Economic & Market Commentary

During the third quarter it became evident that what many had expected to be a synchronized global economic expansion became desynchronized. A weakening Euroland (particularly Germany), continuing weakness in China and Japan, along with a strengthening U.S. dollar conspired to throw sand in the gears of any movement towards synchronization. These factors combined to raise the spectre of a global slowdown and caused the S&P 500 to retreat from its mid-September all-time high. A strong August was sandwiched between a negative July and September to allow the index to eke out a positive 1.1% return for the full quarter. Long Treasury bonds were the best performing asset class for both the quarter and year to date, as interest rates once again declined (bond prices rose), and the 10 year Treasury bond yield declined from 2.53% to 2.49% during the quarter. Equity volatility which had been dormant for the first half, woke dramatically and the CBOE Volatility Index (VIX) increased 40% for the quarter.

As would be expected with the rest of the world in the throes of economic difficulties, the U.S. was again the best geography for equity investing. Small and midcap issues produced negative returns for the quarter, as well as for the 9 months, and growth outpaced value for both periods. High quality issues were better than all others, reversing the trend of prior quarters. In fact the others all produced negative returns, which reversed the preference for risk so evident earlier in the year. On the stock side, the energy sector (top performance in Q2) was the worse place to be, as it, along with utilities (another early year darling) produced a negative result. Five of the ten S&P sectors outperformed the index for the quarter, led by healthcare and information technology, both of which were top performers for the year to date as well. Disappointingly, three of our major commitments, industrials, energy and financials, did not provide the expected help.

The desynchronization of the global expansion once again calls into question the performance of the U.S. economy for the next several quarters. Earlier this year we wrote that 2014 could be a year in which real GDP growth was above our trend expectation of 2-2.5%, and that the ingredients were there to produce real growth in the area of 3-3.5%.Then the dreadful first quarter GDP report of (-2.9%) made that outcome problematic. However, a second quarter that was unexpectedly strong (+4.6%) put the possibility back on the table. We have outlined that case in previous Economic and Market Commentaries and we still think the points are valid, so there is no need to repeat them now. Job growth continues to be solid and this will benefit incomes. In addition, the decline in the price of oil will give an added fillip to help consumer spending.

A continuation of good demand is a requisite for one of our major investment themes – that is a pickup in business spending or capital expenditures. The response so far has been muted and frankly disappointing. We laid out the case for capital expenditure growth in our Q1 and Q2 Commentaries. The case remains valid and, in fact, recent data points have been supportive.

- Capacity utilization and manufacturing indices have been moving up all year and are indicative of renewed business spending. The latest capacity utilization number is just shy of 80%, which historically has been an inflection point for capital spending.
- There has been a sharp slowdown in labor productivity since 2011, well below the long term average. This is usually a good reason for corporations to spend in order to enhance productivity.
- With plant age near all-time highs, liquidity available and cheap, the probability is high that spending will pickup.
- However, the consumer must continue to spend to provide added impetus. It is clear that there must be demand pull to get the ball rolling. As mentioned earlier, job growth, income growth, the consumer balance sheet, and the benefit of lower energy cost should enhance this prospect.

So, we still think business spending will pick up and add nicely to economic growth in the coming quarters. Therefore, we see no reason to change our position at this time. We think business spending will contribute to several good quarters of U.S. growth, in line with our earlier expectations. Clearly we do not foresee a recession looming for the U.S. economy. While this recovery has been lengthy, recoveries do not die of old age, but of imbalances that build up over time, or policy mistakes made by legislators or central banks. We have survived questionable policy decisions over the past few years, and our central bankers are fully cognizant of the need to support economic growth. The strong dollar could put a damper on growth to a modest degree (making exports more costly), and Euroland could transmit problems to the U.S. However, Mario Draghi and the European Central Bank have said they would do “whatever it takes” to support the European economies (they have yet to do so). So, we see the economic fundamentals moving in the right direction, albeit slower than we would like.

That is not to say there are no risks. In fact the risks are higher than they were three months ago. Europe, China and Japan are weaker than they were. Russia, the Middle East and ISIS represent unknowns, and Ebola is a complete wildcard. These need to be watched, but are difficult to handicap, and have little impact on our domestic fundamentals at this time.

The price of oil has been a major surprise to investors and we should comment on our view of the situation, as energy is another area where we have a significant commitment. Two of the major energy producing areas in the world are in turmoil (the Middle East and Russia), yet the price of oil is declining. Brent has taken the biggest hit, but West Texas Intermediate is trading at $81 per barrel, down from a midyear peak of $107, a decline of 25%. What happened to the geopolitical risk premium that most put at $20 per barrel? It either disappeared or oil is really trading at an economic value of $60 per barrel – a price not seen since early 2009 as we were emerging from our deep recession no one got this right! The consensus expectation was that oil would remain at $100 per barrel and, if anything, move higher as the Mideast turmoil increased. The current outcome is in spite of worldwide demand being down slightly and supply being up slightly (U.S. supply is up, but Iraq, Iran and Libya are down).

The fear is that global desynchronization will result in a global slowdown, which will reduce demand significantly. Most of the experts we hear don’t believe this scenario, and expect it to be short-lived. Yet, all energy related stocks have been hammered, with most of the carnage taking place in the last 2 weeks. The average energy issue is down 30-35% from its Q3 high, while the S&P 500 is down 8-9% from its mid-September high. So, we think most of this commodity decline is already priced into the stocks, and if anything they should be bought, not sold.

