The COMPASS Chronicle

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Crisis Averted...for Now

By Louis E. Conrad II, CFA

In our Special Fall Edition of "The COMPASS Chronicle" released on September 26, we highlighted COMPASS' expectation that the "Congressional games of brinkmanship" leading up to the debt ceiling deadline could lead to additional market volatility, but that we did not expect it to result in a stock market correction as market participants had grown desensitized to Capitol Hill's shenanigans.

On a daily closing basis, the S&P 500 declined only 4% from its peak close on September 18 during the budget and debt ceiling standoff. In fact, the S&P 500 reached its recent low mark one week before the October 17 debt ceiling deadline before rallying 5% to its current level, placing its return year-to-date at 22%.

Though we believe a 5 – 10% correction would be a healthy response to such an extended rally, the market has cheered (1) the fact that Congress did not allow the U.S. Treasury to default on our national obligations and (2) the standoff negatively impacted fourth quarter GDP by an estimated 0.3% (according to a survey of economists by Bloomberg News), which is likely to delay the Federal Reserve's plan to "taper" its $85 monthly purchase of Treasuries and mortgage-backed securities until March 2014.

This delay in the "taper" provides liquidity to the market for an extended period and supports a "risk on" attitude among investors. However, earnings growth has been decelerating for several quarters and now stands in the low single digits. With profit margins near peak levels and revenue growth uninspiring due to anemic economic growth, COMPASS continues to expect that stock market advances will be in the mid-single digits over the next 1 – 2 years, down from 16 – 20% over the past couple of years.

2013 FIVE STAR PROFESSIONAL Wealth Manager MULTI-YEAR WINNER

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Is the Housing Recovery Stalling?

By Louis E. Conrad II, CFA

- The housing market, which suffered from a 6-year bear market, has rebounded over the past year.
- However, with an increase in interest rates that occurred during mid-2013, the pace of the housing recovery may slow.

Last year the residential housing market began to recover after a six-year decline. Home prices had fallen 35% on a national basis by the spring of 2012 from their peak level in mid-2006. In 2012, residential home prices began to recover due to support from (1) low prices; (2) low interest rates; and (3) an improving employment market.

Though the job market has continued on its path of gradual improvement, which is supportive of a housing recovery, both home prices and mortgage interest rates have increased meaningfully during the past year, reducing the affordability of housing purchases and threatening the housing recovery. Over the past twelve months, home prices have increased 12.4% on a national basis (6.3% in the Boston area), according to S&P/Case-Shiller. However, the jump in interest rates has had an even more negative impact on affordability.

What does all of this mean for the nascent housing recovery?

Historical Perspective

Back in the fall of 2005, I wrote an article raising the prospect of a housing bubble. As I stated back then, “home prices generally increase in line with personal income, since income determines how much a homeowner may spend on housing.” However, in the several years leading up to the price peak in 2006, home prices had increased more than twice as fast as income levels. Until the housing bubble burst in 2006, the median sales price of existing homes had never suffered from an annual decline on a national basis (based on data from the National Association of Realtors).

Consequently, most real estate prognosticators believed back in 2006 that the housing market was unlikely to suffer from a price decline on a national basis, let alone a six-year bear market.

Current Situation

Since last year’s trough, the residential housing cycle has experienced a meaningful rebound based on price and sales trends. This past spring’s selling season witnessed bidding wars on properties in many areas of the country. Inventory levels were declining and considered tight in some communities, spurring further price appreciation and supportive of a seller’s market.

However, as referenced above, the increase in prices and interest rates has hurt the affordability of home purchases. As interest rates rise, the affordability of homes declines due to the resulting higher mortgage payment. The interest rate spike this past spring caused many prospective buyers to become more active and accelerated their home purchases in an effort to lock in their mortgage rates. Marginal purchasers may no longer have the means of purchasing the home that they could afford just a few months ago.

Future Prospects

Most expect interest rates on which 15- and 30-year mortgages are based to continue their upward trend as the Federal Reserve begins to “taper” and ultimately end its program of U.S. Treasury and mortgage-backed security purchases. However, the pace of interest rate increases is likely to moderate from the explosive pace of this past spring. Even so, further rate increases will reduce the pool of eligible purchasers unless bank underwriting standards are loosened, which was a primary factor leading to the bursting of the prior housing bubble.

As the marginal buyer is priced out of the market, inventory levels should stabilize or increase and price appreciation should moderate. Such conditions will ultimately lead to home price appreciation that is more consistent with income growth and a more balanced supply and demand outlook. For its part, the National Association of Realtors expects the median existing home price to advance nearly eleven percent in 2013 on a national basis, before decelerating to five to six percent growth in 2014.

Monthly Market Commentary

News in recent weeks has been all about the government shutdown and the even more worrisome prospect of violating the debt ceiling sometime later this month. A debt-ceiling violation could lead to the deadly combination of higher interest rates and a slower economy. In a world where markets swoon on a 20,000-job miss in monthly employment data (on monthly job growth of about 200,000), losing 800,000 government jobs in one shot is a very big deal. Although the market has been soft lately, it seems to have hardly grasped the potential of a longer-term shutdown. We have reached this crisis point so many times recently with no negative consequences that the market seems almost numbed to the potential pain. Relatively inflexible wage rates and the propensity of most consumers to keep spending despite short-term adversity all contribute to the economy's overall stability and slow growth rate. But a month-long government shutdown would likely cut GDP growth by at least 0.5% in a world of 2.0% growth.

