

March 2013

# ECONOMIC OUTLOOK

## Summary

The first revision of fourth-quarter 2012 gross domestic product showed the economy managed to grow 0.1% as compared with the first estimate of a 0.1% decline. The two biggest negatives for the quarter were a reduction in inventories and the decline in spending at all levels of government. The consumer, also expected to be a drag on growth due to the long-anticipated “fiscal cliff” and potential tax increases, actually spent more in the quarter than in the previous quarter. Perhaps the biggest driver of growth was the housing sector, as low mortgage rates and an improved outlook by the consumer boosted this segment of the economy, and that has continued into the new year.

Since the end of the quarter, the consumer outlook also has continued to improve. The Conference Board’s index of consumer confidence rose strongly in February, as readings improved for both the present situation and expectations. Concerns regarding potential tax increases and the fiscal cliff dissipated. Even the potential for sequestration budget cuts to take hold did not seem to phase the consumer much. The manufacturing and non-manufacturing segments of the economy, as evidenced by the Institute for Supply Management indexes, also showed evidence that the economy is continuing to expand, as they are at levels not seen in over a year. While the figures indicated the economy could continue to grow, it was not expected to be strong growth until the labor market improves, which is not likely for some time.

### POSITIVES

- ❑ Increased consumer confidence despite Washington uncertainties
- ❑ ISM manufacturing and non-manufacturing indexes show improved growth
- ❑ Improvements in the housing sector create positives elsewhere in economy

### NEGATIVES

- ❑ Reduction in spending by all levels of government
- ❑ Personal income fell in January with higher tax rates
- ❑ Construction spending fell in January

### UNKNOWNNS

- ❑ Ultimate resolution and impact of the sequester on the economy

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# EQUITY OUTLOOK

## Summary

Equity markets continued to climb in February, although the tenor of the advance changed to a more defensive tone. The S&P 500 closed the month with a 1.36% gain, bringing the year-to-date return to 7.6%. Domestic equities outperformed international, as the MSCI EAFE index of developed markets outside North America lost ground in February, declining 1.16%. The top-performing sectors included consumer staples and telecom, both defensive in nature, which gained 3.0% and 2.6% respectively. In the basement were technology (Apple) and materials, the former up only 0.4%, the latter giving up 1.7%. The worst-performing sector so far this year has been technology, up a little more than 1.7%.

We have maintained that an accommodative monetary policy has the strongest impact on setting the backdrop for rising equity prices. That certainly remains the case for the foreseeable future, taking the Federal Reserve's recent comments at face value. The markets, as a leading indicator, appear to be saying that, despite the rhetoric surrounding the election, "fiscal cliff," euro and sequestration, economic momentum continues to improve. In fact, auto sales remain robust, the housing market continues to surprise to the upside, unemployment claims continue to decline and consumer confidence is improving. As a result, retail sales remain positive, neither too strong nor weak, and estimates of corporate profits for 2013 may again be on the upswing.

The enthusiasm for stock ownership in the last few months tends to give pause for the time being, a case of too far, too fast. Money flows to equity mutual funds and exchange-traded funds turned into a torrent last month, reversing months of outflows as investors sought the safety of bonds. Investor sentiment has turned decidedly bullish. Such enthusiasm historically has acted as a contrary indicator of short-term market performance, suggesting a consolidation in market prices. However, we see no reason to change our fundamental position for long-term clients to maintain their allocated weighting in equities.

### POSITIVES

- Fed policy remains positive
- Hurdles of uncertainty falling (e.g., sequestration)
- Profits on the rebound

### NEGATIVES

- Short-term enthusiasm for stocks too high
- Government continuing resolution looms

### UNKNOWNNS

- Fed exit strategy from QE3

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# FIXED INCOME OUTLOOK

## Summary

Although the “sequestration cliff” was an impetus for a great amount of political discussion, the spending cuts arrived and were implemented with barely a shudder by the bond market. Unlike the “fiscal cliff” discussions leading into year’s end, there was no last-minute rabbit to be pulled out of a hat. Both sides appeared to stand firm on their philosophical ground while blaming the other side in the media.

Despite the political follies and a strong stock market, interest rates stayed within a narrow band for most of February. As it appeared that no deal was forthcoming, rates dropped a bit to end about 10-15 basis points lower for the month in the 5-to-10-year part of the curve. Corporate credit spreads narrowed slightly for investment-grade bonds, causing the sector to modestly outperform U.S. Treasury, agency and mortgage-backed debt. The overriding themes of deleveraging and austerity affected economies, central banks and investment markets. In the U.S., the sequestration cuts likely will reduce gross domestic product growth to around 1.5-2.0%, even with a rebound in housing, increasing auto sales and an improving employment market. In Europe, austerity measures continued to cripple many of the major economies as they struggle to plug major budget deficit holes. Unemployment across the 17-nation union is almost 12%, while Spain’s rate has risen to more than 26%.

In reaction, central bankers in the U.S., Europe and Japan remained committed to keeping interest rates low and making additional asset purchases to promote growth and push investors into riskier markets by removing the return from the safest and most-liquid markets. For at least the remainder of the year, their efforts should be successful in keeping rates from rising dramatically. Corporate credit again should provide a measure of incremental return, as investor demand modestly compresses spreads.

## POSITIVES

- ❑ Inflation is well within target ranges
- ❑ Weak economic growth so the Fed continues to purchase assets
- ❑ Strong equity markets could cause rebalancing in favor of bonds

## NEGATIVES

- ❑ China’s economy is rebounding from temporary lull
- ❑ Current yields lower than expected inflation
- ❑ Bonds reflect manipulation by central bank purchases

## UNKNOWNNS

- ❑ Secular shift to/from equities to/from fixed income