

ECONOMIC OUTLOOK

Summary

After contracting 2.1% during the first quarter of the year, the belief that the economy clearly improved in the second was confirmed by the recent Bureau of Economic Analysis release detailing a strong 4.0% expansion of the U.S. economy. A question remains whether this strong growth is a harbinger of future growth or just a rebound from weather-induced winter weakness.

In our opinion, there is reason to be optimistic about the economy going forward, but little reason to expect that annual growth will return to and sustain the post-WWII average of approximately 3.3%. On the plus side, payrolls have now increased by more than 200,000 for each of the last six months. At the margin, this should help support higher retail sales, including autos. Also creating optimism are the manufacturing and non-manufacturing surveys of the Institute for Supply Management, whose combined index rose to the highest level since 2005. On the cautionary side, the contribution to growth from the housing market is slowing, increases in inventories (which contribute to growth) are likely to reverse and wage increases have not surpassed the rate of inflation.

It should also be remembered that the U.S. economy does not operate in a vacuum. The expansion and contraction of other economies can have significant direct and tangential influences on domestic activity. At the moment, there are no other major world economies whose activity will cause domestic growth to accelerate. Europe is still a mess as it continues to struggle under the weight of stringent labor regulations, unfavorable demographics, and an undercapitalized banking sector. In fact, Italy has now reentered a recession after GDP fell 0.1% in the first quarter and 0.2% in the second. Even stalwart Germany saw factory orders fall 3.2% in June, the most in two and one-half years. China could be on the brink of a sharp slowdown as its real estate market contracts and defaults emerge in its sizable

high-yield bond market and shadow banking system. Some economists are predicting a “default storm” as a record number of privately issued debts mature this year. China’s services purchasing manager index fell to 50 in July, the lowest since the survey began in 2005. And the list goes on and on.

Overall, we think the economy will stabilize further, but the average rate of growth will remain near the post-financial crisis average of 2.0% to 2.5%.

Positives

ISM surveys indicate increasing business confidence

Solid gains in payrolls

Wealth effect supports spending

Negatives

Recovery in new and existing home sales has stalled

Construction spending declining

Weak wage gains

Unknowns

Business sentiment for new capital expenditures

Extent of China’s construction and debt bubbles

Impact on economies if Cold War era hostilities are renewed

EQUITY OUTLOOK

Summary

The convergence of global strife and the specter of a less accommodative Fed proved more than the market could bear last month. A plunge on the last day of July shook the market out of its complacency, resulting in a 1.4% monthly decline by the S&P 500. Smaller and lower-quality companies fared even worse: the Russell 2000 Index of smaller companies declined 6.1%.

Only the telecom and technology sectors scored positive returns of 2.6% and 1.4%, respectively (price only). Utilities, which had been the best performing sector this year, swooned 6.9%.

This bull market is indeed long in the tooth — five-plus years now — while the economy continues at a lethargic pace. Second-quarter GDP was reported growing at a 4% annualized rate, a significant turnaround from the weather-induced decline of 2.1% in the first quarter. The surge was driven primarily by inventory replenishment and auto sales. Jobs are being created, but at a pace that only accommodates labor-force growth and does little for the bulk of unemployed workers.

The second-quarter corporate earnings season has mostly wrapped up, with a respectable majority of companies (slightly more than 60%, according to our sources) reporting better-than-projected revenues and earnings. Admittedly, some of the improvement in per-share earnings was the result of aggressive share repurchases; borrowing costs remain at historically low levels!

Attention has focused like a laser on the pace of employment-related measures of inflation. The government's own employment cost index for the private sector reported that compensation rose 2.0% for the twelve months ending in June, with benefits rising 2.4%. According to the Bureau of Labor Statistics employment report, average hourly earnings in July

increased 2% over last year as well. However, the closely-watched personal consumption expenditures price index rose just 1.6% in June on a year-over-year basis, well below the 2% target set by the Fed.

While these reports are not inflationary at present, the direction made investors take notice and raise the debate over whether the Fed will fall behind the curve of normalizing short-term interest rates, and even what the appropriate rate levels should be in this weakened growth environment.

We expect the remainder of the dog days of summer will be just that for the markets: directionless and choppy with little resolution to this impasse until a clearer picture of pricing appears in September.

Positives

Corporate earnings still trending higher

Interest rate environment still accommodative

Negatives

Investor complacency is rampant

No healthy market correction in 18 months

Unknowns

Global geopolitical uncertainty

FIXED INCOME OUTLOOK

Summary

The Treasury market remained in a fairly tight trading range during July as moderately improving domestic economic data was offset by weakening data in most other major developed economies and a further escalation of tensions in the Middle East and Ukraine. For the month, 3- and 5-year yields increased the most at about 12 basis points (bps), while the 10-year increased 3 bps and the 30-year bond actually declined by 4 bps. With shorter rates increasing and longer rates increasing less or declining, the curve-flattening trend continued. Most of the major bond market indexes delivered slightly negative returns in July as the decline in market value more than offset the income generated, but returns are strongly positive for the year so far. Once again, corporate credit performed slightly better than comparable-duration Treasury bonds.

It was just over a year ago that yields on intermediate and long-term Treasuries shot up sharply on prospects that the Fed might begin tapering the amount of Treasury and mortgage-backed securities it was buying in the open market. The end of these purchases, affectionately known as Quantitative Easing, was feared to be the last breath for a dying, 33-year old bull market for bonds. The buying did not actually slow for another few months, but we now find ourselves within 90 days of the likely end of all Fed purchases and yield on the 10-year bond is essentially unchanged at 2.55% (after rising to 3.03% at the end of 2013). The cessation of purchases has not had the impact that many expected, but other factors, such as the sanctions placed on Russia recently and their impact on economic growth in Europe, have clearly contributed to keeping rates well contained.

With slower-than-previously-expected growth worldwide, well-supplied global commodity markets and the overhang of high debt levels, there is little reason to expect accelerating inflationary pressures, the natural enemy of bond investors. With no growth or inflation fears, the demand for safety supersedes fundamentals, especially when you throw in a potential return

to a Cold War footing against Russia and an ex-KGB leader who is a ruthless despot.

It has been and remains our belief that long-term rates (30-year Treasury yields) have peaked for a rate-hiking cycle that has yet to begin. Treasury yields will likely stay low through the summer as we wait to see how all manner of geopolitical tensions play themselves out over the next few months.

Positives

Increasing geopolitical tensions

Moderate U.S. growth and slowing world growth means low inflation

U.S. is a relative value compared to the rest of the developed world

Negatives

Inflation nearing Fed's 2% target

Ending of open market security purchases by the Fed

On an absolute level and relative to inflation, rates still historically low

Unknowns

Corporate desire to increase capital expenditures

Resolution of Israel/Gaza and Russia/Ukraine conflicts

Demand for bonds due to institutional rebalancing