

What We Are Telling Clients

By James F. Dykstal, CFA, Portfolio Manager, August, 2015

Below is a summary of our views on the economy and markets, which we are sharing with discretionary clients.

Economic Outlook

- GDP growth will be modest at approximately 2% but the economy will experience periods of sluggishness such as the first quarter 2015 which was impacted by the weather. Personal consumption will remain below longer term trends at around 2.5% annual pace.
- Job creation will be stable and the unemployment rate will remain in the 5.0 to 5.5% range. Eventually the labor market will tighten enough to provide a boost to wages.
- The dollar will maintain strength relative to other currencies. The strength is due to the removal of domestic quantitative easing and continuing QE programs in Europe and Japan. The strong dollar will ultimately impact the rate of earnings growth, particularly in domestic large cap companies which will limit the upside potential of stocks.
- The Federal Reserve will finally increase interest rates and the result will be a flatter, yet higher Treasury interest rate curve. Global capital will flow into Treasuries to garner relatively higher global interest rates.
- Economic growth in emerging markets will be higher than developed markets, even with slowing GDP growth in China. Lower energy prices will be a longer term benefit to energy importing developing economies.

Strategic Market Outlook and Tactical Allocations

Fixed Income: A trend toward higher interest rates is expected as the Fed is removing monetary stimulus. Macro-economic events will periodically spur a “flight to quality” and capital will flow into US Treasuries, pushing yields downward at times.

- High yield should outperform in a rising rate environment. Lower oil prices have impacted energy company debt and credit spreads have widened, presenting a buying opportunity. Credit is weighted more heavily than Treasuries and duration is tilted shorter than benchmarks.
- Commercial real estate is viewed as an attractive yield alternative to bonds, however, queues can delay additions to positions and an increase in interest rates could dampen valuation improvements.
- International bond yields have been pushed lower due to quantitative easing in Europe. The stronger dollar is negative for US holders of international bonds. Emerging market debt denominated in US dollars provides diversification and yield potential.
- Hedge funds with a non-directional (or absolute return focus) are viewed as an attractive uncorrelated option.

Equities: The domestic stock market appears to be fully valued as earnings growth slows due to a relatively strong dollar and its impact on domestic firms with global earnings. We expect more volatility in domestic equity markets due to the slowing earnings momentum. The European Central Bank’s quantitative easing project should bolster equity returns despite slow economic growth. Emerging market stocks are viewed favorably due to stronger economic growth and attractive valuations relative to developed nations.

- Small cap stocks are equally weighted to large cap stocks in portfolios. Small cap stocks, while more inherently volatile, are impacted less by currency fluctuations than multinational large cap stocks. Equity positions have a higher dividend component to generate income in a low interest rate environment. We are looking for corrections in the market as points to “buy in” and bolster small cap positions.
- In addition, we are looking for corrections to “buy in” to international stocks. The quantitative easing programs in Europe and Japan should provide a tailwind to stocks at just the same time the Federal Reserve is poised to raise interest rates at home. The relative attractiveness of international stocks takes into account the lackluster economic growth in Europe and Japan.
- Emerging market stocks are comparatively attractive due to their low relative P/E multiples, and are over weighted to target. Unfavorable economic news has been priced into valuations.