Equity & Fixed Income Outlook September 2015

Federal Reserve Monetary Policy

Only 38% of respondents to a recent survey believe the Fed will raise rates in September. This is a decline from 50% just a month ago. The Fed's mandate is to maximize employment while keeping inflation in check. Investor expectations for September's rate change decreased due to recent stock market pressure. This has nothing to do with the Fed's responsibilities, but it seems to be the market's perception based on past quantitative easing announcements. The Fed may have created a problem for itself with markets thinking the Fed will come to the rescue of declining stock prices.

Inflation

The year-over-year consumer price index (CPI) released in August was 0.2%. The CPI, excluding food and energy costs, remained at 1.8%. The Fed is concerned that inflation may be at the edge of increasing beyond its 2% target rate. We expect to see a slight increase toward 2% in the coming month and then a bigger push higher going into the beginning of 2016. We will fine tune this estimate in the coming months.

Economic Activity

Markets experienced a rough 31 days in August. Stocks were down, and volatility was up. Regular readers of this monthly outlook were probably not surprised by this action. In the past couple of months we mentioned low labor force participation rates, stagnant wages, U.S. and worldwide growth below expectations, corporate revenue and earnings challenges, elevated P/E ratios and tired stock markets. Mix these items with the Federal Reserve's prospect of raising rates, and something had to give. But that's all history now. What do things look like moving forward?

Before the market declined in August, energy stocks had been under pressure, especially smaller less-capitalized companies. This sector alone was a drag on markets all year. Throughout August, energy stocks traded fairly consistently, with the broader market suggesting the excess volatility of this sector may be behind us.

P/E ratios are more in line with historical averages, but still a bit high. Economic growth both in the U.S. and worldwide will likely fall short of original estimates, and corporate cost-saving efficiencies that helped produce attractive earnings up to this point have mostly been implemented.

Without the driver provided by strong underlying economic and market fundamentals, the focus of the market will likely be on the action of the Fed. If the Fed raises interest rates in September, expect more pressure on stocks. If the Fed postpones a rate increase, the market has typically responded favorably. We expect the initial market reaction to be consistent with this, but we could see some selling pressure after that as markets realize the reason for postponing the rate increase is because economic growth remains below expectations.

The federal government is out of money … again. The debt ceiling suspension expired on March 15 this year, and the government has been pressing up against it ever since. This will likely present a problem before the end of the year.

Fixed Income

Normally, stock market pressure results in a "flight to quality," where proceeds from selling stocks goes into Treasury bonds. It is surprising the sell-off in the stock market has not translated to a sustained decline in interest rates for U.S. Treasury bonds. We are not sure how to read this situation. Perhaps the bond market is hedging its bets on the prospect of rising short-term rates as well.

One of the topics that has not had much discussion in bond circles is the prospect of a flattening yield curve. A flattening yield curve occurs when short-term rates rise while long-term interest rates remain the same (or go lower). With tepid economic growth, this is a possibility.

Low interest rates make it hard to earn much money in bonds. Remember, the range of bond volatility is much more defined than stock volatility. Translation … the right maturity structure in bonds is safer than stocks when markets are experiencing downward pressure.

Stock Market

After having a hard time sustaining advances, stocks decided to enter a repricing phase. The market is off 10% from its highs – making this a correction. Will the market continue to correct another 10%, or will it regain upward movement? The last few years have conditioned the market to look to the Fed to bail it out. This time is probably no different. If the Fed raises interest rates later this month, the market could linger around this level. If the Fed postpones the interest rate increase, the market will probably push higher until the topic comes up again later in the year.

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