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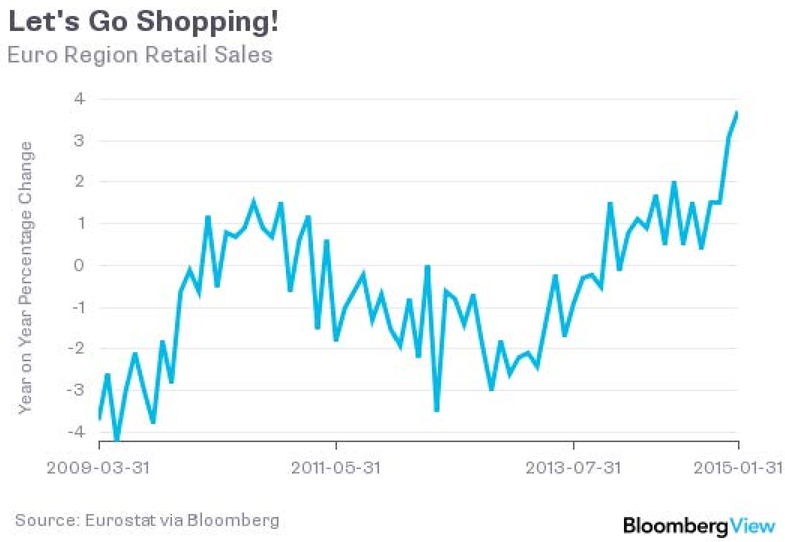
First Quarter 2015 Economic Commentary

If there comes a little thaw,
Still the air is chill and raw,
Here and there a patch of snow,
Dirtier than the ground below,
Dribbles down a marshy flood;
Ankle-deep you stick in mud. In the meadows while you sing,
"This is Spring."
-Christopher Pearce Cranch, A Spring Growl

Well, spring finally sprang in the Northeast. The back and forth of our weather lately certainly has most of us anxious for warmer temperatures and sunnier days. Just when we think there is no way that life and beauty could possibly emerge out of the cold depths of winter, spring always comes. Is it finally time for an economic spring thaw and is the outcome being stuck in the mud?

So far this year, we seem to be following last year's pattern…not a great start to 2015 either. In the US, March retail sales, industrial production and housing figures all disappointed, and what seems to be persistent softness in U.S. economic data is beginning to raise suspicions among economists that the country may have difficulty reaching the 3% annual growth rate that investors had expected at the beginning of the year. Meanwhile, first quarter growth in China decelerated to 7%, the slowest pace in six years. European statistics, on the other hand, appear to be stronger than most had anticipated. Although deflation fears in Europe translate into what seems like pitiful yields of 0.10% or less for the privilege of lending to the German government for ten years, European consumers are not acting in tandem with a deflationary forecast. Under this type of scenario, consumers should be unwilling to spend because they expect to see better prices in the future; yet, retail sales annualized at 3.7% for the fastest growth in a decade:



So, the question becomes: is this a mid-cycle pause similar to some we experienced in the mid-90's or a more meaningful leg down nearer the end of the business cycle?

We think this is a very important question because of the credit cycle. If this pause results in a reduction in credit growth, the eventual credit contraction would almost certainly mean recession, whereas if we see continued credit growth, the mid-cycle pause would be quite short-lived, and the outcome would be an economy that should be able to withstand the long-anticipated rate hike that the Fed has promised. Though Fed tightening is often regarded as a melancholy truth, we suspect that the realization of a pre-destined, almost inescapable rate hike will be far easier to swallow than one which comes as a surprise.

What the Fed is now doing is telling markets that the weak Q1 data are not enough to keep it from raising interest rates in the summer. It may delay raising rates. For example, June is still officially on the table for a rate hike and many Fed officials are still saying so explicitly. But they are also saying they are willing to look through the Q1 data and are simply waiting to see whether the Q2 data bounce back.

