Vanderbilt Ave. Asset Management

3rd Quarter 2015

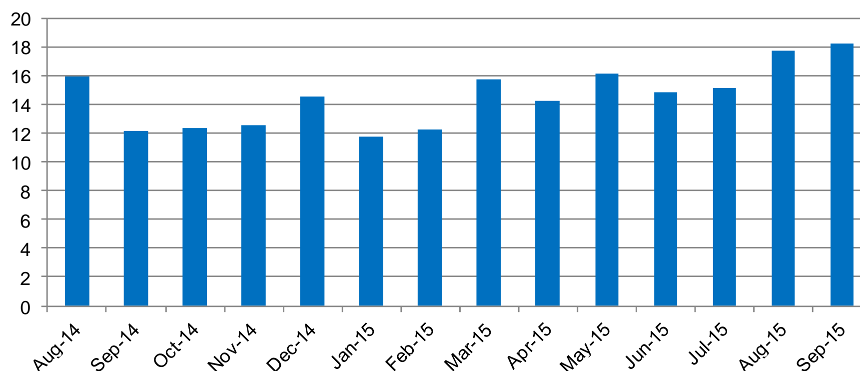
The employment data for September was on the weak side. While the unemployment rate held at 5.1%, only 142,000 new jobs were created and the prior two months of employment data were revised downward. It is hard to reconcile the employment data with other statistical figures. Indeed, second quarter real GDP rose 3.9% with the consumer sector up 3.6%. Household debt relative to income is declining. This debt ratio has returned to levels of late 2002-early 2003. In addition, the consumer confidence survey for September was the highest level since 2007. This confidence has manifested itself in strong auto and housing data.

The fiscal arena will witness an interesting period between now and year end. John Boehner, current House Speaker, has resigned and the federal debt ceiling needs to be raised. The U.S. is the only major industrialized country that has such a limit. The debt ceiling is only a theoretical concept since it has been raised 14 times in the past 15 years. It is, however, an illustration of how dysfunctional Congress has become. Congress is the body that passes appropriation bills that do not match tax revenues then is surprised that the debt ceiling has to be addressed.

Personal consumption expenditures will be helped by several factors. Falling energy prices have provided a boost to growth of real disposable income. This income growth aided in the acceleration of personal consumption expenditures in the second quarter and will boost growth in the near term. Consumer home delinquency rates have declined to near record low levels. This should result in easing credit terms and increased bank willingness to lend.

Housing is another sector that has and should continue to provide support to GDP growth. Housing continues to recover as a result of lower mortgage rates and an increase in the household formation rate. This sector has benefitted from strong investor interest, the release of pent up demand by current and potential home owners, an indication of loosening of mortgage credit terms and positive sentiment from home builders. Housing remains robust.

The auto industry is another sector that is providing momentum to the economy. With gasoline prices moving lower and credit for auto lending becoming easier to obtain, the U.S. automobile industry has posted strong year-over-year sales. U.S. auto sales rose to a seasonally adjusted annual rate of 18.2 million in September-the highest in more than 10 years (see chart below). The momentum of the past six years shows no sign of abating.



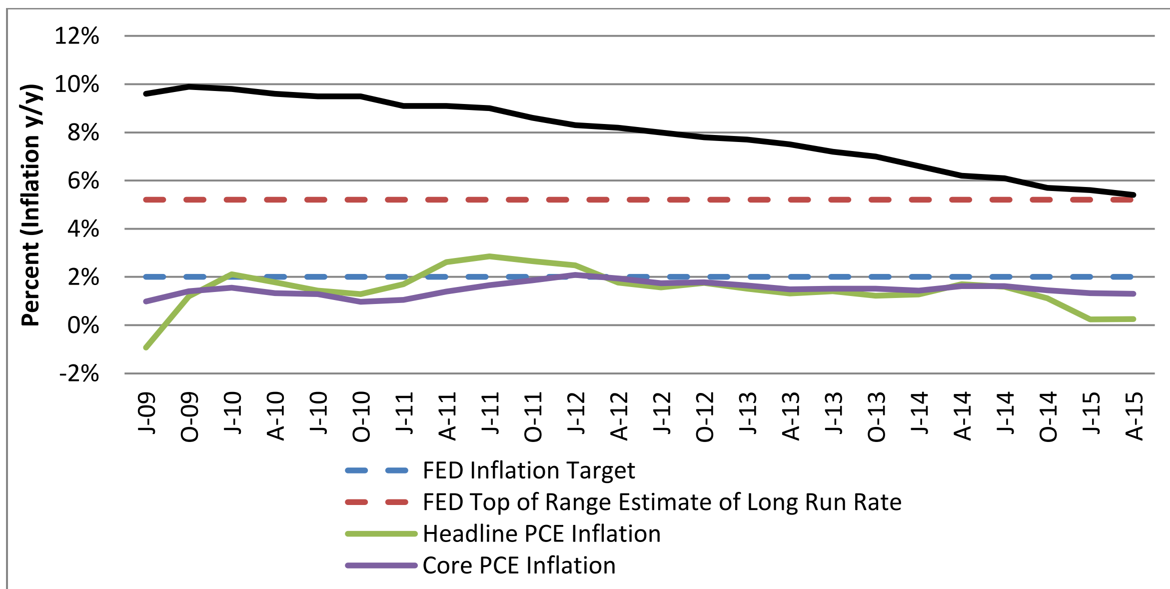
Inflation should move towards the Fed's 2% objective as a result of an improving economy. The Fed believes the continuing improvement in the labor market will lead to higher wage gains and increased consumer spending that will move underlying inflation closer to their 2% target. In the near term, the Federal Reserve should begin normalizing interest rates and by late 2016 fed funds could be approaching 1½%.

