

ECONOMIC OUTLOOK

Summary

Driven by increased inventory investment and capital expenditure spending, the economy grew at a revised 3.8% annual rate in the third quarter, up from the original estimate of 2.8%. The negative factor: little change in final demand. The inventory investment could be offset in the fourth quarter. In fact, real final sales, which is GDP excluding the change in inventories, rose only 1.9%. Other economic numbers released over the past month have shown, or appeared to show, more positives than negatives. The Institute for Supply Management (ISM) manufacturing index rose in November to its highest level since April 2011. However, the ISM nonmanufacturing index, which represents the majority of the economy, fell to 53.9 in November from 55.4 in October. The housing industry has continued to show signs of further stability and strength as sales of new single-family homes were up sharply in October and building permits rose.

The labor market also has shown some strength within the past two months. In November, nonfarm payrolls rose by 203,000 and the unemployment rate fell to 7.0%. However, part of the reason for the decline in the unemployment rate was the return to work of government workers furloughed during the recent shutdown. The labor force participation rate in November was only 63.0%, near a record low. Most likely this low participation played a part in the decline of the Conference Board's Consumer Confidence Index to its lowest level in seven months. The expectations index fell almost three points, reflecting some of the issues ahead.

The better economic figures are increasing speculation that the Fed will begin tapering sooner rather than later. We continue to believe it will not begin tapering until after the first of the year.

Congress still must come up with a budget resolution, and there is the debt level issue. While some economic figures look more promising, we continue to believe economic growth will be slower in the fourth quarter and into the new year. This could change if consumers feel better, but we believe there are still too many concerns and uncertainties to see expectations and the economy move substantially higher.

Positives

ISM manufacturing index rose to highest level since April 2011

Housing sector showing additional signs of stability and strength

Labor market improving with increase in nonfarm payrolls and decline in unemployment rate

Negatives

ISM nonmanufacturing index declined

Labor force participation rate near record low

Conference Board's Consumer Confidence Index fell to lowest level in seven months in November

Unknowns

Ultimate timing and degree of tapering by the Fed

EQUITY OUTLOOK

Summary

U.S. stock prices pushed higher in November, with the S&P 500 up 3.1%, bringing the year-to-date gain to 29.1%. Domestic stock prices have significantly outperformed most of the world indexes. The MSCI EAFE recorded a 21% increase.

Sector performance was decidedly mixed, with the defensive utility and telecom sectors declining 2.4% and 2.6%, respectively. Healthcare and financials paced the pack, up 4.5% and 4.4%, respectively, but a solid performance was recorded by industrials, discretionary and technology as well.

With the domestic political theater on hold until early 2014, and barring a significant macro event that rattles confidence, it appears that the U.S. market is on track to hold the majority of this year's gains through year-end.

At this time of year we begin to polish our crystal ball and prepare our fearless forecasts for the markets in 2014. It may well be that the few remaining economic data points to be released this month will be highly predictive for the direction of the macro environment in 2014.

We will focus our attention most laser-like on a few key measures leading the economy. The first is the housing market, which has already meaningfully discounted the recent increase in mortgage rates. The second is auto sales, where recent numbers were reported at a very robust 16.3 million annual rate of sales. Finally, U.S. manufacturing and subsequent capital spending, which have lagged this recovery, may be set for recovery.

The largest cloud overhanging the market is the continued positive trajectory of corporate earnings. While growth can be "manufactured" through corporate buybacks, without economic acceleration, real earnings growth will be muted and the outlook for the markets tepid at best. We'll keep our eyes open!

Positives

Economy solid at low level

Short rates stable

Negatives

Economic strength will revive "taper" talk

Budget impasse revives in January

Unknowns

China syndrome

FIXED INCOME OUTLOOK

Summary

Longer-maturity Treasury yields rose in November, causing bonds with more than five years to maturity to decline in value. Shorter-maturity yields held steady or even fell by a few basis points. The yield curve steepened, with the 2- to 10-year spread tying with the highest level seen within the past two years. At just over 250 basis points, the yield curve is a full 1% steeper than it was in late April. Corporate credit outperformed Treasury, government agency and mortgage-backed debt in November as credit spreads continued to narrow. Financial company debt has outperformed Treasury debt by more than 3% this year, while industrial and utility credits have underperformed. Increasing regulation and capital requirements designed to make large, too-big-to-fail institutions safer appear to be working in that regard.

The on-again, off-again discussion about the Fed's tapering of asset purchases appears to be on again. After surprising the markets with the decision to not taper in September, many forecasters pushed out their expectations for the reduction to begin in the summer of 2014 at the earliest. A series of strong economic data has since moved many of those forecasts into the first quarter of the year. Some even expect an announcement at the Federal Open Market Committee's mid-December meeting.

We do not expect the FOMC to announce the beginning of the tapering process in December, but we do believe it could occur in the first quarter of 2014. Although inflation remains well below the Fed's target as measured by the core GDP deflator, FOMC meeting minutes indicate that many committee members are beginning to question the effectiveness of additional purchases and the potential for unintended risks. To avoid disruption in the markets, the Fed will continue to attempt to deflect attention away from the change in balance sheet policy by emphasizing that short rates are likely to remain exceptionally accommodative for an extended period. With short rates anchored, and with a very steep yield curve, investors are

highly motivated to purchase bonds to capture the "roll" as the security ages to a shorter maturity. Therefore, when the Fed does eventually taper, we do not believe the bond market will have a significantly negative reaction.

Positives

Inflation remains below the Fed's target by almost all measures, and commodity prices in aggregate continue to be weak

The historically steep yield curve provides increased return potential from bonds aging or rolling down the yield curve

Strong equity market performance could lead to incremental demand for fixed income as portfolios are rebalanced

Negatives

The overall size of the Fed's balance sheet could cause disorder in the bond market as purchases are curtailed and eventually ended

Retail flows into bonds are weak and could offset large plan rebalancing

Stronger economic data leads to fears of a reversal in inflation trends

Unknowns

Level of distortion created in financial markets by Fed purchases and natural clearing levels

Degree and timing of Fed's eventual tapering of bond purchases
