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An Investment Advising and Financial Planning Firm

Firm Inception 08/03/10

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Quarter in Review

The Markets

What an end to 2014. US equities had positive returns for the quarter, ending the year up 13% and 14% respectively for large and mid cap stocks. Small caps, down for the majority of the year, had a huge rally in Q4 up over 9%, finishing close to 5%. The two biggest winners of the year though were long-term bonds and real estate. Despite the Fed's talk of rising interest rates, the Barclays long-term government/credit index was up almost 18% last year. If the Fed does start to increase interest rates this year, it will not be the sector to be in. Real estate was also up almost 19% for the year, but what hurt most of our portfolios was Commodities. Down almost 28% for the year it took as much as 3% off of some portfolios returns, while most were only affected by about 1.5%. The main cause for the commodity losses was oil dropping by essentially half its price. This was an unprecedented move that even most energy traders didn't see coming and are still licking their wounds.

4th quarter GDP looks on track to rise about 3.3% annually at the time of this write up, compared to actual 2.7% year over year ending Q3. Interest rates contracted in the backend of the curves as Treasuries rallied late in the year. The Fed's tone remains constant but there are definitely caveats to raising rates too soon. With inflation simply not there, energy costs cratering, and Europe ready to do more quantitative easing, the incentive to raise rates may not be there. Although the fed has "stopped" its bond-buying program, they continue to reinvest principal maturities into agency mortgages.

Jobs posted another 250,000 increase for December, but part time or temporary services are at an all time high, while wages remain stagnant. Industrial production was positive and in line with a revised Q3 number at just over 1%. This isn't bad but manufacturing employment, although up, is at the lowest its been, on a percentage basis, EVER in our countries history. Consumer confidence is high, but income was revised lower, while credit continues to expand. Inflation has disappeared, as the CPI was negative over the past two quarters, and well under 1% on an annualized basis, producing the second Chaos quarter in a row.

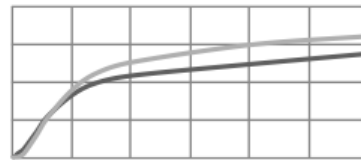


Interest Rates

The December FOMC statement maintained a positive view that the economy and labor markets continued to expand at a moderate pace. The committee didn't change its federal fund target from 0 to .25% but the market's consensus is that they will begin in June of this year. The committee felt that inflation would rise again to 2% target as the affects of lower energy prices dissipate. Principal maturities of their agency and mortgage backed securities holdings will continue to be reinvested in agency-mortgage backed securities, keeping their holdings at an elevated level. Their belief is that this should help accommodate better financial conditions.

Treasury yields continued to decline in the back end (longer maturities) dropping 35 to 51 basis points. It would seem that Treasuries, above everything else, are the safe haven that global investors run to, and did throughout 2014.

Years	12/31/14	9/30/14	Difference
0.08	0.03	0.02	0.01
0.24	0.04	0.02	0.02
0.5	0.12	0.03	0.09
1	0.25	0.13	0.12
2	0.67	0.58	0.09
3	1.1	1.07	0.03
5	1.65	1.78	-0.13
7	1.97	2.22	-0.25
10	2.17	2.52	-0.35
20	2.47	2.98	-0.51
30	2.75	3.21	-0.46



Leading Economic Indicators

The Conference Board's leading economic indicators (LEI) increased again in the fourth quarter of 2014. With solid gains for both the months of October and November, the ISM new orders index, interest rate spreads (as seen above), and leading credit index were the consistent contributors for both months. The diffusion index, measuring which of the 10 components were positive measured 70 and 80 respectively showing that the majority of components contributed positively.

Jobs

At the time of this write-up **nonfarm payroll** posted an increase of 252,000 jobs for December. We have gained 3.0mm jobs over the past 12 months (ending December), and the unemployment rate now stands at 5.6% (down 0.1% from September). However temporary help services is at an all time high, both nominally and relatively to those employed. Coupling this with low wage inflation, the pick up in jobs needs to have a bit of a caveat. Jobs are



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being created but with temporary employment. Another cautionary tale is that precipitous drops in temporary help services have been a good indicator of a potential economic slowdown. Now we will need to see if those drops are increases in long-term employment or a true sign of a slowdown. The household survey, the survey used to calculate the unemployment rate, added 111,000 jobs in December, a rounding error for the most part. Median duration of unemployment though is at a multi-year low at 12.6 months and the aggregate weekly hours worked index is at an all time high.

