Equity & Fixed Income Outlook March 2015

Federal Reserve Monetary Policy

At the next Federal Reserve meeting on March 18, we expect the Fed to leave rates unchanged between zero and 0.25%. Many question when the Fed might begin to raise rates. Several anticipate rates will begin to rise this June, but we believe rates will not increase until later in the year.

Inflation

The year-over-year consumer price index (CPI) released in February dropped to -0.1%, a rate much lower than the 0.6% we expected. The core inflation rate, which excludes food and energy costs, was 1.6%. The Fed tends to place more weight on the core rate, because food and energy costs move around a great deal, and they believe such movements can distort the Fed's longer-term planning.

Economic Activity

New job creation has been above 200,000 for the last 11 months. Wages remain mostly stagnant, but they could see some upward movement if the pace of job growth picks up.

The energy sector has been a major driver of new employment over the last few years. The uncertainty in oil prices could decrease hiring in this sector and become a threat to the job growth numbers mentioned above.

Quantitative easing (QE) has been the primary tool of choice aimed at stimulating the economy and pushing inflation higher. Its effectiveness on the economy is questionable at best while inflation is falling, which is the opposite result of QE's intended effect. Instead, the biggest area of influence has been asset price inflation pushing stock and bond prices higher. Japan experienced the same result when it implemented its own QE program. The desired results did not materialize. Now Europe is implementing the same program. Was it Einstein who described insanity as doing the same thing over and over again and expecting different results?

Fixed Income

Bonds have entered some sort of wonderland. There are very few investment professionals who ever expected to see negative government yields. Several European countries are offering bond buyers a guaranteed loss if bonds are held to maturity. Who would buy these bonds? We don't know the answer to that question, but so far nearly $2 trillion in European bonds are outstanding with negative yields. That figure represents one quarter of the entire European government bond market.

As if negative government bond yields weren't perplexing enough, bonds issued by the European chocolate maker Nestlé (maturing in 2016) traded at a yield of negative 0.2%! Put negative interest rates into a cost of capital calculations and see what happens.

The ultimate bond question is, how does an investor get paid for the risk of default when interest rates are so low and even negative?

Stock Market

Analysts' estimates and company guidance for revenues and earnings are drifting lower. For the first quarter in 2015, earnings are expected to decline 4.6% from the previous year, and second-quarter earnings are expected to decline 1.5%. Yes, a good portion of these declines comes from the energy sector.

Revenue and earnings pressure normally would push stock prices lower, but market relationships that existed in the past have mostly disappeared in the wake of generous monetary programs implemented by the world's central banks.

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