

ECONOMIC OUTLOOK

Summary

Federal Reserve Chairperson Janet Yellen may be the most dovish central banker in the post-World War II era. She hasn't been at her post for six months yet, but signs point to a progressive approach to easy monetary policy. When a Fed chair dismisses creeping inflation data as "noise" and raises concerns about pockets of credit excess due to an extended zero interest rate policy and looks the other way, things can get tricky. A recent example of this behavior is the much-debated topic of economic instability generated by market stability.

Current economic policy wonks are exploring the concept of the future destabilizing impact of a stable (low-volatility) market environment. Here's how it goes: zero interest rates and quantitative easing encourage risk-taking and dampen market volatility. That in turn encourages more risk-taking. Combined stock, bond, commodity and currency volatility has plunged to the lowest level in recent history — at least since the tracking of volatility data began in the mid-1990s. If an overwhelming number of market participants believe the Fed has everything under control, why not take a little bit more leveraged risk?

This is exactly what is, and has been, occurring in the credit markets: underwriting standards are dropping and credit quality is deteriorating. It occurs in every business cycle, but, in its current state, the Fed may be unwittingly encouraging the speed and scope of risk-taking by systematically reducing volatility through extended quantitative easing. Although these

circumstances may be positive for risk markets in the near to medium term, unsustainable asset valuations may occur in parts of the economy. Hardwired financial stability could be sowing the seeds of future market instability. The Fed doves have another view and may eat crow down the road. We are monitoring these developments and believe issues related to them are not a 2014 story.

Positives

Capacity utilization at 79.1% remains close to cycle highs

Domestic vehicle sales exceed 16.9 million units, annualized

Housing starts hold more than 1 million units, annualized

Negatives

Q1 2014 GDP declines 2.9%, third revision

Consumer Price Index hits 2.1% for trailing 12 months, a new cycle high

Q1 2014 real personal consumption holds near 0% year over year

EQUITY OUTLOOK

Summary

U.S. equity markets snapped back sharply in June as the S&P 500 climbed 2.1%, while the Russell 2000 index of smaller companies rocketed 5.3%. That brings first-half 2014 gains for these two indexes to 7.1% and 3.2%, respectively.

In June, the best-performing sectors were energy, up 4.9%, and utilities, up 4.2%. Turmoil in Iraq and the continued search for yield may explain the performance. Interestingly, these two sectors also fill out the two top-performing sectors year-to-date; up 11.7% and 16.4% respectively. The more defensive sectors of staples (-0.5%) and telecom (-1.3%) were the lagging performers for June.

The economy continues to rebound from the grip of winter. Late last month, the third and final revision to first-quarter GDP found the economy contracted 2.9%. Recently, however, pockets of the economy, including job openings, auto and truck sales, housing starts and architectural billings — just to name a few — have all been pointing upward.

Federal Reserve policy is of two minds: the tapering of its long-term asset-purchase program continues unabated, while the fed funds rate remains anchored at 0.25% for now. However, some signs of inflation are creeping into view. The Consumer Price Index for May reported a year-over-year increase of 2.1%, the largest in several years. Rising fuel and food prices were the culprits, certainly not wages, which are holding at just a 2% annual rate of increase.

The tension between better economic activity on the one hand and the specter of higher prices on the other (which may force the Fed to raise short rates sooner than later), will increasingly raise the anxiety levels of market participants, especially as equity markets grind higher.

We have maintained for some time that as long as monetary policy remains accommodative, there is continued room for equities to outperform bonds. We still believe this, but we are becoming more watchful of valuations as inflation approaches the Federal Reserve's stated threshold.

Positives

Economy showing renewed vigor

Job gains accelerating

Negatives

Cost-push inflation on the rise

Geopolitical uncertainty

Unknowns

Iraq

FIXED INCOME OUTLOOK

Summary

As bonds traded at the lower end of the relatively tight range that has been established since the end of January, the curve still experienced a slight bull flattening as shorter rates increased 8 basis points, the 10-year increased 6 basis points and the 30-year increased only 3 basis points. With this small increase in rates, most of the common bond indexes delivered slightly negative returns. Corporate bonds and mortgage-backed securities delivered positive returns as their incremental yield and spread narrowing offset the increase in comparable-maturity U.S. Treasury securities. Still, for most of the month, trading was uneventful as the index measuring interest-rate-option volatility collapsed to near record lows.

While appearing to lull many investors to sleep, under the surface there is debate as to whether yields should rise in response to signs of a strengthening economy, or whether rates should remain low or even decline further given global violence, geopolitical factors and deflationary concerns. While acknowledging that rates are historically low relative to inflation and just about any other measure, our take is that there are several reasons why these rates are justified at or slightly above current levels. Despite reasonable growth in payrolls, strong auto sales and an improving housing market, there is little evidence to support the belief that economic momentum will begin to accelerate rapidly enough to cause significant inflationary pressures. In fact, much of the developed world is still fighting deflationary concerns with extraordinary monetary policies of their own. While variable on a quarter-to-quarter basis, we expect overall GDP growth to continue to average about 2.5% for the next few years. Combined with geopolitical concerns in the Middle East and Ukraine, we believe we will not be fortunate enough to see bond yields rise significantly anytime soon. Still, the U.S. bond market remains a bargain relative to the rest of the developed world.

Positives

Dovish Fed chairperson not likely to push for higher rates

Global central banks' efforts to combat slow growth and deflation

U.S. rates attractive compared with those of other developed economies

Geopolitical concerns raised by events in the Middle East and Ukraine

Scarcity of debt; interest payments exceed issuance

Negatives

Yields still historically low

Corporate spreads are less attractive than in the recent past

Rebalancing of large portfolios is largely complete

Unknowns

Input price pressures, especially in agricultural products

Resolution of geopolitical tensions
