04/22/16

Quarter in Review

The Markets

A year ago we were worried about Greece exiting the European union and this quarter there is a referendum in the United Kingdom to leave. Greece stayed, and a new set of austerity measures put in place, while Europe continued to fund an almost failed state. The UK's exit would be much more problematic than Greece's, and with many European countries reinstating border checkpoints, in an attempt to stem the massive flow of migration from Syria and other ISIS controlled areas of the world, the unification, or the one Europe experiment, has started to show serious cracks in its foundation. On this side of the pond markets in the US in the first quarter were very volatile, with US stocks down over 5% in January and then rebounding over 7% in March. **Mid Cap value was the best performer for the quarter up over 3.9%,** while the rest of the **developed world stocks were down** by roughly the same amount. This was actually the only dark spot among all the sectors as fixed income was green across the board was up close to 5% for long, high yield, and global bonds. The best performing sector though was real estate up over 6% for the quarter. Commodities didn't quite recover all its January and February losses, but were only down around 30 bps for time period.

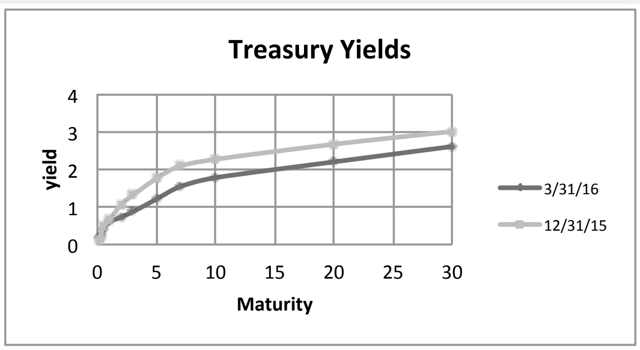
The Fed started to raise the funds rate in December, the target is now 0.25% to 0.50% and the funds rate is right in the middle at 0.37%. But since December the curve has actually flattened and bonds have rallied. The average increase in jobs for the past year has been 233,500. Industrial production has once again slipped into negative territory for both March and the total Quarter. This is not a great sign, as we still haven't recovered all the jobs lost pre-recession in the manufacturing sector. In fact it looks like the downward trend is starting up again. Consumer confidence has been in the same place it was last November, but the consumer, feeling better about their personal finances, isn't sure whether the economy will continue to grow and whether they will benefit from it. The trump card (no pun intended here… seriously) has been inflation. With sub 1% inflation in either PCE or CPI, and the Fed being data dependent, analysts aren't expecting more than one more fed funds rate increase for 2016. Unfortunately I tend to agree, which means my thesis for staying out of long-term bonds in a rate-increasing year has cost us basis points in the near term.

Interest Rates

In December the Federal Reserve raised the federal funds target rate 25 bps to a range of 25 to 50 bps. It is currently hovering around 37 bps smack dab in the middle of the range. The last time the fed raised rates was June 29th 2006, almost ten years ago! Since December the Fed has remained on hold as Europe and China waver and several economies have ventured into negative interest rates (Japan, Sweden, Denmark and ECB). Inflation has once again stalled up only 0.87% for the last twelve months ending March.

Treasuries have rallied back all of the weakness in the curve. In fact the March 2016 curve looks very much like the March 2015, with the exception of the front end being wider by about 20 bps up to the 2 year. Much of the pundits aren't calling for another rate hike until later this year if any. With inflation in check, the unemployment rate at 5%, and a bunch of doves in the voting seats at the FOMC, I have to agree with them. But I am getting a little tired of sub 3% 30-year bond.

Years	3/31/16	12/31/15	Difference
0.08	0.18	0.14	0.04
0.24	0.21	0.16	0.05
0.5	0.39	0.49	-0.1
1	0.59	0.65	-0.06
2	0.73	1.06	-0.33
3	0.87	1.31	-0.44
5	1.21	1.76	-0.55
7	1.54	2.09	-0.55
10	1.78	2.27	-0.49
20	2.2	2.67	-0.47
30	2.61	3.01	-0.4



Leading Economic Indicators

The Conference Board's leading economic indicators (LEI) did increase by 0.3% for the six-month period ending February 2016 but this is much smaller than the prior six months increase by over 2%. It shows a definite slowing buoyed mainly buy a reduction in unemployment claims, while the other indicators where general mixed. Building permits and new orders reduced the LEI the most with both having reductions during the period. The stock rally in March will help the March LEI report, along with the ISM new orders statistic, but the interest rate spread and claims data will be static, so not much help there.

