Equity & Fixed Income Outlook September 2014

Federal Reserve Monetary Policy

At the next Federal Reserve meeting on September 17, we expect the Fed to leave rates unchanged between zero and 0.25%. The Fed's quantitative easing program is winding down. It still looks like 2015 will be when the Fed fund rate begins to shift higher.

Inflation

The year-over-year consumer price index (CPI) released in August was 2.0%. This was a slight decline from the July release which was 2.1%. Declining gas prices will help keep this in the 2% range when the data is reported on September 17.

Economic Activity

Europe is desperate to increase economic growth. With GDP growing at only 1%, they are worried about slipping into a decline. The European Central Bank (ECB) cut its deposit rate for member banks from negative 0.10% to negative 0.20% (yes these are negative deposit rates). The ECB also announced they will start buying asset-backed bonds in the open market. This has the look and feel of quantitative easing used heavily in the U.S. and Japan. We expect the same result in Europe – good for investors but very little help to the economy as a whole.

The most recent census report shows 317 million people living in the U.S. at the end of 2013. Of this population, 145 million were working, and 172 million were not working. In 2008, there were 143 million people working and 161 million not working. Workers increased 1.4%; non-workers increased 6.8%. U.S. non-discretionary spending increased a whopping 31% over the same time period. We recognize non-workers include school age children so spreading non-discretionary spending out over this group is broad, but it shows non-discretionary spending growing significantly faster than taxpayers' ability to pay for it.

In 2000, personal taxes were 160% of non-discretionary spending. In 2013, personal income taxes were less than 98% of non-discretionary spending. The interesting part is that 98% coverage is an improvement from coverage ratios between 80% and 88% over the previous four years. There is still a significant way to go to pay for discretionary programs like education, defense and infrastructure.

Fixed Income

Last month we mentioned that U.S. yields are some of the highest of the developed countries. With that in mind, the demand for U.S. Treasury bonds should remain strong suggesting our interest rates will remain low.

Low U.S. Treasury rates do not keep up with inflation. The seven-year treasury has a yield slightly above the inflation rate, but that is a big bet for no return after inflation.

Stock Market

Recent news reported the U.S. economy only created 142,000 jobs last month. That is well below expectations. Did the stock market sell off due to the suggested weakness? No, it rose higher on the belief that the Fed will extend its easy monetary policy longer than expected. Is this the "rational thinking" that is the foundation of properly functioning markets?

When the media says the stock market is doing great, it is important to define what they mean by "the market." The S&P 500 is up 10% year to date, the Dow is up 5%, the NASDAQ 100 is up 15% and small cap stocks are up 1.7%. That is quite a disparity for "the market."

Where to from here? Market participants seem to be choosing the prospect of easy money over economic fundamentals as the basis of decision-making. This suggests more of a push higher. We believe that good core fundamental thinking should play a larger role, so it is hard for us to see markets move much higher without better economic data.

Greg Sweeney, CFA,
Chief Investment Officer

Tenure: 9/92

Years of Investment Experience: 29 years

Education: Greg holds a bachelor's degree in business from the University of North Dakota and is a CFA charter holder.