Déjà vu All Over Again

By Mel Miller, CFA | Chief Economist

Yogi Berra was one of my boyhood idols. Known as one of the greatest baseball catchers, coaches, and managers in history, and revered to this day for his “Yogiisms,” the impact of Yogi Berra lives on. One of his more famous Yogiisms applies to the first quarter economic climate: “It’s like déjà vu all over again.”

Thus far, 2015 “feels” similar to the last few years. Economists’ year-end predictions detail how GDP growth will accelerate in the coming year, only to be followed by a dose of reality, as the economy struggles in the first half of the new year. To date, economic releases in 2015 have certainly underwhelmed and, in many cases, resulted in outright disappointment.

Can this “feeling” be verified? Yes. Citigroup Economic Surprise Index measures data surprises relative to market expectations. A positive reading means that data releases have been stronger than forecasted and a negative reading means that data releases have been worse than expected.

As highlighted on the graph, economic releases have disappointed so far during the first quarter of 2015 as the index currently stands at -58.60. What I find interesting is that it is “déjà vu all over again” as the pattern is the same as our actual experience in 2014. The consensus rationale for last year was the record-breaking cold winter in the Midwest. It is easy to speculate that the record-breaking snow on the east coast had the same economic damping impact in 2015.

Not so fast! Look at the pattern for the last five years since the recovery from the Great Recession started. It is repeated every year and cannot be strictly weather related. Many theories abound for this phenomenon, with the most plausible being that the magnitude of the Great Recession has altered the economy and the econometric models have yet to reflect the permanent changes.

Let’s review some recent economic disappointments. Industrial production, while continuing to expand, is only slightly above the level reached in 2006 prior to the recession.
Manufacturing hurt by weak European demand and the rising U.S. dollar, has developed a negative trend. According to the Institute for Supply Management Index manufacturing is still above the recession demarcation level of 50, but the trend is alarming.

The housing “recovery” continues to disappoint as actual results are less than consensus forecasts. Annualized sales of existing homes is currently 4,880,000—below the post-recession level reached in July, 2013 of 5,310,000, and well below the record level of 7,250,000 from September, 2005.

The consumer remains cautious as evidenced by the annual growth in retail sales. Surprisingly the annual increase in retail sales has been on the decline since December, 2011. The annual increase is currently only 1.2%, which is barely keeping up with inflation. Another sign of consumer malaise is the decline in outstanding consumer credit. Even with the increase in student loans, total outstanding consumer credit has declined to $11.56 billion from a post-recession high of $19.6 billion in the first quarter of 2013. Not only are housing, retail sales, and consumer credit reflecting a cautious consumer, the recent increase in the personal savings rate highlights the point.

Following a positive start to the year, recently U.S. durable goods new orders have been disappointing. As an example, economists were forecasting a monthly increase of 0.2% for February, 2015, but the actual release reflected a decline of 1.4%. Overall, it is difficult to find positive economic news.

Let’s turn to the labor market. Positive job growth continues as the total employees on non-farm payrolls continue to increase over 200,000 per month. In fact, positive job growth has been present every month since October, 2010. However, this level of job growth is lower than population growth overall. Also, the trend has turned negative as the growth in March, 2015 was only 126,000.

The unemployment rate has declined from 10% reached in October, 2009 to the current 5.5%—definitely a positive trend, about it carries a huge caveat. Since the job creation level is only generating sufficient jobs to absorb population growth, the decline is primarily attributable to the decline in the labor participation rate.

The decline in the labor participation rate has many causes: weak job prospects encourage more individuals to seek advanced degrees, others leave the labor market, and more and more retiring baby boomers.
My GDP forecast for 2015 called for growth of between 2.5% and 3%. Am I worried that the actual first quarter results point to a lower annual growth rate. Yes, as Yogi Berra said, I feel like it’s “déjà vu all over again.” I was concerned last year at this time, when first quarter “growth” was a negative 2.1%; yet the economy expanded 2.4% for the year.

I remain committed to my 2015 forecast. The first quarter will, in my opinion, be the weakest quarter of the year. In fact, based on my reading of the economy, I fear that first quarter GDP could be as low as 1%.

Here’s another pertinent Yogiism: “It ain’t over ‘til it is over.”

**First Quarter in Review: Diversification Helped**

By Kevin O’Keefe, CIMA®, AlF® | Chief Investment Officer

U.S. stock indexes posted modest returns for the opening quarter of 2015. The S&P 500 Index reached a new record during the quarter, but pulled back in late March when the surging value of the U.S. dollar (versus other major currencies) gave rise to concerns about the dollar’s impact on the earnings of large U.S. corporations—those with significant overseas operations.

Other concerns included uncertain global economic growth, oil price volatility, and the timing of the Federal Reserve’s impending interest rate hike.

