a bit, but house price appreciation has continued at a 5 to 6% annual clip. The consumer feels better, is spending and income levels are increasing albeit slightly. Lastly inflation has once again picked up a bit, enough to probably justify a December rate increase.

I don't see much reason for a more defensive position in the portfolios for now. I will take a look at the fund and ETF composition and see if anything warrants a change but am perfectly happy waiting for the new year. Small and Mid-cap stocks made up some ground on its Large-cap brethren this quarter, but unless tax reform for the little guys magically gets through in the next couple of months (not holding my breath) then I don't think they will catch up by year end. Of all the things that could have me worried is the simple investor complacency and more importantly the expectation that 15 to 20% annual equity returns are now the norm. I am hearing the same type of statements I heard ten years ago prior to the recession. This expansion has been slow and long, nothing is on the horizon and that unknown has me more spooked than seven straight months of negative industrial production could or the fact that we are closing in on a year since the Fed started to tighten in earnest. (12 to 18 months being the average prior to a recession).