Equity & Fixed Income Outlook December 2014

Federal Reserve Monetary Policy

At the next Federal Reserve meeting on December 17, we expect the Fed to leave rates unchanged between zero and 0.25%. The Fed ended its quantitative easing (QE) program on October 31. Talk is developing around delaying raising Fed fund rates until late 2015.

Inflation

The year-over-year consumer price index (CPI) released in November remained at 1.7%, where it had been in October. The next release is December 17. We expect to see some downward movement toward 1.6%, especially with the decline in gas prices.

Economic Activity

Turn on almost any business news channel, and there will be reports of strong economic data. True, the economic data looks good. The missing link is backup for how the data got that way. Real median household income over the last six years has declined 8% from $56,436 to $51,939, according to data from the Census Bureau. This does not seem like information that drives strong economic reports.

Consumers get a special year-end bonus in the form of declining oil prices. Gasoline prices are below $3 per gallon in most of the U.S. As you might expect, there are some drawbacks to lower oil prices. For one, some estimates suggest the growing U.S. oil market provided 30% of the new jobs since the recession ended. Such job growth will slow noticeably if oil prices remain low. Plus, there is the gnawing question about why oil prices are declining in the first place. Is it the strength of the dollar? Is it increased supply? Supply volumes should not have surprised anyone in the oil business, since they have been watching supplies increase for the last few years. Is it reduced demand? That is our concern. A growing world economy uses more energy, not less. Are declining oil prices an indication of slowing economic growth worldwide?

Earnings are widely viewed as the primary justification for what a stock is worth. Many of us question how top-line earnings growth can continue to wane while the equity markets march higher. According to Goldman Sachs, U.S. companies will buy $450 billion of their own stock this year. That is 50% more than mutual funds and exchange-traded funds will buy and is projected to cancel out households' ongoing liquidation of their direct equity holdings, estimated to be $430 billion. To give some perspective, S&P 500 companies bought back $155 billion of their own stock during the third quarter of 2014. Over the past four quarters, they have spent $560 billion. These stock repurchases help explain why the stock market keeps rising. With debt still cheap, the urge for corporations to use cash to buy stock, reduce the float of shares, and increase earnings per share remains strong.

Fixed Income

The U.S. has one of the highest government bond yields among developed countries, and foreign buying has replaced the Fed's QE purchase program. Plus, with the dollar rising against most major foreign currencies, foreign buyers of U.S. Treasury bonds get three distinct benefits. First, U.S. Treasury bonds have higher interest rates than rates available in a buyer's home country government bond market. Second, as the dollar appreciates, foreign buyers get a currency return when interest payments made in U.S. dollars are converted back into their home country currency. Third, buyers get liquidity.

Stock Market

Third-quarter earnings season is essentially over. Once again, the pattern of growth in bottom-line profits is masking weakness in top-line revenue growth, while equity markets marched higher. Earnings growth has been aided by a number of factors that have little to do with actual growth: tight cost controls kept margins near or at record highs, and buybacks have cut down on shares outstanding, which is the denominator in the earnings per share (EPS) equation.

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