Outlook for May, 2013: "Sell in May…."

With the calendar turning to the month of May, we are reminded of that old saw ***"Sell in May and go away"***. While the cyclical swoon in late Spring / early Summer, which has been a recurring feature in each of the past three years, is certainly possible yet again, we are not at all sure that the old adage will hold true this year – especially given the ***extraordinary momentum*** seen in the equity markets recently.

Employment conditions improved modestly in April with non-farm payrolls increasing by 165,000, roughly in line with the previous 12 month average. More positive news came from the revisions for February and March that showed a net increase of 114,000 jobs. Most of April's job growth came from the professional and business services sector followed by leisure and hospitality, retail trade, and health care. Government payrolls continued to decline with 11,000 jobs lost in April.

Average hourly earnings were up fractionally month-on-month and have increased a paltry 1.9% over the past year, barely edging out inflation. The workweek for all private employees settled at 34.4 hours, a slight decline from a year ago. A separate survey of households yielded a national ***unemployment rate*** of 7.5%, a fractional decline from 7.6% in March and down from 8.1% a year ago. With the Fed's unemployment target set at 6.5%, we should expect the money spigot to continue flowing for quite some time.

The ***innards of the report*** tell the same old story: teenagers have by far the worst employment prospects among age groups, more people are giving up looking for work, part-time employment edged higher, and the long-term unemployment number is still disturbingly high. As we noted months ago, more companies are hiring part-time workers given the uncertainty over regulation, taxes, and health care. A broader measure of "labor underutilization", known as the ***U-6 measure***, increased slightly in April from 13.8% to 13.9% of the labor force.

Economic activity accelerated in the first quarter of 2013 with ***GDP up 2.5%*** on an annualized basis, for the first calendar quarter. While the number failed to beat market expectations for a 3.1% increase, it did improve on 4^{th} quarter 2012's 0.4% rate. Most of the gain came from personal consumption expenditures (PCE), residential investment, and private inventory investment. A steep decline in government purchases and an increase in imports also brought the measure down. Regional and national surveys of business conditions in the manufacturing and services sector in aggregate showed expansion, albeit at a deteriorating rate that signals caution ahead.

The ***housing sector*** is slowly, but surely, recovering: Although we expect the path forward to be choppy, we do think that housing will likely provide positive support to the economy over the near to medium term. The supply of existing homes for sale remains low which is causing property values to appreciate in most regions. Furthermore, ***new home sales*** numbers over the past six months have been encouraging. Banks are beginning to relax some of their credit standards, whether this is good or bad news is subject to interpretation, which should bode well for ***mortgage origination*** and housing development. All in all, housing which had hitherto been a drag on GDP will likely switch to a mild positive for the upcoming quarters.

While the data is mostly on the positive side, it is also quite boring: There seems to be a lack of substance and direction in the data. ***"Muddling along"*** is what we've been saying for the past year, but its relevance today could not be more fitting. This suggests that the monetary spigots will remain at full open until such time the Fed feels that the economy is on a self-sustaining cycle of expansion.

Japanese economic data have continued to underwhelm: Industrial production posted a decline of -7.3% (y/y) for the year ended March while retail trade also declined -0.3% (y/y) for the same period.

Housing starts in Japan was the one bright spot rising 7.3% with the annualized housing starts approaching the 0.950 Million units. It is quite clear that the Bank of Japan has increased the monetary base by 23.1% (y/y) for the year ended in April and yet, measures of money supply – primarily M_2 and M_3 have barely posted positive increases in the past year (3.0% and 2.5% respectively).

What is a central banker to do to ***increase money supply*** then? It all comes down to ***velocity of money.*** Despite the sizable gains in the monetary base (really the concept of "stock" of money in the economy), the velocity of money in the Japanese economy continues to drop dramatically. While this has been seen in other developed economies as well, a decline in the velocity of money suggests that the economy is struggling more with ***deflationary forces*** rather than inflationary ones.

Meanwhile, ***earnings for 1Q2013*** for the S&P500 have come in slightly better than expected: With 437 of the S&P500 companies having reported results so far, the aggregate gain in earnings appears to be around 3.0% (y/y) on a share-weighted basis. However, of these 437 companies, the gain in earnings for ex-financial companies (358 of them) is a smaller 2.1% for the year ending March, 2013. 297 of the 437 companies (or 69.7%) exceeded expectations, 38 (or 8.7%) met expectations and the remaining 102 (or 23.3%) missed expectations.

The figures for 1Q2013 in terms of the breakdown are not statistically significant from those of 1Q2012. In other words, American companies as part of the S&P500 continue to post ***reasonable earnings growth*** – especially relative to expectations. However, the lack of top-line growth among S&P500 component companies – in terms of their sales – is a little concerning. While company managements have gotten quite adept at managing expectations over time, they have also continued to meet or exceed expectations by virtue of ***cost cutting rather than growing sales***.

Normally, one would expect that companies in aggregate ought to grow their sales / revenues at a pace that is at least equivalent to that of real GDP. In other words, real GDP (which is primarily made up of labor force growth and productivity improvements – with a small error term) ought to at least be the pace at which companies are able to grow their top line – failing which it becomes difficult for the companies to justify their existence. We feel that this lack of top line growth is probably a cyclical (and short term) phenomenon.

Equity markets have continued to fare well – posting solid gains – rejoicing in all the excess global central bank liquidity. While many a ***market seer*** that has called for a ***correction has been confounded***, we continue to believe that such a sell-off / decline might not occur at all; simply because markets often move in the path of least resistance (as well as causing the ***most pain*** for a majority of the participants) and right now that appears to be increasing in price.

Commodity markets have remained quite volatile: Gold prices have seen outsized gyrations on rumors of forced liquidations by leveraged investors as well as worries about a reduction in monetary accommodation from central banks around the world. Indeed, gold prices fell almost 15% in two days in mid-April, but calm appears to have been restored to this market of late. Other commodities including the energy complex have remained volatile and much of the change at the margin has to do with expectations of growth in Asia and China in particular.

In ***summary***, financial markets continue to be propelled higher by the sea of excess central bank liquidity and ongoing skepticism about the sustainability of higher equity prices. There is no question in our mind that markets often move in the direction they cause the most pain (which in this case is up!). 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.

This report was prepared by

Suresh Raghavan, CFA and Clark Blackman III
MBR Financial, Inc.
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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