The S&P 500 rose 1%—its ninth consecutive quarterly gain—while mid-cap stocks outperformed. Generally, mid-cap companies do not rely as much on overseas revenues as do large-cap companies, hence the surging dollar could be expected to have less of an impact on the earnings of mid-cap companies.

As has been the case more often than not since 2007, growth stocks outpaced value stocks. A footnote which reminds us of the “dot-com bubble” is that the Nasdaq Composite advanced nearly 4% last quarter, rising above the 5,000 level for the first time since 2000.

Among the various sectors of the U.S. stock market, health care stocks enjoyed a strong rally, driven by several large acquisitions. The energy sector declined along with falling oil prices. The poor performance of the utilities sector—5% decline for the quarter—reflected concerns over rising interest rates.

**International**

International stocks outperformed during the first quarter, after significantly lagging the U.S. stock market in recent years. Efforts to restructure economies in Japan, China, and the Eurozone, with the help of low interest rates, are moving the global economy in the right direction. Conditions are not great by any means, but when conditions have been bleak for an extended period, modest improvement can be enough to spark a meaningful advance in stock prices.
Lower oil prices will likely work their way through the economies of oil-importing countries such as Japan, helping bring down manufacturing costs. Also, a strong dollar will continue to help major exporters in countries with weaker currencies.

**Europe**

Most national stock markets in the European Union (EU) enjoyed some of the best quarterly returns in years. Overall, the MSCI Europe Index rose 12% in local currency. However, with the euro falling to multi-year lows against the U.S. dollar, the Europe Index’s gain was reduced to only 3% in dollar terms.

The rally in European stock prices had support from three primary sources:

- Improving economic numbers, specifically strong retail sales, increased export activity and improved credit availability for both businesses and households;
- Tumbling oil prices; and
- The European Central Bank’s aggressive new stimulus program, whereby the ECB, taking a page from former Fed Chairman Ben Bernanke’s playbook, committed to launch its own Quantitative Easing program by purchasing €60 billion of government bonds per month. The new program took effect on March 9, 2015.

The weak euro makes European exports more attractive, which helps explain why consumer discretionary stocks gained 18% in the quarter. Industrials rose 14%, thanks to the improving global economic outlook. Not surprisingly, energy stocks lagged.

The ongoing saga that is Greece reared its ugly head several times last quarter, spewing its own special brew of fear and loathing in the financial markets with the recurring question: “Will Greece exit the Eurozone?”

When a left-wing anti-austerity party won the Greek election in January, there were renewed fears that Greece would default on its debts and become the first member state to leave the 19-member Eurozone. The reason for such concern has to do with precedent: If Greece leaves, what does this mean for other member states? There are no provisions for a state to leave or to be expelled. So, despite Greece being a small country, the disruption could be significant.

Fortunately, an eleventh-hour reprieve in February gave Greece additional time to negotiate with international lenders, which brought some calm to the markets—at least for the time being. During the quarter, the yield on the Greek 10-year bond reflected this uncertainty, fluctuating between 8.5% and 12%. It ended the quarter yielding 11.6%.

**Asia-Pacific**

The dominant market in the Asia Pacific region is Japan. The Japanese stock market is the world’s third largest by market capitalization, despite its long malaise. For a long time, it was the second-largest. China became the second largest in 2007, but the China stock market is not yet considered a
developed market. To be considered a developed market, a country must have relatively high income, and its capital markets must be open to foreign ownership. Movement of capital must be relatively easy and its market institutions must be highly efficient.

Other countries in the Asia-Pacific region considered to be developed are Australia, New Zealand, Hong Kong, Singapore, and South Korea. Of these, Japan is by far the largest. This is why Japan receives more attention in global market reviews. American investors whose stock portfolios are diversified globally will typically have greater exposure to Japan than to any other non-U.S. country.

Japanese stocks had a terrific quarter. Fourth-quarter results were reported in February which confirmed that Prime Minister Shinzo Abe’s efforts to shake off decades of stagnation were having a positive effect, and that a period of national economic expansion was underway despite the less-than-rosy global outlook.

This new indication of economic growth, combined with strong corporate earnings and expectations that a number of companies would increase their dividends, helped propel the MSCI Japan Index to a 10% gain. Overall, the MSCI Pacific Index rose 9%. Health Care was the best-performing sector, with a whopping 23% gain. Energy was the only sector with negative returns; it retreated 1% due to lower global oil prices.

Lest we give the wrong impression about Japan’s economic rebound, let’s acknowledge that it is uneven and fragile. GDP growth was later revised downward to an annualized 1.5%. Exports rose, but business investment declined. In February, industrial output declined from January’s level. And for the 11th consecutive month, household spending dropped over the year-earlier period. On the other hand, major corporations, including the world’s largest automaker Toyota, appeared to be heeding the government’s call to raise workers’ salaries.

