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OUTLOOKS

July 2015

ECONOMIC OUTLOOK

Summary

The U.S. economy's poor first-quarter initial gross domestic product reading of -0.7% was revised upward to -0.2% (on its third revision) as personal consumption expenditures and private domestic investments exceeded initial readings. Estimates for second-quarter GDP rose on this news and are within the 2% to 3% range, which would be a nice bump from a first quarter dragged down by bad weather and a port strike. The Federal Reserve forecasts approximately 3.0% growth for the economy during the second half of 2015.

One important industry segment that has seen more robust readings of late is the housing sector. Existing home sales in May were close to the top end of estimates and showed a month-over-month (MoM) gain of 5.1%, compared with consensus forecasts for a 4.4% increase. The data lifted the number of sales to a 5.35 million annualized rate. This is up 9.2% year-over-year, second only to March as the most robust gain seen in nearly two years. Sales for single-family homes rose 5.6% MoM to 4.73 million units, far outstripping multi-family sales, which rose only 1.6% MoM.

Even more encouraging is data on first-time home buyers, who accounted for 32% of buyers during the month, equal to the highest share since September 2012. This segment of the buying public has been fairly lackluster since the Great Recession, but rising rents, a desire to preempt higher mortgage rates and improving employment conditions are motivating millennials to pull the trigger on that first house. Existing home sales represent about 90% of the overall housing market, and the ripple effect of additional purchases such as appliances and furniture adds a nice multiplier effect to overall economic growth. This development adds a nice tailwind to economic momentum over the near term.

Positives

- Home affordability composite index highest in two years
- U.S. auto and truck sales steady and near cycle highs
- Stock prices remain near all-time highs in United States

Negatives

- Industrial production down four out of six months and below year-end levels
- Average hourly wage gains remain stuck within the 2% to 2.5% range
- Potential Greek exit from the eurozone raises contagion fears

Expanding Possibilities

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OUTLOOKS

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EQUITY OUTLOOK

Summary

It's time to tally the scorecard for the first half of 2015. U.S. stocks, as measured by the S&P 500, managed to hold a gain in the first half of 2015, closing in the black, barely, up 1.2%. Winning sectors include health care, up 8.7%, and discretionary, up 6%. Losers include utilities, down 12.3%, and energy, off 6%. Interestingly, both are high-dividend-yielding sectors. (Sectors reflect price-only returns.)

Developed markets, as measured by the MSCI EAFE (Europe, Australia and the Far East), managed to save large first-quarter gains even in the face of "Grexit" turmoil this past month, and closed the first half up 5.5%. Emerging markets, driven by volatility in China, also gained; the MSCI EEM Index was up 2.9%.

Market volatility will continue at high levels pending a resolution to the Greek debt issue. But European troubles are not the only source of financial market turmoil. Chinese markets soared earlier this year on rampant speculation, and the unwinding of leveraged bets began in earnest last week, and most likely there is more to go. Financial markets hate uncertainty, so we expect these global events to remain front and center through the summer months.

Beyond the financial headlines though, there are plenty of signs that economic growth in the United States is sticking, admittedly at a slow pace. First, no particular sector of the economy is overheating. Also, although job growth has been solid, recent downward revisions for April and May job creation indicate a realistic view of modest job gains going forward.

Housing may be the economic engine for the second half of the year. Pundits have long cast doubt on the willingness of the millennial generation to participate in home ownership. However, the recent trend in household formation (positive for the past two reported quarters) combined with continued job growth, paints a positive backdrop for a boost in single-family housing demand. Credit should remain available to qualified buyers regardless of Federal Reserve policy for short rates.

The wildcard for the second half will be corporate profits. Corporations and analysts alike have reduced earnings estimates dramatically this year, so expectations are low. A resolution to the eurozone flare-up would go far to normalize global economic activity, resulting in continued trade and an opportunity to resume earnings growth.

Positives

U.S. economy chugs along

Early economic indicators in Europe positive

Negatives

Continued uncertainty surrounding resolution of Greek crisis

U.S. corporate earnings recession a possibility

Unknowns

Fed policy on short-term interest rates

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FIXED INCOME OUTLOOK

Summary

Continuing the trend of the previous two months, interest rates rose across the curve in the early weeks of June as economic reports generally surprised on the upside. Chief among these was the May non-farm payroll report, which showed more jobs added than anticipated. The collection of strong reports led to increasing speculation that the Fed will still increase the fed funds rate this year. By mid-month, the 2-year Treasury note had increased about a dozen basis points (bp), to reach 0.73%, and the 10-year increased 36 bp hitting an 8-month high of about 2.50%.

The move toward higher rates finally succumbed to a wave of buying pressure as investors sought the safety of U.S. Treasury notes when European leaders failed to reach a new agreement with Greece. As the likelihood of Greece leaving the eurozone increased, interest rates dropped for most of the world's higher-quality markets. Although they declined a bit from their new highs, rates still closed June higher for all maturities, especially those longer than five years to maturity. Adding to the price declines, corporate bond spreads widened in the face of growing global uncertainties and significant new issuance. In the end, most of the major bond indexes delivered negative total returns for May. This makes the third consecutive negative month for the benchmarks that contain bonds maturing beyond 10 years.

On its own, the U.S. economy appears to be strong enough to justify a few rate increases by the Fed, which would likely push longer rates slightly higher as well. But the U.S. economy and markets do not operate in a vacuum. Given the uncertainties surrounding the solvency of Greece and Puerto Rico, the nuclear agreement with Iran, and the impact of the stock market collapse in China, we believe the Fed will probably delay the first increase in the fed funds rate until after its September meeting. We believe longer-term bonds are fairly valued, but have moved toward the lower end of the likely trading range. Any sort of agreement on Greece that kicks the can out a few more years and allows it to remain in the eurozone could cause rates to move back up to recent highs or slightly higher. Contrary to the recent trend, the yield curve should flatten modestly in anticipation of the first rate increase happening.

Positives

- Greece solvency turmoil
- China's slowing economy reducing global demand
- Modest domestic economic momentum
- Declining commodity prices and inflation already below target
- Highest yield for a high-quality safe country

Negatives

- The first fed funds rate increase since 2006 still likely in late 2015 or early 2016
- Real returns well below historical levels
- Investors may soon have paper bond market losses for the year

Unknowns

- Timing and succession of fed funds rate increases
- The success of European QE program in light of Greek crisis
- Greek debt restructuring and possible exit from eurozone
- Contagion in muni market from Puerto Rico

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