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OUTLOOKS

March 2016

ECONOMIC OUTLOOK

Summary

The rock band Genesis put out an album in 1986 titled "Invisible Touch" with a song called "Land of Confusion," a title that pretty much sums up our economy and markets today. Some of the lyrics include:

There's too many men, too many people – Making too many problems – And not much love to go round – Can't you see this is a land of confusion.

We could apply this today to monetary policy accommodation, negative interest rates, quantitative easing, currency wars, Eastern European and Middle East conflicts, South China Sea tensions, ISIS, migrant crises around the world, etc.

We all get the picture and there are both well-meaning heads of state trying to constructively deal with these problems and global agitators trying to undo the peaceful and constructive work of others.

Well, not everything's gone wrong, but we can say that the global economy and her citizens face a boatload of challenges. Developed-world economies have been firing their stimulus missiles for over six years with modest success. The fiscal/tax side of the ledger is constrained by heavy debt loads, political gridlock and a strong dose of ideological fragmentation.

Financial markets went from pricing in a near recession three weeks ago to ushering in a massive rally in risk assets on the backs of stable-to-rising commodity markets and reasonably good economic data. Time and consumer/business healing, in a non-crisis atmosphere, may be just what the doctor ordered. The labor, housing and auto/truck markets are doing fine and the U.S. dollar may have topped out for now. These are positive developments, and with more time and healing, may keep the economy on its 2%-growth trajectory despite a confusing mix of circumstances.

Positives

Strong gains in payrolls; unemployment rate steady at 4.9%

The labor force participation rate improved again this month to 62.9%

Auto/truck sales were steady last month

Negatives

ISM manufacturing survey was below 50 for the fourth month in a row

Pending home sales dropped 2.5% last month

Non-farm productivity dropped at a 2.2% annual rate last quarter

Expanding Possibilities

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OUTLOOKS

March 2016

EQUITY OUTLOOK

Summary

Markets in February struggled to digest the implications of slowing global growth, a continued slide in commodity prices and the introduction of "negative" interest rates as monetary policy. The S&P 500 slipped a bit, down 0.13%, while international markets fared much worse. The MSCI All Country World Index excluding the U.S. fell 1.14%.

It is interesting to note that four sectors recorded strong rallies last month. Of those, two, materials (up 7.3%) and industrials (up 3.5%), had been among the worst performing last year. Given their relative outperformance, in conjunction with recent strength in the energy sector, the worst of the commodity decline and dollar strength may be behind us.

While market participants worry that another recession is imminent, economic facts belie that outlook. Consider the litany of positive statistics in the U.S.: over 242,000 new jobs created last month, labor force participation increasing, new car sales topped 17-million SAAR again, existing home sales at a 5.47-million annual rate, consumer confidence is positive and inflation pressures still benign.

With selling pressure easing, we expect the most beaten-down sectors of the market will likely continue to rally into the election. These include those mentioned above, which comprise the "value" basket of stocks, i.e., low price-to-book ratios, declining dollar beneficiaries and dividend paying stocks. This is in stark contrast to what had been the market leadership over the past three years of high-growth, price-momentum stocks.

Which leads us into the election. The success of either of the current leading candidates in capturing the White House would have an impact on financial markets. Uncertainty as to the outcome will continue to leave the markets susceptible to volatile price movements.

Positives

Commodity prices appear to be stabilizing

U.S. economy points higher

Negatives

Election year jitters

Corporate earnings lackluster

Unknowns

The next U.S. president is... ?

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OUTLOOKS

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FIXED INCOME OUTLOOK

Summary

Adding to the gains in January, U.S. Treasury bonds again delivered strong returns in February as yields dropped for bond maturities longer than three years. The 2-year yield ended unchanged at 0.78% while the 10-year declined 19 basis points to end the month at 1.74%. The 30-year declined by 13 basis points ending at a 2.62% yield. While the month-over-month change was meaningful, the intra-month decline in yields was much more spectacular. On February 11, the 10-year reached 1.53% on an intra-day basis. This was the lowest yield on the 10-year since the summer of 2012 when Greece was in a freefall and the future of the European Union hung in the balance. That summer, the 10-year reached the lowest level in over 50 years at 1.38%.

Why would rates plunge to a mere 15 basis points above the worst of the European crisis? It was driven by a sharp slowing in economic activity, swooning oil and stock markets, and increasing concern that China's growth is slowing enough to cause increasing debt defaults in their massively leveraged economy. The skepticism that the Fed will actually raise the fed funds rate more than once this year has become outright denial and defiance by investors. The fed funds futures market has completely removed any further tightening action by the Fed for the remainder of the year.

Investment-grade corporate bonds modestly trailed the returns of Treasury notes as spreads continued to inch wider, about 10 basis points in aggregate. For the year, spreads are almost 45 basis points wider, led by the carnage in the energy and material sectors.

Looking forward, we continue to believe that the Treasury market is more accurately reflecting the moderate pace of future rate increases by the Fed, but yields may have moved a bit lower than they should be based on that change in expectations alone. Growth is likely to be variable across the globe with the U.S. performing relatively better than most of the other large developed economies. Deflation will still present a bigger concern to central bankers than the fear of inflation. Rates could move modestly higher, but will not likely reach the levels from the start of the year anytime soon. With an emphasis on issue selection, we still believe investing in high-quality corporate bonds should prove to be attractive for investors over the next year or two.

Positives

The Fed is beginning to rethink the path of future rate hikes

Inflationary pressures remain moderate

Estimates for global growth declining, especially in the emerging economies

Japan and Europe's central banks continue to ease accommodation

Negatives

10-year Treasury yields remain below the targeted rate of inflation

Unemployment has tipped below 5%, which may pressure the Fed to act

Oil and energy prices may have reached a near-term bottom

Unknowns

U.S. elections

Increasingly protectionist global trade rhetoric

Economic growth in China, Latin America, and other emerging markets

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