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Capital
Management

An Investment Advising and Financial Planning Firm

Firm Inception 08/03/10

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Quarter in Review

The Markets

The first quarter of 2012 continued where the fourth quarter of 2011 left off. Most major **stock indexes posted double-digit gains** for the quarter. **Bond indexes saw very modest gains**, and the long bonds saw a 2% decline (but that is off a 22.5% gain in 2011). Alternatives as well posted good gains with **real estate up over 10%** and **Commodities up around 7%**.

With what looks to be an end to the Greek debt drama, based on a 95%+ participation rate in the second program, private bondholders took a 53.5% reduction in their notional amounts. Europe's GDP declines in the 4th quarter were also less painful than expected, but data still shows a mild recession the European economy in 2012. The Greek political situation is still up in the air with elections scheduled for early May. The ND and PASOK parties, which supported the austerity measures needed for the bailout, look less likely to gain a majority in parliament. The smaller parties, riding public support, may make it difficult to install the austerity measures, especially while Greek pensioners commit suicide outside their parliament.

In the US the 1st quarter 2012 saw our economy continuing to recover while most economic statistics in the US continued to point in that direction as well. The back end of interest rates climbed roughly 50 bps, as the Fed continued its maturity extension program, but more easing looks to be finished. The conference board changed 4 of the 10 leading indicators in their composite, but it still pointed to a continued expansion. Jobs hit a speed bump in March but the unemployment rate is down to 8.2%, and 635k jobs were created in Q1. Industrial production was off to a slow start and the employment figures released on manufacturing could point to a flat IP number in the first quarter. Housing is still losing ground and the government programs have done little to help or to distribute money earmarked for underwater borrowers. The consumer continues to look better with income up, credit increasing (albeit in student loans), and inflation moderating to a mid 2% level on an annual basis.



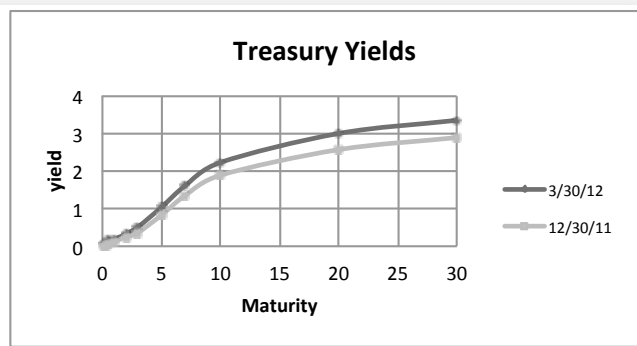
Interest Rates

January marked two significant changes in the FEDs communication policy. First was the release of participants' federal fund rate projections, a look into how each policy makers thinks the Fed Fund rate will look like in 2012, 2013 and 2014 and what the long run rate will be. It also shows when the participants of the FOMC think the first increase from 0 to 25 bps will occur.

(<http://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20120125.pdf>) An interesting observation on the latter is how widespread the thinking of voting members is on when the appropriate time to increase the Fed Funds rate will be. The seemingly additional information offered to the public may have added to the opaqueness of the decision, instead of demystifying the process.

The Fed's maturity extension program is now 2/3rds over in both time and amount purchased. They have purchased exactly the amounts in the 6-8yr, 8-10yr, 20-30yr, and Tips 6-30yr buckets they specified in their statement (http://www.newyorkfed.org/markets/opolicy/operating_policy_110921.html). This quarter however the back end of the treasury curve started to steepen with the 2yr to 10yr spread up from 164bps to 190bps. Conforming balance 30 year mortgage rates have moved back up around 4%, 5 bps higher than they were at the end of December.

Years	3/30/12	12/30/11	Difference
0.08	0.05	0.01	0.04
0.24	0.07	0.02	0.05
0.5	0.15	0.06	0.09
1	0.19	0.12	0.07
2	0.33	0.25	0.08
3	0.51	0.36	0.15
5	1.04	0.83	0.21
7	1.61	1.35	0.26
10	2.23	1.89	0.34
20	3	2.57	0.43
30	3.35	2.89	0.46



The March FOMC minutes were slightly more positive than January's, but in reality the FED still doesn't see enough of an expansion to warrant a change in its 2014 policy rate guidance. At a 0-25 bps target for the fed funds rate, and the maturity extension program finishing in June, few at the FED are calling for any more "Quantitative Easing." However at the time of this write up non-farm payrolls only posted 120k new jobs for the month of March, which have seemed to touch off selling in the equity markets. As more economic data is released this may influence the minds of the FOMC participants.



