Market & Economic Commentary

Summer 2016

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THE NORTH PIER*spective*

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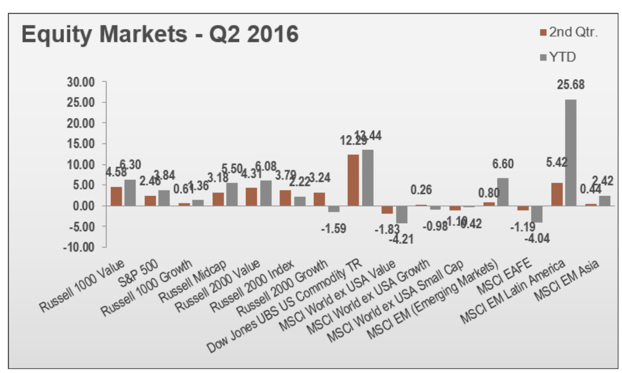
There's No Place Like Home

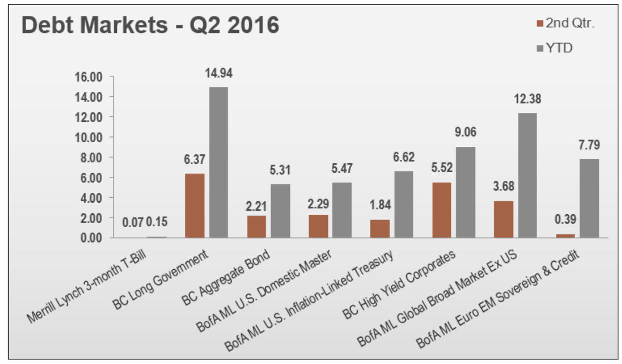
Economic and Market conditions in the United States continued to generally improve during the second quarter of 2016. Stocks remained stable with a calm tone for much of the quarter before the U.K. shocked global markets with a populist vote in late June to leave the E.U. ("Brexit"). This surprising outcome rocked global markets for a couple of days as speculation ran rampant regarding the potential impact for the EU, U.K., and broader global economies. This selloff (approximately 5% in the U.S. and in excess of 10% for many international markets) was short-lived, and prices largely recovered by the quarter's close. The broader concern was not just based on the specific impact of the U.K. leaving the EU, but that it may set off a precedent for more nationalist moves, leading to the eventual collapse of the EU. Once this emotional and speculation-based reaction subsided, traders regained their composure.

I was fortunate to be in the Catalonian region of France and Spain during the Brexit vote. There I got to discuss the growing desire among the Catalans to break away from Spain (and eventually France) and reclaim their culture and independence. Similarly, the Scottish movement to separate from the U.K. was reinvigorated after the Brexit vote, as many Scotts want to remain a part of the EU. Though the media portrays these moves as xenophobic, my direct experience is that there is much more to this wave. There is a genuine desire to be self-governed and maintain unique cultures amidst the growing trend of homogenization and globalism. To discount the energy behind these movements as being driven by uneducated, narrow-minded people, misses a crucial component of the phenomenon. We are seeing this at home in our POTUS election as well. Though it is easy to extract sound bites from the Trump-side of the electorate, of which there are many to choose from, there is another important factor that gets far less respect. Many people of the United States are feeling that they have lost their voice… and they want it back. How else could one explain the coexistence of populist support of Bernie Sanders on the extreme left and Donald Trump on the unorthodox r… – well – let's just say Donald Trump.

How the Markets Fared



It was a relatively quiet quarter for U.S. equities until the last week of June. The tone was stable with a generally upbeat bias. Even when faced with some disappointing jobs numbers in the beginning of June, the markets only sold off a couple of percentage points. Generally, value-oriented stocks performed better than growth names as confidence in the economy drove investment into cyclicals. Small caps benefited from this money flow slightly more than larger companies. International stocks did not fare as well. Developed markets sold off nearly 10% in the days following the Brexit vote. Though they also largely recovered in the final days of the quarter, the net result for Q2 was a loss of a few percentage points for most European and Asian markets. One bright spot internationally was the continuation of the rebound in Latin America. Led by the recovery in commodity prices, Latin emerging markets gained another five and a half percent during the quarter, leading all major equity index returns.



