Ashdon Investment Management

Q2 2015 ECONOMIC COMMENTARY

July 2015

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Second Quarter 2015 Economic Commentary

Investors have had to sort through a series of incoming events in 2015. During the second quarter, the European Union, Greece and the ECB attempted to deal with the Greek debt load. Back and forth negotiations filled the headlines, with no resolution during the quarter. In Asia, the Chinese equity market continued its impressive rise early in the quarter, but broke down in rather dramatic fashion beginning in late May. Finally, we cannot fail to note the ongoing deliberations of the Federal Open Market Committee (FOMC – the “Fed”) on when to raise interest rates. The tug of war under this economic news showed up in both stock and bond markets: stock markets were nearly unchanged for the three month period and bonds returned all the gain created in the first quarter. The net effect of this year’s activities has been “sideways” markets.

Generally speaking, stocks in the Energy and Materials sectors performed poorly due to a continued story of oversupply in these basic commodity markets. Utilities and other high dividend-paying stocks also fell in price as many investors repositioned portfolios anticipating a rise in interest rates. Health Care and Technology sector stocks all rose with strength, primarily due to the market chasing any form of double digit growth – regardless of quality. International stocks were broadly weak for the quarter in sympathy with US stocks. Hong Kong and China were notably strong markets, but that now appears to have been the last push of liquidity into a market bubble. Bonds had a weak quarter with the broad index (Barclays Aggregate Index) down over 1.5%. The short term price swings in the bond market are not particularly meaningful, though they can be unnerving. The net result of this was that the overall market and our portfolios were little changed.

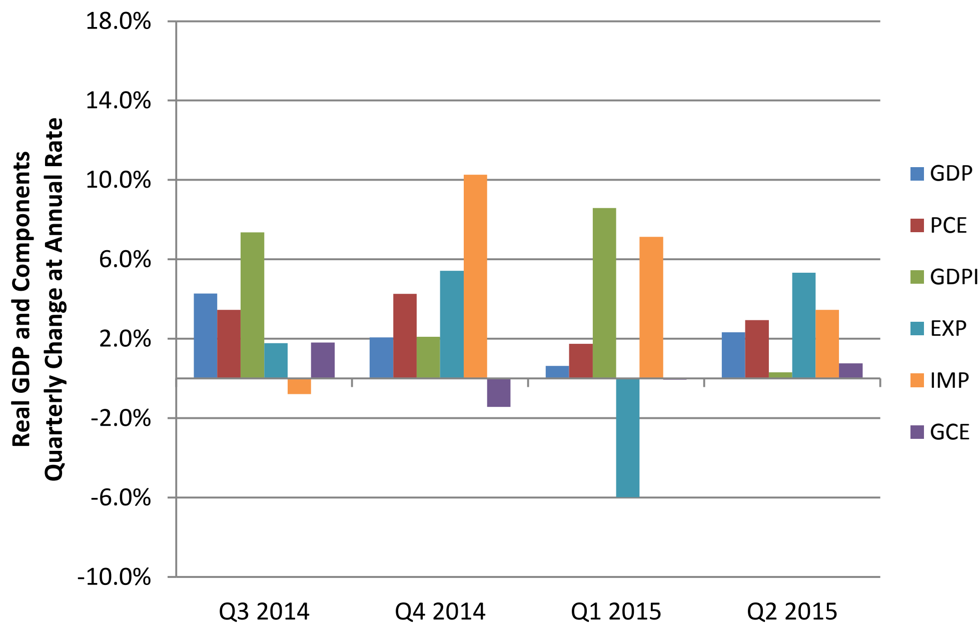
We do not anticipate changing portfolio positioning in the short term. We anticipated a flat market as one possible response to the rapid climb since 2011. However, broad-based earnings growth has not moved upward sufficiently to make the equity markets a good value, and they are definitely not “cheap”. If equities run higher from here, our client portfolios are positioned to participate. If markets remain flat, conservative positioning will help to stabilize value. However, if prices correct downward sharply, cash and short term treasuries will help preserve value and can be deployed to the opportunity to purchase companies at a discount.

Economy

So much of the news is focused on current hotspots, but investors are rewarded for focusing not on what Prime Minister Tsipras says publically for local consumption but instead looking more deeply at the state of the US economy. The US economy continues to lead the global economy forward and demands the most focus. As goes the US, so goes the globe – for now. The US economy remains on track to continue along the trajectory of moderated growth giving investors more limited downside risk, but less upside potential.

