

July 2013

ECONOMIC OUTLOOK

Summary

While the final reading on real GDP for the first quarter showed slower growth than previously estimated, the economy has not continued to slow and appears to have stabilized. Economic figures released in June actually showed improvement in a few key areas, such as the labor market and consumer spending. There were negative readings as well, such as the decline in the ISM non-manufacturing index, which generated doubts about the strength of the economic recovery. The ISM manufacturing index improved in June, above the 50 level, which is positive, but manufacturing is a minor part of the economy these days. While the ISM non-manufacturing index did not fall below 50, it did decline, showing weakness in the largest part of the economy.

The rise in the Conference Board's consumer confidence index to a five-year high shows the consumer is feeling better in the wake of low mortgage rates, rising property values and higher stock prices. Since the survey for this index was taken prior to the increase in mortgage rates at the end of June, it will be interesting to see how confidence may have changed when the July readings are announced. The key for the consumer, the Fed and the economy though is the labor market. Although the level of job creation has not been robust, there has been steady improvement in job creation. The average increase in non-farm payrolls for the first six months of the year was 202,000 new jobs. The unemployment rate is still relatively high, but it is projected to gradually drop as we go through the second half of the year. This should do as much, or more, than any other factor in helping the consumer feel better about the future. It could also offset the potential negatives of higher interest rates and the possibility of changes in Fed monetary policy.

The end result is that the economy should continue to grow, but the presence of positives and negatives will most likely result in a continuation of the moderate growth we have experienced over the past couple of years.

POSITIVES

- ❑ Continued steady improvement in the labor market and in job creation
- ❑ Sharp increase in the Conference Board's consumer confidence index
- ❑ Strong increase in consumer spending and retail sales in May

NEGATIVES

- ❑ Decline in ISM non-manufacturing index even though it remained above 50
- ❑ Increase in mortgage rates and intermediate interest rates
- ❑ Increase in the trade deficit due to higher imports in all categories

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- ❑ Degree to which higher interest rates and mortgage rates will hurt economic growth

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EQUITY OUTLOOK

Summary

In June, global equity markets were tossed about in the wake of Federal Reserve comments meant to clarify the current easy money regime, but which were interpreted as a shot across the bow of QE Infinity.

The S&P 500 slipped 1.5% for the month, as only the telecom (up 1.8%), consumer (up 0.75%) and utility sectors (up 0.6%) remained in the black. The more cyclical sectors of materials (down 4.5%) and information technology (down 3.7%) were hardest hit. (All returns are price only.)

Year-to-date, the S&P 500 remains the leader, returning 13.8%, with most sectors experiencing double-digit gains. The rest of the developed countries, many of whom are dealing with austerity programs, have not fared as well as measured by the MSCI EAFE Index, which was up just 4.1%. Emerging markets as measured by the MSCI Emerging Markets Index plunged 9.6% as many developing countries struggle to shift growth strategies.

What to make of the Fed's warnings, real or perceived, and what is our outlook for the equity markets in the second half? Volatility has increased, and with it some expectations for a shift in leadership. Returns in the first half of the year accrued disproportionately to defensive sectors. The slightest glimmer of recovering growth in the developing world would most likely benefit the deeper cyclical sectors.

Economic growth in the United States remains muted, but steady. Low short-term interest rates, positive consumer confidence, recent wage gains, and recovering housing and auto markets point to continued growth in the latter half of the year. Equity valuations remain reasonable, and a dose of caution has been thrown into the bond market. Despite increased volatility, which cleared some excesses from the market and reined in over-enthusiastic tendencies, we maintain our fully invested equity position.

POSITIVES

- ❑ Steady economic growth
- ❑ Strong housing and auto markets

NEGATIVES

- ❑ Increased volatility
- ❑ Looming Obamacare rollout

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- ❑ China growth deceleration

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FIXED INCOME OUTLOOK

Summary

Interest rates rose sharply in June, with the 10-year Treasury note increasing 36 basis points to 2.49%. This caps a calendar quarter where the yield rose 64 basis points in total. The 2-year yield rose only 6 basis points for the month and 11 basis points for the quarter; as a result, the curve is significantly steeper. Credit spreads also increased during the month and quarter, causing corporate bonds to underperform. Overall, the monthly return of the full Government/Credit Index was -1.80% for the month and -2.51% for the quarter. Added to a slightly negative return in the first quarter, this year's return is the second-worst two-quarter period in the past 20 years.

Why have bond yields increased so sharply? During the press conference that followed the Federal Reserve's June 19 FOMC meeting, Chairman Bernanke stated that the Fed may begin to reduce bond purchases later this year and subsequently end them in mid-2014. Although this timetable was widely viewed as the consensus, the markets reacted like it was quite a surprise.

So we are again asked whether this is the much heralded end of the 32-year bull market. Yes, the bull market is likely over, but we do not expect a protracted bear market to begin. We believe that much of the move was front-loaded (like the release of a spring) and the market quickly moved yields to a level reflecting the current environment, with the forecast reduction of Fed purchases. Rates should establish a new and slightly broader range around the recent high levels for the remainder of the year.

POSITIVES

- ❑ Inflation is well below the Fed's target range; expected inflation has declined
- ❑ Overall economic growth remains moderate domestically, but is still weak in Europe, China and emerging markets
- ❑ Steeper curve makes bonds more attractive as they appreciate from rolling to lower yields

NEGATIVES

- ❑ Retail selling may cause further price declines as sentiment deteriorates
- ❑ Rates still lower than nominal projected GDP, a historical benchmark

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- ❑ International tensions: Iran and North Korea; Egyptian political unrest
- ❑ Fed's commitment to wind down QE3