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Investment Counselors

MARKET INSIGHTS

April 2015

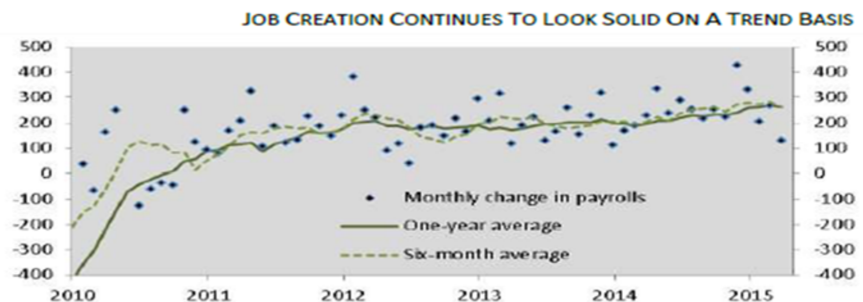
“The trend is your friend until the end when it bends”

During the past five years, domestic economic growth has been slow and steady. The trend for unemployment has been down, while the trend for incomes has been up. In fact, given recent weakness in inflation measures, real incomes are currently growing at over 4% per year, the highest rate in almost 16 years. We believe that the most recent weak payroll numbers are the exception, not the norm, likely being negatively influenced by weather. Thus, we expect improved employment figures as we progress throughout the year. With the uncertainty surrounding a potential rate hike by the Federal Reserve on investors’ minds, it is likely that U.S. equity markets will remain volatile until the initial hike. Ms. Yellen and her colleagues continue to err on the side of caution regarding rate hikes, being aware that if they hike too early or too aggressively that this may disrupt the economic recovery that they have so carefully nurtured. At this stage we expect that once a hike occurs, and investors become comfortable that we are in a self sustaining recovery (that we can ride our bicycle without training wheels) then domestic stock markets resumes their upward movement. One of our biggest concerns, and one which we have been preparing for, is that despite the FED’s best efforts, long-term yields reverse their multi-decade long trend and begin a march upward ahead of current expectations.

Job Growth Remains on a Solid Positive Trend

The March 2015 employment report was a disappointment, and confirmed recent slowing GDP indications. We believe that this data point was likely an exception, outside the current trend. Large fluctuations in monthly payroll numbers are normal. Thus it is usually more relevant to look at the broader picture. Chart 1 shows that payrolls have been steadily increasing over the past five years into the 250,000 plus per month range.

Chart1
Job Creation is on an Upward Trend



Unemployment levels have dropped to under 6% and businesses are planning to increase compensation

Job creation has led to a decline in the unemployment rate from a high of 10% in 2010 to its current level of 5.6%. With falling unemployment comes increasing average hourly earnings. While admittedly slower that most people would like, the probability of rising wages is increasing. The NFIB U.S. Small Business Optimism Index continues to show a strong willingness to increase wages.

Chart 2
Unemployment is Down

Source: Bloomberg

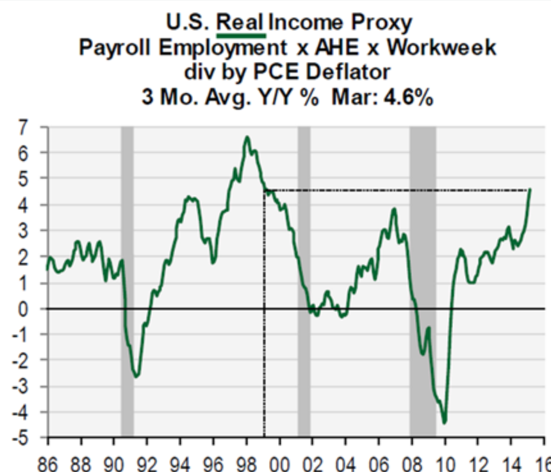
Chart 3
Small Business may Raise Pay

Source: NFIB and Cornerstone Macro

Real Incomes are rising at the fastest pace in 16 years

While we have looked at these positively trending employment charts over the past several years, what has recently surprised us on the upside was that real income gains, with the help of declining inflation, are growing at the fastest pace in 16 years at approximately 4.6% per year. See Chart 4. In this chart Ms. Lazar of Cornerstone Macro creates a proxy of nominal income using payroll employment times average hours worked times the work week. She then divides it by the PCE Deflator (a measure of inflation), to arrive at a proxy for REAL income.

