

**June 2013** 

## **Summary**

The economy continues to show positive signs, as well as signs that growth is struggling. The first revision of annualized GDP growth for the first quarter was 2.4%, down slightly from the originally reported 2.5%. Further weakness in government spending offset the additional positives in consumer and consumer-related areas. The consumer continues to generate positives in the second quarter. The Conference Board's Consumer Confidence Index gained more than 14 points in April and May, reaching its highest level since February 2008. The rebound in the housing market has contributed greatly to these higher confidence levels and has had positive ripple effects throughout the overall economy. A positive stock market also has contributed to consumers' better outlook. Although the consumer has been more optimistic, the manufacturing side of the economy has continued to slow. The ISM manufacturing index fell again in May, this time dropping slightly below 50. It is now at its lowest reading since June 2009. Part of the weakness in manufacturing relates to continued weakness overseas. A positive factor, though, is that manufacturing represents only 12% of the overall economy. In contrast, the ISM non-manufacturing index rose slightly in May and has remained above 50. While the Fed has made statements related to at some point possibly reducing the amount of bonds being purchased, it does not appear likely it will make changes in the near term. The overall economy has pockets of strength, but also areas of weakness. A recent increase in Treasury yields could have a negative impact on the housing market in the form of higher mortgage rates, but they are still very low by historical standards. The labor market has continued to grow, but, while steady, it has continued to be slow growth by historical standards for this far into a recovery.

Our forecast has not changed. We continue to expect the economy to remain in a growth mode throughout the remainder of the year. Growth is not expected to be strong, which should keep inflation at bay, but it is more sustainable and can last for a longer period.

#### **POSITIVES**

- ☐ Housing market has continued to improve, and prices have firmed and moved upward
- Consumer confidence has risen due to housing and a greater wealth effect
- ☐ ISM non-manufacturing index remains above 50, indicating growth in the biggest part of the economy

### **NEGATIVES**

- ☐ ISM manufacturing index fell below 50, indicating contraction in that sector
- ☐ Industrial production declined in April, in part due to factors out of Washington
- ☐ Continued weakness of overseas economies

#### **UNKNOWNS**

☐ Timing of and ultimate change in Federal Reserve's monetary policy



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# **Summary**

"Sell in May and go away" didn't apply this year! U.S. equity markets powered higher most of the month, although a mini meltdown on the last trading day erased a lot of the earlier gains. Still, the S&P 500 managed to hold on to a 2.1% increase in May.

The defensive, dividend-paying sectors were clobbered as rising interest rates in the fixed-income market took their toll. Utility, telecom and staples sectors plunged 9.6%, 7.4% and 2.4%, respectively. Cyclical sectors outperformed, with financials up 5.9% and industrials up 4.6%. (All returns are price only.)

We believe this wide distribution of sector returns is an important signpost. Most telling for stocks last month was the market's reaction to even a hint by Federal Reserve committee members that the current pace of asset purchases (QE) may begin to taper in the future. It impresses upon us the importance of the liquidity component in assessing market direction and valuations.

The economy continues its modest upward trajectory, with the strongest areas being connected to the purchase and renovation of houses, which benefit inordinately from low interest rates, energy exploration and distribution, and the manufacture of autos and trucks.

There is no question that in the short term investor sentiment appears overly bullish – frothy, in fact. Money previously parked in money market funds is finding its way into stocks, playing a game of catch-up. So, although valuations do not currently concern us in regard to long-term investors, we prefer a timeout that would give pause to the unbridled enthusiasm for stocks that seems to be developing. Periodic retracements are necessary, and, in fact, healthy occurrences.

### **POSITIVES**

- Global central bank liquidity
- Dampening of euro fears

### **NEGATIVES**

- Outsized investor enthusiasm
- ☐ Changing focus to the end of liquidity

### **UNKNOWNS**

☐ Japan's unintended global currency impact



**June 2013** 

## **Summary**

Interest rates rose sharply in May as the monthly payroll report indicated that almost 100,000 more jobs than expected were created, including revisions to previous months. Logic follows that an improving economy, identified by increasing employment, needs less monetary accommodation. There has been an increasing amount of discussion about when and how the Federal Reserve may begin to taper the amount of open market security purchases from the current \$85 billion per month. With a reduction or removal of the support for bonds, many investors and forecasters fear that rates will move sharply higher as they settle into a less manipulated, natural clearing level. The 10-year Treasury yield increased 46 basis points in April after declining more than 25 basis points in March. All major market benchmarks experienced negative returns, with the broader benchmarks down almost 2%. Credit-related bonds performed slightly worse as spreads increased moderately. Inflation-adjusted Treasury bonds declined more than 4% as yields rose even as inflation expectations remained stable.

Our belief that bond market volatility would remain muted was seriously challenged, as the one-month range exceeded our expectation for a yearly range. We expect the Fed to continue the same rate of purchases, at least into the final quarter of the year. When the tapering does begin, we expect a gradual removal of accommodation, with purchases reduced steadily over 6 to 12 months. The markets should not be too surprised when the process is conceived and revealed to the public. Rates may trend modestly higher, but slow global growth and minimal inflationary pressures should limit increases over the year. With short rates remaining anchored for another two years or more, the curve will steepen, which becomes a significant tailwind for all bond investors.

### **POSITIVES**

- ☐ Inflation is well below the Fed's target range
- Overall economic growth remains moderate domestically, but still weak in Europe
- U.S. rates are competitive with those of other developed market rates (i.e. Germany, Japan, Swiss)

### **NEGATIVES**

- Current yields are about equal to expected inflation, as indicated by TIPS market
- Bonds yields reflect massive purchases by central banks

#### **UNKNOWNS**

- International tensions: Iran and North Korea
- ☐ Timing of reduction/removal of Fed's open market security purchase program