

August 2013

ECONOMIC OUTLOOK

Summary

Economic growth improved slightly in the second quarter as real GDP grew at an annualized rate of 1.7%, compared with the first quarter's growth of 1.1%. Although growth in consumer spending slowed in the quarter, there was a strong increase in exports, and state and local government spending also increased. Consumers appeared to hold back on some spending at the end of the quarter and may still feel the impact of higher taxes and continued weak wage growth. The two bright spots were the housing and auto industries. The positives for both sectors could be tied to low interest rates and consumers' desire to lock in the low rates for these big-dollar purchases. There have been positive announcements since the end of the quarter. Both the ISM manufacturing and non-manufacturing indexes rebounded nicely in July. The manufacturing index had its largest one-month increase since 1996. Part of the increase could be tied to the positives within the auto industry and a need to increase production to keep up with demand given low inventory. Although the manufacturing sector seemed to improve in July, there was a slowdown in the number of new jobs created. Consumer confidence also slipped a bit in July as expectations for the future fell in part due to concerns about the outlook for the job market. The Fed appears committed to its current program of bond purchases until there is evidence that the economy is growing stronger and the labor market has confirmed such. We do not anticipate this will occur until later this year at the earliest, and quite possibly not until 2014. Growth should continue, but it is likely to be modest at best and very choppy.

POSITIVES

- ❑ Sharp increases in both the ISM manufacturing and non-manufacturing indexes.
- ❑ Fed maintaining its \$85 billion in bond purchases each month.
- ❑ Interest rates and inflation remain at low levels.

NEGATIVES

- ❑ Slowdown in the increase in non-farm payrolls.
- ❑ Mortgage rates have increased by more than 1%, which may hurt housing.
- ❑ Higher taxes and higher energy costs appear to be cutting into consumer spending.

UNKNOWNNS

- ❑ Timing of Fed's decision to taper bond purchases and impact of the move upon the markets.

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EQUITY OUTLOOK

Summary

After the pause that refreshed in June, stock prices continued higher in July. Investors shrugged off fears that a regimen of rising long-term interest rates would have an adverse impact on the economy, and focused more on the potential benefit from increased growth.

The S&P 500 rose 5%, fueled by broad sector leadership. The health care sector rocketed 7.1%, followed by industrials, financials, materials and energy, all of which climbed more than 5% in price for the month. Only telecom stocks lost ground in July, slipping 0.75%.

Developed markets, as measured by the MSCI EAFE index, also awakened, gaining 5.27% (total return) and breaking a relative losing streak in comparison to U.S. markets. Emerging market equities continue to lag as slowing growth and currency headwinds have taken their toll.

Corporate earnings for the second quarter have mostly all been reported, and while results were tepid in aggregate, some sectors – notably financials and health care – were strong enough to warrant estimate increases. Analysts in general have been reducing their expectations for corporate performance all year. So the bar for corporate success in the third quarter is very low.

Job gains and revisions continue at a positive pace; housing starts, sales and prices (the bulwark of middle-class net worth) are rising, consumer confidence remains high and new car sales are booming. There appears to be enough economic momentum to pull us through the traditionally weak late summer months to a respectable third-quarter GDP print.

Political headwinds of increasing regulation and budget fights are sure to dominate headlines in late August, creating short-term risks for a market that has had an exceptional year so far by any measure. Balancing these risks is the fact that demand for stocks, as measured by mutual fund purchases, remains tepid. The massive allocation to bond funds within the past few years has yet to begin to unwind.

POSITIVES

- ❑ Several U.S. economic sectors remain strong.
- ❑ Consumer confidence high.
- ❑ Interest rates normalizing.

NEGATIVES

- ❑ Increasing government regulation (ACA).
- ❑ Emerging markets decelerating.

UNKNOWNNS

- ❑ Europe turning up?

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FIXED INCOME OUTLOOK

Summary

After increasing sharply over the past two months, interest rates remained within a relatively tighter trading range in July. The 10-year Treasury note began at a yield of 2.48%, rose to a closing high of 2.74%, and then settled at 2.58% to end the month. The two-year note traded within a 10-basis-point range and ended the month a bit lower at 0.31%. Corporate spreads retraced a portion of the previous months' widening and outperformed all other investment-grade bond sectors.

It seems that the most significant impact of the Federal Reserve's decision to reduce asset purchases has been priced into the market's expectations. Although most investors now expect the first reduction in the purchase amount to occur in September or October, a few holdouts forecast that the Fed will maintain the current level of purchases (\$85 billion per month) throughout the year and possibly all of next year.

We expect the Fed to follow through with its plan to reduce purchases. Economic data released over the past month indicates the economy continues to grow modestly and that a reduction in purchases poses little risk of derailing that trend.

Given the consensus view, the direction of interest rates from here is likely to be determined by global growth, not Fed manipulation. Longer rates (10 years) could move modestly higher, but with the overnight rates anchored for years to come, we do not believe investors will experience a repeat of the March-June quarter.

POSITIVES

- ❑ Inflation is well below the Fed's target range. Expected inflation has declined.
- ❑ Overall economic growth remains moderate domestically and in Europe. Emerging markets continue to struggle.
- ❑ Steeper curve makes bonds more attractive as they appreciate from rolling to lower yields and short rates are unlikely to increase.

NEGATIVES

- ❑ Retail selling may cause further price declines as sentiment deteriorates.
- ❑ 10-year Treasury yields still lower than nominal projected GDP, a historical benchmark.

UNKNOWNNS

- ❑ International, geopolitical tensions: Egypt, Syria, Iran
- ❑ Impact of the Fed's tapering of purchases