Meanwhile in Europe, the European Central Bank (ECB) which not so long ago had been unable to commence quantitative easing as the German Bundesbank regarded this as almost voodoo economics, has fallen in love. Not unlike the ten year old boy who rejects girls but after a few years finds himself testosterone-driven crazy for them, ECB chief Mario Draghi after just one month of the ECB's €1 trillion QE scheme is only too happy to take credit for upward revisions in Eurozone growth forecasts and strong gains in their stock markets. The Euro's almost 30% slide versus the US dollar has lifted the profits of European based exporters. The International Monetary Fund (IMF) has indicated that it now expects the Eurozone to grow by 1.5% in 2015, after contracting -0.3% last year.

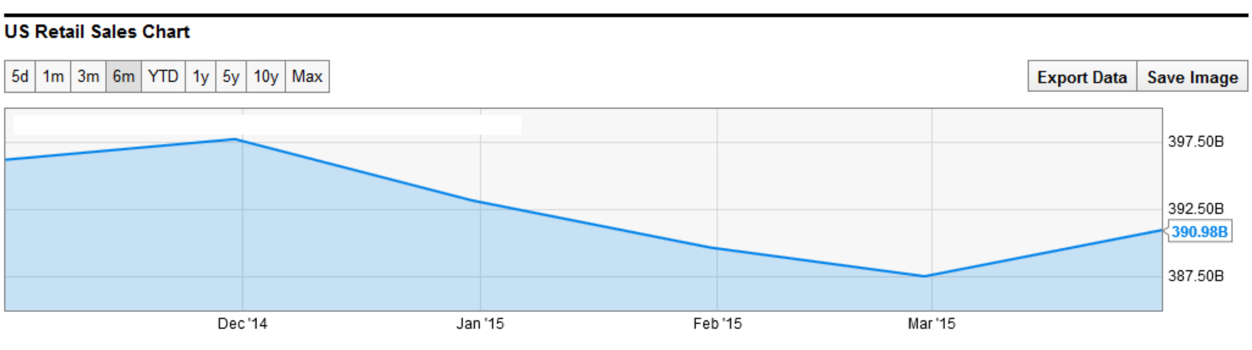
After years of focusing on the downside risks in the Euro-zone economy, investors have shrugged off their concerns, and are now betting on the upside profit potential from a further weakening of the Euro's exchange rate, against the China Yuan, Japan yen, and US dollar. The Euro remains on a downward trajectory, because quantitative easing has pushed about 70% of European government bond yields to below zero!

Negative yields on debt provide a number of substantial benefits. First, it allows European governments to refinance their borrowings at much cheaper interest rates and longer maturities. Provided that governments take advantage of this extra fiscal breathing room to pay down debts rather than incur new borrowing, debt burdens should fall more rapidly than had until recently been assumed. As yields head down, bonds rally. Hence, quantitative easing has driven up the value of bonds held on bank balance sheets, thus boosting their capital ratios. Consequently, QE has helped to recapitalize European banks in a rather cunning way.

It took an exceedingly long time for the ECB to start QE. Don't expect it to rethink that decision rapidly. Though savers, insurance companies and pension funds may protest negative yields, Draghi has likened demands for the ECB to stop QE to a marathon runner thinking about stopping just after the race has begun.

Let's examine more closely some of the US data:

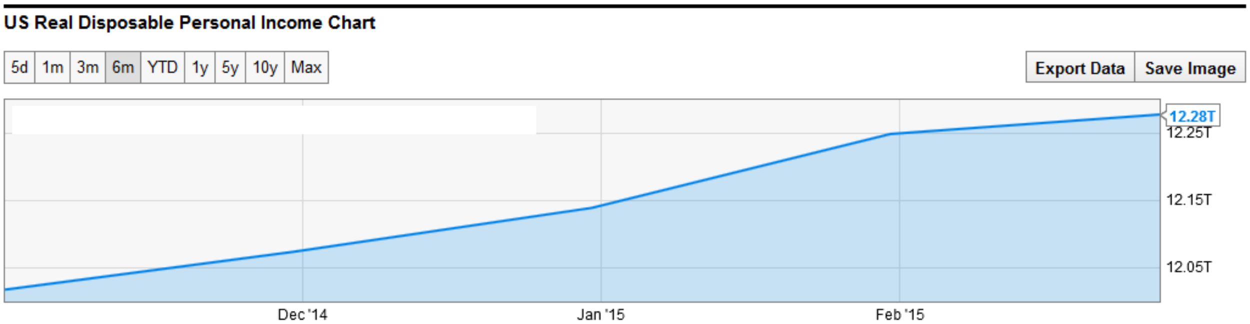
December, January and February retail sales data were weak. And that is what is going to lead to a weak Q1 GDP report later this month. But, this data could be an aberration unduly influenced by weather. March retail sales were up 0.9%, a decent figure, certainly compared to the year so far, but slightly below expectations. Overall, though, the March numbers are still somewhat weather-scarred and we will need to see the data from April and May that precede the Fed's first potential rate hike before we can make conclusions about the underlying trend for retail sales.