Chart 4
Real Incomes are Rising at the Fastest Pace in 16 Years



Source: Cornerstone Macro

We are more confident that the US economy is in a self-sustaining recovery

These employment figures give us more confidence in the self-sustaining nature of our current recovery, even once the FED begins raising rates. Thus, even though the FED is likely to raise rates this year, and even though we expect the stock markets to remain volatile until the FED actually implements an increase, we would be looking to that potential weakness for opportunities to add to our current equity exposures.

As we have said repeatedly since the Great Recession, periods of monetary easing have led to stock market rallies of 10-15%, while periods of tightening have led to initial pullbacks of 5-10%.

Tale of two cities continues as the US is tightening while Europe, China, and Japan are easing

Stepping back from the U.S., the global markets are a tale of two cities. While the U.S. is contemplating raising rates, the economies of the European Monetary Union, China and Japan are implementing substantial stimulus. In Europe we have already seen the positive effects of these efforts in the currency markets. The Dollar/Euro exchange rate has declined from approximately 127 to 106 in the last three months which should result in improved European export competitiveness. This should further leverage the efforts of the European Central Bank to stimulate the local economies. With China and Japan, there is less tangible evidence of success to date although their respective stock markets appear to be discounting a best case scenario where the government will “do whatever it takes” to get the economy going. Headwinds to these efforts are not inconsequential: the weak financial condition still prevalent in several EU member countries, the ongoing transition from a manufacturing to consumption led economy in China and the continuing battle against deflation in Japan. While too early to tell, if the easing efforts of these central banks have similar success to QE in the U.S., one might argue that, looking out, the global economic environment could be substantially better than consensus currently believes. In such a scenario, the U.S. would clearly be a beneficiary further strengthening the case for a sustainable U.S. recovery. We are watching this closely.

We also recognize that there are significant changes that are happening around the Middle East, Cuba, Russia and the Far East. Any geopolitical disruption has the potential to put back the geopolitical premium that the oil markets once enjoyed.

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We raised cash at year-end 2014, but kept Q1 2015 equity allocations relatively flat

Real yields improving on lower inflation, but we are concerned that the bond markets may be unprepared for an eventually increase in rates

During the first quarter of 2015 we maintained our equity allocations close to year-end levels, but made several changes under the surface to our holdings. As a reminder, during the second half of 2014 we lowered our equity allocations by 10%. We felt that was a prudent decision based on our view that the risk/reward levels had become less favorable as we got closer to the time when the FED was likely to begin raising rates, and with valuation levels higher than historical averages.

Yields in the U.S. continue to vacillate significantly due to changes in the underlying assumptions as to when the FED may decide to raise rates. The 10-year yield fell in January to 1.64%, rose in February, and then subsequently fell again in March. We have been relatively patient with our reinvestment of maturing bonds, attempting to purchase 5-year corporate bonds as close to 2.5% as possible, almost 100bps above what it was about two years ago. Given that inflation has declined, the real return is much better. Conversely long-term yields are being held down by low interest rates outside the U.S. Mortgage rates have dropped and housing is more affordable than a year ago. However, we are reminded that history can repeat itself. Higher FED funds rates have historically been followed by higher long-term rates, and we are unsure if the bond markets are fully prepared for this possibility.

While we have only spoken generically about asset allocation in this letter, we believe that it is a very individual decision. We do our best work for you when we are up-to-date on changes that may be occurring in your lives. We enjoy speaking with you and sharing ideas on a consistent basis, and if your situation changes at any time between our regular discussions, please reach out to us and let us know.

We look forward to speaking with you soon and thank you for entrusting us with the management of your money.

Sincerely,

John A. Zaro III, CFA, CIC
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Partner

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