What Gives? Domestic Economic Bliss or Global Risks?

While the domestic economic picture gained clarity and additional momentum throughout the summer and fall, global geopolitical events bombarded our markets on nearly a daily basis. International conflicts (Ukraine/Russia, Israel/Hamas, ISIS/Rest of Known World), the spreading Ebola outbreak in Africa, civil unrest in Hong Kong and economic slowdowns in both the European Union and China have all called into question prospects for global economic growth. The central banks of the European Union and Japan accelerated their easy money programs in the face of deteriorating economic conditions during the third quarter, while the Fed inched toward higher rates in the U.S.

The Rise in Interest Rates Stalled on 1/1/2014

We started the year with a 10-year Treasury rate of 3.02% and believe it isn't likely to reach that level again until next year. What happened to the "bond bubble" popping? While U.S. policymakers should be commended for reigning in the Internal Issues described in our 2Q 2012 Commentary (www.oppenheimerim.com), other major economies in the world have created a rather lengthy External Issue list (see above) for the Federal Reserve to evaluate when contemplating the timing of rate increases. The Fed's mandate from Congress is to maximize employment (currently defined as an unemployment rate of between 5.2% and 5.5%) and provide price stability with an approximate 2% annualized increase in Personal Consumption Expenditures ("PCE"). How are they doing?

- Employment: The most recent unemployment reading dropped to 5.9% in September from 6.1% in August. While a modest decline in the labor force participation rate from 62.8% to 62.7% contributed to the decrease in unemployment, household employment did increase by 232,000. This leaves the three month moving average increase in payrolls at 224,000 and the six month average at 245,000. Stabilization in the labor force participation rate remains elusive. The lower participation rate as well as a reduction in the quality of jobs created during this recovery likely will result in the Fed lowering their Non-Accelerating Inflation Rate of Unemployment ("NAIRU") target. Approximately 2.3 million manufacturing jobs were lost during the last recession. Since 2010, only 701,000 of these jobs has returned. Manufacturing jobs are quality, full-time jobs that typically include benefits and a living wage.
- Inflation: Inflationary pressure remains subdued. Wages were flat month-over-month in September and 2% higher year-over-year. Inflation in the U.S. is wage driven not commodity driven, given our service based economy. Looking back on our 1Q 2006 commentary, we expressed concern about wage inflation. GDP was reported to have grown +4.5%, the unemployment rate stood at 4.7% and capacity utilization was 81.2%. Recent readings of 2Q 2014 GDP at +4.6%, unemployment at 5.9% and capacity utilization at 78.8% merit vigilance, yet we believe the lack of wage inflation suggests more slack in the employment situation today as compared to 2006. This will provide the Fed with more reason to lower the "full employment" target. With global growth contracting, the value of the dollar rising and oil and other non-wage inputs declining, we do not see core PCE breaking out of its sub-2% inflation trend in the near term.

"Janet, it's your turn at the dot plot board"

We are amused by how much attention market participants place on the Federal Reserve Board's "dot plots," particularly individual estimates by members on the timing of the first rate increase. While the proud owners of individual "dots" are not identified, Fed watchers now speculate on whose dot is whose, hoping to gain insight on future "dots" based on public speeches. The Fed "consensus" has become more hawkish over time; but it is the dove voters that have been more accurate in their economic projections. We believe the Fed's "data dependent" mantra will likely continue to prove the doves correct, and that the "dot plot" consensus indicating mid-2015 rate increases will prove too aggressive. Remember, this is the same Fed that has consistently overestimated the strength of the current recovery for the past four years.

The Quantitative Easing (QE) program expansion ends this month. Foreign buyers are flocking to U.S. Treasuries (see our 2Q 2014 commentary), resulting in lower yields and a flatter yield curve than the beginning of the year. Because the Fed hawks are tapping on the table to raise rates while growth prospects abroad turn sour, the dollar has risen in value against major foreign currencies. This has made U.S. goods and services more expensive for foreign buyers and the value of foreign earnings lower for domestic companies. We believe the Fed will be forced to delay the first rate hikes until fall of 2015 or later. The economy has only exceeded 4.5% growth three times during this expansion, and each time it followed a quarter with less than 2% growth. Growth for the first half of 2014 was 1.25% and we anticipate full year 2014 growth of approximately 2.0-2.5%. When we look back on this economic cycle, we will not only see a weak recovery but one much longer in length than the historical norm. Recoveries from "balance sheet recessions" are typically longer and less vigorous than those following more typical "inventory-led recessions." For what this recovery lacks in strength, we believe it will make up with staying power. Furthermore, subdued global growth, a stronger dollar and weak inflation will keep the Fed on hold and rates lower for longer than expected. "Expansions don't die of old age; they are murdered by the Fed."- Rudi Dornbusch, German International Economist.

