ECONOMIC OUTLOOK

Summary

The recently released March payroll report fell short of economists’ expectations. Not only was the monthly increase in jobs well below expectations and the lowest since December 2013, but there were significant downward revisions to the previous two months. Market participants and economists will watch closely to determine whether the softness was a one-month aberration or whether it foreshadows a more substantial slowing in the labor market.

Most economists now believe GDP growth is tracking at less than a 1% rate for the first quarter, and some, including the Atlanta Fed, believe there was no growth at all. The West Coast port slowdown and unusually harsh East Coast weather certainly account for some slowing of activity, but not all. The decline in oil prices has been a two-edged sword. On one hand, declining gasoline and energy prices act like a tax cut and should increase discretionary spending for most of the population. On the other hand, nearly 30,000 jobs have been cut in the energy sector, and capital investments have almost completely stopped. This sector was recently the darling of the U.S. economy. The strength of the U.S. dollar is now viewed as one of the main culprits of the recent weakness.

The outlook has changed so much that Janet Yellen and the U.S. Fed made a sharp U-turn on their projected interest rate path and potential growth rate for the U.S. economy. The dollar’s 11% increase since January is the biggest quarterly move in 42 years. Conducting an aggressive interest rate hike initiative when most of your major trading partners are reducing rates or pursuing a negative interest rate policy is a bad idea. Fortunately, the marketplace never fully bought into the Fed’s estimates regarding the terminal funds rate (i.e., the final rate level). The outlook for GDP growth remains in the post-recession range of 2.0% to 2.5% as the previous long-term level of 3%-plus remains elusive.

Positives

- Trade balance improves
- Small-business optimism near cycle high
- Producer price index down 0.7% reduces input prices

Negatives

- Retail sales down three consecutive months
- Capital investments drop along with oil prices
- Most regional ISM manufacturing and service indexes trending lower
- Payroll growth the slowest in more than a year

Unknowns

- Bounce-back from the impact of weather in East Coast
- Drought in West Coast

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EQUITY OUTLOOK

Summary

While March saw nearly all global equity indexes lose ground, most managed to record positive returns for the quarter. Domestically, the total return of the S&P 500 is 1.0% year-to-date, paced by health care and discretionary, up 6.2% and 4.4% respectively on a price-only basis. The Nasdaq Composite retained most of February’s strong gains and wound up posting a 3.9% total return for the quarter.

The divergence between growth and value investing – very apparent for the past year – continued in the quarter. The Russell 1000 Growth Index rose 3.8% and 16.1% for the quarter and year, respectively, compared with the Russell 1000 Value Index loss of 0.72% in the quarter and a gain of 9.3% for the trailing 12 months.

Developed markets roared to life as the European Central Bank’s program of quantitative easing was detailed. The MSCI EAFE Index jumped 4.9% in dollar terms, and was higher in local currencies, as dollar strength dampened U.S. investor returns.

We entered April anticipating that corporate earnings in the first quarter will have been hurt by lousy weather and currency headwinds. More important, though, is managements’ guidance for the remainder of the year, specifically on the continued impact on profitability due to the increased competitiveness of foreign manufacturers.

The vast array of the economy’s macro-fundamentals remain, on balance, slightly positive. Auto and home sales remain relatively strong; wages are mediocre; durable goods and exports are under pressure from dollar strength; domestic spending is boosted by the oil price decline; job growth has weakened; monetary policy is on hold; and so on.

With a cautious nod to a possible earnings dip due to the impact of the currency and oil markets, the backdrop remains positive for equity investors. Markets are voting for growth stocks, which by and large seek to influence their own growth trajectories, in contrast to the proverbial tide lifting all equity prices.

Positives

- Economy not overheating
- Oil price cut benefits persist

Negatives

- Currency impact on earnings in first quarter
- Relative shift to developed market investing

Unknowns

- Geopolitical backdrop deteriorating

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The recent volatility in the bond market continued in March, with the 10-year Treasury yield increasing 25 basis points (bp) during the first five trading days, then plummeting 40 bp over the next two weeks. Sentiment swung wildly as the Fed’s liftoff from its zero interest rate policy became more uncertain. Most of the major bond market indexes returned about 0.50% for the month, with corporate bond returns slightly lagging those of comparable-maturity Treasury securities.

Traditionally, when the economy looks stronger, it is believed that the unemployment rate will drop, inflationary pressures will increase and the U.S. Fed will be more vigilant about raising the overnight lending rate. When data softens, as it has recently, the reverse happens.

Unique to the current situation is the complete divergence in monetary policy among the world’s largest economies. The U.S. and U.K. are preparing to tighten policy, while Europe and Japan are engaging in aggressive asset purchases in an effort to stimulate their own economies. This policy polarization is likely to keep the Fed on hold because of its impact on the U.S. dollar. The strong dollar is responsible for reducing demand for U.S. manufactured goods worldwide and reducing inflation through lower input prices. Throw in the sharp decline in the price of oil and its impact on the energy sector and inflation, and it becomes increasingly difficult to expect a June rate hike. In the end, it really does not matter much whether the first rate hike occurs in June, September, December, or not until next year.

For a long time, we believed that regardless of when they begin, rate hikes will be few and far between and the terminal or highest point of this rate hike cycle will be well below the average level of expectations in the public sphere. The sense that the first move will not be the initiation of a steady progression of rate hikes is what the markets needed to understand. It now appears that message is being heard. Given that a 10-year rate just below 2% is still the highest in the developed world, rates can and will likely remain lower for a long time to come.

### Positives

- Declining inflation due to a strong U.S. dollar and sharply lower oil prices
- The onset of QE in Europe, and continued QE in Japan
- Slowing growth; possibly 0% to 1% GDP growth in Q1 of 2015
- Highest yield for a high-quality, safe country

### Negatives

- Expectations for the first rate increase in 2015
- The 10-year interest rate slightly above the expected 10-year rate of inflation

### Unknowns

- Timing and succession of fed fund rate increases
- The success of Europe’s QE program
- Turmoil with Greece and possible exit from euro

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