Employment: Another negative consequence of the shutdown is that government agencies have stopped releasing statistics; the Bureau of Labor Statistics' official employment report is missing. The ADP employment report showed more of the slow, unsatisfying growth rates seen for the last several months, with private sector jobs growing by 166,000, up from the 159,000 jobs added in August. The report was a bit of a disappointment, as the consensus estimate was for 180,000 jobs to be added.

Housing: New home sales and housing starts slowed down in the face of higher rates, while existing home sales jumped ahead as homebuyers raced to close quickly before rates moved even higher. Even before the higher rates, housing data had begun to top out as land and labor shortages slowed home construction. This has caused many analysts to scale back their housing growth rate and GDP contribution for both 2013 and 2014.

Consumer spending: Month-to-month consumption data has shown improvement, but the much more reliable year-over-year data suggests more of the same for consumption and the United States economy. Year -over-year three-month averaged consumption growth remained stuck in its slow and unsatisfying rut of 1.9% when adjusted for inflation. That remains well ahead of income growth of just 1.1%, with the higher payroll and income tax rates subtracting close to a full percentage point off of income growth. Income data is beginning to show some improvements that might help fourth-quarter spending data, but initial reports seem to suggest a softer holiday shopping season than last year.

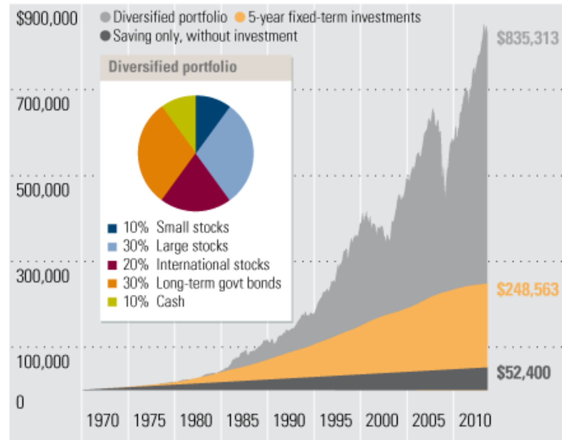
Quarter-end insights: While the overall U.S. economy has been quite stable, the third quarter did bring a number of real surprises, some positive and some negative. In the positive camp, Europe appeared to move from recession into recovery. The U.S., Chinese, and European manufacturing economies appeared to pick up steam in the quarter. Better auto sales and production helped the data, as did some inventory rebuilding and general improvements in consumption from more confident European consumers.

On the negative side, U.S. interest rates continued to climb throughout most of the quarter. The U.S. 10-year Treasury bond approached 3% in the middle of September before settling back a little after the Federal Reserve decided not to taper bond purchases. However, despite this decision, rates are still substantially higher than they were a quarter ago and are unlikely to approach old lows. Although tapering is off the table for another month, it will happen at some point, and the market knows it. Morningstar economists expect the 10-year Treasury bond to reach the 3% to 4% range over the next year or so, and a tapering program of some type to begin in the next three or four months. Projections for the remainder of the year include GDP growth in the 2.00% to 2.25% range, inflation at 1.60% to 1.80%, and the unemployment rate at 7.10%.

Saving Is Not Enough

After two financial crises occurring almost back to back during the "lost decade," investors have every right to be risk-averse, hesitant, angry, or distrustful. The problem with not investing at all, however, is that you may not have sufficient money to achieve your financial goals. An individual saving $100 per month, without investing, would have put away only $52,400 since 1970. By placing that money in five-year fixed-term investments, the investor would have been able to end up with almost five times that amount. And if invested in a diversified portfolio, our investor's savings would have grown to $835,313. It's true that any investment involves varying levels of risk. But, as the image illustrates, even if you have low risk tolerance, you can find a suitable investment for your needs that may still be much better than no investment at all.

Two Types of Investments Versus Saving Without Investment, Jan 1970–Aug 2013



Past performance is no guarantee of future results. This hypothetical example is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Holding a portfolio of securities for the long term does not ensure a profitable outcome and investing in securities always involves risk of loss. The diversified portfolio was created for illustrative purposes only; it is neither a recommendation, nor an actual portfolio. Government bonds are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than bonds. International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, and differences in accounting and financial standards. Diversification does not eliminate the risk of experiencing investment losses. The data assumes reinvestment of income and does not account for taxes or transaction costs.

Source: Small stocks—Ibbotson® Small Company Stock Index. Large stocks—Standard & Poor's 500®, an unmanaged group of securities considered to be representative of the U.S. stock market. International stocks—Morgan Stanley Capital International Europe, Australasia, and Far East (EAFE®) index. Long-term government bonds—20-year U.S. government bond. 5-year fixed-term investments—yield on a 5-year U.S. government bond. Cash—30-day U.S. Treasury bill.

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