Equity & Fixed Income Outlook March 2014

Federal Reserve Monetary Policy

- At the next Federal Reserve meeting on March 19, we expect the Fed to leave rates unchanged between zero and 0.25%. Tapering of QE suggests the fund rate may begin to shift higher in 2015.

Inflation

- The year-over-year consumer price index (CPI) released in February shows inflation at 1.6%. Look for the level to be 1.3% to 1.5% on the March 18 release date. Many people we visit with feel inflation is much higher than reported levels.

Economic Activity

- The debt ceiling was suspended last October in a compromise to re-open the federal government. We suspect that it will remain suspended for quite some time (forever?).
- Federal debt is $17.3 trillion and Gross Domestic Product (GDP) is $17.1 trillion. Debt is now 101% of GDP. The only other time debt exceeded GDP was during WWII. For those interested in seeing the history it can be viewed here: http://www.usgovernmentdebt.us/debt_deficit_history
- The news media seems convinced the economy is picking up steam. Their proof is a decline in unemployment, the Fed's tapering of its QE program and stable housing prices. Maybe they are right; however, we see data that suggests the decline in unemployment is largely due to people leaving the work force. The Fed's tapering may be due to other reasons since its originally stated goals do not appear to have been met and, to the extent it is an economic indicator, housing has been flat for two months.
- Not to mention, income per capita is making little progress - there are still one million fewer people working today than six years ago. Regulations continue to hurt future growth prospects, and a recent Congressional Budget Office report suggests the Affordable Care Act alone will reduce the number of jobs between now and 2017 by 2 million vs. what it would have been.
- We see economic growth more in line with what it had been, which is around 2%. Not bad, and there is room for improvement.
- Minimum wage legislation is noble in concept but violates economic reality. The White House cites seven Nobel Prize winners and 600 other economists saying increases in minimum wages have little or no negative effect on the economy. If that is the case then we wonder why the proposed level is limited to $10.10 per hour. Why not make it $100 or $200 per hour?
- The economic reality of wages is marginal employee output needs to exceed the salary for the job, otherwise the job will go away, be reconfigured or mechanized.

Fixed Income

- U.S. Treasury bond yields as far out as six years are below the most recent reported inflation rate. This means investors purchasing these bonds do not have a positive real return and are moving backwards; that is even before paying the income tax bill.
- After the Fed announced two tapering events, yields on Treasury bonds remain quite stable surprising many market participants who once thought interest rates would rise after the Fed began withdrawing its monthly bond purchase program. This suggests natural buyers replaced the Fed in the bond market -natural buyers don't buy bonds unless they look like a good value. If negative real returns are a good value, there appears to be a number of investors that remain concerned about future economic growth prospects.

Stock Market

- Since the beginning of the year, stocks retreated 5% and subsequently recovered. Today they oscillate on either side of the record levels. It appears the market is having a hard time getting past 1,850 on the S&P 500. There does not appear to be much fuel between now and the start of first quarter earnings releases for 2014 that would push stocks noticeably higher.

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