LIBERTY CAPITAL MANAGEMENT

QUARTERLY OUTLOOK

Vol. XXIV - Number 2 Second Quarter 2016

The Economy

Oil and Interest Rates, a Slippery Slope

It seems the economy is focused on two things these days: the price of oil and great discussion of the state of interest rates.

When oil began its precipitous decline several years ago it was perceived as a tremendous boost to the economy. Instead of people refinancing their homes to finance fuel for their SUVs, the money saved could be used to buy more SUVs. And they did. But, like Halloween candy, too much of a good thing is not always such a good thing.

Our friends in the Middle East continue to pump oil like there is no tomorrow. (Judging by the behavior of some of those folks, that is indeed the objective). With the supply of oil overwhelming the system, energy company profits began to sag, the oil shale boom stopped booming, oil rigs were shut down, and the energy sector became the only part of the U. S. economy to lose jobs. Personally I still like the idea of filling up the car with no lead for twenty five bucks, but I am not in the electric car business which thrives on high priced gasoline. (The exception just might be the new mid-priced Tesla that has thousands of people placing deposits for delivery in 2017 or 2018).

The economy itself is in pretty good shape. We have experienced over six years of job growth. The Labor Department recently reported over 200,000 jobs were created just last month. Wage growth is steady and the unemployment rate is holding at 5%, a number historically associated with full employment. As a small anecdote ‘Help Wanted” signs seem to be appearing everywhere. While most might be considered low end jobs, the people that vacated those positions are assumed to have moved up the employment chain.

Last quarter we displayed what some pundits have called a ‘dot plot’. It was a chart showing projected Fed induced interest rate hikes. A quarter point hike was anticipated in the first quarter, another in the second quarter, and so on for the balance of the year. As we all know the best laid plans can come apart at the seams. Nothing happened in the first quarter and any action in the second quarter is the subject of great debate.

While the U.S. economy seems strong enough to justify a rate hike, our overseas trading partners would be mortified. The European economies are just not healthy enough at this juncture to tolerate this kind of policy shift from the U.S. Many of the Euros are, in fact, taking the opposite approach and dropping rates to stimulate their economies. German interest rates are actually negative!

Beneficiaries of higher rates are:

- Consumers – higher savings rates after a decade of virtually zero
- Banks – greater incentive to lend as interest rate spreads become more favorable and
- Small and mid-size businesses – benefiting from increased bank liquidity

If the U.S. was an island the interest rate decision would be much simpler.

Fixed Income

Is The Bond Market at it Again?

Treasuries are off to the best start since 2008. Municipal bond yields are at 50 year lows. Corporate bond returns are impressive so far. So, how could this be with all the talk about raising interest rates? Well in part, at the last FED meeting the main conclusion was that the committee agreed with the market in so much as that the committee’s previous expectation of four

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rate hikes in 2016 was much too aggressive. Basically, the FOMC came to the conclusion that at most (unless unanticipated inflation occurs), there would most likely be only two more Fed Funds rate hikes this year. The market currently implies an over 50% probability of a hike is in September and still does not imply a second hike in 2016.

Municipal Bonds

Strong investor demand for municipal bonds is evidenced by twenty-two straight weeks of positive net new cash flows into municipal bond funds helping to push municipal yields to levels haven't seen in almost fifty years. The year-to-date return for the 10 year municipal bond index is 1.90% and 1.15% for the shorter 5 year index.

Looking in the months and years ahead for municipal bonds, we note that nearly every presidential candidate has mentioned the need to rebuild the nation's infrastructure, and as stated in an August 2015 white paper by the International City/County Management Association, municipal bond issuance and the exemption has been a critical element in infrastructure development. Considering that the American Society of Civil Engineers have assigned a D+ grade to our nation's infrastructure, we feel that municipal bond issuance and demand will continue to remain strong.

Corporate Bonds

Let's remember that corporate bonds didn't fare well in 2015. Investment grade bonds returned a negative .53%. High yield bond returns were worse, returning a negative 2.48%. What a difference 3 months makes. So far in 2016, intermediate corporate bonds have returned investors 2.76%, AA rated corporate bonds have returned 3.70%, and BBB rated corporate bonds have returned 4.33%. We don't expect this rate of return to continue for corporates in the remainder of 2016. A and AA rated corporate bonds with maturities between 5 and 10 years should provide the best value to investors in the months ahead.

