<u>Monthly Outlook: June, 2015: "Boring does not mean pedestrian"</u>

"Life is really simple, but we insist on making it complicated" said the Chinese sage Confucius. To our detriment, the human psyche perceives ***complexity*** as synonymous with ***truth or value***. If something is complex, it must be correct and worthy of consideration, right? In some cases this is true, but like anything else, too much of something can lead to undesirable consequences, especially when it comes to ***investing***.

The Labor Department's assessment of employment conditions revealed that hiring picked up in May as the U.S. economy added ***280,000*** jobs to nonfarm payrolls. To put this in perspective, the average monthly increase in jobs over the past year has been 251,000. We hope that the latest reading is an indication of the labor market ***firming*** up with sustainable growth and incomes going forward. Employment numbers for March were revised higher (from 85k to 119k) but slightly lower in April (223k to 221k) for a net revision of +32,000 jobs.

Even though May's jobs numbers were strong, the unemployment rate actually ***went up*** by one-tenth of a point to 5.5%. As employers are more willing to hire, people who had previously given up looking for work will likely reenter the workforce. This increases the size of the unemployment pool, and if the rate of job growth is less than this increase, the unemployment rate will rise; even though conditions are improving. ***Clear as mud*** as they say.

The labor force participation rate improved slightly in May, with 62.9% of eligible working age persons employed. This indicator has not moved much since December of 2013, and is off considerably from a ***high of 66.4%*** in January of 2007. The U-6 unemployment measure, which includes part-time workers who would like full-time positions and discouraged workers (and in our opinion a more robust measure of unemployment), came in at ***10.8%,*** unchanged from April's reading.

Service providing jobs accounted for 274,000 of the job gains in May. Professional and business services added 63,000, health services were up 47,000, and trade posted a 50,000 increase. Goods producing jobs increased a measly 6,000, with construction +17,000 and mining and logging losing 18,000 jobs (mostly in the extraction industries – mainly crude oil and natural gas). For 2015, mining and logging has ***contracted*** by 47,000 jobs.

Average hourly earnings were up 0.3% in May compared to April, boosting the annual rate to 2.3%, which is one of the ***stronger*** readings we have seen during this recovery. There is some indication that ***inflation*** might be beginning to creep back into the system, although it's too early to tell how ***persistent*** it will be. Indeed, with Wal-Mart increasing the lowest hourly wage to $10/- per hour (and most retailers being forced to follow suit), we suspect that wages could be rising over the next few quarters.

In addition, survey data like the University of Michigan's long term inflation indicator (of conditions expected to ***prevail five to ten years out***) have started to deteriorate. The latest reading for May came in at 2.8% - still reasonably anchored, but starting to rise. This indicator bears watching (***pun intended!***) over the next few months and quarters as further deterioration would be a harbinger of an ill-conceived inflation spiral.

Farther afield, quantitative easing policies enacted by the European Central Bank are turning ***deflation worries*** on its head in the European Union. Last month, annual inflation in Europe came in at 0.3%, which is nowhere close to the ECB's target of 2%, but is a vast improvement from January's price ***decline*** of 0.6%.

The knock-on effects of deflation worries being removed have reverberated throughout European bond markets, reminding investors that ***bonds can lose money***! The quick turnabout in sentiment can be seen clearly in the movement of ***German Bund yields*** over the past month. After hitting a low of 0.05%, German 10-year Bunds are now hovering at a yield of 0.88%. The volatility in this market has been quite ***extreme*** as traders have had to recalibrate their expectations and determine how this will all play out.

Mario Draghi, the head of the European Central Bank, ***conveyed*** to the markets that the bank's QE strategy would continue in full-force and would not be ***veered*** off track by volatility in financial markets or strong monthly inflation readings. So far, the program has ***benefited*** European retailers and employment, giving investors something to cheer about, at least in the near term.

First quarter U.S. GDP ***contracted*** by -0.7% relative to the fourth quarter of last year. The Commerce Department's initial estimate of 0.2% was revised down by nine basis points as higher imports, which is a subtraction in the GDP calculation, outweighed improvements to residential fixed investment. The surge in imports was due in large part to the ***rise in the dollar*** (which makes foreign goods cheaper) and a resolution to the labor dispute at West Coast ports.

Estimates for second quarter GDP are hovering around 1.5%-2.0%. The Atlanta Fed's GDPNow, which is a forecasting model that attempts to calculate current ***"real-time" GDP***, is showing 1.1% growth for Q2 as of June 3rd. Obviously, the ***liftoff*** in the U.S. economy that was forecasted for 2015 is struggling to materialize. One of the big reasons is a lack of ***consumer spending***, which accounts for more than two-thirds of the U.S. economy.

Times certainly seem to have changed from the days of Paul Volcker and Alan Greenspan when central banking appeared to be simpler and leverage in the system did not seem to hold sway over entire markets. The world today has obviously become a more ***complex and integrated*** entity that is expanding at breakneck speed. The policy response so far seems to be ***more intervention*** and ***more resources*** to control its agglomeration.

This ***intervention*** has created opportunity for people to capitalize on the ensuing complexity it creates. From hedge fund strategies to managed futures and risk arbitrage, promises of new and ***differen***t return patterns continue to lure investors into thinking that investing needs to be ***complicated*** and investors need to look ***smart***. Nothing could be farther from the truth.

With so much cheap money chasing investment ideas, Silicon Valley and some companies in technology appear to have garnered their fair share of ***absurd valuations.*** For example, there are a number of so called ***unicorns*** (as rare as the mythical creature) – private companies, whose valuations are stratospheric in their reach – exceeding $1.0 Billion - with very little profits, let alone revenues to show for it. While we understand all the fancy phrases like "network effects" and "first mover advantage", our training teaches us to be skeptical of these valuations.

Furthermore, a cursory analysis of some of the companies trading on the Shanghai and Shenzhen exchanges in China suggest that valuations are approaching bubble territory – with price earnings ratios north of 1000. We have all seen this movie before – and it does not end well! The bust when it does occur (***and surely it will!***), will be quite spectacular to watch – as long as we do not have exposure to these kinds of companies.

The wise old saying in finance, "never invest in something you don't ***understand*** or can't ***explain*** to someone else" will likely be forgotten as a surge in product innovation will attempt to satisfy the complex demands of society. However, our strategy will likely remain the same in the ***time honored tradition of disciplined analysis and contrarian decision making.*** We will continue to allocate capital to investment managers that have a clear, distinct process with an underlying strategy that is ***simple to grasp and articulat***e, ***boring though it may be.***