Reflective of the projection in our previous quarterly letter, the yield curve flattened albeit not as a result of tighter than expected monetary policy. A combination of weaker global demand and increased volatility in financial markets precipitated a flight to quality which in turn manifested itself as a flatter yield curve. The spread between the 10-year and the 2-year Treasury notes tightened 29 basis points, from the previous quarter end, to 141bps. The table below shows the yield curve at the end of the second and third quarters.

	30-Jun	30-Sep	Change
3-monthTreasury Bills	0.01	-0.01	-0.02
6-month Treasury Bills	0.11	0.07	-0.04
2-year Treasury Note	0.65	0.63	-0.02
5-year Treasury Note	1.65	1.36	-0.29
10-year Treasury Note	2.35	2.04	-0.31
30-year Treasury Bond	3.12	2.85	-0.27
10-year vs. 2-year (bps)	170	141	-29

A key development over the course of the quarter, in addition to the flattening of the curve, was that the 3-month Treasury bill traded at a negative yield. This typically reflects a shortage of safe assets relative to demand. This phenomenon is likely linked to the sell-off in risk assets experienced over the latter part of the quarter. Another key event was the decision by the Federal Open Market Committee to leave the stance of policy unchanged.

Uncertainty persists in markets as policy makers weigh their policy objectives against the backdrop of increased volatility in financial markets and declining liquidity. On the one hand, the Fed's objective of full employment is, by some measures, fulfilled. On the other hand, headline inflation remains below their 2% target. Moreover, inflation expectations, as measured by the difference between yields on inflation adjusted Treasury securities and standard ones of the same maturity, remain anchored well below the target. The chart below demonstrates the diverging path of the FED's policy objectives.



Quarterly Inflation and Unemployment since the Current Expansion; source: Federal Reserve economic data

As shown in the graph, the unemployment rate has been continuously trending downwards. The most recent reading of 5.1% for the month of September is well within the range of the most recent Fed estimate of the long-run rate of 5% - 5.2%, suggesting that the economy is rapidly approaching, if not at, full employment. Conversely, headline inflation remains well below the 2% target. The August reading came in at 0.3% on year-over-year basis. Core inflation, which strips out the food and energy components, is considerably closer to target at 1.3% y/y. The subdued inflationary pressures place the Fed in a box.

Futures markets are currently assigning a low probability to a rate hike within the fourth quarter. This is a stark contrast from the expectations implied during the first-half of the year, when futures markets were pricing in a high probability of a rate hike during the third or fourth quarter. We do not share this view and actually think the Fed will raise rates before yearend. The Fed is being sensitive to the fact that not raising rates is creating its own volatility loop.

Corporate Securities

Weakness in the corporate bond market accelerated during the third quarter as global growth worries dominated investor attention. Intermediate corporate bond spreads rose by 0.31% to 1.56% over comparable U.S. Treasury issues. Interest income offset the price declines from the wider spreads, resulting in a 0.35% total return. However, the return underperformed Treasury securities as excess return for the sector was -1.11%. The same dynamic was seen in short maturity corporate bonds as spreads rose by 0.23% but the total return remained positive for the quarter at 0.18%. Shorter maturity corporate bonds for the year-to-date, however, have provided returns in line with the Treasury market. The wider spreads provide attractive income over other sectors of the fixed income market as long as the U.S. economy continues to expand sufficiently to support financial fundamentals.