Time to Reflect on Why We Own Bonds… *Again*

With low interest rate upon us again, we feel it is important to remember the key features of fixed income securities and their proper role when it comes to portfolio construction. Yes we know that we mentioned this in the previous Quarterly Outlook, but we feel it is important enough to mention again in an abridged edition. The traditional role of fixed income securities in an investment portfolio can be described as follows:

***Steady and Predictable Income Stream*:**
The foundation of return for bonds is the income from coupon payments… So as interest rates rise, maturing bonds will be reinvested at higher interest rates hence generating additional income.

***Reduced Volatility to a Balanced Portfolio*:**
Bond investing can be characterized as a defensive strategy which tends to reduce the volatility of returns from holding a portfolio composed of just equities. Let's take a hypothetical investor named George who retired on Jan. 1, 2000, at age 65 with a $1 million all-stock portfolio, and spent $50,000 a year on his living expenses, adjusted for inflation. Considering the S&P 500 lost 41.2% in nominal dollars (or 53.4% after inflation) between the day he retired and Feb. 28, 2009, George would have just about $100,000 left of his nest egg by the end of September 2014. Had he held a 70/30 stock/bond portfolio, using intermediate Treasury's as his bond component, he would have $428,000 left; and had he held a 40/60 portfolio, he'd have $703,000 left.

***Capital Preservation*:**
Bonds also provide stability. By definition, the principal on a bond is to be repaid to the investor when it matures. When this is combined with the strong creditworthiness of many fixed income issuers, it provides a valuable form of capital preservation.

Bottom Line

So what does a fixed income investor do? Don't forget why you have fixed income. Fixed income has a permanent place in a balanced portfolio; it serves some investors' most fundamental needs, specifically: capital preservation, diversification, and predictable cash flow. With the uncertainty surrounding the Federal Reserve and the timing of when they will raise interest rates, the approach of maintaining a fixed income portfolio with reduced sensitivity to changes in interest rates are positive contributors to our fixed income

"... We continually monitor the bond markets seeking anomalies ."

philosophy. We continually monitor the bond markets seeking anomalies that will provide opportunities to our clients fixed income portfolios.

Selected Yields			
		Recent (03/30/16)	3 Months Ago (12/29/15)
TAXABLE			
	Corporate Bonds		
	Financial (10-year) A	3.32	3.74
	Industrial (25/30-year) A	4.00	4.35
	Utility (25/30-year) A	4.06	4.42
	Utility (25/30-year) BBB	4.62	4.88
TAX-EXEMPT			
	General Obligation Bonds		
	1-year AAA	0.62	0.51
	1-year A	0.97	0.78
	5-year AAA	1.17	1.31
	5-year A	1.83	2.01
	10-year AAA	1.78	1.99
	10-year A	2.60	2.74
	25/30-year AAA	2.57	2.85
	25/30-year A	3.59	3.63
	Revenue Bonds (15 Years)		
	Education AA	2.50	2.74
	Electric AA	2.64	2.25
	Housing AA	3.03	3.09
	Hospital AA	2.65	2.22
	Toll Road AA	2.63	2.70

Source: Bloomberg Finance L.P.

Source of Chart:
The Value Line Investment Survey—April 4, 2016

Equity Markets

Roller Coaster of Volatility

So wasn't that roller coaster ride fun? I see we're back at the start of the ride; who wants to go again!

For the record, returns for the DJIA, S&P 500 and NASDAQ indices were 1.50%, .8% and negative 2.7.% for the first quarter of 2016. What that doesn't show was the dramatic drop in January, only to be followed by a rise back to near the start of the year.

As I have continued to say since last summer, it's a correction! The actions we've seen this past quarter in no way reflect a change in the long term trend of this bull market. Yes, market corrections are scary, but they also fix an overpriced market like what we saw last year as earnings growth slowed. Market prices are now more reflective of their company's growth forecasts.

Domestic economic growth continues it's slow, steady, sub par growth. While employment growth and housing continue to show healthy strides, other areas of the economy have struggled, notably energy. US crude oil production has noticeably dropped over the last several quarters. While it appears that the price of oil has bottomed and stabilized at, currently around $38-$43 per barrel, a rise much above $50 is doubtful. As the price reaches that $50 level, shale oil producers, which have closed up shop due to their higher extraction costs, will resume production. That inflow of supply will satisfy demand and keep prices constrained. Additionally, Iran is beginning to increase their production and have vowed to ramp up to over 600,000 barrels per day.

While the bond markets have stubbornly resisted the Federal Reserve's policy on interest rates, at some point we all have to realize interest rates are going up. It will probably be slow and over the long term, but the Fed has established a trend. Executed well, a rising rate environment can benefit corporate profits. It's later, when inflation truly becomes a major issue that a change in long term market direction arises.

