CliftonLarsonAllen
WEALTH ADVISORS

MARKET AND ECONOMIC OUTLOOK

July 2015

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Job Confidence Rises, Interest Rates, and Greece

The Great Recession of 2008 – 2009 impacted labor markets in dramatic fashion. But after years of slow recovery, we are finally seeing signs that normalcy is returning on the jobs front. This is great news for key economic growth inputs, such as housing, autos, retail sales, and capital goods. It appears we are entering a new phase where consumers will have a higher ability to spend, save, and invest, while corporations begin to digest the higher costs of labor.

Some positives and negatives in the economic and investment background include:

Positives	Negatives
Improving employment	Federal Reserve stimulus/quantitative easing ending
Corporate earnings and cash	U.S. stocks no longer cheap
Strong auto sales	Strong U.S. dollar negative for multinational U.S. companies
Firming housing prices	Deflation risks outside the United States
Low inflation	Possible Greek exit from eurozone
Lower gasoline prices	

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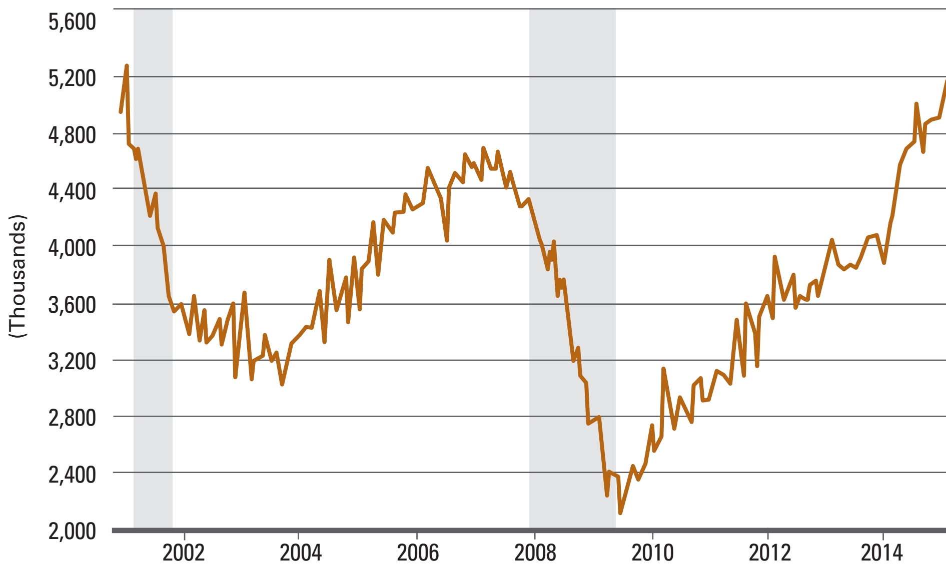
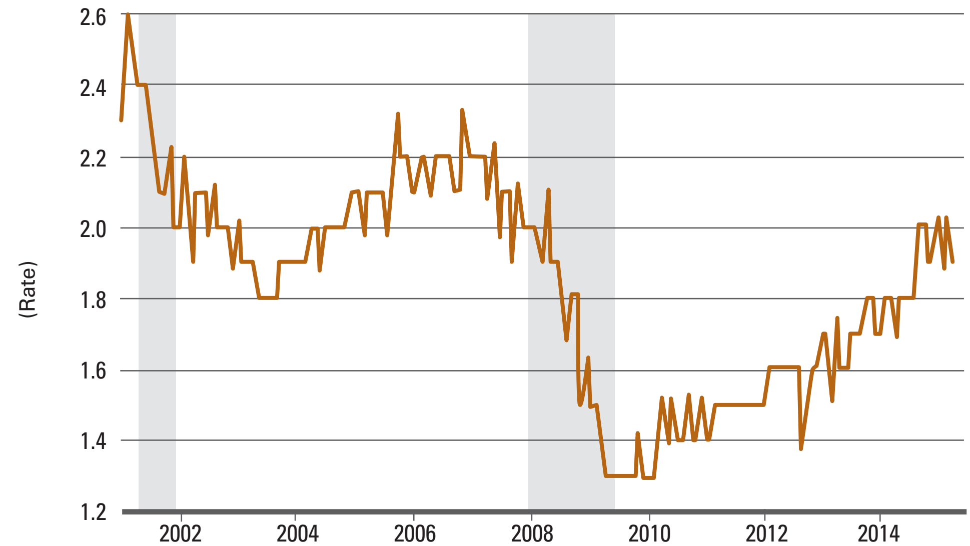
Is the balance of power switching from capital to labor?