Corporate fundamentals have peaked but remain relatively stable. Interest coverage for the investment grade universe has declined modestly to 10.3 times from 11.0 times in the fourth quarter of 2014. This coverage level stood at just 8 times at the end of the last recession. Other indicators of health in the sector remain supportive. For instance, during the last earnings season 75% of S&P 500 companies reported earnings that exceeded market expectations, a modest improvement from the prior quarter and in line with historical experience. The Lighthouse quantitative model, which incorporates equity value, equity price volatility and the level of debt to determine the credit risk for the issuer, calculated 0.88% of credit risk for the overall U.S. corporate market and a positive 0.16% of excess return. Therefore, current spreads incorporate recent equity price moves and the recent high equity price volatility. The best performing major sector within the corporate universe were financial companies. Though not immune from all of the market turmoil, issuers in the sector combined stable to improving financial fundamentals, positive second quarter earnings and attractive spreads. Core positions in your portfolio include issuers like Goldman Sachs and JPMorgan Chase. Goldman Sachs has a Basel III capital ratio of 11.7 times, a significant earnings surprise for the second quarter and is trading 34 basis points cheap to its credit risk. JPMorgan has an 11.0 times capital ratio, a positive earnings surprise and is trading 26 basis points cheap.

In response to global growth weakness, commodity price pressure and weakening fundamentals, several positions were sold during the quarter. Those issuers include Buckeye Partners LP, a petroleum products pipeline, and Freeport-McMoran Inc., an international natural resource company. Though both companies provide relatively high interest income, they are exposed to a high level of pricing pressure. The sales reduced the price volatility and credit risk of your portfolio. Overall your portfolio remains overweight to corporate bonds due to sound fundamentals, solid earnings and reasonable valuations in the current economic environment.

Asset Backed Securities

While the short end of the U.S. Treasury curve was unchanged to slightly lower in the third quarter, short asset backed securities (“ABS”) posted an outperformance to comparable duration Treasuries. The short ABS index returned 38 basis points, which translated to a positive excess return of 14 basis points over similar duration Treasury securities.

The outperformance in short AAA-rated ABS can be attributed to a decrease in supply. We continue to reinvest the proceeds from maturing ABS in other short-term ABS in order to continue earning income for your portfolio.

These securities are high quality, AAA rated and have short durations. They are collateralized by credit card receivables, auto loans/leases and equipment loans. These collateral types continue to offer stable cash flows that do not fluctuate with interest rates as opposed to securities backed by home mortgage collateral. A recent purchase is CARMX 2015-1 A3. This security is collateralized by motor vehicle payments, offers stable cash flows with an average life under 2 years and a yield of 1.3%.

We continue to maintain an overweight allocation to ABS. In addition to offering attractive yields versus Treasury and Agency bonds, they provide an efficient, liquid sector as an alternative to cash.

Equity securities

The equity market experienced a negative rate of return for the third quarter. The S&P 500 Index declined 6.44% (total return includes dividends) bringing year-to date returns to -5.29%. In spite of the market decline, corporate earnings have been aided by GDP growth as well as continued low interest rates. While operating profit margins have remained high, margins could be pressured by several factors. As the Fed begins to normalize interest rates this could ultimately result in higher interest expenses for the corporate sector. Also an improved labor market should cause wages to accelerate on a more sustained basis. These two factors could pressure margins if companies are unable to pass these increased costs on in the form of higher prices. Continued sluggish productivity gains may reduce operating margins. Global growth concerns have heightened as the slowdown in China's growth impacts emerging market economies. In terms of valuation levels, the equity market is above longer-term averages but not excessively. The S&P 500 is trading at 16.3 times its trailing 12-month earnings. This is higher than its 10-year average of 15.7 times earnings. In addition, the price-to-EBITDA ratio for the S&P 500 Index is greater than in 2007-9.0 versus 6.7. The price-to-sales ratio is also higher at 1.7 versus 1.5. Finally market breadth has been weakening. The S&P 500 has just 17% of stocks over their 5-day moving average. This total has been weakening steadily since December, making lower highs in February, April, June and August. Due to the above concerns, we maintained a relatively defensive investment posture with regards to equity allocation.