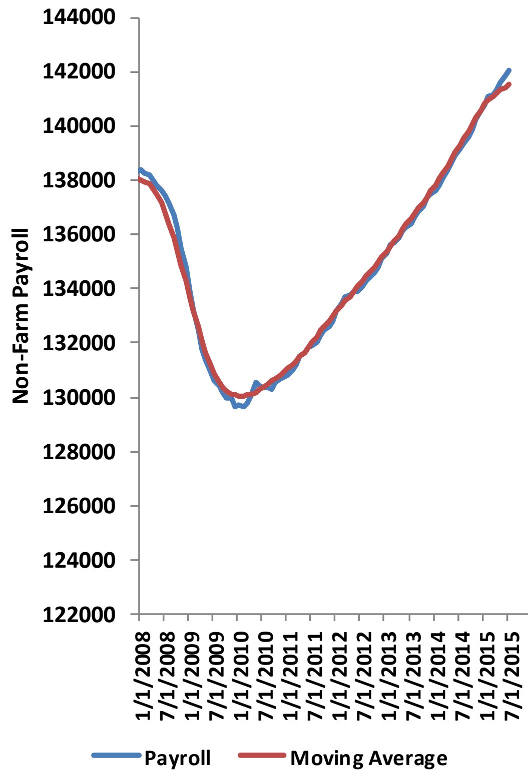
GDP

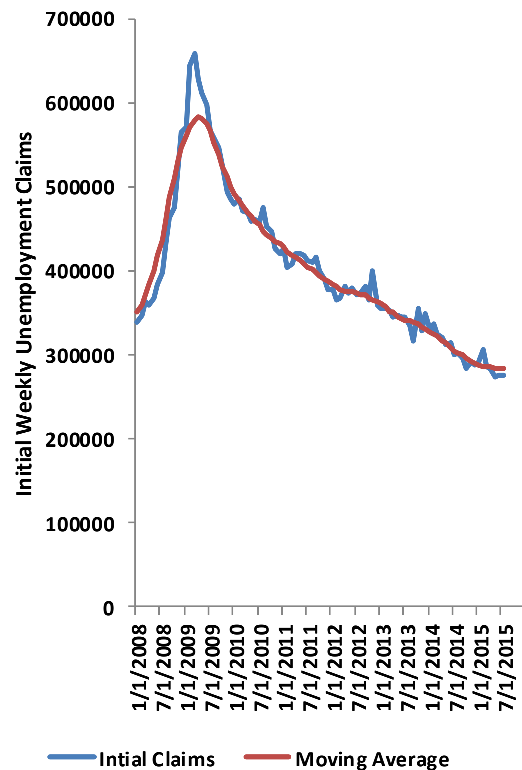
GDP growth in the second quarter resumed the modest pace that has been in place since 2009. Early releases for Q1 indicated that the economy had decelerated. Q1 revisions released with the Q2 data showed that the economy grew at an annual rate of 0.6% for Q1. For Q2 the first data release showed growth of 2.3% for the Q2 annual rate. The US economic machine continues to move forward. The chart below shows GDP and its components for the last four quarters. Growth is well distributed across the economy. Second quarter growth came from Personal Consumption Expenditures (PCE), the largest part of the economy. This growth was offset by a growing Imports (IMP)/ Exports (EXP) balance.