The U.S. stock market (using the S&P 500 Index) peaked in mid-September at 2019, ended the quarter at 1972, and has since traded down close to 1820. We are clearly in the midst of a “correction” (defined by the technicians as a decline of 10% from a peak). You may recall we had a corrective move in January, when the S&P 500 took a 6% swoon. On the whole, the equity market has been most generous for the past several years, and we have not had a correction of 10% in three years. Interestingly, over the past 35 years, the S&P 500 has had 27 up years, 7 down years, and one flat year. In 26 of the 27 up years, the S&P 500 experienced at least one decline of 5% or more. So the current market action is not unexpected or unusual. We do not think this is the beginning of a more serious decline, based on fundamentals that are currently in place. More importantly, this corrective phase has brought the market back within the range of fair value, from what had been pushing the upper end of fair value. The decline has taken more than one multiple of earnings away from valuation, and we now have a market selling about 15 times current year’s earnings and about 14 times earnings for the year beginning in less than 3 months. Most other valuation metrics point to a similar conclusion. So we are not inclined to take any precipitous action at this juncture, and choose to remain invested. In terms of strategy, given our view of the economic fundamentals, we continue to believe our exposure to economic sensitivity is a correct course. We discussed our energy exposure earlier, and with those stocks down 3 times the market, we would be more likely buyers than sellers. The same can be said for our industrial exposure. Earlier we outlined the case for business spending being a strong contributor to economic growth in the coming quarters. The industrials will be direct beneficiaries. Like the energy issues, these have been hit disproportionally hard, with the stocks, on average, down twice the market. So we don’t anticipate making wholesale changes to the portfolio structure under current circumstances. We will be looking for opportunities to capture more value, such as replacing holdings that are close to fair value and have held up better than average, with fundamentally sound companies that may have been unduly punished.

Fixed Income Review and Outlook

The Barclays Aggregate Bond Index returned 0.17% in the third quarter, bringing the year to date return to 4.10%. Returns for the major bond sectors were mixed for the three month period ending in September. Treasuries, Agencies and Mortgage-backed Securities posted positive returns, while Corporate Credit and Commercial Mortgage-backed Securities returns were down slightly.

In a “risk off” environment, Treasuries led the overall market with a 0.34% return for the quarter and 3.06% year to date. As in the previous two quarters, the Treasury curve flattened. Short end rates rose, while the ten and thirty year yields fell 4 and 16 basis points (hundredths of a percentage point), respectively.

During the quarter, we increased our allocation to Treasuries. We thought that the spreads versus corporates and mortgages had gotten a little too tight and wanted to have the liquidity (the ability to transact easily at readily available prices) that Treasuries offer in order to take advantage of opportunities as they arose. We are maintaining portfolio durations close to 90% of the benchmark, with a bias towards intermediate and long maturity Treasuries. This is in anticipation of short-term rates moving up more than intermediate and longer term rates. We continue to use a barbell strategy that has us holding more cash equivalents and longer bonds in order to maintain a short duration, with curve exposure less dependent on the two and three year segments. A consequence of this strategy is slightly higher yields to the overall portfolios since the curve is still very steep.

Agencies returned 0.13% for the quarter, and year to date have provided investors with a 2.92% return. We are continuing to add bullet Agencies with less than one year to maturity as a highly liquid cash equivalent, in order to generate a small yield advantage over that available in short Treasuries. A bullet is a bond with a pre-determined final maturity date.

Investment grade corporate bonds underperformed the market with a -0.08% return for the third quarter, but were the best performer year to date with 5.60%. Longer bonds outperformed shorter bonds and utilities continued to lead the market higher while financials lagged. Our strategy with respect to corporates has not changed. We reduced the allocation to credit by selling the holdings that didn’t offer enough yield to compensate for assuming the credit risk. We exited some bonds that had rolled down the yield curve and found bonds in the same names with longer maturities that will roll down the curve in late 2014 or early 2015. It’s our intention to add corporate exposure later in the year. Our focus will most likely be on bank credits, both money center and regional banks. In terms of balance sheet strength, banks haven’t been this robust in decades. And while they no longer trade at spreads wider than industrials and utilities, they offer comparable yields to those sectors often with greater liquidity.

Away from banks, we continue to prefer credits with the ability to raise prices or those engaged in ongoing balance sheet repair. And as always, we tend to avoid those companies that issue debt in order to pay dividends or buy back shares. Mortgages rose in the third quarter, returning 0.18%, bringing the year to date return to 4.22%. Mortgages have benefited from lower issuance in 2014, and there has been a lot of competition for a declining supply of securities. With the Fed exiting Quantitative Easing (QE) 3 in the fourth quarter, we would expect some weakness in MBS prices and may be able to take advantage of that opportunity.

The Fed has purchased more than $782 billion of Treasuries and Mortgages during this latest iteration of Quantitative Easing. Since the Fed began using these techniques to boost the economy, it has purchased $3.95 trillion of securities. And while the Fed will not be actively buying Treasuries and Mortgages in the open market to provide stimulus, it will continue to grow its balance sheet by reinvesting coupon payments and mortgage prepayments.

With QE3 and the taper out of the way, the market's attention has turned to when the Fed will start to raise the Fed Funds rate target. Expectations of the Fed's first move didn't change much in the third quarter. On June 30 of this year, Fed Funds futures contracts indicated a better than 50% chance of initial tightening in July of 2015, with an end of 2015 rate of 75 basis points and an end of 2016 target of 180 basis points. At the end of the third quarter, Fed Funds futures contracts indicated a similar result, though there was a greater chance of additional tightening (two moves priced in by July, rather than just one). End of 2015 and 2016 expectations were down a little from those in June. The end of 2015 rate was projected to be 70 basis points, with an end of 2016 target of 170 basis points. The market is clearly taking Fed Chair Yellen at her word that she expects slow and measured tightening when it does begin. We agree that the first move will be in mid-2015 and think it could be later in the year if global growth slows more than is priced in now.