Source: Ycharts.com

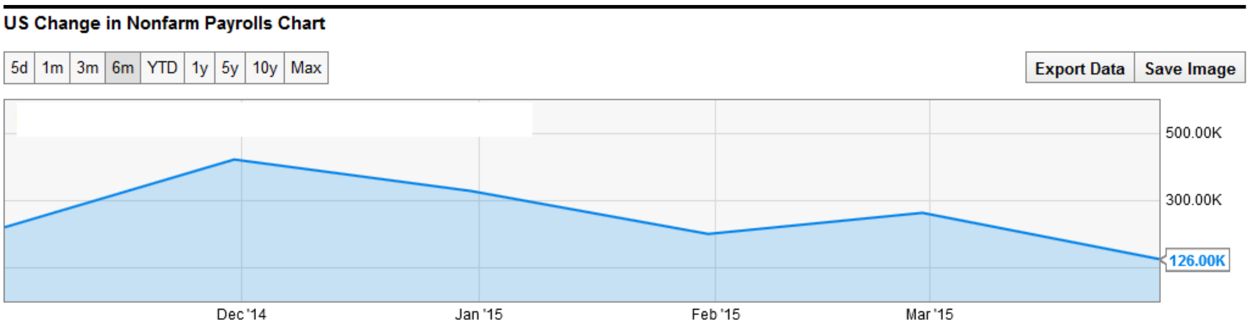
If the Q1 slowdown was really weather-related, what we should expect for Q2 is that we get a rebound. And the rebound should be robust because there will be pent-up demand due to the weather-affected slowdown. That is certainly what we saw in Q2 and Q3 of last year. And if we do not see this in the data for April and May, then we should conclude that the weakness in Q1 was more than just an aberration.

From our perspective, the biggest point in favor of the temporary slowdown thesis is personal income. It is up consistently at a 0.3-0.4% pace for every month over the last five months. Personal income for 2014 was up 4.0% y-o-y after a mere 2.0% rise in 2013. All of this speaks to household income that should help retail sales stay on track, all else equal.



Source: Ycharts.com

Considering the employment situation, following a blowout number for 423K increase in nonfarm payroll for November of 2014, monthly data has softened to March's very disappointing 126K.



Source: Ycharts.com

As you can see, the consumer side of the economy is providing some very mixed signals, much different than the incremental growth that had been widely anticipated from the "tax cut" impact of lower energy prices.

On the manufacturing front, let's look at the Institute for Supply Management (ISM) metrics. The ISM monitors employment, production inventories, new orders and supplier deliveries in the manufacturing economy. One of the more important economic indicators that the ISM provides is the Purchasing Managers Index, or PMI. The PMI was down to 51.5 in March from 52.9 in February, which in and of itself is worrying. But the most important aspect of the March Report is that all of the forward looking indicators were weak, with the backlog of orders contracting outright. Look at the three squares highlighted below.

