The Type 2 Investor

June 6, 2016

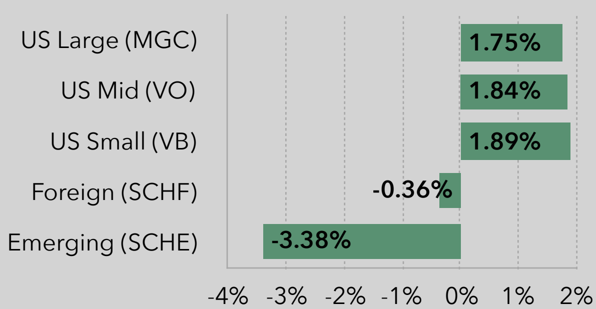
May 2016

Economic Data

- New home sales surged to their highest rate in over eight years in April
- Year over year inflation (CPI) edged up to 1.1% in April; upward trend likely to continue
- Retail sells jumped 1.3% in April, driven by increased auto sales and higher prices at the pump, but auto sales fell off a cliff in May
- Only 38,000 jobs were added in May; unemployment dropped to 4.7% as 458,000 more people vanished from the labor force

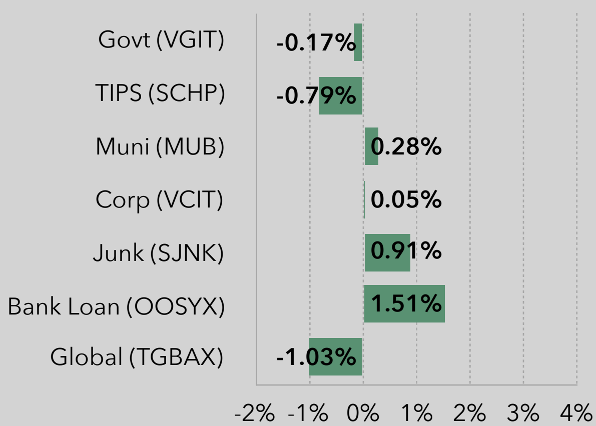
Stocks

April Returns



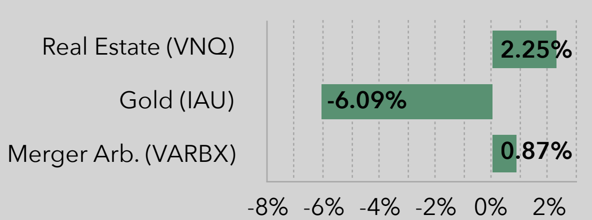
Bonds

April Returns



Alternatives

April Returns



Performance data provided by Morningstar.

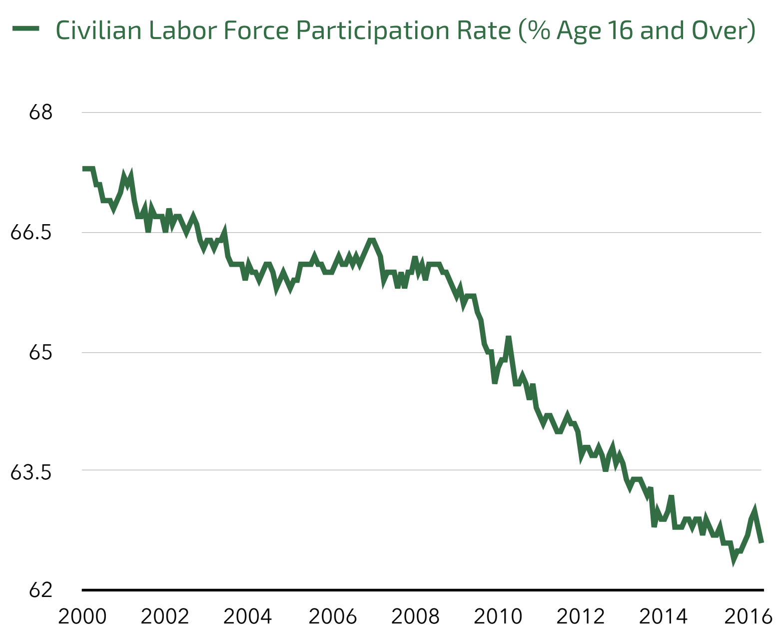
The brain uses two systems to process information. The first system type is intuitive but lazy, rapidly forming judgements with no conscious input. The second system is slow, reflective, and is not guided by emotions. It is that second system – type 2 – that we want in control of our investment portfolios.

They Took 'Err Jobs!