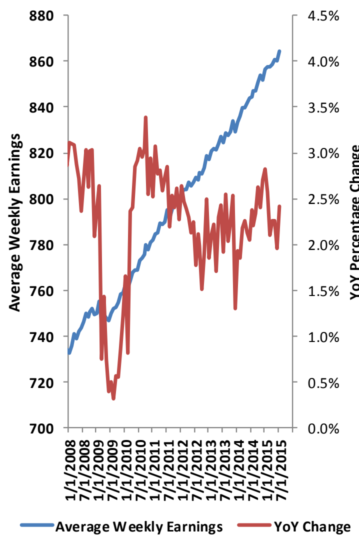
Unemployment

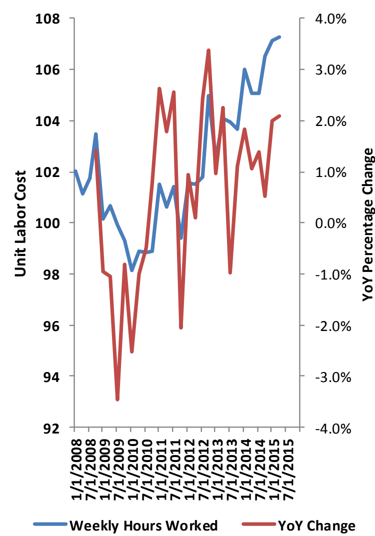
The GDP results are corroborated by data for employment, sales, production and incomes. These are the data used to determine if the economy is in a growing or contracting phase. All data point to moderated growth. The charts below show trends in total payroll and new claims for unemployment insurance. Total employment continues to grow to new highs. Unemployment claims continue to decline to very low levels. The unemployment rate at the end of Q2 was 5.3%.

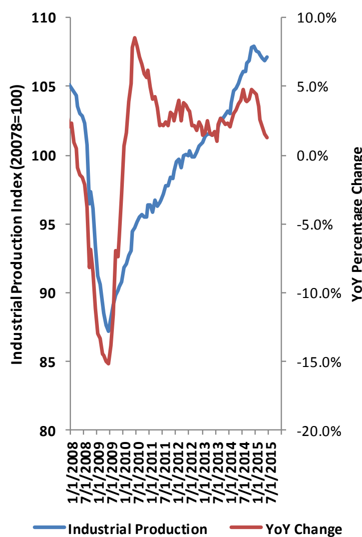


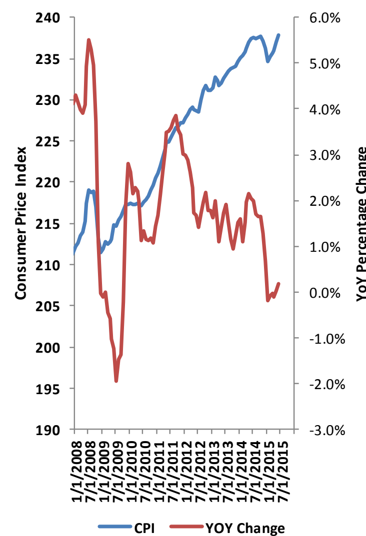


However, trends in wages and labor costs reveal a deeper perspective. Low rates of unemployment typically lead to rapidly growing wages and labor costs – presenting an inflation risk to the economy. This has not been the case since 2008. Wages are growing, but at modest rates – consistent with our modestly growing economy. Unit Labor Costs are also growing modestly. This unusual result is a consequence of the very deep “reset” of the economy in 2008. Excess labor has been mopped up over the last seven years but productivity has been high. Technology-enabled productivity improvements (See Industrial Production) have helped to keep inflation low. This has placed downward pressure on wages. Anecdotally, we are adding to our team and are able to attract qualified candidates to high quality work at reasonable compensation – Nashville-area average hourly earnings declined more than -3% in 2014. To be sure, there are jobs that demand growing compensation. But excesses of labor, reluctance of employers to add to payrolls, and shifts in the preferences of workers are all a part of the current national economy whose character includes a low growth of wage rates. Finally, modest wage growth has helped to keep inflation well under control (see Consumer Price Index).

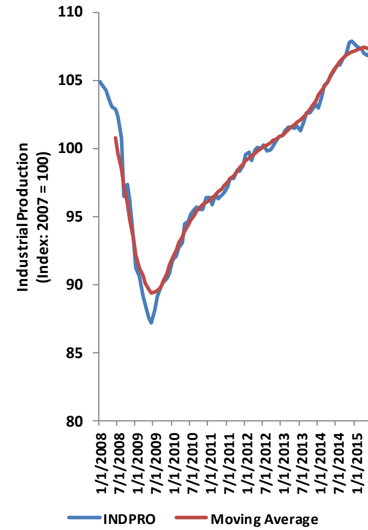




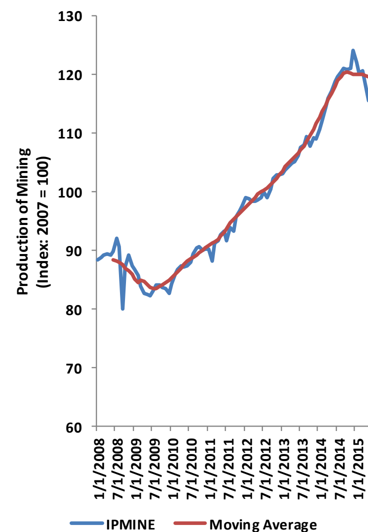




The data-driven FOMC will not be forced into a rapid normalization of interest rates. They may well move rates higher by a symbolic amount – something like 25 basis points – but that leaves rates just off the zero bound and is in no way detrimental to the economy. As long as this dynamic remains in place, we can anticipate a stable economic situation. We believe this will be the case.