MANUFACTURING AT A GLANCE
MARCH 2015

Index	Series Index Mar	Series Index Feb	Percentage Point Change	Direction	Rate of Change	Trend* (Months)
PMI®	51.5	52.9	-1.4	Growing	Slower	27
New Orders	51.8	52.5	-0.7	Growing	Slower	28
Production	53.8	53.7	+0.1	Growing	Faster	31
Employment	50.0	51.4	-1.4	Unchanged	From Growing	1
Supplier Deliveries	50.5	54.3	-3.8	Slowing	Slower	22
Inventories	51.5	52.5	-1.0	Growing	Slower	3
Customers' Inventories	45.5	46.5	-1.0	Too Low	Faster	4
Prices	39.0	35.0	+4.0	Decreasing	Slower	5
Backlog of Orders	49.5	51.5	-2.0	Contracting	From Growing	1
Exports	47.5	48.5	-1.0	Contracting	Faster	3
Imports	52.5	54.0	-1.5	Growing	Slower	26
OVERALL ECONOMY				Growing	Slower	70
Manufacturing Sector				Growing	Slower	27

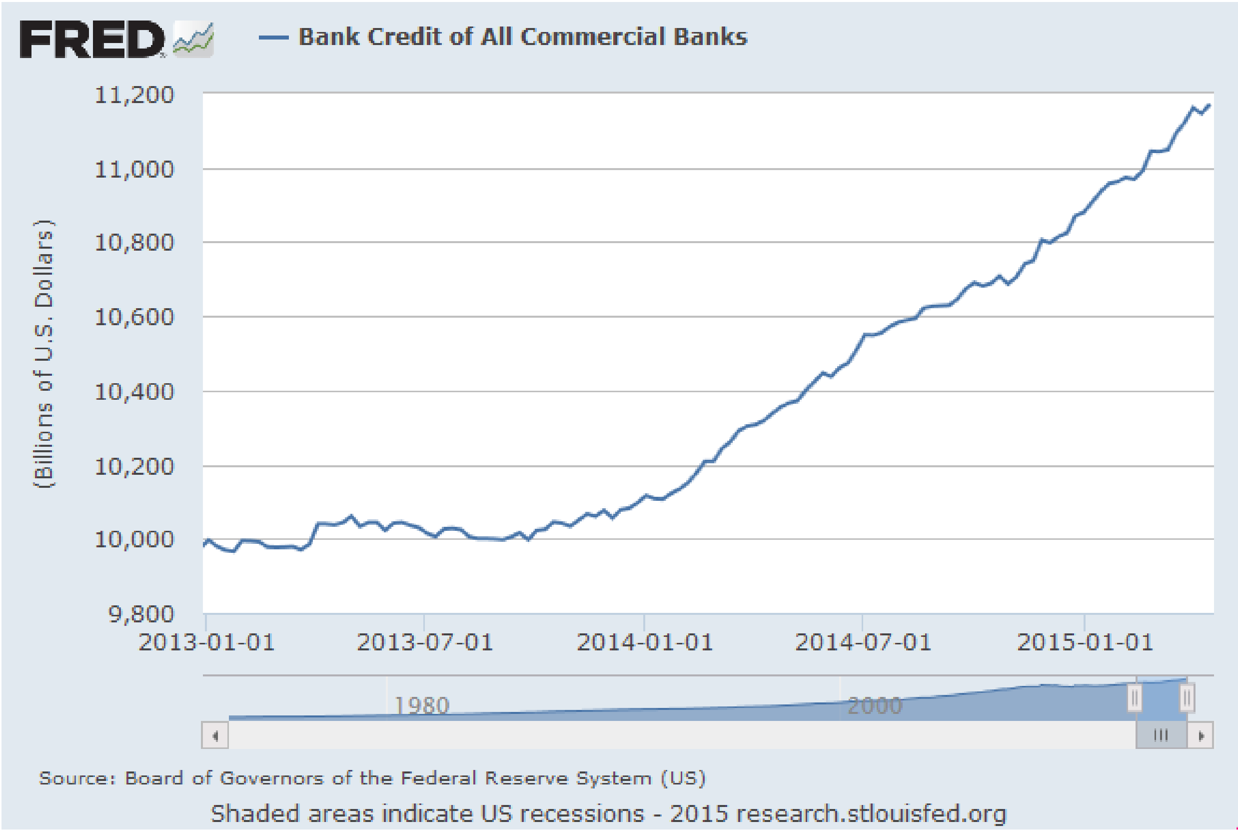
Manufacturing ISM® ***Report On Business®*** data is seasonally adjusted for New Orders, Production, Employment and Supplier Deliveries Indexes.

