First Citizens Investment & Trust Services

Investment and Trust Services
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OUTLOOKS

June 2014

ECONOMIC OUTLOOK

Summary

"Money for Nothing" by the British rock band Dire Straits was a popular song back in 1985. That title and band name pretty much sum up the recent European Central Bank (ECB) monetary policy moves under President Mario Draghi. Charging banks a negative deposit rate of -0.10% for the luxury of holding excess reserves at the ECB is unprecedented in major developed economies. By doing so, the ECB has clearly shown the dire straits it faces in fighting deflation in Europe and herding the political cats who refuse to implement needed structural reforms within the European Union.

So, the lowest volatility trading environment in around 20 years continues unabated as central banks shower the world with liquidity in the hope of fostering more rapid economic growth. A major impediment to this desired outcome are large and growing public and private sector debts. Economists note that when the public and private sector debt load exceeds 275% of a country's GDP, the potential growth rate of that economy deteriorates. The United States' debt load is around 375%, while Europe, Japan and Great Britain all exceed 450%. These percentages have moved from the lower left to upper right side of the page recently.

All this debt depresses economic growth and presents significant vulnerability to higher interest rates and painful debt-servicing costs. As one ponders future interest-rate paths, it seems we may be in a world of much slower-than-normal developed-country GDP growth and central banks that are loath to crank up debt-serving costs. If we had an inflation problem, this scenario would be particularly troubling. However, inflation-adjusted wages are likely to be up less than 1% over the next few years (2.8% average since 1980), keeping a lid on the U.S. economy and general price levels. We believe 2.60% in 10-year Treasury yields may be the new normal for a while, with a modest 0.40% range above and below that level for the time being.

Positives

Purchasing managers indexes rise to a six-month high

Case-Shiller home price index rises 12.37% year-over-year

Total vehicle sales top 16.7 million units in May

Negatives

GDP contracts 1.0% during a weather-snarled first quarter of 2014

Pending home sales decline 9.4% year-over-year

Trade balance, at -$47 billion, is worst in six months

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EQUITY OUTLOOK

Summary

U.S. equity markets were markedly higher in May, paced by a strong recovery in the NASDAQ Composite, up 3.3%, and followed by a 2.3% gain in the S&P 500. The blue-chip-heavy DJIA rose 1.2%.

No particular trend was evident as all S&P sectors, except utilities (down 1.6%, price only), recorded positive returns in the month. On the opposite side of the risk spectrum from utilities, information technology was up 3.5% and telecommunications gained 3.4%; energy rose only 1.0%.

Emerging markets – tracked by the MSCI Emerging Markets Index – snapped back as well, charging ahead 3.5%. The MSCI EAFE Index lagged, rising only 1.6% last month.

On balance, conditions remain favorable for stocks to outperform bonds, which is the basis for our tilt toward greater stock exposure in our asset-allocation recommendations.

What catalysts would serve to change our outlook? Since this has been a market strongly influenced by the liquidity provided by the U.S. Federal Reserve, any hint of inflation or rapidly accelerating GDP would undermine the current accommodative environment and dampen our enthusiasm for equities.

Although some sectors of the economy are robust – auto sales and energy exploration come to mind – sufficient headwinds are buffeting retail sales and housing to prevent a growth spike. The housing conundrum is most interesting, born of several factors, including memories of the crash of 2008, declining new-family formation, a lack of immigration and tight lending standards. While new single-family housing starts remain suppressed, it will be difficult for the economy to gain enough velocity to shock monetary policy.

So the backdrop remains benign, providing corporate managers an environment to continue to eke out top-line revenue growth and use balance sheet adjustments to enhance reported earnings.

Positives

- Fed policy accommodative
- Inflation absent
- Moderate GDP growth

Negatives

- Growth is scarce, as are earnings opportunities
- Complacency abounds

Unknowns

- Effects of latest ECB policy experiment with negative interest rates

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OUTLOOKS

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FIXED INCOME OUTLOOK

Summary

To the bewilderment of bond market bears, returns were again strong in May as rates continued to decline. In a period of slightly more than two weeks, the 10-year Treasury note declined from a monthly high of 2.66% on May 13, to a low of 2.40% on May 29. The sharp technical drop was likely fueled by demand from investors who had been betting against the market. Overall, the 7- and 10-year bonds closed the month 17 basis points lower as 5- and 30-year bonds declined by a lesser amount. Corporate credit extended its winning streak as spreads narrowed even further. In fact, since the beginning of the year, corporate bonds have delivered almost twice the return of Treasury bonds, albeit some of the incremental return is due to having longer average maturities.

Multiple factors continue to drive rates lower instead of higher. The first is uncertainty about the rate of growth in the domestic economy. After seeing first-quarter GDP revised downward to -1.0% from a previously estimated +0.1%, many question optimistic estimates for the second half of the year. Geopolitical concerns centered on Russia also are increasing demand for safe, liquid assets, such as U.S. government bonds. However, the most important factor is, and likely will continue to be, the global effort to revive growth and reduce the potential for deflation. This has prompted central banks around the world to take increasingly extraordinary steps to spur economic activity. The European Central Bank just announced new measures to increase funding of financial institutions while reducing borrowing rates and it is using a negative deposit rate as a penalty for holding reserves. Importantly, it stated that it is committed to take further actions, if necessary, to increase bank-lending activities and promote growth.

Even with our Fed winding down its asset-purchase program, much of the developed world remains committed to fighting slow growth. As a result, yields across the globe should remain lower for longer than many expected entering 2014. In comparison to the debt of other developed nations, U.S. yields are attractive, and since money is fungible worldwide, there is little reason to expect that U.S. yields will increase to the level where they began the year.

Positives

- Inflation remains below the Fed's target; slack in U.S. labor force
- Global central banks' efforts to combat slow growth and deflation
- U.S. rates attractive compared with those of other developed economies
- Geopolitical – Russia's aggressive actions
- Rebalancing of institutional funds
- Scarcity of debt; interest payments exceed issuance

Negatives

- Yields still historically low
- Corporate spreads are less attractive than in the recent past

Unknowns

- Success of Central Bank efforts
- Russia's intentions and U.S./NATO response