**03/23/18**

# Quarter in Review

## The Markets

The main theme of the first quarter of 2018 was increased volatility in the US stock market. The VIX, which measures the implied volatility of the S&P 500 saw levels not seen since August of 2015. Since February these levels have been and continued to be elevated. The Q1 also saw another shooting, this time in Florida, which garnered another public response to gun violence. Companies, in leu of congress, started to take matters into their own hands, removing certain items from the stores. Walls street has stopped offering some security issuance to certain companies as well, and in my opinion is what a free market response should be, instead of trying to legislate the opinions of millions of Americans. In Fed news, chairman Powell presided over his first rate increase in March, while the White House enacted tariffs on steel and aluminum. NAFTA discussions are still underway, but the US has threatened China with tariffs on 50 or 60 Billion of its products for intellectual property violations. The quarter also saw many changes to staff at the White House, with Steve Bannon, Gary Cohn, Rex Tillerson, and H.R. McMaster either leaving or being asked to. As an aside to H.R. McMaster being replaced (this is the third national security advisor in this administration) people often forget that Reagan had six different advisors over his eight-year term and Eisenhower had five. The Senate was able to pass a 1.3 trillion spending bill in late March, but immigration reform, and thus DACA, will probably not get done without a wall on the Mexican border. In merger news, Broadcom not only met heavy resistance from Qualcomm's board but finally an executive order blocking the purchase completely. Facebook faced justified scrutiny from both the public and congress over the mishandling of 80 million peoples' data and the actions afterward to secure it. However, Mark Zuckerberg successfully supported the companies beleaguered stock with a good showing at his congressional hearing in front of the embarrassing and inane questions from an uneducated panel. I think regulation is on its way, and in this case probably should be. Lastly the estimates for Q1 GDP are half, 1.5%, of Q4's quarter over quarter seasonally adjusted annual rate. This was mainly due to the reduction in private consumption down from 4% in Q4 to only 1% estimated in Q1. Jobs in March slowed but the average is still near 200,000 monthly gains over the quarter, and the unemployment rate is only set to grind lower this year.

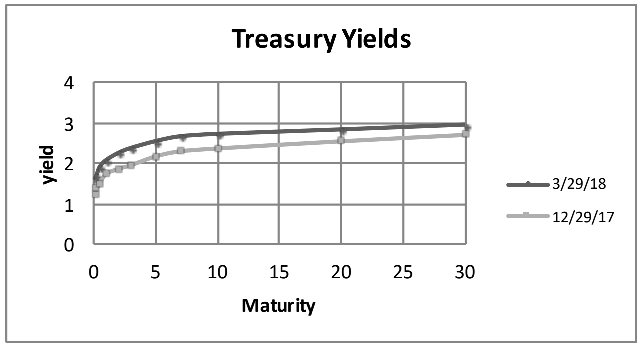
On the international front dozens of people died in Iran's protests during the beginning of the year, and this news item has essentially disappeared into the ether, swamped by dozens of other stories. The largest of these was Kim Jong Un's proposal to denuclearize North Korea and to enter into peace talks with the United States. He has already visiting president Xi in Bejing and now has plans to go to South Korea this month. In Europe Angela Merkel was finally able to cobble together a government in early February but only after the two largest parties, the CDU and SPD lost 8.6 and 5.2% of their percentage of government. The populist movement in Europe was not absent in Germany, with the AfD (Alternative for Germany) party gaining almost 8% of the vote. Putin was elected (shocker) to another 6-year term with 77% majority. The other options being the communist or imperialist parties… wow. Dozens of Russian "diplomats" were expelled from the US and the UK following the alleged poisoning of a former Russian spy and his daughter. Seems a touch convenient for ratcheting up the expulsions and sanctions after the conclusions have been made that Russia had influence during both the Brexit and US presidential votes. In China the National People's Congress removed term limit laws allowing President Xi to rule past 2030 and giving him more power to enact his "One Belt, one road" economic and technological plan for China's future. Lastly one of the largest laws, MiFID II, with over 1.2 million paragraphs was enacted. It now requires all brokers and fund managers to purchase their own research instead of paying through increased trade commissions or product purchases. Why what a novel idea, did it really take 1.2 million paragraphs to say that? In all seriousness the goals for the law is increased market transparency, more orderly or structured markets, lower cost data and better execution are all good goals, and the financial crisis of 2008/2009 caused it, but the legislative nightmare that produced this document are some of the same people that helped to cause Brexit.

