<u>Monthly Outlook: August, 2015: “Rate Lift-Off…”</u>

It has been over ***nine years*** since the US Federal Reserve raised interest rates. Back then, the U.S. 10 year Treasury note had an interest rate just north of ***5.0%;*** it currently sits right around 2.1%. Despite worries about a ***“devaluation”*** of the Renminbi Yuan (RMB), declining commodity prices, and a rising US Dollar, we still believe the Federal Reserve will likely raise rates next month. It is time to begin the process of ***restoring normalcy***, however slight that may be.

Economic data for the month of July was ***reasonable:*** Nonfarm payrolls added 215,000 jobs for the month with the previous two months’ gains seeing a net upward revision of 14,000 jobs. Within the private sector, professional and business services added 40,000 jobs, education and health services were up 37,000, and leisure and hospitality gained 30,000. Mining and logging continued to shrink with a ***decrease*** of 4,000 jobs while the government added 5,000.

For 2015, the economy has been adding an average of 243,000 jobs per month. These numbers indicate the labor market is gradually gaining momentum and the economy is improving – slowly but surely. Yet, looking at the headline number alone masks ***weakness*** in the labor force participation rate, the long-term unemployment rate, and the part time/full time jobs ratio. This is the ***conundrum*** that the Fed will have to deal with at its next policy setting meeting in September: Is the economy expanding at a rate that justifies higher interest rates or is it still on shaky ground and not yet ready for a “Rate Lift-off”?

We continue to believe in the former statement not because the economy is growing “gang-busters” but because the ***risk of delaying*** further is fraught with danger. Never before have we seen rates this low for this long in modern times. Surely there are ***unintended consequences*** as a result of consistent intervention in the market’s mechanics and we feel that the longer we wait to get back to normalcy, higher the risk of a mishap of some sort occurring.

Furthermore, the Fed currently does not have much ***“ammunition”*** left in their gun, especially if their normal plan for dealing with a recession is to lower rates. We can’t go much lower than zero (although ***negative rates*** are plausible and have been seen in Switzerland already, but let’s not go there). The futures market believes that the most likely rate increase will not occur until December; regardless, we think the market has ***priced in*** both of these scenarios already as evidenced by the flattening of the yield curve and tighter spread between 2 year and 10 year notes.

The real question is not when it will happen, but to what degree and how often will the rate increases come. With the unemployment rate unchanged at 5.3% in July, the U-6 underemployment measure at 10.4%, and low inflation, we don’t think we will see a Federal Reserve that is going to be ***aggressive in raising rates.*** Our expectation is that the Fed ***raises*** interest rates at a very gradual pace going forward.

If interest rates are likely to increase in the near future how should we handle the ***bond*** side of your portfolio? As you know, as interest rates increase, bond prices fall due to the fixed nature of the current embedded coupon in the bonds owned in a portfolio (hence the term “fixed income”!). In this type of environment you want a fixed income manager that can offset this risk by ***lowering duration*** in the portfolio as well as focusing on the credit quality of the issuers.

You also want a manager that buys up bonds on the cheap due to ***irrational selling*** by investors who believe bonds are likely to underperform and throw the ***proverbial baby out with the bath water***. We believe we have the right managers in place to accomplish these goals. While it is our belief that equities do provide a better risk/return tradeoff over our asset allocation horizon of twelve to eighteen months, bonds remain an integral part of the ***"diversification alpha"*** and thus do have a place in client portfolios.

Additional economic data in July pointed to consistent growth in the manufacturing sector, as measured by the ISM Manufacturing index. There are signs that the ***stronger dollar*** is crimping exports, but the new orders reading in this particular report was surprisingly robust, pointing to stronger growth potential in the coming quarters. Likewise, the purchasing managers' non-manufacturing index, which some economists and market watchers view as a ***leading indicator*** of economic growth, remained in expansion territory.

The Commerce Department reported that second quarter GDP expanded by 2.3% on a seasonally adjusted annual rate. This compares to first quarter's revised growth rate of 0.6%, which is much better than the previous estimate of a 0.2% ***contraction***. Thus, the first half's growth rate of 1.5% is clearly quite disappointing. Indeed, as the economy enters its seventh year of "recovery" this remains one of the ***weakest expansions on record***. Also in the announcement was a set of revisions for the past three years that indicate the U.S. actually grew at a slower pace than originally forecasted.

Earlier this week, the People's Bank of China (China's "Federal Reserve") surprised the world by intervening in currency markets to ***devalue*** the Chinese Yuan. In recent years China, whose currency is pegged to the USD, has seen its currency ***appreciate*** relative to Europe and most of the developed world. The latest data on trade gives us a sign of why China decided to act now.

In July, exports fell by 8.3% on a year over year basis, with exports to Europe ***falling by 12%*** during this time period. While Europe's issues in dealing with a potential "Grexit" (Greek exit from the European Union) may have been temporarily solved (simply by ***kicking the can*** further down the road) these moves by China will undoubtedly place a strain on European exporters.

It also may be a sign that the world's second largest economy is slowing much faster than the government would like. One easy way to ***goose the economy*** is to make your goods cheaper to the rest of the world by lowering your currency. This ***"beggar-thy-neighbor"*** game has been played extensively before last century, leading to depressions in parts of the developed world.

This is essentially the problem with currencies: A currency exchange rate is a ***relative price***, which means for one to cheapen, another one has to appreciate! The truth of the matter is, the Chinese, the Europeans, the Japanese – all want their respective currencies to remain low and cheap – in order to help their exporters. This sort of ***competitive devaluation*** is never a good thing for international trade.

From a bigger picture asset allocation perspective, it has been a difficult time to find sectors or styles that are ***cheap.*** Although we have seen short-term dislocations in certain sectors of the market mainly following earnings releases or company guidance (energy, biotech, media, etc.) these have provided short-term trades and not ***longer term*** investment opportunities.

We continue to believe that a ***long awaited rate hike*** by the FOMC will likely occur next month, but hopefully have a limited impact on financial markets, especially since this move has been so well telegraphed to market participants. We continue to scour the world for opportunities to add value to your portfolios and do believe that your holdings are appropriately positioned for the ***difficult environment ahead.***

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