Monthly Outlook: December, 2015: "The more I learn, the more I realize how much I don't know."

Albert Einstein, a brilliant man, also understood the constraints of the human mind: He was quite humble – knowing that there are certain faults man is incapable of overcoming. As the world becomes more reliant on the ***elite "philosophers"*** of institutions to guide economic growth, it's important to remember that they are merely human, as imperfect as you and I.

Before we get into the always ***exciting*** economic data piece of this letter, we want to clarify a couple of things. The customary data we present to you is a brief summary of the key economic news that has come out over the past month. It is, by definition, ***short-term*** in nature. Our investment approach on the other hand, is focused on ***longer-term*** changes in economic trends we see happening around the globe.

Economic data, on balance, is pointing to a ***moderate*** year in the US: The Labor Department reported that nonfarm payrolls increased by ***211,000*** in November, slightly above expectations of 190,000. Payroll data for September and October were revised higher by 25,000 jobs. The latest report brings the monthly average employment gain to 237,000 over the past 12 months. Among industry sectors, construction added 46,000, professional and technical services +28,000, health care was up 24,000, and retail trade gained 31,000.

The overall ***unemployment rate***, as measured by the Household Survey, was unchanged in November at 5.0%. The total number of unemployed persons, the number of long-term unemployed, and the labor force participation rate were also little changed for the month. Monthly earnings data was up slightly this month, taking the 12 month average hourly earnings growth rate to 2.3%. The ***U-6*** (which is a broader measure of under employment) report actually showed a slight increase to 9.9%.

According to the Commerce Department's ***second*** estimate of U.S. Gross Domestic Product, the U.S. economy grew by 2.1% (seasonally adjusted annual rate) in the third quarter, a higher rate than originally estimated (previously 1.5%), but below second quarter's frenetic pace of 3.9%. The revision was due to ***higher levels*** of personal consumption, nonresidential and residential fixed investment, and state and local government spending.

Nonresidential construction was down a ***hefty 7.1%*** compared to the previous quarter and the strong growth in intellectual property we have experienced over the past couple of years slowed significantly in the third quarter. Pre-tax adjusted corporate profits were $2.1 trillion in the third quarter, which is a modest decline of 1.0% compared to the prior quarter, but a much ***larger decrease of 4.7%*** from a year ago.

Data on manufacturing activity in the U.S. pointed to an overall ***contraction*** of the sector in November. The widely followed Institute for Supply Management survey came in at 48.6, a reading below the critically important 50.0 level. The market saw this coming for the past several months, as the index level was walking a ***fine line*** between growth and contraction. Furthermore, a stronger dollar and slower economic growth in China along with slowing global trade seemed to weigh heavily on overseas corporate profits.

Of course, all of this data is taken with a grain of salt because we know that it can sometimes be ***misleading***. The market never waits on the data, it ***typically moves ahead of the data*** - despite the phrase "data dependent" - which has been overused by the Federal Reserve lately. And good data does not always mean positive market returns. There are many instances throughout history when economic fundamentals were positive while market returns were negative, and vice versa.

So far December has not been very ***merry*** for investors: After a strong (pleasant but unexpected) rally in October, the equity market has traded mostly ***sideways to down*** in November and early December. If we were to come up with reasons for the lack of upward momentum in markets, investor anxiety over the Federal Reserve's policy meeting on Dec 16th along with worries about slowing Chinese economic growth, falling commodity prices and a rising US Dollar would be top of mind.

Current expectations suggest that the FOMC will pull the trigger on Dec 16th - the first such rate increase since June, 2006. We expect the accompanying FOMC Statement to be quite ***dovish***, with assurances about being gradual and slow to get to ***"normality".*** Despite this move being "priced in" for now, there will probably be more volatility in the short term as market participants get used to the Fed's new tools to manage interest rate changes.

Previously, the Fed would vary the quantity of reserves in the system in order to set interest rates. However, given that the Fed's balance sheet has ***ballooned*** from around ***$800 billion in 2008 to almost $4,500 billion now***, the old tools are unlikely to do the job. Essentially, raising rates by the Fed implies ***raising the floor*** for interest rates. The Fed (through its money market operations – also called Open Market Operations – hence the term Federal Open Market Committee), will use two new tools: ***Interest on Excess Reserves (IOER) and Overnight Reverse Repurchases (RRPs).***

The IOER is only available to "depository institutions" (or banks) and therefore simply raising the interest that the Fed pays on excess reserves (which removes monies from the banks' balance sheets and is therefore not available to be lent to the public) will lead to an imperfect or ***"leaky" floor***. In other words, shadow banks and other institutions could still borrow in the money market at rates ***below the IOER.*** To firm up the floor, the Fed will also resort to RRPs – a second new tool - which also have the effect of siphoning monies away from the system.

With the overnight Reverse Repurchases, the Fed is allowing non-banks and other financial institutions to "lend" money to the Fed at a pre-determined interest rate, thus ***reinforcing the floor.*** Currently, the RRP program has a cap of $300 billion – perhaps hardly sufficient capacity to provide all the mopping up that the Fed needs to do to raise interest rates. The Fed is likely to increase the cap to a much larger size – perhaps even up to $1.0 trillion in order for it to function effectively. More detail on financial plumbing than you ever wanted to know, we are sure!

The European Central Bank for its part has extended quantitative easing for another six months (from Sep 2016 to Mar 2017) and further lowered its deposit facility rate by 10bp from -0.20% to -0.30% last week. However, markets appeared to be disappointed at the size of the move, having expected more from Mario "whatever it takes" Draghi.

Earlier in the year we talked about potentially adding an ***energy*** position given the extreme dislocations we have seen in that sector. So far this year, the S&P 500 Energy sector is down 21% and the Goldman Sachs Commodity Index is off 31%. The MLP sector has fared even worse, at a ***decline of almost 50%***. As is often the case in these commodity markets, prices will probably overshoot and provide an opportunity for patient longer term investors.

It is not a foregone conclusion that ***rising interest rates*** are bad for financial markets. While it makes sense, there have been times in history where the opposite reaction occurred. We will try to avoid making investment calls and portfolio shifts on short-term factors. Instead, we will continue to focus on a ***longer term investment strategy*** that takes into account your individual goals and objectives, all the while keeping in mind "the more we learn, ***the more we realize how little we actually do know!"***

We would like to take this opportunity to wish you and yours, "Happy Holidays and the Best of the Season!"

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