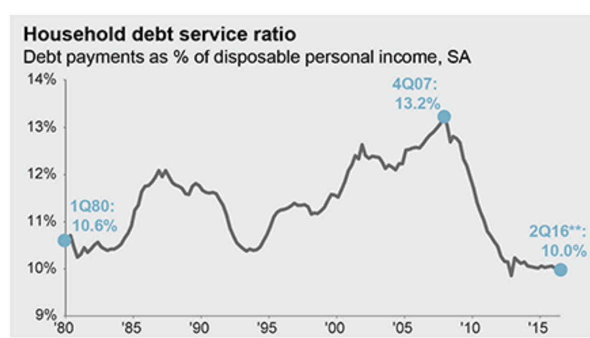
The second quarter was generally a good time to be in bonds… any bonds. The 10-Year Treasury started the quarter at 1.78% and closed the quarter at 1.48%, collapsing over 25 bps. in just two days following the Brexit vote. Unlike equity markets, which recovered the final days of the quarter, Treasury yields sank further, ending the quarter near their lows, which were actually reached on July 6th at 1.336% before firming. At the same time yields were declining on high quality fixed income, credit spreads continued to narrow, as energy and mining industry concerns ebbed (with oil prices firmly over $40 per barrel) and appetite for risk returned to the credit markets. In fact, high yield bonds out-performed most equity markets during the quarter. International bonds saw gains in excess of their U.S. counterparts with large gains coming from falling yields (again, in the wake of Brexit), which were offset somewhat when measured in Dollars due to a decline in the Euro. (The Euro fell 4% the day of the Brexit vote.) The continued drop in U.S. Treasury yields are likely due to foreign investment and not the typical flight to safety, which has recently been the reasoning behind falling rates. Even at 1.5% yield, U.S. 10 year bonds are paying significantly more than most other developed market issues. As an example, following the Brexit vote, the German 10-year Bund's yield turned negative for the first time. They say you can't get something for nothing, but apparently you can get nothing for something these days in the global fixed-income markets.

Consumed With Brexit

Americans are still feeling rather confident about their present financial condition, but are growing skittish about the future. The recent Consumer Confidence Index was virtually unchanged at 97.3 in July. (June was revised slightly lower to 97.4 from 98.) An interesting divergence occurred during this month's report as people's expectations for future conditions declined to 83.3 from 84.6 last month, while their view of the present situation improved to a rosy 118.3 from 116.6 in June. The present situation index is once again challenging the best levels since before the financial crisis. The initial University of Michigan Consumer Sentiment Report, which came out a few weeks ago, showed a similar decline in future expectations from 82.4 in June, to 77.1 in the latest July report. The report was produced at the height of the volatility and media rhetoric surrounding the Brexit vote, which likely influenced the report. North Pier expects the August report to look healthier, assuming there are no major headline-shocks in the coming weeks.

Put Your Money Where Your Mouth Isn't

The people of the U.S. can be subject to mood swings depending more on current events and news headlines than their true economic states. Add the rancor of a contentious election to a juicy story like Brexit and it's no wonder that consumers' thoughts about future conditions might have gotten a little cloudy of late. However, their short-term opinions do not appear to have diminished their appetite for buying. Retail sales increased 0.6% in June – up 0.7% if you exclude more seasonally sensitive auto sales, which also increased 0.4% in May. The strongest area of spending was in building materials and garden equipment. Clearly people are optimistic about investing in themselves. Total outstanding consumer credit grew another $18.6 billion in May (a 6.25% increase over last year) after increasing $13.40 billion in April. This was led largely by new installment-based debt, which increased by $16.20 billion. When



J.P.Morgan Asset Management - Guide to the Markets July 31, 2016 (Pg. 19; Fig. 2) consumers are not confident about the future, they don't enter into longer-term payment obligations for items such as appliances or automobiles. Revolving credit also increased by $2.30 billion. But don't worry too much about Americans overextending themselves like they did in 2007. Household balance sheets are still in great shape, savings rates are still high (above 5%) and debt service is hovering at a 30 year low. (See chart on pg. 3) As a whole, personal spending leaped an impressive 0.4% month-over-month in June, after rising 0.4% in May and a whopping 1.0% in April. Polls and the media might say that consumers are running for the Br*exits*, but their wallets are casting a completely different vote.