*Number of months moving in current direction.

Source: creditwritedowns.com

Note the number of slowing trends that have developed in the most recent data. Though overall trends for the overall economy have been growing for 70 months, and order and production trends in manufacturing have trended similarly for about the last 25-30 months, the forward looking stats of new orders and backlogs are disturbing new developments. The employment sub-index, which is another diffusion index, indicates growth in jobs if the index is above 50 and contraction below 50. As of March's data, it was hovering on the edge.

The state of credit growth in the US is somewhat moot. Based on the Federal Reserve depiction of bank credit, credit growth appears robust. Accordingly, based on this evidence, potential tightening would not derail the US economy absent fiscal tightening given this strong upward trend in private credit growth.



Unfortunately, more disturbing readings emanate from the National Association of Credit Management's Credit Managers' Index. This index, compiled from a monthly survey of credit managers including both banks and their customers is showing numbers that do not bode well for the growth of the economy going forward.

Combined Manufacturing and Service Sectors (seasonally adjusted)	Mar '14	Apr '14	May '14	Jun '14	Jul '14	Aug '14	Sep '14	Oct '14	Nov '14	Dec '14	Jan '15	Feb '15	Mar '15
Sales	59.1	61.8	65.6	63.9	65.2	64.8	60.9	65.7	62.7	61.4	61.5	59.5	57.9
New credit applications	57.3	59.3	58.9	61.5	62.4	60.9	59.0	59.4	58.1	59.2	58.3	54.4	57.4
Dollar collections	56.4	58.1	61.2	59.3	61.0	62.7	59.9	61.5	60.3	56.6	60.1	62.8	60.1
Amount of credit extended	63.1	63.8	65.0	64.8	66.1	66.7	64.0	63.8	63.7	64.6	62.2	52.1	46.1
Index of favorable factors	**59.0**	**60.7**	**62.7**	**62.4**	**63.7**	**63.8**	**60.9**	**62.6**	**61.2**	**60.5**	**60.5**	**57.2**	**55.4**
Rejections of credit applications	52.4	52.3	52.7	52.0	52.1	51.9	52.5	53.6	51.7	51.5	51.9	48.1	42.9
Accounts placed for collection	54.1	51.7	53.8	52.5	51.5	52.1	50.7	52.7	51.8	51.1	50.1	50.8	49.8
Disputes	50.9	54.7	50.2	49.5	50.3	50.6	49.2	50.4	50.8	48.5	49.5	48.8	49.0
Dollar amount beyond terms	52.4	50.0	51.5	49.6	51.1	50.3	47.2	53.6	52.3	48.7	50.6	48.4	45.5
Dollar amount of customer deductions	51.2	50.3	50.4	49.4	50.6	49.9	49.8	50.8	49.7	48.5	50.2	51.8	48.7
Filings for bankruptcies	58.4	58.1	58.4	58.9	57.6	57.5	55.8	58.1	56.8	58.5	56.9	55.0	55.1
Index of unfavorable factors	**53.2**	**52.8**	**52.8**	**52.0**	**52.2**	**52.1**	**50.9**	**53.2**	**52.2**	**51.1**	**51.5**	**50.5**	**48.5**
NACM Combined CMI	**55.5**	**56.0**	**56.8**	**56.1**	**56.8**	**56.7**	**54.9**	**57.0**	**55.8**	**54.9**	**55.1**	**53.2**	**51.2**

The combined score is getting dangerously close to indicating economic contraction and has not been this weak since 2010. Though the current reading at 51.2 still indicates growth, these readings have been in the mid -50s and above—comfortable territory and generally trending up from one month to the next and that appears to have reversed.

The index of favorable factors (the top 5 rows of the survey) has slipped substantially but remains mid-range. These measures had been mid-60's through most of the last two years. Note that the "amount of credit extended" per line four is contracting dramatically since year-end.

