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ASSET MANAGEMENT GROUP

U.S. ECONOMIC AND MARKET REVIEW – MAY 2014

The U.S. economy stalled to near-zero growth in the first quarter of 2014. It's possible, when the revisions are calculated, that the economy may have shrunk for the first time in three years. How concerned should investors be, and what are the implications for markets? In this rare instance, we believe the (cautiously optimistic) stock market knows better than the (overly anxious) bond market.

Right now, these two markets are pointing in opposite directions. Resilient stock prices, on top of last year's rapid rise in P/E multiples, suggest a growing confidence in the economy, which would normally be associated with rising interest rates. In contrast, the fact that the benchmark 10-year Treasury yield has been falling, from 3.0% at the beginning of the year to 2.6%, is consistent with a weakening outlook for the U.S. economy that should undercut share prices.

The traditional take is that the bond market is smarter than the stock market. Furthermore, the bond market seems to be sending a stronger message. The S&P 500 index rose 1.9% in the first four months of the year, and at one point (in early February) was down nearly 5.8%. In April, share prices dipped again and recovered, ending the month essentially flat. Meanwhile, long-term (20+ year) Treasury bonds gained over 9% in the first four months of the year, 1.8% in April alone.

Before accepting the bond market's gloomy verdict, however, we need to put a couple things in perspective. Much of the slowdown in the U.S. economy does, in fact, appear to have been related to particularly bad winter weather, and a number of key indicators have been showing steady improvement in recent months. Retail sales, which fell in January, rebounded and by March were up 3.7% compared to a year before. Car sales in March were up 7% from February, and 7% from a year earlier. Industrial production, which shrank in January, rebounded in February and March. Capacity utilization has been rising steadily, which suggests a growing need for new capital spending. And job creation, after dipping alarmingly this winter, surged by 288,000 in April, bringing the unemployment rate down to 6.3% (from 7.5% a year ago).

To be sure, there are soft spots in the data. The nascent recovery in the U.S. housing market lost momentum in the first quarter, with new housing starts down 3.6% from a year ago, and existing home sales down 6.6%. The slowdown was partly due to declining affordability – rising home prices and higher mortgage rates – but also to a decline in foreclosure liquidations and a reported shortage of skilled construction workers. Wage growth continues to be flat, but some U.S. companies say they are starting to see upward pressure on wages. Still, weak revenue growth has kept many U.S. firms focused on cost-cutting, rather than expanding their business, which may account for why real investment in structures, equipment, and intellectual property fell at a 2.1% annual rate in 1Q14, shaving a quarter of a percentage point off GDP growth. Net exports, which were a positive contributor to growth in 2013, fell early this year due partly to weather hampering logistics, but also to an export-led recovery in Europe and the short-term effects of a slowing China.

The primary reason for the fall in U.S. Treasury yields, however, has less to do with weakness in the U.S. economy than with external uncertainties. Growing economic troubles in China, along with the tense standoff between Russia and the West over Ukraine, have investors worried about problems they can't easily quantify, sending them scurrying for safe harbors. As we have said before, however, we believe that (1) while the political and military crisis in Ukraine may be important in many ways, it is unlikely to have a significant negative impact on the major economies of Europe or the U.S.; and (2) China's economic adjustment, while profoundly disruptive, will ultimately benefit the U.S. economy by unlocking new sources of net global demand.

While fear and uncertainty may continue to keep U.S. Treasury yields suppressed for the near-term future, we do not see this as a long-term sustainable trend, and we believe that U.S. equities will continue to deliver positive returns this year, and will outperform Treasuries and other "safe" harbors over the next 2-3 years.

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