Corporate earnings will be very important going into the rest of this year. We have had three quarters of declining profits for the S&P 500. The primary culprits have been a strong dollar which impacts multinational US based companies, a building backlog of inventories and declining commodity prices, noticeably oil.

It appears at this point that the dollar's strength and rise against other major currencies has leveled off. That eases the headwind against multinational corporate earnings. Inventories are beginning to show signs of lower levels and should allow production to increase. Finally, while energy and oil in particular have been hard hit, it would seem that the lows have been set and a price range around $50 per barrel seems reasonable.

"We should see an improving market as we move into the second half of the year."

So as these short term problems fade we could see earnings increase over the near term.

As we begin to see first quarter earnings reports from companies we are particularly focused on industries and sectors that can generate organic growth in this subdued economy. Companies in the Health Care, Consumer Staples and Technology sectors reflect this approach. The Energy and Financial sectors are still showing very low growth forecasts and should be viewed as trading candidates.

While near term volatility will continue we should see an improving market as we move into the second half of the year.

As often said, when it comes to the stock market it is two steps forward and one step back. Maintaining the long term view and paying attention to company fundamentals will reward our portfolio selections.

By The Way …

It is with great pleasure that we welcome our newest team member, Charles L. Dettloff, Senior Vice President. Chuck brings over thirty three years of investment management experience to the firm. He began his career at Manufacturers National Bank of Detroit which later merged with Comerica Bank where he was Senior Vice President/ Investments. Mr. Dettloff managed over $1 billion of equity, ETF, municipal and corporate bond portfolios. Mr. Dettloff earned his Bachelor's degree in Finance and a MBA in from the University of Detroit Mercy. We've all known Chuck for many years and are thrilled to have him join the firm.

Compliance Corner…

The As a registered investment adviser, we are required by securities laws to annually furnish you with updated information about our firm, which we detail in our firm's Form ADV Part 2 Brochure disclosure document.

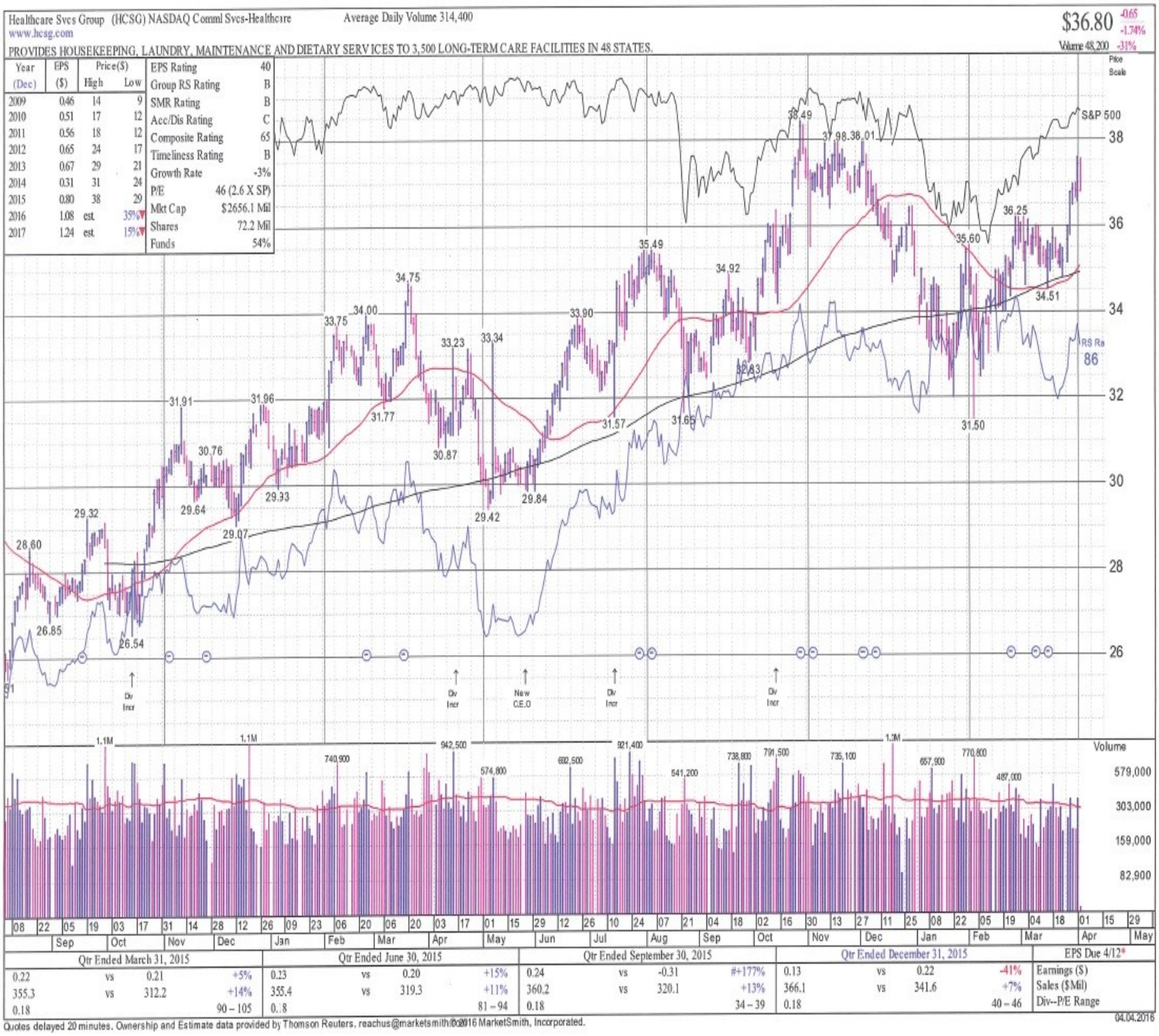
Since the firm's 2015 annual update Brochure, we have made changes to reflect changes to our professional staff. We have also made other minor updates, but no other material changes were made.