The lower half of the table highlights unfavorable factors. This has now dropped below 50 to 48.5, indicating contraction. This index has not been here since the days right after the recession ended in 2009.

The new credit applications category improved from 54.54 to 57.4 but when we combine this reading with the metric for the amount of credit actually extend (52.1 to 46.1) there may be more applications for credit, but there is not much being extended.

Most economic forecasts are much rosier than ours and seem to ignore some truly important and basic aspects of this economy. We do see some positive aspects to this economy on the industrial side. For example, truck tonnage has increased in five of the last six months, a useful barometer of the US economy as trucking represents about 70% of all domestic freight. The truck tonnage index is near its all-time high reached in January.

The recovery has been a reluctant one, because the market has from the very beginning been reluctant to embrace the notion that the recovery was durable. There are plenty of good reasons for the market to be concerned, of course: unprecedented changes in monetary policy, misguided fiscal stimulus, the deep-seated problems in the Eurozone, the housing disaster, and the huge federal deficit, among others. The fundamentals have improved, but market sentiment remains pessimistic. This creates an interesting environment for investors, since it means that the bar for economic performance has been set very low: seemingly, the economy only needs to avoid a recession for markets to react positively.

Households have undergone some significant deleveraging since prior to the Great Recession, but on the margin not much has changed for the past few years. I think this is a sign that caution still reigns; people are reluctant to go on a borrowing binge, preferring instead to accumulate savings and keep their powder dry. It's a time of prudence. Nobody is taking outsized risks these days, except perhaps with their security selections to get farther out on the risk curve and parlay this into superior returns.

The Greek debt situation remains unsustainable. Greece is expected to submit a more complete list of reforms in order to free up funds so the country can service its obligations. Four times the Greek government has provided lists and four times the European group of finance ministers rejected it.

The IMF, which violated its own rules over the objections of its senior staff in its extensive exposure to Greece, insist that Syriza, the Greek political party in power known as "The Coalition of the Radical Left" abandon its anti-austerity drive and institute the necessary reforms to avoid default. The unelected and unrepresentative IMF leadership has indicated that it has no obligation to take seriously the desires of the Greek electorate.

The issue of contention appears to come down to the Greek government's unwillingness to include additional cuts in pensions and further labor market reforms into is proposals. Just the Greek government appears to have under-estimated the resolve of the both core and peripheral countries not to relax their demands, so too have the official creditors under-estimated the resolve of the Greek government, as inexperienced and clumsy as it may be. For the last few months, the argument is been cast as either Greece makes the necessary reforms, or it leaves EMU (European Monetary Union) and defaults. US states failed in the 19th century and some US cities have failed, including most recently Detroit, no one seriously contemplated them (city or state) from leaving the union. Just as Europe has devised rules and procedures (standardize) the failure of financial institutions, it needs to do the same with regions and states. And it needs to do this within the confines of monetary union. Greece is once again proving to be the catalyst for the evolution of Europe. The only chance Greece has of remaining within the Eurozone is if it can pull of a huge economic resurgence that beats back the populist political wave which will almost surely spell exit as long as joblessness remains so high. I don't see this happening without significant reform to Eurozone institutions. The path to exit from the Eurozone is arduous because there are no mechanisms for getting there. It is a legal and operational quagmire that involves considerable preparation. As a result, Greek exit, now known as Grexit can only occur through mutual consent in a formalized process that would take months if not years. This outcome is instructive for other peripheral nations because it would set a clear path through which to leave the Eurozone.

As you can see, the outlook has become more disordered and muddled than the consensus view. We believe that glassy-eyed optimists will be disappointed in the pace of world economic growth. Though consensus growth forecasts the first quarter are starting to recognize this, we believe that it is the wrong time to be cavalier about future growth. Our conservative stock selection and continued use of longer term fixed income instruments reflect this outlook.

As always, we appreciate your continued confidence and trust. We welcome questions and comments.

Richard Konrad, CFA, CFP®
Managing Member