Equity & Fixed Income Outlook May 2014

Federal Reserve Monetary Policy

- At the next Federal Reserve meeting on June 18, we expect the Fed to leave rates unchanged between zero and 0.25%. It still looks like 2015 will be when the fund rate begins to shift higher.

Inflation

- The year-over-year consumer price index (CPI) released in April shows inflation at 1.5%. This is a noticeable step up from the previous month, when the CPI was 1.1%. We expect another step this month and are looking for 1.7% to 1.8% annualized inflation as reported by the Bureau of Labor Statistics.

Economic Activity

- Total employment in the U.S. is back to 145 million people. That is where it was at the end of 2007. There is still more work to be done in this area. The percentage of working-age population with a job is as low as it has been in the last 30 years, with only 63% of this group working.
- First-quarter gross domestic product (GDP) growth disappointed many forecasters who were looking for a good start to the year. Growth was only 0.2%, which is less than 1% annualized. Much of the blame is being placed on cold temperatures delaying housing starts and other outdoor projects. There has been no mention of big additions to GDP from the utility sector, which collectively could have been worth more than the building projects, during this time period. In short, there were offsetting conditions and simply little growth in the first quarter of this year.
- Even though jobs have been increasing, income per person in the U.S. remains flat. Combining this condition with higher taxes, regulatory costs, and rising core living costs leaves consumers little or no room for additional discretionary spending to provide the hoped-for growth in GDP.
- After being out of the headlines for quite some time, housing is in the news again. The theme now centers around whether values have increased too fast. Additional concerns impacting the housing sector include increased underwriting regulations and interest rates about 1% higher than they were at this time last year; Although there is a bit of slowing, we don't see this as a reason to take an adverse outlook on housing.

Fixed Income

- There appears to be no shortage of demand for fixed income securities. Treasury bonds, agency bonds and corporate bonds are all in strong demand. Treasury bond yields have moved lower, and spreads are tighter, even in the face of the Fed reducing its open market bond purchases.
- One could argue that geopolitical pressures from Russia are pushing investors toward more quality or that the disappointing first-quarter GDP leaves questions about growth prospects. Whatever the case, economists continue to expect interest rates to rise, but the rates have remained stubbornly low.

Stock Market

- Low interest rates continue to keep borrowing costs low for companies. Rather than borrow for expansion, cash is used to repurchase shares, which has the effect of increasing earnings per share even when corporate earnings are flat.
- Buying back shares tends to be a last resort for corporate executives normally looking to grow their companies. If the return on investment were expected to be high, we would see corporations making investments in plans for future growth by investing in property, plants, equipment, technology or other means of providing foundations for genuine growth.
- The other avenue corporations pursue to boost sluggish profits is takeovers. Historically, this has been a signal for the final stages of a bull market. Financial engineering has become the surrogate for genuine business expansion.

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