If you would like a complete copy of our current 2016 Brochure, you may contact us by email or phone and we will be happy to send you one at no charge. You may also obtain a copy of the form and other information about our firm from our website at www.lcmgt.com or the SEC's Investment Adviser Public Disclosure (IAPD) system at www.adviserinfo.sec.gov.

Focus On . . .

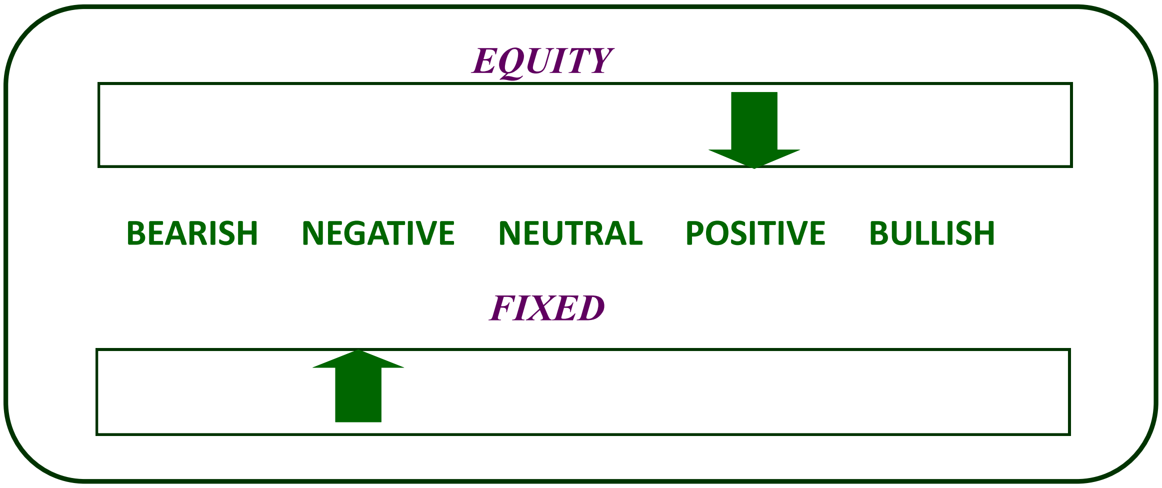
Healthcare Svcs Group (hcsg)

Healthcare Services Group, Inc. provides housekeeping, laundry, linen, facility maintenance, and food services to the healthcare industry, primarily in the United States. Its housekeeping services consist primarily of cleaning, disinfecting, and sanitizing patient rooms and common areas of a client's facility, as well as the laundering and processing of the personal clothing belonging to the facility's patients. The company is expected to continue to grow by 17% over the next 3-5 years. It boasts a solid ROE of 19% despite a low debt to capital ratio. This stock provides stability and quality in a market that has grown more volatile in recent years.



LIBERTY CAPITAL MANAGEMENT

MARKET BAROMETER



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~ Closing Figures as of March 31, 2016 ~

DJIA	**17685**	**10 yr. Treas.**	**1.79%**	**Funds Target**	**0.25% - 0.50%**
S&P 500	**2059**	**3 mo. T-Bill**	**0.18%**	**Prime Rate**	**3.50%**

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