



# ECONOMIC OUTLOOK

## Summary

Economic growth slowed slightly in the first quarter as real gross domestic product rose at an annual rate of 2.2%, down from the fourth quarter's 3.0%. A big part of the weakness was another decline in government spending. Consumer spending, which accounts for around 70% of economic activity, rose 2.9% in the first quarter—the fastest pace in more than a year.

The labor market generated more than 200,000 new jobs in both January and February, but the rate of growth dropped by half in March. The sluggishness continued in April as non-farm payrolls rose by only 115,000. This trend may cause weakness in consumer spending in the coming months. The slight decline in the Conference Board's Consumer Confidence Index appears to reflect concern about the recent labor market weakness. In fact, measures of consumer spending plans for the next six months deteriorated significantly in April.

The Institute for Supply Management (ISM) indexes for both manufacturing and non-manufacturing have remained above 50 of late, but just barely. A figure over 50 indicates growth, but anything in the low 50s indicates that growth is not very strong. Any weakness in the non-manufacturing index will likely signal overall sluggishness in overall economic growth since the service sector represents a majority of the economy.

Even though economic growth has slowed, it still remains positive—we anticipate no change here. There is a good base of economic activity that includes consumer spending and continued growth in both the manufacturing and non-manufacturing sectors. However, as long as the labor market is sluggish, economic growth will likely be less than robust.

## POSITIVES

- ❑ Increase in current levels of consumer spending
- ❑ Accommodative Fed policy; continued focus on keeping interest rates low
- ❑ Increase in Index of Economic Indicators signals continued economic growth

## NEGATIVES

- ❑ Weakness in growth in non-farm payrolls
- ❑ Recent decline in ISM non-manufacturing index to lowest level of the year
- ❑ Large drop in orders for durable goods

## UNKNOWNNS

- ❑ Impact of election-year rhetoric on consumer psychology and consumer spending
- ❑ Ultimate resolution of the financial problems in Europe



# EQUITY OUTLOOK

## Summary

Weak equity markets were the norm in April as renewed thunderheads in Europe and uninspiring economic data domestically trumped generally-robust corporate earnings reports.

Defensive sectors of telecommunications and utilities recorded positive returns of 4.2% and 1.8%, respectively. The more volatile sectors of financials and technology suffered the most, dropping 2.5% and 1.9%. Generally, high-quality domestic stocks that pay dividends held up particularly well, while developed markets fared worse as measured by the 2.6% drop in the MSCI EAFE index.

Since stocks have historically retreated in May, conventional wisdom gravitates toward reducing risk and moving to the sidelines. However, background conditions, with one exception, remain conducive to higher equity prices later this year. These include better corporate earnings, an accommodative Federal Reserve, modest job creation and reasonable stock valuations.

The exception is Europe. Voters in both France and Greece, overwhelmed with austerity fatigue, rejected their current political path in favor of promises for an alternative path of growth out of their malaise. Markets will justifiably be on edge while the more fiscally prudent members of the eurozone ponder these political rumblings.

Finally, developing countries continue to steer their economies toward greater growth. Australia cut interest rates recently as inflationary pressures have subsided in the past year and populations move toward greater prosperity.

## POSITIVES

- Oil prices receding
- Inflationary pressures are benign
- Valuations still compelling

## NEGATIVES

- Massive spending cuts and tax code reversals to take effect at year end
- Election rhetoric to escalate
- Wage growth is stagnant

## UNKNOWNNS

- Resolution of European debt crisis



## Summary

The yield of the 10-year Treasury note dropped in April back into the trading range that prevailed for most of the prior six months. The mid-March spike upward now appears to have been an aberration and a buying opportunity rather than the beginning of a new long-term trend. The rally in bonds was fueled by the continuing European financial crisis—now focused squarely on Spain—and evidence of slower domestic economic activity. Given this environment, the Federal Reserve’s Open Market Committee reinforced its outlook that the federal funds rate will remain at its current level until late 2014. With significant flight into the safety of Treasury bonds leading to wider corporate credit spreads, corporate bonds underperformed by about 50 basis points on a duration-adjusted basis. After four months of tightening, financial spreads widened, but performed better than the corporate universe in aggregate.

Once seemingly on the right path to fiscal rectitude, the situation in many of the larger European economies appears to be unraveling again. Economic growth was a requirement for these plans to have a glimmer of hope in reining in budget deficits. Most of the European Union economies have either re-entered or are about to re-enter a recession. Austerity is demonized as the cause of the economic collapse and there is an eagerness for pro-growth initiatives that range from labor market reforms to deficit spending. Upcoming elections and then negotiations within the different countries will determine which disaster-aversion path is pursued. Until there is more certainty about their prospects for success, the bond market should remain within the new, which is the same as the old, trading range.

### POSITIVES

- ❑ Uncertainty in European financial markets
- ❑ Inflationary outlook is benign, measures well within target ranges
- ❑ Fed is still prepared for QE3 if economy weakens

### NEGATIVES

- ❑ Fed’s program of purchasing securities is ending
- ❑ Entire Treasury curve inside of 10 years lower than rate of inflation

### UNKNOWNNS

- ❑ Potential armed conflict between Iran and Israel
- ❑ Large scale asset allocation shifts could pressure bonds