Outlook for April, 2015: "A steady hand on the tiller…"

Financial markets appear to be dealing with an impressive set of worries: Declining earnings expectations, a Federal Reserve that is approaching rate "liftoff", global divergences in policy outlooks as well as sundry worries about geopolitics and slowing global growth. Indeed, we view our mandate as one of ***needing a steady hand on the tiller*** amidst all this tumult rather than knee-jerk reactions to the inevitable mini crises that come along seemingly every other week.

Our assessment of evolving market conditions remains one of ***cautious optimism***: To quote ***Warren Buffet***, arguably one of the most successful investors, it is wise to "be fearful when others are greedy and greedy when others are fearful." Forgive us if we sound a little cautious, given the six year bull market that equities have experienced since the Great Financial Crisis of 2008/09 – which, by the way, still remains fresh in many investors' minds.

On balance, economic data in March has been disappointing: The U.S. Labor Department reported an increase of ***126,000 nonfarm payroll jobs*** for the month (seasonally adjusted). Compared to the past several months, this represented a sharp decline. Furthermore, January and February payroll numbers were revised downwards for a net loss of 69,000 jobs. Overall, the first quarter of 2015 posted an average monthly increase of 197,000 jobs, with the economy adding 3.1 Million jobs in the previous twelve months.

From a sector standpoint, professional and business services added 40,000 jobs, followed by health care at 30,000 and retail trade at 25,900. At the opposite end of the spectrum, federal and state governments cut 6,000 jobs and mining and logging accounted for a decrease of 11,000. Bad weather in the Northeast along with lower prices for crude oil and natural gas were factors in the decline. The widely followed ***unemployment rate*** held steady at 5.5% in March while the U-6 unemployment rate, a more robust measure of labor under-utilization, fell to 10.9% from 11.0%.

The Commerce Department's third estimate of U.S. GDP was unchanged from the prior estimate, reporting a ***2.2% increase*** in economic activity for the 4Q 2014 at a seasonally adjusted annual rate. Estimates for 1Q2015 GDP growth have seen steady downward revisions – currently placing them below a 1.0% rate as a result of ephemeral developments like bad weather and a West Coast dock workers strike.

If 1Q2015 GDP growth is unusually weak as a result of these temporary factors, then we would also expect a significant rebound in 2Q2015 with data for 3Q2015 providing a better read on the "clean underlying" growth rate of the economy. We may experience ***"déjà vu all over again"*** (to quote famous Yankee catcher Yogi Berra) when 1Q2015 GDP numbers are released in late April as it was only a year ago (in 2014) when GDP declined -2.1% on the backs of similar "transitory" displacements like bad weather.

The ***ISM purchasing managers index***, which gauges the overall health of the manufacturing sector, posted a decline to 51.5 from 52.9 in the month prior. While this represents the fifth consecutive monthly decline, it does not indicate that the sector is contracting because readings above 50 imply that the sector is growing, albeit at a slower pace. Certainly a case can be made that the manufacturing sector appears to have ***lost some momentum*** – perhaps as a result of a stronger USD making US exports less competitive relative to Europe and Japan.

There is a lot of talk surrounding ***valuation of equities***: Are they too expensive or are they reasonably priced? The problem with these measures is that there are so many of them and much depends on the yardstick that one chooses to use as well as the various inputs into each of these valuation measures. A case can be made for any viewpoint and most people select the data that best suits their objectives. To paraphrase Benjamin Disraeli (***"Lies, Damn Lies and Statistics, wicked in the order of their meaning!"***).

Valuation measures are also ***terrible tools*** to use when attempting to time the market: Just because we consider valuations are rich, it does not mean that they cannot get any richer. Just because we consider valuations as cheap, it does not mean that they cannot get any cheaper. Have we confused you enough? Our assessment at current levels is that valuations are reasonable, meaning that they are certainly not cheap, nor are they expensive. Clear as mud, as they say!

Estimates for first quarter earnings for the S&P 500 have been ***ratcheted down quite a bit,*** with the consensus now expecting an actual ***decline*** compared to a year ago. Companies are hedging their bets by issuing guidance to analysts and investors that the first quarter was a rough ride given the backdrop of a rising USD, which hurts exports, and bad weather keeping consumers and businesses at home.

There appears to some merit to the ***"excuses"*** conjured up by companies in regards to the weak economic data of late. The 13% rise in the USD against the Euro will likely have a negative impact on companies' ability to export US goods abroad as our goods are now more expensive on a relative basis. But currencies are by their very nature quite volatile, and highly unpredictable, which makes betting on a prolonged direction, a fool's errand.

Despite this ***soggy backdrop***, we still feel that prospects for the US economy are reasonably good over the medium term, and that earnings may surprise the market given how low consensus expectations are. The markets may be pricing in more downside than is currently warranted and if anything most of the bad news is probably already ***"in the price".***

The Federal Reserve appears to have debated at its recently concluded Federal Open Market Committee meeting whether to ***increase rates for the first time in June, 2015***. While rate increases are not that worrisome by themselves, the pace of such increases are a worry for markets. Indeed, currently the Eurodollar Futures strip is implying a terminal rate in December 2015 of 0.64% (meaning at least two rate hikes this year) and a December 2016 rate of 1.50% (meaning six such rate hikes) – both of which suggest a higher level than where the Fed is likely to end up at.

We believe that the Federal Reserve will be very gradual in raising rates and ***the pace of such increases*** will be quite deliberate and well telegraphed. Some Fed officials have resorted to using the phrase ***"rate liftoff"*** to describe the first increase in rates since 2006. This is a little disingenuous in our opinion: Liftoff conjures up images of a rocket with a fiery plume rising into the blue sky – the Fed's pace of tightening is going to be anything but such an image!

In conclusion, we constantly challenge ourselves to ***think differently*** and many times we find ourselves embracing contrarian themes and ideas. Being a contrarian can often be lonely, since it implies having the courage of our convictions to be invested in places where others see no value and to leave investments where the crowd seems complacently comfortable. We do not believe that timing markets results in superior risk adjusted returns because that game is nearly impossible to win (let alone win consistently).

Our ***disciplined investment process*** forces us to keep a steady hand on the tiller (to borrow a nautical term, saying an ode to the sailors amongst you), by managing risk and seeking rewards in places where others fear to tread and yet staying laser focused on the mandate that you have so kindly entrusted in our hands.

This report was prepared by

Suresh Raghavan, CFA and Clark Blackman III, CPA/PFS
MBR Financial
2000 West Loop South, Suite 1510
Houston, TX 77027

www.mbrfinancial.com

For further information please contact us at
Voice: 832.667.8787
Fax: 281.974.2108
Email: contactus@mbrfinancial.com

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