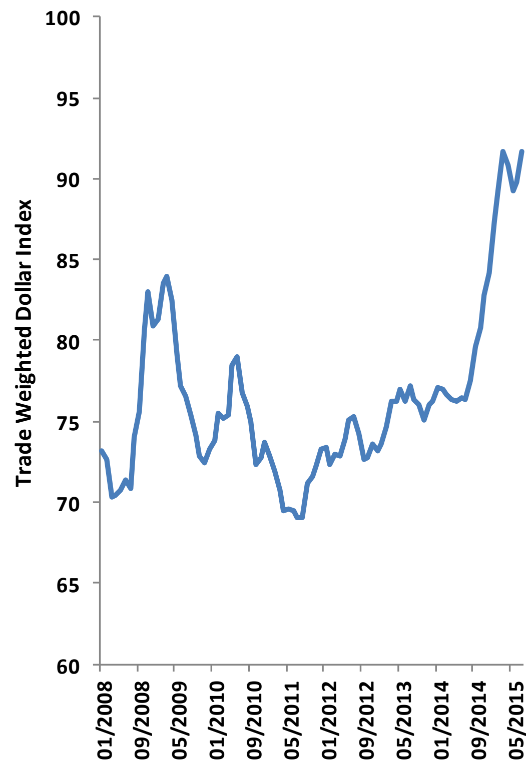


We continue to look for cracks in the US economy. For example, recent productivity data showed a down turn and challenged a key component of our view. However, a deeper look showed that the decline in production was due primarily to the slowdown in energy extraction after the rapid decline in oil processing last March. The decline in oil prices is driven by a complex set of factors affecting supply, demand and exchange rates. Slowing economies in Asia have reduced demand, as has transportation technologies. Extraction technologies have opened new fields, particularly in the US and Canada. The recent slowdown in production is related to those factors and not a signal for wide spread production deceleration in the US.



At this point in the global economic cycle, the US is the only developed economy that has ended its quantitative easing programs and is actively considering tighter monetary conditions – no matter that such considerations call for what is practically a symbolic move. Neither Japan nor Europe is in a position to begin to normalize policy and the runway ahead seems to measure in years not months. The news that China recently revalued their currency was explained as a technocratic change. It probably was that, but it was also consistent with the kinds of weakness we have seen in other regions. We do not think that the Chinese have finished devaluing the Renmimbi.

We have steered our clients clear of Emerging Market securities, and when we have been in non-US markets, we have been focused. This recommendation has been proper to date. However, we are increasingly of the opinion that the recommendation will remain in place for an extended time. The strength of the US dollar relative to all major currencies has been pronounced in 2015 (see chart below). This move has indiscriminately suppressed returns from international allocations. Our investment manager partners have helped to illuminate for us the meaning of the dollar's strength. While US economic strength is a part of the dollar's relative value, there are other complex systems that are working to weaken non-dollar currencies broadly. Essentially, one must recognize that sustaining a strong currency requires an interaction with another economy. These interactions tend to be inflationary for the other economy. In the unusual world of global quantitative easing, currency defenses create a deflationary force. The problem is that at some point the deflationary forces will overwhelm an economy, forcing currency devaluation. One particular manager has compared the situation today with the situation that preceded the Asian financial crisis in 1998.



Our portfolio recommendations are in line with the views here. Holding higher than normal levels of cash and equivalents, tilting toward low-gross alternative strategies, and building new positions slowly are all in line with this view. While our expectation is that markets will remain flat through the year, we are positioned well for either the case of continued advance or decline. Market data suggest that risks are building in the market. A recent Wall Street Journal article noted the decreasing breadth of the market advance. This is reminiscent of market behavior prior to past corrective cycles. We agree and will continue to monitor the market and economic conditions and will seek to keep portfolio recommendations timely.

"The Only Six Stocks That Matter" Wall Street Journal, 7/30/2015

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