The **4-week moving average of unemployment claims** increased to **290,750** compared with the third quarter's number. A rebound in claims numbers isn't great but it is still well below the long run averages. The ISM manufacturing report on business showed an employment number that remains around the 55 mark (numbers over 50 are expansionary). These are all positives, but weaker positives in lieu of the temporary help services numbers.

Industrial production

Industrial production grew at 1.16% in Q4 up from an upwardly revised 1.13% in Q3. Manufacturing Employment continued to rise on a year-over-year basis, up 1.54% from December 2013 to December 2014. These are consistent gains but on a historical basis the percentage of manufactured jobs to total non-farm payroll is at an **all-time low, at 8.72% (and falling)**. This compares to an average rate of 21% in the 1970s, 16% in the 1980s and a 13% in the 1990s. The president may boast about saving the auto industry and creating a manufacturing revolution, but the numbers don't lie. Capacity utilization remains slightly below the long run 80.6% average; there doesn't seem to be a slow down in production or cause for concern in this area.

Housing

Single-family new homes sales were 438,000 units per year as of November 2014, below the downwardly revised September number of 455,000. **Existing home sales** dropped below the five million mark, while mortgage applications continued to decline. The S&P/Case Shiller index stabilized in the month of October, rising 0.8% in October for the 20-City Index with all of the 20 MSAs (Metropolitan Statistical Area) reporting an increase. Year over year the index is up 4.6% percent. Prices rebounded somewhat but we are definitely seeing a slow down, as confirmed by the FOMC statement as well.

The Consumer

Consumer confidence rebounded very well in Q4, posting highs in both the Conference board and Michigan surveys. Personal income numbers though were revised down for the many of the previous months. This shows in



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the year over year growth only reached 4% in October, whereas before the 4% number was reached in April. The trend is definitely positive but the revision helps support the relatively tame general inflation numbers. All the measures, from disposable income to real personal consumptions expenditures on durable goods (mostly cars) were positive. However the savings rate, negative for the majority of the year, just pushed through to 2.3% year over year in the month of November (another revised number). These are bad signs for the consumer despite their confidence. Consumer credit is once again on the rise with the total up over 7% year over year and both revolving and non-revolving credit on the rise. I guess all the lessons learned just six years ago have been forgotten, with all those temporary jobs created, why not go out and get loans and credit cards.

Inflation

CPI slowed again this quarter ending down -0.62%, while producer inflation PPI was down as well -1.26% for December alone. Over the last twelve months there has only been a 0.66% increase in CPI. This could become somewhat problematic, especially if the economy stalls or is affected by economic factors abroad. There isn't any place to go for the Fed Funds rate, and if there is a quantitative easing 4, then the Fed will have lost what credibility it has left. Deflation is not our friend, despite getting cheaper prices at the pump. Oil going to \$50 a barrel has been the main driver here, but will a snap back occur soon enough for inflation to be anywhere near the Fed's 2% annualized goal before the anticipated June rate increase? I am concerned that the Fed will use this as justification for keeping rates unchanged, despite full employment. Employment may be full but if people are taking part time jobs for less money they simply can't afford the goods and services at certain price points (or pay back \$100,000 student loans). The Fed is caught here, because they cannot determine what type of jobs are created, and as can easily be seen pumping an unprecedented amount of money into the system hasn't caused firms to increase wages. I will never think that increasing the minimum wage is the answer but are the Fed's tools, or more importantly the Fed, simply ineffective as firms continue to have the ball in their court regarding employment costs?

In Closing

We are now **66 months** into an economic expansion with the **average expansion being 42 months** for the past 33 cycles. Despite industrial production vacillating around the zero point, the quarterly number is still positive as are the rest of the main statistics I follow. I still view the probability of contraction around 13%. I rebalanced the portfolios again this quarter shifting around 5% from the high yield bucket into intermediate bonds, and taking more gains in real estate and equity and bringing commodity exposure back up to allocation levels. Commodities really hurt the portfolios last year, and I feel there might be a better vehicle out there to take this exposure going forward. I don't like to give up liquidity for sure, but I think market value weighting may be an inappropriate way to create a broad basket commodity fund.