Jobs

At the time of this write up **nonfarm payroll** posted an increase of 215,000 jobs for March. We have gained 2.8mm jobs over the past 12 months (ending June). The unemployment rate is currently 5.0%; actually a tenth higher than February of this year. The **Weekly Unemployment claims stand at 253,000,** which are well below the four-week moving average of 265,000 and also the 58th consecutive week below 300,000, the longest streak since 1973. The median duration of unemployment is back to 11.4 month, after being below 11 for the latter half of 2015. The employment report for the month of March was pretty benign. Enough gains not to spook the stock market but not enough to get the Fed increasing interest rates. Lastly the ISM survey for manufacturing jobs declined to 48.1 and has been below 50 for past four months. This has reinforced the negative numbers in industrial production the past two months, and thus cementing the quarter in stagnation. Non-Manufacturing PMI reported an employment statistic of 50.3 back above the 50 mark and up from 49.7 in February. One area of concern was the Challenger and Gray report on job cuts. Although down from February to March, March was 31.7% higher than a year ago, and also "the fourth consecutive year-over-year increase," on a monthly basis. (http://www.challengergray.com/press/press-releases/2016-march-job-cut-report-monthly-cuts-fall-quarterly-total-31)

Industrial production

Industrial production has re-entered negative territory not only for the month but also for the quarter. Down 0.59% in February and March, we once again are entering unfamiliar territory. Meaning consecutive negative industrial production numbers without a recession. The weakness in the IP report for March was in motor vehicle and parts production along with other key durable goods sectors. This is in contrast to the PMI report early this month showing a rebound in New Orders, Prices, and the overall index. However GDP estimates weren't reduced further by the negative report, but still sit at 0.50% annualized.

Housing

Single-family new home sales were 512,000 units per year as of February 2016. **Existing home sales declined** to 5,080,000 in the month of February. Mortgage rates have fallen over the past year with 30 year fixed rates at 3.85% as of the time of this write up, but are off their January lows of 3.66%. The S&P/Case Schiller index has risen 5.74% in the twelve months ending January 2016 for the 20-City Index. Mortgage applications have risen though as rates have declined, with request to buy homes the highest since October 2015, and refis are also at their highest in seven weeks.

The Consumer

Consumer confidence has been hovering in the same place since last November. In both the Conference Board and the Michigan surveys, there is little definite direction. Consumers feel their personal finances are very good with income increase reported by 38% of respondents in the Michigan Survey. This is the second highest reading since 2005. But people are still unsure of whether the economy will continue to grow or start to contract. The personal savings rates are now 5.4% the exact same spot they were a year ago. Total consumer debt increased again this quarter but some interesting statistics are that student loans now comprise over 50% of total non-revolving debt up from 32% 10 years ago, and also comprise of 37% of TOTAL consumer debt, up from only 20% during the same time period. As of 12/31/2015 there was **1.319 TRILLION dollars of student loans**. Last September the Federal Student Aid Office (part of the Department of Education) reported that the FY 2012 3-Year Official National Cohort **Default Rate was 11.8%,** down from 13.7% in 2014 and 14.7% in 2013. The trend is better but the absolute number is horrible. The bigger problem though is that of the **62 Billion dollars sent to private collection only 3.56% was recovered** over the past quarter (https://studentaid.ed.gov/sa/about/data-center/student/default) while an additional 9 Billion dollars was added to collection. Well Bernie I guess we paying for free education after all.

Inflation

CPI is back under 1% for the past twelve months. Energy is still the biggest drag, down 12.6% for the past year. Core inflation though (excluding food and energy) was up 2.2% during this time period. I doubt that OPEC will be able to curb production in a meaningful way, especially now that Iran is able to sell to the global market again. The most recent weekly report from the U.S. Energy Information Administration shows an increase in US inventory 536.6 million barrels or oil, and it is growing. With Refineries operating at 89.4% and imports not falling off, how can the supply glut decrease and prices start to rise. Gasoline inventories did decrease but are well above long-term averages. PCE for February was also under 1% and the GDP deflator for Q4 2015 was under 1% as well, for the last twelve months. College tuition was up 5% from 2005-2015, up 3.4% in 2014 and 3.5% in 2015.

In Closing

We are now **81 months** into an economic expansion with the **average expansion being 42 months** for the past 33 cycles. Industrial production has fallen negative again, and I am growing concerned on that front. But the other main statistics are holding. The negative IP has increase the probability of a recession for sure, but with the Fed on hold again is the historical trend of a recession 6 to 12 months after the initial Fed raise still relevant? Jobs are ok, not great, and layoffs are up year over year. Real personal income less transfers is up 2.93% year over year ending

February, and there are definitely signs of wage increases. As Europe is now caught in the grip of Brexit, I will continue to stay un-invested there. I do not foresee any major allocation changes but I may exchange a fund or ETF for something better. I trued up the portfolios this past February in the middle of the month and am glad I did as the shift was from Fixed Income into Equities. I probably won't move them much in April but could do another true up in June or July if equities continue to rally.