The MSCI Australia Index gained 10% in the quarter, with the major banks leading the way. All sectors enjoyed positive returns for the quarter except energy, which retreated 4%.

**Emerging markets**

The MSCI Emerging Markets Index rose 2% amid expectations for low interest rates around the world. Currencies generally continued to slide against the U.S. dollar, although some firmed late in the quarter when the U.S. Federal Reserve indicated it was not in any hurry to raise interest rates.

Technology was the best-performing sector, up 8%. Internet companies and smartphone manufacturers led the way, thanks to positive earnings surprises.

**The U.S. Economy**

While somewhat disappointing, U.S. economic data published during the first quarter was mostly positive. Revised GDP growth for the fourth quarter of 2014 was 2.2% annualized. The unemployment rate fell to 5.5% in February as 295,000 new jobs were filled.

Savings at the pump bolstered consumer confidence. February saw consumer spending rise for the first time in three months, although another harsh winter may have been partly to blame for the slack months.
On the other hand, the ISM Purchasing Managers Index indicated a slowdown in manufacturing activity, with the index hitting 51.5 in March, its lowest level in 14 months.

In February, Fed Chair Janet Yellen, testified before the Senate Banking Committee that slow wage growth is an ongoing concern and that any increase in interest rates would be considered on a “meeting-by-meeting” basis. In March she reiterated that the Fed would be patient in considering any increase in interest rates.

**Outlook**

Historically low global interest rates are a tailwind for stocks in many countries, including the United States. Interest rates in the U.S. may move higher this year, but they probably won’t move significantly higher.

Low interest rates are not the only driver of higher stock prices, however. In Europe and Japan, signs of economic improvement are appearing. If the dollar holds steady at current levels, we think that the giant U.S. multinationals may continue to underperform their non-U.S. competitors.

We recommend that investors continue to be globally diversified and maintain their investment discipline, especially when market volatility spikes.

**Fixed Income… Challenges and Opportunities**

By Charles Sandmel

After a strong rally in January, the credit markets retreated in February, then bounced back in March. Over the first quarter of 2015, long Treasury yields moved down about 0.15%, while intermediate rates (5-10 year bonds) moved down 0.19-0.24%.

Treasury yields represent a myriad of investor hopes and fears, simultaneously projecting inflation rate bets, a global risk-avoidance play, and an income-oriented way to play the currency markets.

The U.S. economy looked half-full one day and half-empty the next, as data releases showed fluctuations in initial jobless claims, capacity utilization, salary levels, and core inflation.

Speculation on when and by how much the Federal Reserve might raise rates also contributed to volatility in both the stock and bond markets. Even the weather added to uncertainty, with record snow in the eastern United States and a continuing drought in the west. Returns were modest; the Barclays U.S. Aggregate Bond Index returned 1.61%, slightly less than the 1.79% return realized during the fourth quarter of 2014.

Municipal bond yield gyrations were more muted, with net changes over the quarter far less dramatic than those of Treasurys. Overall returns of 1.01% measured by the Barclays Municipal Aggregate Index represented a drop from 1.36% in the prior quarter.
Historically, municipal bond yields have not moved in lockstep with Treasurys, and for good reason. New municipal issuance has run high, largely on the strength of refunding issues; investors bought up the new issues to replace bonds that will be called. And since about 70% of municipals are in the hands of individual investors, demand has tended to drop off when absolute yields get uncomfortably low.

The value proposition behind owning municipal bonds has traditionally been safety, and recent statistics continue to bear that out. According to data from Merrill Lynch, in 2014, $1.54 billion in total outstanding par value of municipal bonds entered into debt service payment default for the first time—down nearly 46% from the $2.83 billion in default for the full year of 2013. In 2014, municipal bonds in monetary default represented 0.042% of total municipals outstanding, compared with 0.076% for 2013.

Digging deeper, it turns out that about half of 2014’s default dollar volume was isolated in two private-activity issues. Most of 2013’s defaults were related to the City of Detroit. Recent history suggests that bond selection—one of the advantages of professional management—enables municipal bondholders to avoid default losses.

California’s extensive and potentially catastrophic drought has implications for bond investors. Crisis is usually both a danger and an opportunity. Farming communities, particularly in the Central Valley, will need to adapt rapidly, and will likely look to the state for leadership and support.

Population growth can no longer be viewed as a constant in desert areas. The large coastal communities and the water utilities that support them will need to invest in capacity and conservation—which will be funded with bonds and paid for with higher user charges. We are seeing some promising opportunities and constructive infrastructure reactions.

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