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OUTLOOKS

March 2015

ECONOMIC OUTLOOK

Summary

Currency wars are a zero sum game: one party wins at the expense of another. However, the free movement of foreign exchange rates serves a useful economic purpose when done for the right reasons. Many investors in America are well versed in current stock-index-related trading levels and have a pretty good grip on available yields from Treasury obligations. Dollar/yen, euro/yen or dollar/ruble trading levels are slightly more esoteric. Here in the U.S., we use the world's reserve currency, and that circumstance lessens the need for a more vigorous understanding.

However, stock and bond prices have been more unstable recently, and one reason is elevated currency volatility. Over the past two years, the value of the Japanese yen has fallen 50% versus the U.S. dollar, while the euro dropped more than 20% versus the U.S. dollar during the past eight months. This is significant movement and the result of deliberate monetary policy measures imposed by the central bank in each region. A domestic manufacturer competing with a Japan- or euro-based manufacturer has seen their relative price competitiveness deteriorate 50% and 20%, respectively, all else being equal.

Sales volumes, profitability levels, workforce size and capital spending initiatives are all affected by relative currency valuation adjustments. Since the United States is coming up on the wrong side of this equation, these developments bear watching. To be fair, consumers tend to benefit from lower commodity and manufactured goods prices, but employers attempting to maintain profitability targets must reduce their cost structure. So, depending upon one's circumstance in life, these changes can range from good to bad and small to large in nature. We cannot alter the $1 trillion daily trading within the foreign exchange market, so we should monitor these less familiar market drivers.

Positives

- Import price index declines 8% year over year
- Case-Shiller U.S. Home Price Index up 4.62% year over year
- ADP National Monthly Employment Report exceeds 200,000 for 12 consecutive months

Negatives

- 4th-quarter GDP revised down to 2.2%, full-year 2014 growth at about the same annualized level
- Capital expenditures and factory orders in the United States have weakened during the past few months
- Potential Greek exit from the eurozone increases contagion fears

Expanding Possibilities

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OUTLOOKS

March 2015

EQUITY OUTLOOK

Summary

After an inauspicious beginning to the new year, equity markets roared back to life as the S&P 500 surged 5.8% in February. The NASDAQ Composite, heavily populated with technology and health care companies, fared even better, jumping 7.3%.

U.S. markets were driven by gains in the discretionary and tech sectors, up 8.5% and 7.9%, respectively. Laggards included utilities (down 7%) and energy (up 3.5%). (Sector performance reflects price change only.)

As the NASDAQ approached the record highs of more than a decade ago, February's performance was indicative of a clear differentiation between growth and value investment strategies. According to BofA/Merrill Lynch Performance Monitor, growth leads value 4.4% so far this year.

More impressive is the resurgence in developed market equities, especially eurozone stock exchanges. The MSCI EAFE index, encompassing Europe, Japan and Australia, gained 5.8% in February and stands well ahead of U.S. market returns year-to-date.

In past Outlooks, we stated that better values were to be found in non-U.S. companies, but value alone did not make for increased investment. It seems value has been unlocked by the better economic metrics found in bank lending and purchasing indexes combined with further monetary stimulus in Europe.

A cheaper euro, vis-à-vis the dollar, will continue to afford competitive advantage to European exporters within the global market, while causing headaches for domestic exporters.

Already, earnings estimates for U.S. multinationals for 2015 have been slashed. Coupled with the massive curtailment of oil patch spending, several analysts see aggregate corporate earnings this year being only slightly better than last year.

Finally, recent strength in employment in the United States most likely will spur the Federal Reserve to abandon its zero interest rate policy, and begin normalizing the fed funds rate. We continue to believe we will see greater volatility in U.S. markets this year. Factoring in the aforementioned headwinds only reinforces our conviction.

Positives

Domestic job growth accelerating

Inflation not visible

Negatives

Currency headwinds persist

Aggregate corporate earnings trending downward

Unknowns

Iran, Russia, Israel, Ukraine, etc.

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FIXED INCOME OUTLOOK

Summary

In January, the yield curve experienced a dramatic "bull flattener" as all rates declined, with longer rates declining the most. Bonds delivered their highest monthly return in many years. Sentiment reversed in February, as rates moved sharply higher during the first two weeks of the month. It was a "bear-steepening" move as the yields on 5-, 10- and 30-year bonds increased about 35 basis points (bp) and the 2-year note increased only 17bp. The upward movement in yields eliminated almost half the return earned the prior month. Calming of tensions in the Ukraine/Russian conflict, a temporary extension of the Greek bailout and a strong domestic payroll report overwhelmed those expecting rates to decline further with the onset of a massive quantitative easing (QE) program in Europe. Corporate credit performed well as the global economic outlook brightened and spreads narrowed.

Now, in the first week of March, rates have moved even higher than they were at the beginning of the year, leaving fixed income investors with a paper loss. So was the recent move an overreaction? Or was January's downward movement unjustified? Given the troubles in Europe and the decline in rates across that continent, the Ukrainian conflict and the ISIS uprising, we can certainly justify rates as low as they were in our markets. With a strengthening currency and declining oil prices and low inflation, our rates were still attractive on a global basis. On the other hand, those who expected no increase in the fed funds rate this year are probably altering their outlook. Given the recent strong payroll report and with the unemployment rate now at 5.5%, we expect the Fed to be back on track for a June rate increase, although inflation continues to run below the Fed's target rate.

The frequency and magnitude of the rate hikes, as well as the expected terminal level, will be key in determining the future path of interest rates. We expect increases to be sporadic and data-dependent. We believe the overnight rate will likely be 0.75% at the end of the year and reach 1.5% to 2.0% at the end of 2016. Given our outlook, the entire curve could move slightly higher in a "bear-flattening" move, but the 10-year rate will not increase much beyond 2.5% in the near term unless there is significant economic progress in Europe and rates increase sharply.

Positives

- Lower energy prices and global deflationary concerns
- Start of QE in Europe; impact on yields abroad
- Slowing U.S. growth after two quarters of a 4%-plus rate
- Declining domestic inflation as wages stagnate and the strong U.S. dollar reduces import prices
- Amoung countries with what is considered high-quality, safe debt, U.S. yields are the highest

Negatives

- Expectations for the first increase in the overnight rate by the Fed is back on track for June
- The 10-year rate is about 40bp higher than the expected 10-year rate of inflation; shorter rates are lower than the expected rate of inflation

Unknowns

- Timing and succession of fed funds rate increases
- The success of European QE program
- Turmoil with Greek debt after temporary reprieve and its impact on the rest of Europe