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Leading Economic Indicators

As of December the Conference Board changed the components of leading economic indicators (LEI). This was in response to last year's report on the effectiveness of the LEI during the last recession, and how M2 may not be as good of an indicator any more.

The new components of the LEI are:

1. **New Orders for (nondefense) Capital Good *excluding Aircraft***, which replaces New Orders for (nondefense) Capital Goods.
2. **ISM New Orders Index for Manufacturing** with replaces ISM Supplier Deliveries Index
3. **A combination of Consumer expectations of Business and Economic conditions from the surveys conducted by Reuters/University of Michigan and The Conference Board** which replaces the Reuters/University of Michigan Consumer Expectations Index
4. And finally the **Leading Credit Index (LCI)** which replaces M2 (money supply measure)

The **LCI** is comprised of 6 indicators that the conference board believes better represent the structural changes in the U.S. Economy since the 1980s.

- 1) Two-year Swap Spread
- 2) Libor 3-month Less Treasury 3-month yield
- 3) Debit balances at margin accounts at broker dealers
- 4) Senior Loan Officer C&I Loan Survey - Banks Tightening Credit to Large & Medium Firms
- 5) AAII Investor Sentiment: Bullish (%) Less Bearish (%)
- 6) Total Finance: Liabilities - Security Repurchases

Thus they have replaced one index, M2, with 6 others. Over the period from 1990-2009 the conference board compared the new LCI (both a 5 and 6 component index) to other financial indicators or indexes and found the LCI was a substantially better indicator.

The issue I have with the new components is that of timing. As an investor I am concerned with being both late and early to the party (a turning point in the economic cycle). The new LEI (ex M2 with LCI) started to show the 2008 recession 21 months prior to it actually occurring or about March of 2006, while the old LEI showed a recession coming about 5 months prior. If an investor had turned bearish in March of 2006, they would have missed double-digit returns in the equity markets. Granted they would have missed an over 30% downturn in 2008 but the old LEI would have done a pretty well, warning them five months prior, and missing the latter half of 2007 which saw flat to negative equity returns anyway.



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I believe the new components have improved the LEI, and have made me review my own economic model, but the new LEI can still only be used in conjunction with a current economic conditions model when an investor is seriously thinking about reallocating to a more defensive or aggressive position.

The Conference Board's leading indicators continued their positive trend in January and February, with 8 of the 10 diffusion indexes up for February. The index was helped by the reduction in unemployment claims, interest rate spreads, stock prices, and building permits. The negative contributors were average consumer expectations for business conditions and ISM new orders index. Looking at some of the components of the LEI for March, the LEI should probably be positive again unless the LCI comes back with a surprise.

The OECD business cycle clock still shows industrial production in the expansion quadrant as of February and now the composite leading indicators, business and consumer confidence indicators are all in the recovery or expansion quadrants. This is a substantial improvement over both the third and fourth quarters of 2011.

Jobs

At the time of this write-up **nonfarm payroll** posted an increase of **120k for March 2012**, and **635k jobs gained** in the **first quarter of 2012**. This compares to **492k, 383k and 389k jobs gained in Q2, Q3 and Q4 respectively**. Thus the total for LTM gained was **1.9mm**. The unemployment rate continued to decline from 8.5% in December to 8.2% in March. One of the other measures of unemployment is part of the Household survey, the A-15 report, which shows Total Unemployed including those "marginally attached to the labor force." This is of particular interest now more than before because of the amount of people that have been unemployed for so long. It is widely known that the longer someone is unemployed their chance of finding a job is diminished, based on stigma, skill loss etc. Therefore when looking at the U-6 (including those marginally attached) the unemployment rate is 14.5% vs. the 8.2% that is widely reported. Although high, this number too has come down from a year ago (15.7%) and is a positive for the economy. We are still far from the Fed's long run unemployment rate range of 5 - 6%, but we have made a dent these past 4 quarters.

Temporary or part time job services were **positive in Q1**, and the year-over-year increase is back around 8%, and the 4th quarter numbers were revised to show 8s as well. The **4-week moving average of unemployment claims** has stayed well under the **400,000** level now since November 2011 and stands at **364,250**. Lastly the Institute of Supply Management (ISM) employment index continued to have a level above 50, an increase from 53 for the prior two quarters to 54.5. Other than the 120k-nonfarm report, jobs continue to look good, let's hope that was a speed bump, and not an Upper East Side pothole.