In Markets, asset class performance was mixed, and definitely better in the emerging market equity, global bond, and commodities spaces. Although emerging market equity sold off like other asset classes in February and March, it still had a 1.4% return for the quarter. This compared to the value side US and Developed markets return being down from 1.9% to 2.8% for Q1. Staying short the US bond curve paid off with long bonds down 3.6%, medium term bonds being down 1.5% and short-term bonds down only 0.50%. Even though inflation has started to rise the TIPS index was still down 0.80%, and with an average maturity the same as the U.S. Aggregate index, there are duration affects here. High Yield actually didn't do that bad, down 1.2% for the quarter, but the best performer was Global Bonds up 3.6%. The alternative sectors of Real Estate and Commodities had mixed results down 4.2% and up 1.8% respectively.

**Interest Rates**

The Federal Reserve increased the target range for the Federal Funds rate by another 25bps in March to 1.50% - 1.75%. The effective rate has been around 1.69% since the meeting except for a few days over year end. This quarter the entire curve shifted up in an almost parallel fashion with the majority of the curve up 35 bps.

| Years | 3/29/18 | 12/29/17 | Difference |
|---|---|---|---|
| 0.08 | 1.63 | 1.28 | 0.35 |
| 0.24 | 1.73 | 1.39 | 0.34 |
| 0.5 | 1.93 | 1.53 | 0.4 |
| 1 | 2.09 | 1.76 | 0.33 |
| 2 | 2.27 | 1.89 | 0.38 |
| 3 | 2.39 | 1.98 | 0.41 |
| 5 | 2.56 | 2.2 | 0.36 |
| 7 | 2.68 | 2.33 | 0.35 |
| 10 | 2.74 | 2.4 | 0.34 |
| 20 | 2.85 | 2.58 | 0.27 |
| 30 | 2.97 | 2.74 | 0.23 |




The Primary Mortgage Market Survey from FHLMC showed the 30-year conforming balance fixed rate mortgage has ticked up over the quarter from 3.99% to 4.44%. 15-year conforming balance moved up more from 3.44% to 3.90%. The Mortgage Bankers Association weekly survey showed average 30yr-Fixed Conforming Balance rates at 4.66% (with 0.46 pts) while Jumbo 30-yr Fixed Rates were 4.53% (with 0.38 pts). Average 15-Year fixed rate mortgages were at 4.08% (with 0.50 pts). The current Mortgage Bankers report on applications has increased 4.9% from a week ago, while refinancing increased 4% as well. The purchase index was up 6% from a week ago.

**Leading Economic Indicators**

The Conference Board's leading economic indicators (LEI) stood at 109 for the quarter ending March 2018. Although only 6 of the 10 factors contributed positively this month, the measure was up three tenths from February. The largest contributors were the Interest rate spread (10-year treasury bonds less federal funds), ISM New Orders and the Average Consumer Expectations for Business Conditions. The largest detractors were Average workweek for production workers and Average weekly initial claims. I don't foresee the LEI continuing on a positive trajectory for much longer. Although still above 60 ISM new orders have been declining since December of last year, and the interest rate curve has been getting flatter in the 2s to 10-year area since March of last year. The LEI percentage change from the preceding months have also steadily declined. Not cause for concern just yet but something to keep an eye on.

**Jobs**

At the time of this write up **nonfarm payrolls** posted an increase of 103,000 jobs for March (consensus was 185k). The Household survey was actually down 37,000 jobs. Both number were below their statistical significance, and thus it could have meant we created zero jobs for the month. The labor force participation rate of 62.9 was a couple ticks higher than Q4 and the **unemployment rate held steady at 4.1%** and has been since October 2017.

The 103k nonfarm post was not a great number, an although the average was 200k for the quarter, jobs look a little soft, or at least the beginnings of it. Historically the unemployment rate as dipped all the way to 2.5% but that was post WWII 1950s, an entirely different time period. Interestingly though the Labor force participation rate at that time was sub 60% and falling. This was right before the recession that started in August of 1953. My point is that although Q1 2018 wasn't a great quarter, the economy doesn't look bad and I need more data prior to getting alarmed.

The ISM survey for manufacturing jobs has been just below 60 for the quarter with March's number at 57.3. This is expansionary, and a relatively strong number. Manufacturing employment in the BLS survey was up about 22k jobs in Q4. Year over year manufacturing employment is up about 232k jobs. All in all not a great jobs report but as we should expect this late in the cycle.

