Outlook for July, 2014: "Summer Doldrums…"

With temperatures rising in the Northern Hemisphere and as traders head to the beach in a time honored tradition of ***life in the slower lane***, US equity markets continue their onward march undeterred by pronouncements from many a market maven that valuations are stretched. Indeed, as we enter 2Q earnings season and the world appears to be focused on ***"Futbol" in Brazil***, volatility remains quite well behaved.

Economic data over the past month has been positive: In June, ***non-farm payrolls increased by a robust 288,000***, beating expectations for 211,000. Revisions for the previous two months added an additional 29,000 jobs for the period. Sectors posting the largest gains during the month of June were professional and business services (+67k), retail trade (+40k) and food services (+33k). However, other services posted a loss (-6k) of jobs during the month with information (-40k) being the only sector where jobs have been lost in the past twelve months.

The big gain in June improved the monthly gain in jobs over the past ***twelve months to a respectable 195.5k jobs per month***, with service sectors continuing to add the bulk of the jobs (+165k per month) rather than goods producing sectors (+30k per month). The unemployment rate fell two-tenths to 6.1% while the ***U-6 measure*** of underemployment continued to trend lower by 0.1% to 12.1%. Over the past year the rate has dropped by a surprising 2.1%.

Buried in the report was the number of people forced to take part-time work for economic reasons (i.e. employers cut hours or were not looking to hire full time staff). This measure increased by 275k and now represents 7.5 million workers. As we have said before, we believe companies are creating more ***part time positions*** as a result of regulatory overhang from the Affordable Care Act (aka Obamacare). Wage pressures will likely remain depressed as long as lower quality jobs remain the bulk of the jobs being added.

The Commerce Department released their third and final estimate of 1st quarter GDP which showed the economy contracting by 2.9% (seasonally adjusted annual rate). The largest revisions occurred in personal consumption expenditures. Given the Department's initial estimate back in April of 0.1% growth, the declines in personal consumption expenditures (especially in the services component) is quite puzzling. We believe the first quarter data was more an aberration, resulting from bad weather, than a foreshadowing of things to come.

We also believe that given the unusual weakness in 1Q GDP statistics, 2Q GDP (the first estimate of which will be released in a couple of weeks) is likely to be biased upwards. Indeed, we are already seeing some estimates in the 4.0% to 5.0% range (seasonally adjusted annual rate) implying that markets could be in for a surprise further buttressing the bullish case for equity markets.

Former Fed Chairman Ben Bernanke is reputed to have said in a ***"private" speech*** that he thought interest rates were unlikely to rise ***for a long time – perhaps not during his lifetime!*** His statement appears to imply precisely what we have feared all along – that the Fed really has ***no "exit" strategy*** from its massive holdings of Treasury and mortgage instruments. In other words, the Federal Reserve might simply allow the size of its balance sheet to stay large (continuing to replenish its holdings as they mature) rather than specifically shrinking the size of its balance sheet – once Quantitative Easing ends.

Minutes of the Federal Reserve's Open Market Committee meeting held in mid-June clearly telegraphed to the markets the ***worst kept secret of all***: Quantitative Easing was going to end in October this year – especially as forecasts for economic growth and inflation seemed to suggest further improvement in the economy's fundamentals.

Current Federal Reserve Chair (we continue to feel uncomfortable using an inanimate object to describe an exalted position, but in these times of PC, anything goes we suppose!) Janet Yellen used the phrase ***"macroprudential supervision"*** repeatedly to describe her general philosophy on how she views the conduct of monetary policy by the FOMC and the Fed. While simply sounding bombastic, macroprudential does not mean much to us: We are not even sure if this is a single word or if it should hyphenated when it is used!

This is ***classic Fed Speak*** – where words and phrases are used to imply "trust us, we know what we are doing". Leaving the conduct of monetary policy – perhaps the most important policy lever when it comes to financial markets – with no specific rules, is quite unnerving from a longer term perspective. The chances of a well-intentioned but misguided policy error rise significantly, especially since such systems are not ***rules-based*** but depend on the ***vagaries of human behavior*** and judgment.

The US Supreme Court opined in late June that a series of ***"recess" appointments*** made by President Obama to the National Labor Relations Board were illegal – especially since the Senate (that august body which has not passed a real federal budget in a number of years!) at that time had indicated that it was indeed continuing to operate. Many members of both the Senate and the entire House of Representatives will be spending this summer campaigning for re-election: It is after all a mid-term election year and the ***incumbent party*** in control of the White House tends to fare poorly at the hustings in such a contest.

In an ode to the 2016 Presidential Campaign, ***Hilary Clinton*** (the former Secretary of State) appears to be gingerly distancing herself from the Obama Administration and its policies – although we suspect that she will find it hard to do so – especially since she was the architect of much of the Obama Administration's foreign policy in its first term.

It is a sad state of affairs in Washington DC that neither Congress nor the Administration appear to be able to cooperate on anything, if at all. Indeed, as both sides of the political aisle are jockeying ahead of the mid-term elections this November, the important ***"work of the people"*** somehow seems to have gotten lost in the shuffle.

Credit spreads around the world continue to contract – especially as the flood of global excess central bank liquidity looks for a home. With Government bills and notes around the world offering paltry nominal yields, investors have been forced to move out the credit (and risk) curve. Such a move also implies a ***"down in quality***" shift in portfolios (which we have resisted and guarded against for a while now). We have seen this movie before, and as many policy makers have cautioned before, such things do not typically end well for investors chasing yield.

Financial markets endured a ***storm in a teacup*** when worries about Portugal's second largest bank came to the fore. It was reported that the holding company of ***Banco Espirito Santo***, Portugal's second largest lender was likely to miss a bond payment – technically putting it in default. However, worries about European bank failures and the domino effect that it would have on markets lasted a mere day further buttressing our long held belief that markets typically move in the direction that is likely to cause the most pain – and no, we are not into self-flagellation!

Despite the ***unusual calm prevailing in the markets*** currently, we remain cautiously optimistic longer term. However, we remain wary in the near term – especially as volatility continues to decline. It also goes without saying that our abiding faith in a ***fully diversified portfolio*** - that has a balanced approach to both risk and return - as the main way to attain ***favorable investment outcomes*** over the long haul, remains steadfast.

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