<u>Monthly Outlook for May, 2015: "Humility!"</u>

"It ain't the heat, it's the humility" said Yankee great Yogi Berra – to quote one of our favorite people. Yogi turns ninety years old on May 12th this year and will likely continue to entertain many of us with his "Yogi-isms" for years to come. As in life, financial markets have an uncanny ability to trick people into thinking they have it all figured out, when in actuality, a healthy dose of humility is probably more appropriate.

The Labor Department reported that the US economy added 223,000 jobs during April, a significant increase from March's paltry gain of only 85,000 (revised down from an original release of 126,000). In our opinion, this was a ***"goldilocks"*** type release (with the porridge temperature just right) as it was right around consensus expectations. In addition, the number was neither too strong (which would put the Fed back in play) nor was it too weak (increasing worries about growth in the economy).

Within employment sectors, professional and business services gained 62,000, education and health services added 61,000, and construction was up 45,000. Mining and logging tacked on a loss of 15,000 jobs and government added a mere 10,000. Average weekly earnings were up 0.2% for the month and +1.9% over the past year, indicating that wage pressures remain quite muted.

The ***unemployment rate declined to 5.4%*** in April, down from 5.5% in the previous month, as reported by the Labor Department's household survey. The ***U-6 measure*** (a more robust assessment of the true nature of unemployment and underemployment) was also down one basis point from the prior month, settling at 10.8% in April. Our analysis of these data suggests that there appears to be some loss of momentum in labor markets, but this might be temporary, given transitory factors like a severe winter.

The U.S. Department of Commerce reported that ***GDP grew by 0.2%*** (seasonally adjusted annual rate) in the first quarter. It is possible that the second and third revisions, to be released over the next couple of months, will show that the economy actually contracted during Q1. ***Exports were a big negative*** as the US dollar strengthened against both the Euro and the Japanese Yen as well as several other currencies. This in turn makes our goods and services more expensive to foreigners. There was also considerable weakness in consumer spending and business spending, most likely a result of bad weather.

National and regional surveys that gauge the pulse of the ***manufacturing and service sectors*** in the country are also mixed. On the one hand, the services sector seems to be growing at a healthy pace, as reported by the Institute for Supply Management's latest survey. On the other hand (in true two handed economist speak!), the manufacturing sector seems to be slowing down, especially as it pertains to employment. While we subscribe to the belief that exogenous factors have attributed to a weak start to 2015, we are a bit surprised as to how long the effects have lingered and wonder how much longer it will persist.

The past couple months have reminded investors of the need to exercise ***humility***. Since crude oil closed at a low of $42.03 on the New York Mercantile Exchange in mid-March, the commodity has sharply reversed course, hitting a high for the year of $60.93 last week, a 29% increase (but who is counting?) during the period. The sudden reversal is a result of many factors, almost all of which are unforeseeable. The lesson for investors in most markets is that humility ought to come with the territory.

In another ***reversal*** of trends, ***European interest rates climbed higher*** as worries over economic growth and deflation subsided. In fact, European bond markets have been quite ***exciting*** over the past month, if such a thing exists! The German 10-year yield hit a bottom in mid-April around 0.05%, but has since reversed course and has headed ***virulently higher***, with the current yield around 0.70%, an increase of a mere ***ten times*** in less than a month***.***

At the time of writing, the U.K. 10-year yields 1.98%, Italy is at 1.85% and Spain is at 1.83%. Quantitative easing announced in January, 2015 by the European Central Bank (and begun in March) has certainly been a factor in pushing interest rates lower. Slow economic growth and worries over deflation are also partly responsible. Or, as a wise man once said, maybe it's a function of more buyers than sellers. In any case, I think we can all agree that the long-term outlook for returns from European bonds is ***difficult*** at best.

So what is an investor to do? The answer is, not much. Abandoning bonds is not an option for large institutions, nor should it be for individual investors. Even though yields are so low, bonds serve a primary purpose in a diversified portfolio: they ***dampen*** volatility and ***protect*** capital on the downside. It can be tempting to take on additional risk to make up for low interest rates. Even Federal Reserve Chairwoman Janet Yellen hinted at this when she made off the cuff remarks last week suggesting that investors are taking too much risk in debt markets; a by-product of the policies she and her predecessors have helped perpetuate.

With over 91% of the S&P500 companies having reported earnings for 1Q2015 so far, the ***share weighted earnings growth rate is 2.3%.*** At one point, analysts were expecting a ***decline*** of 4-5% in earnings for the first quarter, citing the sharp decline in oil prices and the stronger dollar as the primary culprits as well as the negative guidance coming out of managements. While some of this is no doubt "earnings expectations management", we do worry about the risk of falling margins – especially if wage growth were to accelerate in the coming quarters.

We would characterize ***valuation multiples*** as ***"reasonable"*** – neither too cheap nor too expensive. While multiples are generally above median, Fed Chairwoman Janet Yellen characterized them as ***"quite-high"***, further clarifying her remark that "valuations were not so high when you compare returns on equity to returns on safe assets like bonds, which are also very low, but there are potential dangers there." It reminds us of Alan Greenspan's infamous irrational exuberance speech in 1996, a full three years before the market's peak in early 2000.

Yellen's comment is precisely why we think this six-year bull market has further legs. It is our belief that professional investors as a whole are quite skeptical and markets often tend to move in the direction they cause the most pain – which in this case is up not down in price! Further, many investors have money on the sidelines, awaiting the next big correction before committing to putting their money to work. It goes without saying that the hoped for correction has been quite elusive. We tend to agree with Sir John Templeton, who said, "Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria."

The Federal Reserve at its Federal Open Market Committee meeting in late April decided to leave the Fed Funds Target unchanged, but chose to remove all references to the calendar from their FOMC Statement and emphasizing that the next move in interest rates would be ***"data dependent"*** – thus adding more policy uncertainty to the mix going forward. We do expect a small rate increase later this year, but perhaps not in June.

As long as interest rates stay low, inflation remains subdued, and easy money policies propel the global economy, we will remain fully invested in your portfolios. Regardless, we never forget that to be an investor means to take the good with the bad, to win some and lose some, and most important of all to have a ***healthy dose of humility***, especially since markets tend to remind us of how little we actually do know on a daily basis.

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