

September 2013

# ECONOMIC OUTLOOK

## Summary

The first revision to second-quarter GDP showed the economy grew at a faster annualized rate of 2.5% versus the originally reported 1.7%. The main drivers for the upward revision were net exports and private inventory investment as opposed to higher spending by consumers. The economy has experienced both positives and negatives since the end of the second quarter. The housing industry has been one bright spot. Although the average 30-year fixed-rate mortgage is the highest in more than two years, spending on new home construction has risen to the highest level in nearly five years. The Conference Board's consumer confidence index rose again in August, on the basis of improved income expectations. However, there was a decline in the present situations component of the index, reflecting current concerns domestically and worldwide. The Institute for Supply Management manufacturing and non-manufacturing indexes rose in August, with the non-manufacturing index reaching its highest level since 2005. The manufacturing index was aided by improved auto demand and the rebound in residential construction. The labor market is the part of the economy continuing to slow over the past few months. While the unemployment rate fell to 7.3% in August, it declined due to the lowest workforce participation rate in 35 years. Growth in non-farm payrolls has also been slowing, with the average monthly gain this year falling below last year's overall pace. The Fed has vowed to keep short-term rates at current levels until the unemployment rate reaches 6.5%. This does not appear imminent. The health of the labor market is a key determinant of the health of the economy, according to the Fed. The recent slowdown in the labor market may be enough to cause the Fed to delay its first move to begin tapering its bond purchases. Even if not, the amount of the reduction in bond purchases may be reduced.

The economy remains in a positive growth mode, but the level of growth appears to have slowed a bit as consumers pull back in reaction to a slowing labor market and concern about the situation in the Middle East. The recent increase in interest rates may also have a dampening effect on the economy. Any slowdown now should lead to more positives as we approach the new year.

### POSITIVES

- ❑ Conference Board's consumer confidence index rose again in August
- ❑ Improvement in ISM manufacturing and non-manufacturing indexes
- ❑ Housing sector has remained in an uptrend, even with mortgage rates increasing

### NEGATIVES

- ❑ Growth in non-farm payrolls has slowed below last year's pace
- ❑ Durable goods orders overall, as well as excluding transportation, fell in July
- ❑ Spending by the public sector has been hurt by the sequester in Washington

### UNKNOWNNS

- ❑ Timing and degree of the Fed's tapering of its bond purchases the markets

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# EQUITY OUTLOOK

## Summary

The dog days of summer, Middle East turmoil and Federal Reserve jawboning were too much for equity markets to bear. The S&P 500 lost 3.1% and the DJIA fell 4.4%, while the NASDAQ slipped 1.1% (price return only). The retreat was led by utilities (-5.5%), financials (-5.2%) and staples (-4.5%). The only relative wins were recorded by materials (-0.2%) and technology (-0.8%).

By far, the greatest impact on the markets was managers positioning portfolios on the basis of expectations of “normalization” of long-term interest rates. Whether the Federal Reserve will wind down its asset-purchase program is a matter of some debate, since economic fundamentals seem to dictate continuation. We wonder more about the lack of political backing to continue the purchases.

We emphasize a need to distinguish between the demise of this program and any policy changes in the short-term rate (fed funds). The former has been a boon to housing finance and leverage, and the markets’ reset of interest rates within the past six weeks has slowed home purchases perceptibly. More important to the longer-term stability of equity prices is the direction of the latter. Given a lack of inflationary pressures and ample liquidity, and affirmation of stable short rates by the Fed itself, we remain confident that the underpinnings for higher equity prices remain in place.

Whether corporate earnings can continue to expand is a different issue. Growth remains sub-par as wages are stagnant, job growth is slow, immigration is stalled and credit is tight. According to Bloomberg statistics, earnings growth for the S&P 500 in the second quarter was 4.1%, nearly all of which can be attributed to a sharp rebound in bank profits. We can’t count on the financial sector to carry growth forever.

For the past two months, the market has rewarded “growth” to the detriment of “value” as attributes of stock selection. Perhaps acknowledgement of slow growth for the foreseeable future is driving the search for companies capable of generating earnings growth without the tailwinds of a vibrant economy.

## POSITIVES

- Auto sales, aerospace and energy remain strong
- Consumer confidence high
- Short rates stable

## NEGATIVES

- Corporate earnings growth slowing
- Housing clipped by rising mortgage rates
- Emerging markets still decelerating

## UNKNOWNNS

- Outcome of Middle East issues

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# FIXED INCOME OUTLOOK

## Summary

Interest rates resumed their climb from record lows with another moderate increase in August. The 10-year Treasury ended the month 21 basis points higher, at 2.79%. The 5-year, not to be outdone, ended 26 basis points higher, at 1.64%. The 2-year rates rose an additional 9 basis points on the month, further steepening the curve. Credit spreads increased slightly again in August, sending corporate bonds into their fourth month of underperformance this year.

The minutes of the Federal Open Market Committee's July meeting, released in mid-August, revealed that almost all participants were "broadly comfortable" about moderating the pace of security purchases later this year. Although tapering should come as no surprise by now, additional mixed economic data continues to cloud the outlook for its timing. The overall tide of data is improving, but markets worldwide continue to attempt to price in the timing and effect of a reduction in liquidity.

We believe fits and spurts in rates may eventually land us higher as the Fed slowly pulls away and the economy improves. However, the attractiveness of higher yields, benign inflation, a steeper curve and solid corporate balance sheets should begin to shine more brightly for a greater number of investors.

### POSITIVES

- ❑ Inflation expectations remain contained even as real yields show drastic improvement
- ❑ Domestic economic growth likely to remain below 3%; emerging markets growth continues to struggle
- ❑ Steeper curve offers increased return potential from rolling to lower yields

### NEGATIVES

- ❑ Rates analysts continue to raise forecasts for U.S. Treasuries
- ❑ Retail selling has continued as sentiment weakens and volatility increases

### UNKNOWNNS

- ❑ U.S. fiscal policy battles, oil prices and geopolitics (Egypt, Syria, Iran)
- ❑ Degree and timing of Fed security purchases tapering