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White Papers and Articles that We Found Insightful:

US Job Polarization Persists, FRB of St. Louis:
http://research.stlouisfed.org/publications/es/article/10210

Interesting short article discussing a trend over the last 30 years toward more high-skill/wage and low-skill/wage jobs at the expense of middle income jobs.

How much do Medicare Cuts Reduce Inflation?
FRB of San Francisco:
http://www.frbsf.org/economic-research/publications/economic-letter/2014/september/medicare-cuts-reduce-inflation-budget-control-act/

The article reviews the impact of government payment cuts via the Medicare program and their impact on private insurance payments to healthcare providers. It is interesting to note, that the Congressional Budget Office (CBO) reduced its projection of Medicaid Program costs in August by $395 billion over the next ten years as a result of the implementation of the Affordable Care Act. The Medicare Trust life expectancy (when expenses will exceed worker contributions) increased from 2026 to 2030 for the same reasons. While these achievements did not receive many headlines, they are meaningful and warrant noting.

Understanding the relationship between real wage growth and labor market conditions, FRB of Chicago:

http://www.google.com/url?sa=t&rct=j&q=&esrc=s&frm=1&source=web&cd=1&ved=0CB4QFjAA&url=http%3A%2F%2Fchicagofed.org%2Fdigital_assets%2Fpublications%2Fchicago_fed_letter%2F2014%2Fcfloctober2014_327.pdf&ei=ZIE1VMv6EZCpoQTWg4GQBA&usg=AFQjCNHqSL6xYndoEtjsU5qoLBBC3oNxEA&sig2=bwuRl79TyRXcgWNkfnoNcw

This study goes into greater detail and focus on wage inflation, recent hiring practices of companies and the use of part time employees.

Capital Markets and Performance

The taxable fixed income market was pulled by the opposing forces of an improving domestic economy and sluggish global growth during the quarter. U.S. economic data was stronger in the quarter, but little inflation pressure has kept the Fed policy accommodative and on hold until next year. Other global economies (such as Europe, Japan and China) continue to report decelerating economic activity. U.S. Treasury securities were the best performer in the quarter and lower quality corporate securities underperformed. The relative pressure on corporate securities was further exacerbated by record supply. The bellwether 10-year Treasury yield declined four basis points during the quarter to close with a yield of 2.49%. The Barclays Capital U.S. Aggregate Index returned 0.17% for the third quarter and 4.10% year-to-date. Treasury securities returned 0.34% for the quarter and 3.06% year-to-date. Corporate security total return lagged in the quarter at -0.08%; however, corporates still boast a year-to-date best performance of 5.60%. The quarter also witnessed longer maturities outperforming shorter maturities and lower quality bonds underperforming higher quality bonds. High Yield performance, as measured by the BofA/Merrill Lynch High Yield Master II Index, returned -1.92% in the quarter, lowering year-to-date returns to 3.61%.

While the third quarter of 2014 was not an exceptional quarter for our composite performance versus our respective benchmarks, we remain steadfast in keeping an eye toward the future and maintaining our long term investment mentality. We remain overweight corporate securities, believing they still offer the best opportunity for outperformance over the longer term as the U.S. economy continues its long, slow recovery and the market digests recent new supply. Although the timing of interest rate increases may be extended into 2015, we will keep portfolio durations shorter than our respective benchmarks in anticipation of this interest rate movement.

How we are positioning portfolios at this time?

Readers of this commentary should note that as long-term value fixed income investors, we remain focused on portfolio duration and credit. We maintain our bias toward rising interest rates and favor corporate credit. While the credit sector will hit bumps in the road, as it did this quarter, we expect that long term investors will be rewarded. With the 10-year Treasury trading at sub 2.4% yields and the U.S. economy performing well, clipping the more attractive coupon provided by U.S. corporate investments should result in superior portfolio performance over the long term. Remember, our bottom-up investment process and extensive research focus helps us identify relative value opportunities in the marketplace, giving us confidence in the risk-reward trade-offs in our portfolios. While market fluctuations can cause short-term underperformance, our long-only style of investing has delivered positive results with reduced volatility over the long term. If you have any questions on strategy, performance or business development, please do not hesitate to contact us.

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