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OUTLOOKS

September 2015

ECONOMIC OUTLOOK

Summary

The U.S. labor market continues to improve at its most basic level, but less so from a more comprehensive view. The U3 unemployment rate, the official number reported by the U.S. Bureau of Labor Statistics, was 5.1% in August, down from 5.3% in July. It hit a high of about 10% during the worst part of the financial crisis. The U6 unemployment rate, a measure of underemployment, is 10.3%, down from 17.1% at its worst.

An important variable of the calculations of both measures is the labor force participation rate. This statistic estimates the number of working-age adults able to work who are actually working, expressed as a percentage. Today's number is 62.6%, about a 40-year low. The measure's recent high was 66.4% in 2007. Although the nearly 4% difference doesn't seem like much, it represents about 6 million fewer employed workers. As such, the significant decline in the official unemployment rate is less about strong job creation and more about an unwelcome decline in the available labor force.

As we approach the first prospective rate hike by the Fed in almost nine years, nuances contained within the labor reports highlight the difficult challenges for monetary authorities. The U3 number points to a likely rate hike, while the U6 measure suggest an abundance of slack labor. If average hourly earnings are thrown into the mix (2.2% year over year), we hardly see an overheating labor market. The recent tightening in financial conditions around the world and a steep drop in commodity prices may stay the Fed's hands for now, but eventually, tightness in the labor market will cause a change in its zero interest rate policy.

Positives

Housing starts hit the highest level since 2008

Second-quarter GDP revised higher, from 2.3% to 3.7%

U.S. auto and truck sales hit 17.7 million units (annualized), a cycle high

Negatives

Business inventories are at their highest in six years

China's exports fell almost 9% from the prior year

Manufacturing and private payrolls surprise to the downside in August

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EQUITY OUTLOOK

Summary

Market sentiment was overwhelmed with a host of unsettling events last month, including, but not limited to, clumsy monetary policy moves from China, a resurgence of deflation concerns and possibly the first rate hike by the Federal Reserve since 2006.

The S&P 500 slid 6% in August, pushing the year-to-date results into negative territory, off 2.9%. The market didn't discriminate between value, growth or income stocks, as all sectors wound up in the red for the month. Health care, the best-performing sector over the past 12 months, led the decline, giving up 8% in value. Telecom, with big-dividend-paying stocks, slipped just 3.4%.

Economic growth has been in short supply globally, and China has been transitioning from a manufacturing-based economy to a service-oriented one. It is inevitable that growth would slow there as manufacturing creates more growth per capita than does services. Think how many jobs are created when commercial offices, highways and housing are constructed, versus growth in services such as financial, retail and entertainment.

Markets worldwide are resetting valuations based on a trajectory of reduced growth expectations for 2015. The International Monetary Fund recently trimmed its estimates for 2015 to 3.3% growth over 2014, from 3.5%.

This reset has been fraught with increased volatility, a condition referenced in many of our monthly pieces this year. Although we are still supportive of nonrecessionary, modest economic expansion in developed economies, we are concerned that estimates for corporate earnings may be too optimistic given recent events, especially for companies with a strong export base.

It appears the market has already discounted much of what may be a round of earnings forecast reductions in the coming months.

Positives

Slower growth forecasts should hold down interest rates

Energy prices are low, and consumer confidence remains high

Negatives

Uncertainty will persist until the Fed meeting mid-September

Unknowns

Just how weak is China really?

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OUTLOOKS

September 2015

FIXED INCOME OUTLOOK

Summary

Before the recent plunge in many of the world's stock markets and the collapse in oil prices, investors were about equally split between those expecting an increase in the fed funds rate at the Federal Open Market Committee's September meeting and those not. Within the past three weeks or so, the probability of a rate increase has declined to about 30% to 35%. With the unemployment rate now at 5.1% and the economy plodding along at a 2.0% to 2.5% average growth rate, an argument can easily be made that we no longer need an emergency rate near 0% and that rates should move toward a more "normalized" level, whatever that may be. Conversely, there is increasing evidence that China's growth rate is, in fact, slowing significantly, causing a collapse in many commodity prices, which, in turn, led to recessions in many commodity-dependent emerging economies. Slowing global growth and declining commodity prices mean inflation is likely to move further away from the Fed's stated objective instead of progressing toward it. With moderate domestic growth, slowing global growth, declining commodity prices, low wage growth and below-objective inflation levels, a case can equally be made to defer an increase in the overnight rate.

Will the Fed raise the overnight interest rate or not? Quite frankly, it doesn't matter unless you are managing a money market fund, funding an asset in the short-term market or are engaged in the intricacies of the reverse-repo market. A small increase in the overnight lending rate should have little impact on the average investor or the actual economy. One of the most anticipated central bank meetings in history will continue to garner attention in the financial media and is likely to cause continued volatility, but eventually the market will focus on what is really important – the timing of further rate increases and the ultimate terminal rate for this cycle. We are confident that further rate increases will be spaced out over longer periods than they have historically been and that the high point of this interest rate cycle will be much lower than in any cycle within the past 30 years.

Across the yield curve, rates are little changed from the level where they began the year (all yields are within 25 basis points). Perhaps the market had it right in the beginning, and this volatility has been nothing more than angst and opportunity created by the financial media over something somewhat irrelevant to the average investor. We don't want to trivialize the role of those of us who make a living watching worldwide political and economic events to formulate investment ideas, but it is quite possible that interest rates were fairly priced in the beginning of the year and are fairly priced again today. If that is the case, yields could remain at similar levels for some time to come, which we believe will be the case.

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

- Low unemployment could begin to cause an increase in wages
- Real returns well below historical levels

Unknowns

- Exact timing and succession of fed funds rate increases
- The success of Europe's quantitative easing (QE) program
- Degree to which China's growth is actually slowing
- Contagion in muni market from Puerto Rico