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OUTLOOKS

November 2015

ECONOMIC OUTLOOK

Summary

Recent data from the Institute for Supply Management's (ISM's) manufacturing and nonmanufacturing indexes show that the two indexes are moving in opposite directions. This indicates that the U.S. economy's service sector is in good shape. The trade-sensitive manufacturing index is weighed down by a stronger U.S. dollar, weak exports and soft markets. The nonmanufacturing index, measuring service-related business activities (generally performed domestically), reflects strength.

This table highlights the dramatic difference between the two data series.

ISM Survey	Manufacturing	Nonmanufacturing
Index	50.1	59.1
Employment	47.6	59.2
New Orders	52.9	62.0
Inventories	46.5	52.5

To interpret these values, use 50 as the border between advancing and declining economic activity. Above 50 indicates increasing activity; below 50 reflects contracting activity.

With the service sector comprising 85% of total U.S. employment, the broader economy should still be fine. We still see little spillover of the manufacturing and energy sectors' problems into the rest of the economy. This may give the Fed sufficient confidence to at least initiate one rate increase later this year, if incoming data remain steady. To be sure, there are still disinflationary aspects to the present economic environment, but the current "emergency" rate range of 0.00% to 0.25% seems unnecessary.

Positives

Fed's favorite job openings measure hits a business-cycle high

First-time claims for unemployment insurance at 40-year lows

Building activity is solid, with housing starts hitting seven-year high

Negatives

First measure of third-quarter 2015 GDP soft at 1.5%, versus 3.9% for the second quarter of 2015

Personal income up only 2.1% year over year; should be closer to up 3.0% with 5.1% unemployment rate

Regional manufacturing surveys universally weak and close to contraction

Expanding Possibilities

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EQUITY OUTLOOK

Summary

Domestic equity markets reversed course in October, with the S&P 500 rocketing ahead 8.4%. A significant reversal in the previously worst-performing sectors this year – materials (up 13.5%) and energy (up 11.3%) – powered the market higher, while utilities (up 1.05%) and staples (up 5.6%) lagged.

The rally wasn't confined to only the U.S. market: MSCI's EAFE (developed markets) and EEM (developing markets) gained 7.8% and 7.1%, respectively.

Global markets seem calmer after the disastrous triumvirate of China/Fed/China stumbles of the past summer. Attention has turned to quarterly corporate reports of business conditions in the third quarter. Although the reports are not yet complete, early indications suggest revenue increases were difficult to come by, and, although net earnings increased slightly, many per share increases were bolstered by share repurchases.

All of this confirms weakness at the corporate level of the economy in the third quarter, substantiated by early reports for GDP growth of only 1.5%. However, markets don't spend much time looking in the rear view mirror, and the U.S. Bureau of Labor Statistics' just-released employment report shows 271,000 new jobs created in October, well above consensus estimates of 181,000. Barring a revision next month, the way appears clear for the Federal Reserve to reverse an easing cycle in the fed funds rate for the first time since 2006.

The tension between expectations for an improving economy and a new interest rate regime could result in even more volatility in equity markets. Given the extraordinarily low level from which this new regime is beginning (if, indeed, it is beginning), it will take quite a while for higher rates to have a significant impact on the economy and corporate earnings. We may have entered a period of greater volatility, comparable to what we experienced this summer.

Positives

Global markets returned to calm

Moderate corporate guidance for fourth quarter

Negatives

New rate regime is always volatile

Unknowns

China's currency policy after Fed raises rate guidelines

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OUTLOOKS

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FIXED INCOME OUTLOOK

Summary

As Halloween approached, the Fed again decided against giving the market a trick at its late October meeting of the FOMC, but also signaled that there was not much candy left in the bowl either. Its post-meeting communication indicated that it continues to monitor economic data and that investors should not take for granted that they will forgo increasing the overnight rate at its December meeting. The markets are still obsessing over the timing of the first rate increase since 2006, after having a steady, near-zero rate since 2008. There is a considerable amount of data to be released and analyzed before that December meeting, including two payroll reports and a number of inflation indicators. Given the general trend toward weaker data, we believe it unlikely the Fed will increase the overnight rate in December and will instead look to the first quarter of next year. With a bit more time to prepare, the markets might not be as spooked as they would be now in the final quarter of a less-than-stellar economic year.

Interest rates still increased modestly across the curve in October with the 5-year increasing by 16 basis points and the 2- and 10-year notes increasing by approximately 10 basis points. With the rise in rates, U.S. Treasury bonds delivered negative returns for the month. On the other hand, after increasing throughout the year, corporate credit spreads narrowed, allowing corporate bonds to deliver positive returns. Blended indexes had flat to slightly negative returns.

We still expect rates to remain near current levels with a slight upward bias as we near the end of the year (more so in short maturities). As usual, hope springs eternal that next year will finally be the year that the economy grows more rapidly. Along with this improving rate of growth will be increasing labor market utilization and rising inflationary pressures. Therefore, the Fed should be able to increase the overnight rate without causing the economy to relapse. Unfortunately, optimism about next year seems to be an annual ritual, until it fades. This year's version should prove no different.

Positives

- Slowing payroll growth and below target inflation measures
- Turmoil in the Middle East and increasing tensions with Russia in Syria
- Expansion of quantitative easing in Europe and Japan with modest results

Negatives

- Federal Reserve that feels compelled to increase the overnight rate
- Fear of increasing credit spreads when Fed increases rates
- Low historical yields relative to inflation

Unknowns

- Extent that investors shift out of fixed income into other asset classes
- Strength of the U.S. dollar versus other currencies and its impact on economy
- Reserve selling by other central banks

Expanding Possibilities