

ECONOMIC OUTLOOK

Summary

The uneven nature of this business cycle continues to both confound and comfort market participants, business executives and consumers. The perennial 3%-growth crowd was sorely disappointed when first-quarter GDP clicked in at a whopping 0.1%. Not to be deterred, they confidently predict a 3%-plus second-quarter result, which is probably spot on given the weather-impaired slowdown earlier in the year. A little math might be illustrative: 0.1% plus, say, 3.5% equals 3.6%, divided by 2, equals 1.8% first-half 2014 annualized GDP growth.

Things are clearly improving in the economy, but not at the level we have become accustomed to over the past 30 to 40 years. Jobs are being created – almost 200,000 per month using a six-month average over the past 18 months. The unemployment rate is dropping – from 6.7% in March to 6.3% in April. However, 800,000 potential workers left the labor force in April, and wages increased 0.00% month over month. This is all part of a consistent pattern of steady but subpar growth and personal incomes that are growing at a snail's pace.

So, if one believes in a secular decline in potential U.S. growth, and without a huge cyclical deficit, what we are seeing is pretty normal. Throw in escalating geopolitical tension in Eastern Europe and Asia, and it doesn't take much to slow the economic train. Therefore, the Fed should remain ultra-easy on monetary policy and be on tenterhooks after completing the tapering

program and thinking about raising interest rates. All we have to do is glance at the residential housing market for a little perspective. Mortgage originations are at their lowest level in 14 years, and new and existing home sales are below prior-year levels. How then would the economy handle another 1.0% increase in long-term rates?

Positives

Leading economic indicators up 12 consecutive months

Jobless claims for unemployment insurance steady in the low 325,000s

Private sector monthly job growth around 200,000

Negatives

Labor force participation rate close to a 35-year low

Business fixed investment anemic five years into recovery

Real personal income up less than 1.0% year-over-year

EQUITY OUTLOOK

Summary

April brought an end to the winter hibernation and a thaw in consumer demand as auto sales, retail spending and job creation ticked up in the month. It also ushered in a defensive rotation as traders unloaded winners from the past few months – mostly high-flying social media and new-issue stocks. Still, the S&P 500 eked out a positive return of 0.7%.

The best-performing sectors in the S&P 500 included energy, up 5.1%, and utilities, up 4.2%. Financials, off 1.6%, and discretionary, down 1.4%, were the worst performing.

We learned just how much impact the winter weather had on our economy, as first-quarter GDP growth was estimated at just 0.1%! As mentioned, more recent data point to pent-up demand surging through the economy from cars and trucks, bank lending, jobs and consumer spending.

One sector still lags the rebound, and suspiciously so. Sales of, and advanced permits for, new single-family homes failed to respond to the better weather. We wonder if more structural demographic changes are at work here. Labor force participation has been plummeting, partly as a result of retiring baby boomers; home ownership in general has been on the decline since the recession; and debt-laden millennials are opting for mobility and apartment life.

We expect a much stronger print for second-quarter GDP. Yet, in combination with the first quarter, we would be hard-pressed

to average much more than 2% GDP this year, which is well below Federal Reserve targets.

So, although stock prices are not as attractive now as they were a year ago, we believe modest earnings growth, little to no inflationary pressures and a monetary policy on hold mean the background remains positive for stock investors.

Positives

Sectors of the economy are accelerating

Europe scraping along the bottom

Negatives

Wage gains almost nonexistent

Demographic headwinds

Unknowns

Russian adventurism

FIXED INCOME OUTLOOK

Summary

Since the beginning of the year, the 2-year to 30-year curve has flattened by 54 basis points (bp) (30-year yield is down 51 bp, and the 2-year is up 3 bp). With a moderately expanding economy and the Fed likely to increase the overnight lending rate in about a year or so, it is easy to see why short rates have ticked up a bit. Though most investors find it difficult to understand why longer-term rates have actually declined, especially given that the Fed is winding down its asset-purchase program.

We believe a few factors are driving long rates lower. First, we are five years into this economic recovery and momentum does not appear to be accelerating as the perennially-optimistic investing community had hoped. Second, there is concern about the economic advancement of many of the world's emerging markets, particularly China. Slower global growth should lead to less inflationary pressures. Third, Russia's intention for Ukraine and possibly other neighbors is unclear in the wake of its annexation of Crimea. In times of geopolitical conflict, investors flee riskier markets for the safety of high-quality bonds. Finally, possibly the best explanation for the decline in longer yields is a comparison of the U.S. rates with those of other developed countries. Less than three years after requiring a bailout, Ireland has 10-year bonds that yield a mere 15 bp more than our bonds. France, Sweden and the Netherlands have yields less than 2%, and Germany has a 10-year rate of about 1.5%. Switzerland has a yield of 0.83%, and Japan's is 0.60%. The yield of our longer-term bonds is being pulled down by the fungible flow of global investing funds.

Compared with those rates, our 10-year yield is a bargain at 2.60%. We would be surprised if the 10-year rate increases much beyond where it began the year.

Positives

Inflation remains moderate; slack in labor force still prevalent; rebalancing of portfolios and demographic trends favor bond allocations

Scarcity of long-duration assets

Global uncertainties create flight to safety: Russia/Ukraine, Iran, Syria, North Korea

Negatives

Yields still historically low on an absolute and relative basis to inflation

Corporate spreads have narrowed and are less attractive than they were within the past five years

Unknowns

Timing and magnitude of the inevitable increases in the Fed overnight lending rate

Russia's desire to annex additional territories;
U.S./NATO response
