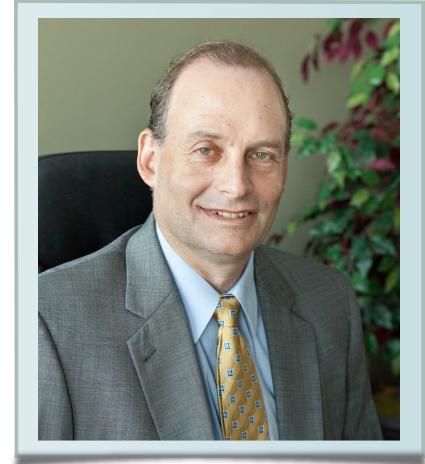
VERITY
Asset Management

Commentary

Core Model

June 30, 2014



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As the second quarter of 2014 ended and the "dog days of summer" approached, many of the recent economic and market trends continued apace, leaving a multitude of questions unanswered and conclusive interpretation of some data a bit murky.

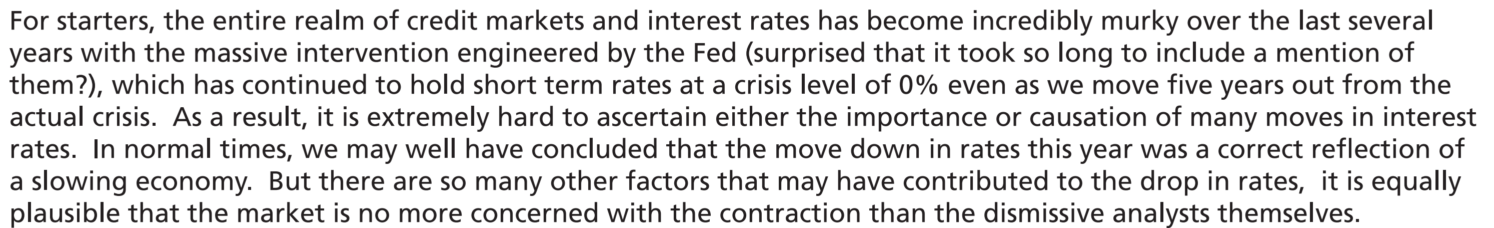
On the economic front, the most widely anticipated monthly data, that relating to unemployment and job growth, continued to reflect an apparently improving situation. Nonfarm payrolls showed job growth well over 200,000 each of the three months in the quarter. The frequently cited unemployment rate dropped to the lowest level in over five years, coming in at 6.1% for June. And significantly, the labor force participation rate moved higher throughout the quarter to its highest level in almost a year.

That fact serves as confirmation that recent improvement in the unemployment rate cannot be solely attributed to disenchanted workers dropping out of the labor force. On the other hand, a more sobering interpretation of the data would note that the labor force participation rate was above 66% in late 2009, while the recent bounce has only seen the rate improve to 63.4%. And when one notes that average hourly wages actually declined each of the past three months, a logical conclusion would be that what we added were an awful lot of low paying jobs. Little wonder a Bloomberg story in May was titled, "A Nation of Temps and Burger Flippers?".

Regardless of the quality of employment however, one would suspect that the generally improving employment situation would have a significant effect on the broad economy. In a country where Personal Consumption Expenditures currently represent 69.53% of GDP, steadily increasing numbers of paychecks should improve the country's bottom line. But in a stark manner, the most recent measure of U.S. GDP reflected anything but significant growth. For the first time in three years, GDP contracted, with the -2.9% rate of contraction the worst since the memorable first quarter of 2009. Analysts were quick to note the constraint that harsh winter weather had put on many aspects of the economy and essentially are confident that the economy will quickly recover to the fairly consistent "slogpath" of about 1.5-2.5% growth that has been sustained since 2010.

We could similarly scrutinize the data related to housing and construction. Suffice it to say that after a material slowing early in the year (there's that weather again), most data points have bounced, but not quite to levels of the previous year. So to summarize the state of the economy at the midpoint of 2014, it appears to be slowly improving in several respects, but the expected strong acceleration that many analysts have been calling for over the past several years still seems just out of reach, looming somewhere over the horizon.

Turning, as we inevitably must, to the markets, what is probably most notable is what has not happened. At the conclusion of 2013, after a fairly significant rise in 10 year Treasury yields, the overwhelming consensus was that yields would continue to rise from the closing level of 3.02%. By the end of the second quarter 2014 however, the 10 year yield had dropped back to 2.52%. So are there important takeaways?



For starters, the entire realm of credit markets and interest rates has become incredibly murky over the last several years with the massive intervention engineered by the Fed (surprised that it took so long to include a mention of them?), which has continued to hold short term rates at a crisis level of 0% even as we move five years out from the actual crisis. As a result, it is extremely hard to ascertain either the importance or causation of many moves in interest rates. In normal times, we may well have concluded that the move down in rates this year was a correct reflection of a slowing economy. But there are so many other factors that may have contributed to the drop in rates, it is equally plausible that the market is no more concerned with the contraction than the dismissive analysts themselves.

The 2013 rise in intermediate term rates gained traction after the Fed announced that they would begin tapering their latest version of Quantitative Easing (their massive bond purchasing program). It stands to reason that other market participants may have taken this as a reason to sell some of their holdings sending rates higher, rather than wait until the market could be potentially destabilized by diminished Fed purchases.

However, across the big pond, speculation in 2014 had become rampant that the European Central Bank would soon do what they had previously insisted was off limits—begin their own program of quantitative easing. In anticipation of that massive intervention, European rates have been falling precipitously as well. For instance, in Spain, a country that many would suggest has more acute structural fiscal issues than the U.S., the 10 year government yield dropped from a 2013 close of 4.15% to end second quarter 2014 at 2.66%. So in a world of global liquidity, it is quite likely European rates exerted downward pressure on U.S. rates, as well.

Turning attention to the stock market, there seemed to be a developing consensus earlier in the year that the market was due for a correction, defined as a 10-20% move lower. The market has gone an inordinately long time (since 2011) without one of these countertrend moves, and markets don't go straight up forever. But all that actually materialized was a fairly sharp move lower in the small caps (9% in the Russell 2000 index), led by the biotech sector and highflying internet and tech stocks. That pullback by the former leaders of the market never morphed into a broad market correction, and the market resumed its uptrend--leaving many commentators still looking for the elusive correction. To be certain, there are many headwinds and potential pitfalls, not the least of which are the questionable sustainablility of the plodding expansion/recovery, the ability for corporations to sustain historically high profit margins even as productivity is beginning to fall, and the potential that global credit concerns once again move to the forefront.

In addition, by any metric, stock valuations are moving higher, and based on how they are analyzed, stocks are certainly no longer undervalued. On the other hand, any real acceleration in the economy could conceivably move the pendulum back toward undervaluation. S & P 500 12 month as reported earnings last quarter set another all time record at $100.85/share, and second quarter earnings estimates factor in significant growth, leaving room for more potential stock market appreciation without moving valuations higher.

One final comparison -- the last secular bull market ended by most accounts in March 2000, with the S & P 500 topping out at 1552. At the time, stock valuations were extremely stretched, but it is worth noting that the S & P 500 as reported 12 months earnings were then 50.95/share. Today earnings are nearly 100% higher, while today's S & P 500 is only 27% higher than that prior market top. None of this is meant as prediction, it is just observation. But given the potential ability for the economy to continue on the slogpath, it may not be unreasonable to believe that the band will continue to play on.

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