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OUTLOOKS

June 2016

ECONOMIC OUTLOOK

Summary

The May employment numbers were a doozy and upset the carefully-crafted messages from various Federal Reserve voting members regarding near-term interest-rate increases. The 38,000 payrolls added in May was the worst reading since September 2010, missing consensus estimates by 122,000. Now, estimating job growth with a civilian labor force of over 158 million people is no easy task and it is fraught with sampling errors, but the two prior monthly reports were revised lower by a total of 59,000 jobs. This lowers the five month 2016 average payroll gain to 149,000 from the 2015 average of 228,000 new jobs.

The perplexing aspect of this report was the fact that the unemployment rate declined to 4.7% from 5% on the weakest payroll growth in over five years. How does that happen? There are two different payroll series tabulated by the Bureau of Labor statistics, the establishment and household surveys. The 38,000 new jobs reported is derived from the establishment report and the unemployment rate comes from the household report. The household survey showed a positive 26,000 jobs for the month, but a loss of 316,000 jobs in April.

The takeaway is that the U.S. economy is not nearly as healthy as a 4.7% unemployment rate would suggest. The employment-to-population ratio has fallen almost 8% since 2000. Since all of the regional Fed manufacturing surveys have remained or moved into contraction territory, the Fed is in a tough spot, albeit one of their own making. We are not talking about a recession, but the Fed's projections for significant rate hikes in the next few years seem to be fantasy and are not corroborated by the data we have seen, or are likely to see in the next six months to one year.

Positives

Atlanta Fed forecasts 2.5% GDP in second quarter of 2016

Existing home sales near six year highs

New home sales zoom to an eight-year high

Negatives

All regional Fed manufacturing surveys are in contraction territory

Capital goods orders at a five-year low

Fed's labor market conditions report lowest in seven years.

Expanding Possibilities

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EQUITY OUTLOOK

Summary

U.S. equity markets rallied last month, led by the technology and health care sectors, up 5.3% and 2% respectively. The S&P 500 gained 1.8%.

Sectors that benefit from a weak dollar (e.g., the energy, material and industrial sectors) stumbled as the Federal Reserve signaled a greater likelihood of interest rate hikes near term. Year to date, energy and the higher-yielding sectors of utilities and telecomm still command double digit returns, while the broader market nurses a 3.6% gain.

More importantly, the pulse of equity markets continued to improve last month as participation broadened to include more stocks. For example, the Russell 2000 Index, which is a proxy for a broad range of small companies, gained 2.7% in May, while the index of larger companies, the Russell 1000, rose 1.9%. Over the past three months the trend has been dramatic, with returns of 11.7% versus 7.8%, respectively.

The unexpected weakness of the May job creation report, released in early June, stunned the investment community, casting doubt not only on the timing of anticipated interest rate hikes, but also the trajectory of the U.S. dollar vis-à-vis our trading partners.

As noted in the past, corporate earnings have disappointed thus far in 2016, due in large part to a strong dollar that made U.S. goods less competitive in the world's markets. The immediate impact of a delay in raising interest rates would be a weaker dollar, and eventually an increase in the competitive position of U.S. exporters, and therefore profits.

Who will benefit from this turn of events? Most likely those sectors most susceptible to (and in need of) a cyclical rebound in demand, e.g., industrials, materials and energy. However, unknown is the impact on domestic consumption should hiring continue to weaken. The consensus view had been that a growing work force would increase demand and, subsequently, corporate earnings in the second half of the year.

Not surprisingly, as the odds of any significant increase in interest rates fade, the time horizon for the relative attraction of dividend-paying stocks is reset and extended.

Positives

U.S. economy still growing, albeit very slowly

Monetary policy will continue to be accommodative of growth

Negatives

Equity valuations appear stretched given slow growth outlook

Consumer and business confidence marred by Presidential race

Unknown

Will a slowing jobs market weigh on consumption at home?

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OUTLOOKS

June 2016

FIXED INCOME OUTLOOK

Summary

Interest rates declined in early May, then rose later in the month as multiple Fed officials spoke openly about their intent to increase the fed funds rate in either June or July. Overall, only the short end of the yield curve showed any significant change for the month. The 2-year Treasury note yield increased 10 basis points (bps) to end the month at 0.88%, while the 10-year note increased a mere basis point to end at 1.85%. The 30-year yield actually declined 3 bps as the yield curve continued to flatten. In aggregate, credit spreads widened a bit, causing corporate bond returns to modestly trail similar-maturity government bonds. The exception was intermediate-maturity bonds of financial companies, which outperformed comparable-maturity Treasury notes.

After obsessing about the timing of the first rate hike last December, all eyes are once again focused on whether the Fed will increase the overnight lending rate again in June or July. During recent speeches and interviews, just about all of the Fed governors and regional bank presidents thought that the timing is right for the next step in this nascent rate-hiking cycle. Unfortunately, just as the economic and market conditions appeared to give the green light for a June increase, the window of opportunity was slammed shut by the disappointing May payroll report. The Fed needs the cover of solid economic data to increase the fed funds rate and the payroll report called that into question.

Some strategists are also questioning whether this should really be considered a “rate hiking cycle” at all. Historically, cycles have consisted of multiple rate increases with some reasonable frequency, not six-month lags. Nonetheless, we still believe that a rate hike in July could be possible given some combination of a) the May jobs report turning out to be a fluke, b) the economy exhibits some relative strength, c) Great Britain votes to stay in the EU, d) oil prices remain above $45 or so, and e) there is no significant fallout from the bad commercial loans swirling around the Chinese banking system. That’s a lot of ifs, but it is slightly more likely to happen given the Fed’s desire to do so. Short rates should eventually move higher, but longer rates will likely remain well anchored.

Positives

- Uncertainty created by the fracturing European Union
- Falling global growth forecasts by the IMF, World Bank and others
- The U.S. still has the highest yield of any large developed safe-haven nation

Negatives

- Inflation expectations have bottomed and are now increasing along with energy prices
- Further increases in the fed funds rate are likely this year

Unknowns

- The extent of the bad-debt crisis in China
- Terrorism and the threats to major world cities
- The effects of negative interest rates over the long term

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