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Capital Management

Q3 2013 Commentary

Note to Clients:

I hope you had a great summer and are looking forward to the Fall season.

As I write this note to you, The United States Government is effectively shut down. Sad indeed, but our politicians could not come up with a budget deal or a deal to address the looming debt ceiling that is due to expire next week. Surprising? Not really!

Throughout the third quarter there was a great debate over if and when the Federal Reserve would slow or taper its current Quantitative Easing (QE)/bond buying efforts. In May, the Fed commented that it might taper its bond buying as the economy and the labor markets seemed to be improving, albeit slowly. The stock markets did not react well to that news and sold off. Mixed signals, such as rising long term interest rates, slight improvement in unemployment, and the overall the health of the economy put the Fed in a position of having to make some sort of decision by the end of the summer.

Many attribute a large portion of the market's gains this year to the ongoing easy money policy the Fed has in place. When the Fed announced that there would be no change in the current policy (i.e., no tapering), many were surprised, and the market rallied on the news. The Fed decided to not taper as a precautionary wait-and-see approach, since they wanted to see the effect of higher interests rates on the economy, particularly mortgage rates on housing. They also cited concerns that the effect of a potential government shutdown would have on the economy.

The U.S. manufacturing sector expanded at its quickest pace in more than two years, as domestic demand remained brisk and trading partners around the globe saw their economies improve. The manufacturing sector is also in a very good competitive position as our cost structures are low, innovation is higher than ever, and quality is very good.

Labor is still slowly improving, but the falling labor participation rate is still a big factor, as more unemployed drop out of the workforce and stop seeking employment.

Long term interest rates have been rising since the spring. This has slowed the pace of home sales and price recovery a bit as mortgages remain cheap by historical standards.

From late August into mid-September, crude oil prices shot up on worries that a military strike led by the U.S. could disrupt oil supplies from the region, which produces roughly a third of global oil supplies. The main concern was that any ramp-up of the conflict in Syria could spread into neighboring countries, such as Saudi Arabia, and interfere with the flow of crude to world markets. With Russia and the U.S. agreeing to dismantle Syria's chemical weapons, that brought some relief to the oil markets.

Over the past several quarter end commentaries, I have written about the bullish sentiment towards the U.S. moving toward energy independence. Keeping with that theme, I recently read a comment that I thought I would share with you. "A study for the Financial Times showed that entry level wage in the energy patch was around $1,800 a week. A $90,000 entry-level job has four times the multiplier effect of a typical base-wage or minimum wage job. And as our energy sector grows, we can stop sending dollars to buy oil from someone we really don't like, the current account adjusts positively, the balance of payments adjusts positively, and the whole equation of global finance shifts in our favor. And that is doing so in spite of the politicians in Washington." This is another reason I remain very bullish towards the energy sector.

The European economy has emerged more strongly than expected from its longest postwar contraction. The euro-zone's return to growth after six straight quarters of contraction was driven by Germany, its strongest and largest economy. It recorded the fastest expansion among large developed economies during the quarter. The recovery is still too sluggish to overcome all the regions ailments, including still rising debts, mass unemployment, hobbled banks and political instability. They are moving in the right direction, but it will take a lot to get back to 2 to 3% growth. Unemployment among European youth is especially problematic.

Chinese economic data provided yet more evidence that the country's economy is stabilizing and will avoid a hard landing, with industrial-production growth accelerating. This is also a move in the right direction.

Investors have started to feel a little squeamish about how high the market is going. Positive economic news and soothing statements from Fed officials have helped stocks in recent weeks. But now it is all about fundamentals to lead the market. As I mentioned in the second quarter letter, investors are looking at earnings growth to move the needle. I think that our portfolios are well positioned going forward.

So, our government is shut down and the era of cheap money continues. Depending on how the government shutdown progresses, the Fed may actually have to increase the bond buying to help keep the economy afloat. After four years of recovery, I hope the government shutdown does not spook both consumers and businesses and threaten the economic recovery. Businesses have been slowly boosting hiring, housing is well off the market crash lows, and household finances have been improving. So, let's hope that our elected officials finally make some good decisions.