

May 2013

# ECONOMIC OUTLOOK

## Summary

The economy grew at a 2.5% annual rate in the first quarter – an improvement from fourth-quarter growth of only 0.4%. An increase in consumer spending following a resolution to the tax issues was the principal driver of improved growth. However, spending cooled a bit at the end of the quarter as talk of the sequester increased and consumers decided they did not want to continue to draw down savings.

Since the end of the quarter, there have been indications that the economy has lost some steam, but also indications of underlying positives that could lead to continued growth and expansion. Both the ISM manufacturing and non-manufacturing indexes fell slightly in April, indicating growth slowed. However, they remain above 50, indicating growth continues in all parts of the economy. The housing industry has benefitted from record-low mortgage rates that have allowed homeowners to refinance, to trade up to a new home or to purchase their first home. As a result, home prices rose year-over-year in February, by the largest amount in nearly seven years. The increase in home prices, combined with rising stock prices, made the consumer feel better off financially. The Conference Board's Consumer Confidence Index rose in April to a five-month high, with both present conditions and expectations increasing. Other gauges of consumer confidence, however, did not show such positive readings. The Federal Reserve pledged to keep short-term interest rates low until the unemployment rate reaches 6.5%. It reached 7.5% last month as non-farm payrolls again showed a decent increase. While the six-month average trend shows slightly more than 200,000 jobs being created each month, that is still not strong enough to move the unemployment rate substantially lower any time soon.

Overall, the economy continues on its upward path, although it may be moving more slowly than desired. However, inflation remains in check, and this is growth that can be more sustainable over time.

### POSITIVES

- ❑ Increase in Conference Board's index of consumer confidence in April
- ❑ Housing market appears to have gained some strength, as prices are higher and demand has improved
- ❑ Labor market continues to expand even as the number of government jobs declined

### NEGATIVES

- ❑ Decline in ISM manufacturing and non-manufacturing indexes
- ❑ Overall durable goods orders fell sharply in March
- ❑ Index of leading economic indicators fell in March

### UNKNOWNNS

- ❑ Ultimate impact on the economy of the sequester and of lower government spending

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# EQUITY OUTLOOK

## Summary

The defense took the field in April as concerns about a consumer slump surfaced. Tepid manufacturing data, a weaker outlook by IBM and slumping retail sales deflated growth expectations in the U.S. An early examination of first-quarter GDP showed the economy growing at a rate of 2.5%, well below expectations. Meanwhile, Europe remained stuck in austerity and economic stagnation.

Investors chose to seek shelter and ride out the uncertainty in the more defensive sectors of the market. The SHUT index – encompassing the low-volatility sectors of the economy of staples, healthcare, utilities, telecom – led sector returns with gains of 2.9%, 2.8%, 5.9% and 6%, respectively (price only).

However, aggressive monetary moves by the Bank of Japan, essentially accelerating quantitative easing efforts, and recent interest rate cuts by European central bankers reinforced the accommodative stance globally to support growth.

Dividend strategies continue to dominate as surrogates for meager cash flows currently provided by fixed-income investments; and corporate managements, recognizing shareholders' demands for income, have responded accordingly by stepping up dividend payouts. Most recently, Apple increased its cash dividend stream by 15%.

We have entered the seasonally weak period for stocks – “sell in May and go away” – and expect a pause in this very overbought market. Unfortunately, so do most other pundits. We are also very aware that many investors remain very risk-averse and portfolios remain heavily tilted to risk-off fixed-income strategies and are not amply compensated in today's market for such an investment profile. Temperament may yet turn more bullish, pushing this market rally much further than current levels.

## POSITIVES

- ❑ Global monetary policy now fully engaged
- ❑ Modest growth in the U.S.
- ❑ Valuations reasonable

## NEGATIVES

- ❑ Upcoming consequences of sequester
- ❑ Obamacare deployment on the horizon

## UNKNOWNNS

- ❑ Syria, etc.

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# FIXED INCOME OUTLOOK

## Summary

Bonds delivered solid returns in April as yields across the curve declined after the announcement of a disappointing increase in job creation in March. The 5-year Treasury note yield declined 9 basis points, with the 10- and 30-year bonds declining 18 and 23 basis points, respectively. A weaker-than-expected first-quarter GDP report seemed to dampen the expectations of the more optimistic forecasters and solidify the position of recovery bears. Corporate credit solidly outperformed Treasury debt by almost a full percentage point (1.83% versus 0.89%). Industrial credits rebounded, outperforming financial company bonds (1.97% versus 1.36%). This was partially due to a longer duration on average (7.74 years versus 5.64).

For the foreseeable future, the Fed will retain its “full throttle” approach to extraordinary monetary policy by maintaining its current program of purchasing \$85 billion per month of Treasury and government-backed mortgage bonds. Its impact on and distortion of the markets is immeasurable, but as long as they absorb the majority of net new issuance, rates are not likely to rise. We still believe a relatively tight trading range will continue into the summer months and that credit should continue to outperform the other investment-grade sectors as investors continue to stretch for any incremental yield. Fortunately, corporations are issuing significant amounts of new debt at these historically low yields and providing some alternatives for fixed-income investors.

### POSITIVES

- ❑ Inflation is well below Fed’s target range
- ❑ Weaker economic growth provides fodder for the Fed to continue asset purchases
- ❑ Strong equity markets could cause rebalancing in favor of bonds
- ❑ Japan embarking on new round of incremental asset purchases
- ❑ Still-strong net new flows into bond funds

### NEGATIVES

- ❑ Current yields are lower than expected inflation, as indicated by TIPS market
- ❑ Bond yields reflect massive purchases by central banks

### UNKNOWNNS

- ❑ International tensions in Iran and North Korea