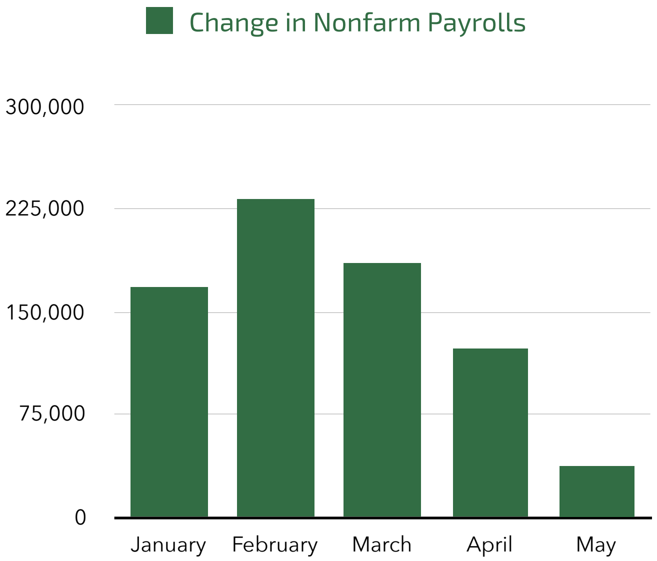
Hey, unemployment fell from 5.0% to 4.7% in May! That's great, right? Right? Wait, only 38,000 jobs were added? The lowest level in over five years, you say? How does that math work, exactly?

Unemployment can go down either by increasing the number of employed (a good thing) or decreasing the labor pool (not a good thing), or a combination of the two. According to the Bureau of Labor Statistics, 458,000 Americans vanished from the labor pool last month, thus reducing the denominator in the unemployment rate equation.

This is just the latest in a long downward trend that started at the turn of the millennium when the labor force participation rate topped out at 67.3%. If the participation rate were the same today, unemployment would be 11.4%. Census trends indicate one-third to maybe half of this drop could be explained by aging demographics, but what about the other 6 million or so people? The masses of discouraged, unqualified, or unwilling are growing.



Source: Bureau of Labor Statistics

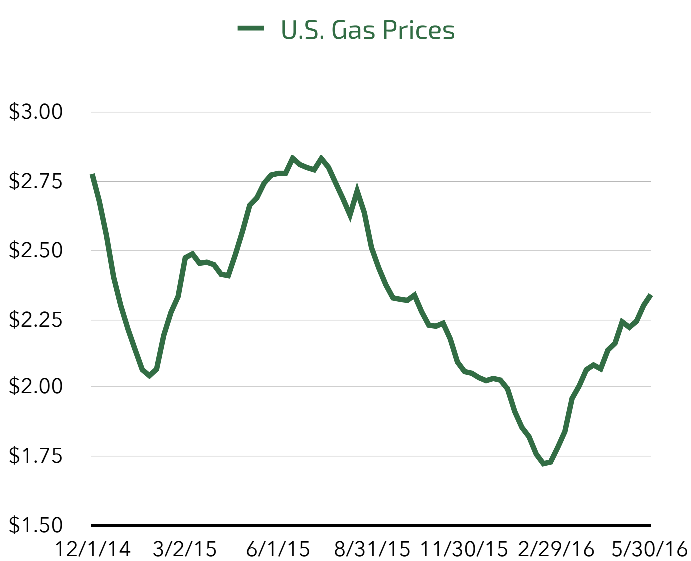


Source: Bureau of Labor Statistics

Some of the weakness in the report can be attributed to the 36,000 Verizon employees who went on strike in May, but even considering that factor the report was a huge miss. And it's not a one-time thing, but the continuation of a three-month downward trend. After a weak jobs report like that, the chances the Fed raises rates at their June 14-15 meeting are close to zero. Following the report's release, the yield on the 10-Year Treasury fell 11 bps to 1.70%, the U.S. Dollar Index fell 1.76%, and gold (IAU) surged 2.74%.