Oo-la-labor

The present unemployment market is arguably the best in over 40 years. Though statistics may have been more attractive in the later years of the dot-com era, that period was led by an unsustainable (Y2K-driven) boom in technology and telecom. The current market is steady and broadly participated in. Continuing claims have been hovering near historically low ranges for over 17 months, with levels last seen in the early 70's, according to Briefing.com.

Jobs reports during the quarter were mixed. May's report shocked pundits with virtually no private sector jobs created. However, June's report overshot estimates to the upside by a similar amount to May's disappointment, showing that the economy added 287,000 jobs during the month. The end result was a second quarter that saw an average of nearly 150,000 jobs created per month. We are beginning to see a slight contraction in the job growth rate here in the U.S. However, with unemployment hovering below 5%, there is simply not much slack in the system to easily create net job gains, and new positions are increasingly harder and more expensive to fill. The 4.9% unemployment rate is considered "full employment" by many analysts. This tightness in the labor supply helped push average hourly earnings to their highest growth rate since the housing boom last decade, with 2.6% year-over-year growth. You won't hear Hilary Clinton or Donald Trump talk about that.

Bored-ing House

Second to jobs and income growth, conditions in the housing market tend to have the second largest impact on consumer spending. There, the situation is starting to sound like a broken record… but one that is stuck on a great tune. Though not adding a lot of excitement to the economic data these days, the U.S. housing market continues to look strong and sustainable. Existing home sales increased another 1.1% in June to a seasonally adjusted annual rate of 5.57 million. This led to a 4.8% increase in the median selling price (up to $247,700). The recent Case-Shiller 20-City Index for May confirmed this growth rate, showing a 5.4% increase in prices over last year. This trend does not appear to be at risk of ending anytime soon. Supply of homes on the market continues to be very tight with just a 4.6-month supply at the current sales rate (while 6-8 months of supply is more of an equilibrium point). Housing starts are nowhere near their levels of the early 2000s, contributing to the limited supply and keeping new supply from swelling too fast. Encouragingly, most of the growth these days seems to be coming from first-time homebuyers, which accounted for a third of all sales in June, the highest level since July 2012. In effect, this steady rise in prices has led to a surge in home improvement spending, which is much easier for a homeowner to do when their home price is rising and they feel confident about the future of the market.

It's **S**till **M**oving

The engine of business activity in the United States is purring nicely. June's Institute of Supply Management (ISM) Report on Business (RoB) for the manufacturing sector showed a surprising increase in June, rising to 53.2 from the

51.3 reading in May. (Anything over 50 indicates expansion.) The most recent July report showed a slight pullback to 52.6, still an encouraging sign for a manufacturing sector which had been hamstrung by the rapid rise in the dollar two years ago. Of the most positive signs in the June and July report is that new orders remain a robust 56.9. The ISM's forecasts that the recent RoB suggests the economy will accelerate to a 3% growth rate in the coming year. Their forecast from the services side of the economy is almost as upbeat, suggesting a 2.6% increase. Here too, new orders are booming, rising to 60.3 in July.

Staying At Home

The trade deficit widened to $41.10 billion in May from $37.40 billion in April. However, the three month moving average is now actually approaching the lowest levels in the last seven years. Though a narrowing trade deficit is seemingly good for the domestic economy, our concern is that *both* exports and imports are declining. Exports in June were down 4.9% while imports declined 4.7% on a year-over-year basis. This trend is consistent with a global mood of nationalism and protectionism that is further evidenced by the popularity of the Trump phenomenon and the surprise Brexit vote. This is a dangerous trajectory for the global economy. Global trade may have some undesirable intermediate-term effects, like off-shoring of some jobs. However, increased global trade leads to an increase in global GDP, a condition that benefits most over the long haul. Many believe that the Great Depression was mostly caused by the stock market crash of 1929. It was actually the 1930 Smoot-Hawley trade tariffs that resulted in reaction to the crash that killed global trade which elongated and deepened the Great Depression. Regardless of who wins the election in November, any widespread impediment to trade that might be enacted would be a dangerous gamble.