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Production

The annual revision for the industrial production numbers was released on March 30th 2012. The revision yielded very similar IP and utilization numbers for both 2010 and 2011, but 2009 saw a steeper decline than what was previously reported. IP was down 11.4% for 2009 with it rebounding 5.4% and 4.0% in 2010 and 2011. The start of 2012 hasn't been very strong with an increase in January of 0.5% and a flat number in February.

The month over month, 3-month average and year over year numbers were all positive ending February for **Orders for durable goods** (items whose use last three or more years). More importantly durable goods orders that **exclude** large or "lumpy" values like aircraft were also up in both the 3-month and year over year average. The **ISM diffusion indexes** continued to report values greater than 50 for the past 32 months, with the **PMI index at 53.4 as of March**. The **non-manufacturing index** as well reported a **56** for March, a number that has been above 50 for the past 28 months.

Housing

Year-over-year changes in **new single-family sales** have been **positive for January (2.6%) and February (11.4%)**, but in truth this number is stuck around 300k. Price data from S&P/Case-Shiller ending January 2012 showed annual declines of near 4% in both the 10 and 20 city composite.

On April 12th 2012 the inspector general released a report that was very critical of the Obama administration's "Hardest Hit" housing program. This program is supposed to inject 7.6 billion into the housing market to help underwater homeowners. To date the program has only spent a little over 200 million. The main issue being that FNMA and Freddie Mac have refused to allow write-downs of mortgage principal. This is a double-edged sword for sure, as an investor I never want to see mortgage write-downs because I am the lender, and thus would bear the cost of the write down. I also know that the percentage of re-defaults after loan modifications for most delinquent loans is also very high as well, so simply reducing the interest rate on the mortgage tends to fail too. If the money from the program "passed-through" to the investor as a prepayment, I earn less interest (less total yield), and would have to re-invest that money at potentially lower yielding instruments. On the flip side if the programs fail to pass the money through I know that the probability of getting my principal back with house prices falling, and unemployment relatively high, gets smaller as time goes on. I find it funny that the Obama administration can't make two government owned and controlled entities toe the line with programs like this, but could re-order the priority of payments at Chrysler a few years back.

On the building side, permits for new home construction were **up 34.27%** in February year over year. This doesn't bode well for reducing our real and shadow inventory, and only benefits the builders.



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The Consumer

Consumer confidence pulled back a bit in the Confidence Board index but expanded again in the University of Michigan index for the month ending March. Each report suggested that the consumer in general was less optimistic about the short-term future, but showed no real signs of the economy turning down overall.

Personal Income and Disposable Income both increased for the first two months of the quarter at an average of **3.2% and 2.65% y-o-y**. Real personal income less transfers (removing social security, unemployment, welfare and disability payments) also increased year over year, but was down for the first two months of the year. Savings again took a hit, down to **3.7% from its post recession peak of 5.8%**. Over the past 53 years our average savings rate has been around **7%**. **Total consumer credit continued to expand**, but this was mainly due to non-revolving debt, specifically student loans. (Still think college inflation is curtailing???) Revolving debt (credit cards) was actually down for the second month, contracting over 5 billion or over half a percent, while interest rates continue to fall.

Again I feel the consumer looks better than it did a quarter or even a year ago. Falling savings rates obviously mean the consumer is spending, and even on durable goods like automobiles. My concern that they are spending too much too soon, may be abated by the simple fact that house prices haven't recovered, and thus the personal balance sheet is still stressed.

Inflation

The first quarter saw price increases in each month, however the annual number for CPI-U has decreased to **2.65% down from 3.00% in December**. Excess liquidity has declined from 6.18% in the 4th quarter to 5.97%. February was a rough month for gasoline prices up 6.0%, and up 1.7% in March. Food was up much less only 0.1% in March, all items less food and energy (core) was up 0.2% in March after a 0.1% in February.

In Closing

We are now 33 months into an economic expansion, with the average expansion being 42 months for the past 33 cycles. Equity markets have risen substantially in the first quarter but have seemed to cool in the early part of Q2. The Feds extension program is now 2/3rds complete and interest rates are starting to rise. Housing is still the 500-pound gorilla in the room with little changed heading into the election season. At this time I see a probability of a contraction to be about 10%, and will not change the current allocation to the portfolios.