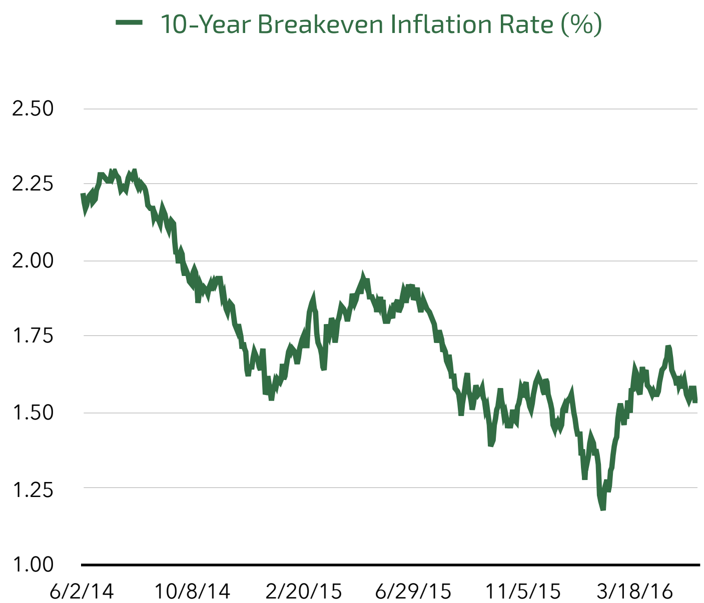
Suppressed Inflation Running on Fumes

TIPS – one of only two bond asset classes we are currently overweighting – did not fair all that well last month. We see good things ahead for TIPS, though, as inflation is likely to heat up significantly over the next eight months. Why? All because of gas prices.



Source: Federal Reserve Bank of St. Louis

You see, gas prices were $2.78 a year ago, so when we compare today's lower price of $2.34 to that it helps to keep inflation low – reducing the headline number by almost a half-point. That base is going to fall to a low of $1.72 by mid-February. It only represents about 3% of the CPI basket, but it can still have a huge impact. Gas prices don't even have to go up! At today's price that would still add a full point to the headline number in February. With core inflation (ex-food and energy) currently at 2.1%, it's not unreasonable to expect headline inflation to be north of 3.0% eight months from now. 10-Year TIPS are currently pricing in inflation of only 1.54%, so we believe this asset class is poised to do relatively well.



Source: Federal Reserve Bank of St. Louis

Our other bond overweight, bank loans, was a positive contributor to portfolio performance in May, outperforming all other bond asset classes. Our underweight to junk bonds proved a bit premature, though, as spreads continued to tighten despite the two largest casualties of the current energy bust filing for bankruptcy this past month – SandRidge with roughly $4 billion in debt, and Linn Energy with more than $10 billion.

NIRP

The amount of sovereign debt with negative yields crossed the $10 trillion mark in May, according to Fitch Ratings. With 14 countries now sporting negative yields on some portion of their debt, more than 80% of government bonds in the developed world now yield less than the 10-year U.S. Treasury Note. As we predicted last month, this has made U.S. Treasury bonds more attractive to foreign investors. Indirect bidding – a proxy for measuring demand from foreign investors – drew a record 73.5% in a $23 billion sale of 10-year Treasury notes on May 11. We expect this foreign demand to continue as long as negative interest rate policies (NIRP) persist.

Gold had a rough month in May, but as noted above is off to a good start in June. We still believe this to be a worthy overweight at a time when central banks around the world are proving to be increasingly ineffective.

Deal Breakers

Merger arbitrage continues to provide moderate, but stable positive returns despite a rash of high-profile mergers falling through. These include Pfizer's proposed merger with Allergan, the Staples and Office Depot deal, and the Baker Hughes and Halliburton merger, all three of which were scuttled by regulator concerns. All three of which were avoided by the Vivaldi Merger Arbitrage Fund we invest in. Despite the troubles in this space, we believe it is still one of the safest places for money right now.

Cruel, (Cruel), Cruel Summer

Stocks continued to do well despite crummy earnings, but there are clear signs of weakness. Year-to-date through May 31, Tiffany & Co (TIF) is down 18.26%, Burberry is down 11.17%, and Nordstrom (JWN) is down 22.26%. Meanwhile, on the wrong side of the tracks, Big Lots (BIG) is up 36.25%, Dollar Tree (DLTR) is up 17.25%, and Dollar General (DG) is up 25.43%. Do you see the problem here?

We don't see much upside in domestic equities in the near term, but if the market proves us wrong we will gladly take the extra profits off the table and further reduce our stock positions. With the Fed on hold due to the weakening labor market, the dollar should continue to weaken and emerging markets stocks should benefit.

Normally I don't pay much mind to the old adage "sell in May and go away" – a market timing strategy based on historical relative weakness in stocks during the summer months. But this season could prove to be deserving of the 1983 Bananarama hit song's title.

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About EmeraldSpark

EmeraldSpark Investments, LLC is a registered investment advisor based in Chicago, IL. We were founded by Ryan P. Layton, CFA in 2015 to provide outsourced investment management services to community bank trust departments and independent trust companies, as well as fiduciary investment management for select individuals. Our investment process blends the foundations of Modern Portfolio Theory with the latest research in the field of behavioral finance. We specialize in asset allocation and investment due diligence to help provide our clients with investment strategies personalized to match their specific goals and risk comfort zone.

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