You Down With GDP?

The first estimate for 2nd Quarter GDP came in at a disappointing 1.2% annual growth rate. Although these estimates have a tendency to be erratic, the market was expecting more than double that pace. More disappointment followed when the 1.1% estimate for 1st Quarter GDP was revised down to just 0.8%. This was almost exclusively related to a surprising increase in the deflator number. The deflator number is essentially a measure of broad based inflation. It is important to note that output was not revised down, but that inflation was revised upward, netting a smaller real GDP growth rate. This is concerning to North Pier. We have speculated that the Fed, under the direction of Janet Yellen, would be too slow to raise interest rates and thus be behind the ball as inflation picked up. We are starting to see the beginnings of that trend. Whether the reason was China, oil, Brexit, or now I'm sure the GDP number, the Fed has been overly dovish in bringing interest rates off of their longstanding near-zero policy. In our opinion, their stance has continued to be based on rank speculation about the effects of their actions, not based on prevailing economic data. As we have written earlier in this report (as well as in the dozen before it) the U.S. economy is stable and running on all cylinders. Now it appears that it's inflation that is eating away at our growth, not the hypothetical effects of slightly higher lending rates. Ironic outcome, isn't it Ms. Yellen?

Inflation Is Swellin', But The Fed's Not Yellen

Now that commodity prices have bottomed and turned (the DJ Commodity index was up over 12% in Q2), we are starting to see increases in material costs to producers and service providers. The Producer Price Index increased 0.5% month-over-month in June after climbing 0.4% in May and 0.2% in April. As mentioned earlier in this report, tight labor markets are leading to compensation increases that are pressuring prices as well. This is now starting to creep into costs for the consumer. The Consumer Price Index (CPI) for June showed a 0.2% increase for both total CPI and core CPI (not factoring food and energy). On a year-over-year basis, core CPI edged up to 2.3%. This is above the

Fed's target of 2%. The real impact of inflation was cloaked by the lower cost of energy, with total CPI – factorings food and energy – only rising 1%. This gives the Fed the cover they need not to ring the inflation alarm bell, allowing them to delay raising interest rates. However, if the current trend continues as we believe it will, inflation won't be able to hide for long.

PIER*ing* Ahead

Whether it's hyped-up concerns over Brexit, fears about oil and China, or cloaked inflation data, the Fed has had plenty of excuses not to raise interest rates, despite all level-headed logic saying that they should. Again, we have a stable economy with strong jobs numbers, appreciating real estate & equity markets, and encouraging business conditions - even in the downtrodden manufacturing sector. What rationale could possibly justify maintaining a near-zero interest rate policy? I'll tell you the reason - the one that the Fed would never dare reveal… TRUMP. Regardless of where your politics lay, supporters and detractors all agree: Donald Trump represents the single largest threat to the status quo that has been seen in generations. The Federal Reserve as well as the ECB, IMF, World Bank, etc. ***are*** the status quo. These institutions will do everything in their power to keep the economy looking rosy and markets looking healthy, right up to the election. The Fed may (and likely will) raise rates a quarter of a percent at the November 1st meeting, while issuing a corresponding statement of confidence in the economy, but I doubt we will see anything prior. This is a dangerous game that they are playing. As we saw in my earlier comments on the GDP, inflation is already eating away at our economic growth. Materials and labor costs are on the rise. If the Fed gets too far behind the curve, inflation may become a real problem. But until then, the winds should be at our backs; even if Janet Yellen has to blow them herself. While the EU deals with the unknown of Brexit, and Japan and China wrestle with their economies, it's my PIER*spective*, that there's no place like home.

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