The U.S. labor market is improving in several key areas — job openings, job seekers, and discouraged workers who are no longer looking for employment.

Job openings are at their highest level in more than 10 years, while employees who voluntarily leave their jobs, presumably for a better situation, are at a six-year high. The quit rate usually does not rebound until workers are feeling confident about their prospects. Quits plummeted during the recession, favoring employers that had more than enough labor to meet demand.



Sources: U.S. Bureau of Labor Statistics, 2015 research.stlouisfed.org



Sources: U.S. Bureau of Labor Statistics, 2015 research.stlouisfed.org

The number of job seekers, as reflected by initial unemployment claims, has declined significantly in recent years, shrinking the pool of available labor. Discouraged worker numbers are also on the decline and suggest that progress is finally being made for long-term unemployed workers. As jobs become more plentiful, discouraged workers (who are not counted as unemployed in the main government statistic) begin to be added back into the labor force. Official jobless rates may actually begin to reflect the real world situation. Federal Reserve Chair, Janet Yellen, has indicated that she watches the discouraged worker numbers closely in her overall assessment of labor market health.

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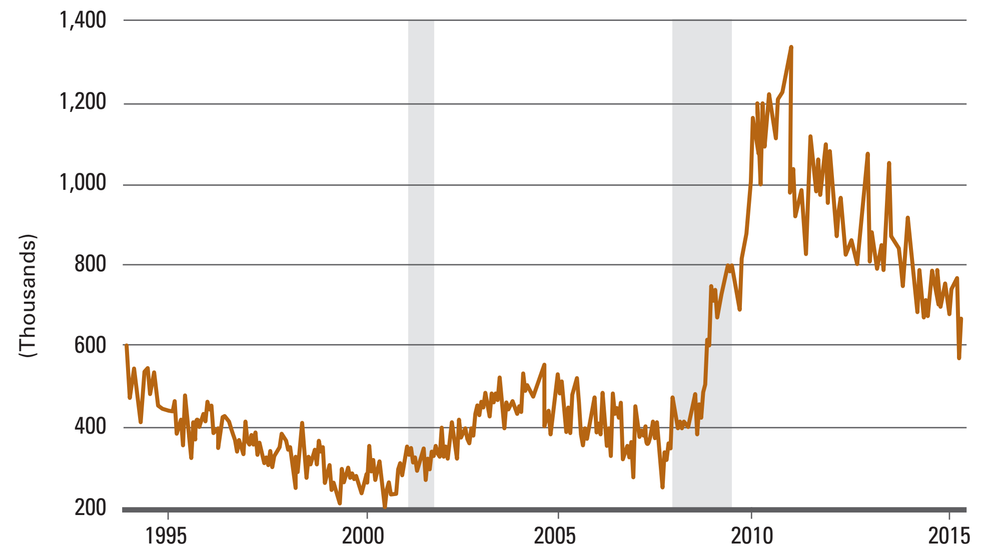
In addition to an employment target, the Federal Reserve has an inflation target — the other half of its so-called “dual mandate.” Historically, inflation does not take hold unless wage inflation is present. There have been few signs of wage inflation in the current cycle; however, continued positive data on employment and firming wages will factor into the Fed’s decision on when to raise interest rates. There is always a risk that the central bank could get behind the curve and be forced to raise rates quicker than currently signaled.

Continued Claims (Insured Unemployment)

Sources: U.S. Employment and Training Administration, 2015 research.stlouisfed.org

Not in Labor Force (Searched for Work and Available, Discouraged Reasons for Not Currently Looking)



Sources: U.S. Bureau of Labor Statistics, 2015 research.stlouisfed.org

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Jan Kruchoski
Managing Principal
CLA Executive Search

Skills gaps leave jobs unfilled

Jan Kruchoski, managing principal of CliftonLarsonAllen's executive search team, says all the major sectors of the economy are hiring. In the private sector, she says construction hiring has finally come back showing some of its most robust activity in recent months. Manufacturing and health care are continuing to hire to accommodate the growth in both industries. And in the public sector, state and local governments are adding to their payrolls again as well.

