

September 2012

ECONOMIC OUTLOOK

Summary

Economic growth for the second quarter was revised up slightly to a 1.7% annual rate from the originally reported 1.5% growth. The upward revision can be traced partly to better consumer spending than first estimated. Since the end of the quarter, the economy has continued to show positives — as well as negatives. The Institute for Supply Management (ISM) factory index fell slightly again in August. This marked the third consecutive month the index has been below 50, which indicates contraction. While the manufacturing sector appears to be contracting slightly, the services side of the economy has remained in growth territory, even though the level of growth has slowed over the last six to 12 months. The ISM nonmanufacturing index was up in August to a three-month high. Given the amount services contribute to the overall economy, this should help offset at least some of the weakness in manufacturing.

The consumer, though, remains the key to growth in the overall economy. Consumer confidence continues to weaken slightly as domestic and world issues are having an impact and the labor market is still not a positive. The Conference Board's consumer confidence index fell in August due to a sharp reduction in the expectations component. This could end up being more of a negative as we head into the end of the year. Even though the recent employment numbers have been more encouraging, they are still not enough to alter dramatically the unemployment picture. The Federal Reserve, in its latest statement, mentioned its concern about the labor market and the lack of overall progress in the economic recovery. The Fed stands ready to help in any way it can and is preparing for several different scenarios.

All things considered, we continue to believe the economy will keep growing. But growth will remain sluggish, which will not alleviate the uncertainty felt by consumers and manufacturers.

POSITIVES

- ❑ Fed stands ready to provide additional policy accommodation as needed
- ❑ Personal consumption expenditures rose in July by the most in five months
- ❑ Conference Board leading economic index rose 0.4% in July, the most in five months

NEGATIVES

- ❑ ISM factory index fell slightly in August, indicating contraction
- ❑ Conference Board's consumer confidence index fell in August to lowest level since November 2011
- ❑ Durable goods orders excluding transportation fell in July

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- ❑ Resolution to the fiscal cliff at the end of the year

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EQUITY OUTLOOK

Summary

Employment gains in early August that beat forecasts ushered in a sharp rally in equity prices, and the market held the gains for the rest of the month. On a price-only basis, the S&P 500 was up 1.98% for the month, but the real action was in the “riskier” areas of the market. The Nasdaq Composite Index jumped 4.3%, led by Apple; small-cap stocks were up as the Russell 2000 gained 3.2%. International stocks, as measured by the MSCI EAFE, were up 2.4%. Defensive sectors took a breather. The telecom and utility sectors declined, while technology (+4.8%) and consumer stocks (+4.2%) provided market leadership.

Three important developments seem priced into global markets. First, the Federal Reserve Board appears ready to resume some level of quantitative easing in an attempt to boost employment. Second, the European Central Bank is prepared to do “anything” to keep the euro together, thereby easing the specter of catastrophe in European and, by extension, world markets. Third, economic growth in China is decelerating from double-digit levels, placing downward pressure on the global commodity complex.

Since the consumer is the primary driver of the U.S. economy, what’s good for the consumer should be good for the markets, and recent indications, though modest, are positive. Household net worth is climbing due in part to positive market returns and rising housing prices. Disposable income is up year-over-year, debt burdens are falling, and savings are stable. Offsetting these tailwinds is the 800-pound gorilla of high unemployment and stagnant wage gains, which continue to be an unwelcome presence.

We continue to emphasize select domestic companies for growth and income over foreign investment, and large-cap versus the rest of the market. Valuations remain reasonable, inflation benign and monetary policy accommodative.

POSITIVES

- ❑ Excessive investor pessimism
- ❑ Monetary policy still positive
- ❑ ECB bridge-building

NEGATIVES

- ❑ The “fiscal cliff” looms large
- ❑ Europe is still slowing
- ❑ Political party conventions are over; let the rhetoric escalate

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- ❑ Iran’s nuclear ambitions

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FIXED INCOME OUTLOOK

Summary

In reaction to the late-July commitment by European Central Bank President Mario Draghi, riskier asset classes like stocks and junk bonds rose sharply in price during the first few weeks of August. Conversely, U.S. Treasury notes and other higher-quality bonds declined in value as interest rates rose by almost 40 basis points on the 10-year Treasury note.

Stocks around the globe held their gains in the last two weeks of the month, but bond yields declined by almost the same magnitude, as weak economic data was released and the minutes of the Federal Reserve's Federal Open Market Committee meeting in August indicated the committee's view had changed quite significantly from the July meeting. Previously, only a few members had said that further stimulus would likely be necessary to promote satisfactory growth in employment. The August minutes indicated that many members judged that additional monetary accommodations would likely be warranted fairly soon, unless incoming information pointed to a substantial and sustainable strengthening in the pace of the economic recovery.

Major uncertainties muddy the outlook for bond yields. Draghi's ability to form a strong enough coalition to put forth a credible plan to cap bond yields for many of the troubled European sovereigns remains a challenge. Any plan must include further integration and oversight of finances of those seeking relief, but this is a tough pill to swallow given the long history of conflicts in the region. It is difficult to envision German support without significant concessions. Without a breakthrough, the demand for high-quality bonds will remain and yields are unlikely to rise significantly.

Likewise, the mixed performance of the U.S. economy means it is challenging to anticipate whether the Fed will embark on additional forms of non-traditional monetary policy, which would also cap any increase in bond yields.

POSITIVES

- ❑ Global economic growth is moderating and inflationary outlook is benign
- ❑ Fed is prepared to purchase assets if economy weakens further

NEGATIVES

- ❑ Current yield levels are lower than expected inflation; yields on TIPS are negative
- ❑ Elevated bond prices/depressed yields reflect significant flight to safety

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- ❑ Uncertainty in European financial markets and path to resolution
- ❑ U.S. election cycle, policy uncertainties and the potential "fiscal cliff"
- ❑ Investors' continued flight from riskier asset classes