**Industrial production**

**Q1 Industrial production numbers were up 1.31%**. This is a definite slow-down from Q4 2017, but a solid print for an economy that looks like it is growing slower. Since the quarter was positive and inflation was positive this quarter was labeled a "growth" period. Since March 2017 IP is up 4.3% but a lot of that number was Q4 2017. Manufacturing Production was only up 0.1% in March, Mining up 1%, but Utilities jumped 3 percent as March saw winter come back with a vengeance. Capacity utilization was at 78% still below the long run average of 80% since 1967.

The total ISM index moved up 1 point on average from Q4 to Q1 to 59.7 and was supported across the underlying indexes. The manufacturing sector looks on stable footing, no warning lights yet.

**Housing**

**Single-family new home sales** were 618,000 units per year as of February 2018, falling both months since December. **Existing home sales increased to** 5,600,000 on an annual basis ending March, after revisions to prior numbers. The S&P/Cash Schiller 20 city composite index has risen 6.35% in the twelve months ending January 2018. **The January report had all 20 cities reporting positive** growth (seasonally adjusted). Factors that are supposedly helping the price increases are "low inventory for home sales and low vacancy rates among owner-occupied housing." Let's see how house pricing hold up as mortgage rates continue to climb, the Fed unwinds its balance sheet, and homeowners aren't able to deduct the amount of interest or real estate taxes they once did.

**The Consumers**

The **Conference Board's consumer confidence index stood at 127.7 as of March 2018**. Although off from February **18-year high** of 130, the trend is still positive. Business conditions (a positive number in the LEI) was considered the main reason, as were people's outlook on the stock market. Consumer's also pointed to the fewer potential jobs and thus lower short-term income, which helped to reduce the March number. **University of Michigan** is already out with its **preliminary April** numbers reversing the trend for Q1 but still showing a strong number. **Consumer Sentiment was 97.8, down from 101.4 in March.** Across all age groups people were concerned about the effects of the tariffs on the economy as well as inflation. Rising interest rates was also one of peoples concerns, although reading the housing report, home affordability doesn't seem to be a problem.

Personal income and outlays showed expansion across total, disposable, and consumption all up close to 4% year over year. Real Personal income less transfers also expanding but at a slower 2% annual clip. This is a lagging indicator but still one of the top the NBER looks at to confirm recession time periods. **The personal savings rate bounced back to 3.4% for February 2018,** but consumer debt still continues to climb at a rate of over 5% annually. Looking back over time consumer credit continued to expand, albeit at a slower pace throughout 2008, and only in 2009 did it start to contract**.** **Overall the consumer looks healthy** but the estimated pull back in spending in the first quarter is the only dark cloud.

**Inflation**

As of March, CPI was up 2.36% over the past twelve months, and seems to be climbing. Although some core goods fell in March, energy (-2.8% month over month) prices were the main driver in the month over month decline in the headline number. Core services, including shelter, transportation, and medical were up in March, while used cars, and apparel were down. With the passing of the budget and tax reform, CPI should stay above the 2% target for the year. It should be an interesting balancing act for the Fed as inflation increases, GDP moderates and unemployment ticks lower.

**In Closing**

We are now **105 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 did an almost parallel shift, up 35bps, along with the Federal Reserve increasing the Fed Funds target range another 25bps. The market expects another rate increase in June of this year, and then two more before year end. The LEI was up again but only 6 of the 10 indicators pushing it, and the rate of change from month to month is definitely slowing. Industrial production though was up 1.3% for the quarter, not the Q4 numbers but a solid print nonetheless. I postulated last quarter that the consumer had started to pull back, but personal consumption and expenditures on durables are still up large increases year over year. Let's see what the first estimate of Q1 GDP shows us. Lower consumer sentiment, caused by tariff talk and increasing interested rates, fell off in both the Conference and Michigan surveys. Inflation expectations continue to increase up to 2.8 as of March. Jobs seemed soft this quarter and unemployment has been at 4.1 for 6 months now. But temporary services have remained strong with no signs of abating.

I made a couple of changes to security selection this past quarter on some of the 401-Ks, but no changes to the risk profile of the accounts yet. First quarter overall wasn't great, across the portfolios we were down about 1.4% as value still continues to lag its growth and blended benchmarks. The place to be this quarter was Emerging markets and world bonds as the us market continues to tighten. I still feel we are 12 months or more away from a recession. There are different forces at work here that might make the curve continue to parallel shift prior to the recession, and thus the curve less of a forecaster of an impending recession. From the Feds reduction to balance sheet to an investor shift back into Treasuries if the ECB starts to stop its own QE. I will need to look elsewhere in the economy for signs of weakness. For now, I will stay in medium term bonds, and in the smaller value names until I start to see the turn.