The overall economic expansion is creating more jobs and businesses, and at the same time, Baby Boomers continue to retire. From a workforce perspective, jobs are abundant, although wages are not growing. From an employer's perspective the greatest challenge is finding hires with the needed skills.

Some of the hardest professional jobs to fill right now are in sales, information technology, middle management, health care (nurses and physicians), and engineering. But positions are going unfilled in manufacturing, trucking and transportation, skilled labor, and technical vocations.

"There aren't many short-term solutions to this skills deficit," says Kruchoski. "Long term, we need to connect young people, educational institutions, and businesses. Students have to be aware of the variety of careers that are available to them. Manufacturing is a clean, sophisticated, professional environment today, and you can earn a very good living — I'm not sure 18 year-olds know that."

Forward thinking industry leaders are reaching out to high schools, technical schools, and community colleges to help the community understand what today's jobs, compensation, and business environment really look like.

"We have to help develop the talent pool of the future, because that pool is growing smaller," Kruchoski says.

Manufactures are proactively developing a solution to its labor shortage. Companies are building relationships with technical schools and community colleges in their local markets. Together, they are developing on-the-job training programs, internships, and apprenticeships that help build the workforce they need. And they are employing these students after training.

Kruchoski believes this model of cooperation between educational and training institutions and businesses could be replicated in construction, health care, technology, or any other sector.

She says, "You can wait for someone else to train your future employees, or you can get out there and help shape the training and work experiences of your future employees. Which do you think will provide you with the employees you need?"

Stocks seem to like the three months leading up to interest rate increases

Looking ahead at a possible hike in the Federal Funds Rate (FFR), it is noteworthy that over the last five rate increase cycles, stocks have performed remarkably well leading up to the initial increases; the average gain has been 4.6 percent. Because mortgage rates are tied to longer-term interest rates, the correlation between mortgages and the first interest rate increase is mixed.

If you know people who are on the fence about purchasing real estate with financing, we suggest they begin to move now. Mortgage rates could rise dramatically as they did in 1999 and 2004.

Change in Financial Variables Three Months Prior to Start of Hiking Cycle

1st Rate Hike	S&P 500 (%)	10-Year Yields (Basis Points)	U.S. Dollars (%)	Mortgage Rates (Basis Points)
March 31, 1983	8.8%	26	3.3%	-64
March 30, 1988	4.1%	-21	0.2%	-45
February 4, 1994	2.2%	19	1.5%	13
June 30, 1999	6.7%	56	1.6%	79
June 30, 2004	1.3%	76	2.3%	42
Average	4.6%	31	1.8%	5

Sources: Federal Reserve Board, FactSet, J.P. Morgan Asset Management

Bonds remain an important risk reducer in diversified portfolios

Rising interest rates will impact bond prices and valuations. However, the pace of interest rate increases is very important in determining how quickly bond

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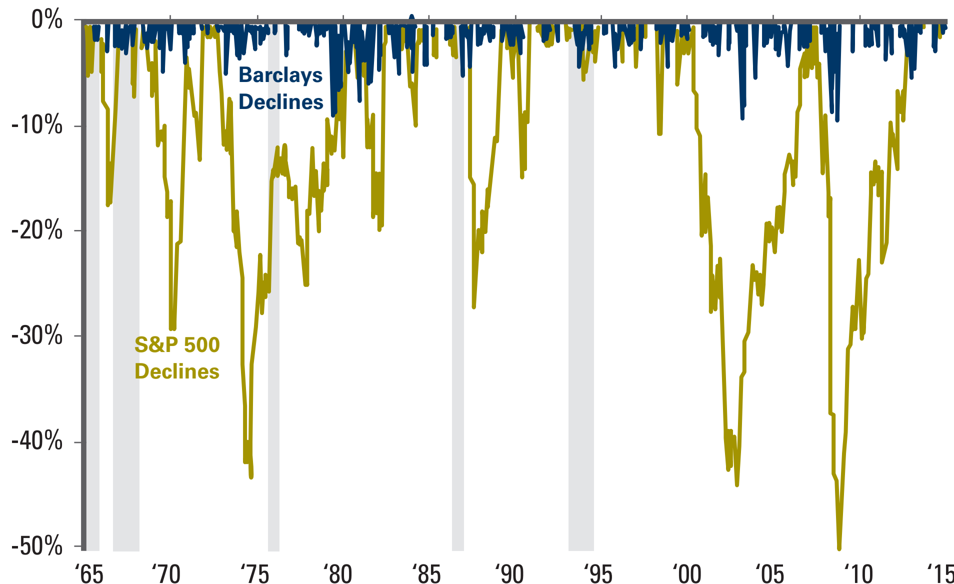
prices may decline. If interest rates rise slowly and in small increments, bond performance will not be as impacted. However, large spikes in interest rates could result in bond losses, which investors have not seen since 2008 – 2009. Keep in mind that "bad" years for bonds are much different than "bad" years for stocks. So, bonds still play an important role in stabilizing diversified portfolios containing stocks, real estate, and other, more volatile assets.

