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573.629.3826
816.279.5900
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OUTLOOKS

August 2015

ECONOMIC OUTLOOK

Summary

The Bureau of Economic Analysis (BEA) recently updated its seasonal adjustment factors and historical economic data as it relates to gross domestic product (GDP). The department felt it was not capturing proper seasonal inputs over the winter months, as the past two years reflected negative GDP on the first release. This resulted in first quarter 2015 GDP being revised from a 0.2% decline to a positive 0.6%. However, economic activity that is added to one quarter must be taken back from other quarters, all else being equal.

The real news from the BEA data update is substantial reductions in annual GDP from the end of 2011 to the end of 2014. The economy expanded at a 2.1% annualized rate, from an originally reported 2.4% pace. This illustrates structural headwinds to economic growth in the United States and places potential growth in and around 2% annualized. This is a marked slowdown from the near 3% level investors and economists might have pegged five years ago.

These statistics do not go unnoticed by the Fed. They will affect the Fed's view of potential growth and suggest the economy is much closer to its potential than the Fed might have thought earlier. However, since the central bank has historically been an ardent supporter of the Phillips Curve (i.e., low unemployment will correlate to higher inflation rates), it's payrolls that matter and, ultimately, the unemployment rate reigns supreme. The Fed's gigantic, multi-factor economic model always tells it that 2% inflation is right around the corner. Therefore, an unemployment rate in the low five-percent range tells the Fed to tighten policy. However, the marketplace says we don't need a federal funds rate much over 2.0% within the next three years. The Fed forecast shows a 3.5% rate for that measure in the future, and that is where the battle lines are clearly drawn.

Positives

- ISM Non-Manufacturing Index strongest in a decade
- Auto and truck sales clipping along at around 17.6 million units
- Housing affordability composite highest in almost three years

Negatives

- Factory orders are down 6.2% from June 2014
- China's economy continues to disappoint, creating headwinds for global growth
- Employment Cost Index smallest in records dating to 1982

Expanding Possibilities

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OUTLOOKS

August 2015

EQUITY OUTLOOK

Summary

Despite weekly market volatility in July, the S&P 500 managed to grind out a positive return of 2.1%, mostly due to falling interest rates, and despite China's speculative market bubble bursting.

In a nod to bond yields softening, the best-performing sectors last month included utilities, up 6%, and staples, up 5.3% (price only). The energy (-7.8%) and materials (-5%) sectors, and commodities in general, were buffeted by oversupply and weakening demand, and continued disinflationary concerns globally. Not surprisingly, emerging market stock prices suffered in line with these sectors, with the MSCI EEM falling 7.7%.

As we mentioned last month, continued growth of corporate profits in this slow-growth economy is concerning. As of this writing, nearly all major corporations have reported second-quarter results, and results were a bit better than expected. According to one source, reported revenues were just under 1% better than estimates. Earnings were significantly better, reported at just above 4% greater than estimates, implying corporations were still able to wring costs from operations.

Impediments to growth include economic weakness in China, currency and pricing headwinds from the elevated dollar, and weak oil pricing in the energy sector. Corporations downplay a robust second half, continuing to guide analyst estimates lower, a trend that has been in play all year.

For all of 2015, we expect aggregate earnings for the S&P 500 to come in marginally higher than last year, due almost exclusively to the collapse in energy sector earnings. Drilling deeper, we find very strong growth rates in estimates for the health care, technology and consumer sectors this year.

This phenomenon of very few winners goes far toward explaining the divergence in performance in 2015 between growth versus value investing, and active versus passive management investment styles. We see nothing on the horizon near term to reverse this turn of fortune.

Positives

- Little to no inflationary pressures
- Slow but steady economic progress

Negatives

- Federal Reserve exiting zero interest rate policy likely disruptive short term
- Markets fairly valued

Unknowns

- Election cycle

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OUTLOOKS

August 2015

FIXED INCOME OUTLOOK

Summary

Will they or won't they? The on again, off again nature of predicting a September increase in the fed funds rate appears to be leaning toward the "on again" camp. Economic data shows reasonable growth, and many Fed officials have stated they believe we are near the Fed's objective of full employment. A few have gone as far as to mention the disparaged notion of the Phillips Curve, which suggests the decline in slack labor resources will lead to general inflation. Apparently, there is much less concern about the sharp decline in commodity prices attributed to slowing global growth, particularly in China.

As the markets began to increasingly anticipate an increase in the fed funds rate, it is logical for short rates to increase. However, over July, the 2-year Treasury yield increased only 2 basis points (bp). Longer rates declined, with the 10-year yield dropping 17 bp and the 30-year bonds yield declining 22 bp. The Greek crisis had a lot to do with the muted reaction in the front end of the curve. Rates declined across the curve in early July as investors sought the safety of short-dated Treasury debt in the final moments before Greece blinked. When an agreement was reached, the entire rate structure moved higher. Longer rates were free to drop again as investors increasingly expect the Fed to increase the overnight rate, which should slow the economy at the margin and reduce any inflationary pressures that emerge.

We believe rates within two to three years to maturity will continue to increase moderately. If the Fed does, in fact, increase the funds rate in September, then the 2-year should be closer to 85 bp, instead of the recent range of 65-75 bp. Longer rates should trade within their recent range, with about 2.10% as the low end and 2.50% as the high. After the first increase, we could see longer rates closer to the recent highs than lows. Corporate credit has significantly underperformed as shareholder-friendly activities continue. We expect credit spreads to remain under some pressure in the near term, but still believe the outlook is favorable for the next few years.

Positives

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

Real returns well below historical levels

Unknowns

Exact timing and succession of fed funds rate increases

The success of Europe's QE program

Greece's ability to reform and complete debt restructuring

Contagion in muni market from Puerto Rico

Expanding Possibilities

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