Drawdowns in S&P 500 and Barclays Aggregate

Measured from peak month average to trough month average. Data as of June 14, 2015.



Largest Drawdowns			
Max Loss Date	S&P 500	Max Loss Date	Barclays Aggregate
December 1987	-26.8%	April 1981	-7.7%
June 1970	-29%	September 2008	-8.6%
December 1974	-43.4%	July 2003	-8.8%
February 2003	-43.7%	October 1979	-8.9%
March 2009	-50.8%	January 2009	-9.5%

Sources: Robert Shiller, Barclays Capital, J.P. Morgan Asset Management

Greek drama

The euro was launched in 1999 to reduce fluctuation risks and exchange costs in the many monetary units that made up the European Union. It has provided a stronger, more stable currency to all member states, but the euro has been controversial. It relies on strong economies to balance the instability and risks of countries in precarious economic situations — like Greece.

Greece's problems are not new. In fact, the key elements of the crisis have remained the same since we first addressed these issues in June 2012, in "Why All Eyes Are on Greece (And Why We Should Care.)" At the time, we suggested that by deferring a Greek default and exit from the euro, policymakers were buying time for the banks to improve their capital positions.

For the last four years, the European Central Bank has been preparing for a Greek exit from the euro. This has allowed most Greek debt to be sanitized (moved) from Europe's banks to primarily public institutions like the International Monetary Fund (IMF) and European Central Bank. In theory, this strategy will mitigate worldwide fall out from a Greek exit, but there is certainly a chance of unintended outcomes.

If Greece is forced from the eurozone by other members and reverts to the drachma, it will be because they failed to meet their debt obligations. Consequently, it would be extremely difficult to find institutions willing to finance its failing economy. Without financing to meet its budgetary obligations, the value of Greece's currency would fall precipitously and result in hyperinflation.

Greece is in a vulnerable position, because they import key materials (like petroleum) necessary for its economy. So, the choices are few: accept the harsh austerity measures necessary to be included in the euro or risk currency devaluation, hyperinflation, and uncertain financial backing in return for a measure of autonomy.

The recent national referendum that rejected further austerity measures does not necessarily provide Greek leaders with a stronger negotiating position. Arguably, it has no bearing on those lending money.

Other European countries are also facing financial challenges, so the chance of getting them to agree to go easy on Greece is nil. In fact, if other eurozone members were influenced by the Greek referendum, the entire political and fiscal landscape could change as citizens of other countries might see the possibilities

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of a more palatable option than the austerity measures being offered by their current leaders.

We don't think Greece's departure from the euro will have long lasting impacts on the European or world stock markets, but short-term instability will certainly result.

In summary, we cannot say if Greece will ultimately be forced from the EU. Either way, we believe there is now little risk of dangerous contagion. While market volatility may spike in the short run with the headlines, the long-term effects of this crisis on the markets are likely to be very modest.

To raise or not to raise interest rates — that is question for the Fed

Most observers believe the central bank will begin raising the FFR at its September 2015 meeting. For long-term investors, this will have little impact. Ultimately, growth in the economy and underlying company earnings should continue to guide stock prices upward (as they historically have done).

For bond investors, a rise in interest rates acts like a headwind. This does not mean bonds should be abandoned, but lower returns should be anticipated. Historically, treasury bonds have returned about 2 percent over inflation. We suspect that treasuries will probably deliver much less than they have been, but they will still provide important diversification when blended with stocks, real estate, commodities, and other volatile assets in the coming years.

Alternative investment opportunities

We continue to educate our clients about using private real estate where appropriate for those who can lock up a portion of their risk capital for a number of years and bear the risk of potential loss that is associated with real estate investments. The income generated from *properly managed* rental real estate can exceed what is available in the stock and bond markets while also providing appreciation and an inflation hedge should it become an issue in the next few years.

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