Market Insights

4th Quarter 2014 | Economy | Capital Markets

Economy

One constant in today's uncertain environment is the economic link between the countries of the world. Issues affecting one country tend to ripple into others, which can cause both new opportunities and unintended consequences. A few global events during the fourth quarter illustrate this new reality: the combination of reported slower growth in China; the Ebola outbreak in northern Africa (along with a few high profile cases in the United States); and the dramatic decline in the price of oil. These events led to heightened volatility in global financial markets, general uneasiness among investors and a lessened demand for risky assets early in the quarter. The Federal Reserve's exit from their monetary stimulus programs coincided with these events in October, which further exacerbated investor anxiety. However, the economy and capital markets once again proved their resiliency and posted solid economic data while the stock markets hit new all-time highs by early December.

Several of the key indicators of growth, which have led the recovery over the past few years, continued to trend higher during the quarter. The themes of modest inflation, a rebound in housing, an improving jobs picture and solid growth in the manufacturing sector remained steady. The two-quarter growth rate in the economy (4.2 percent annualized) is now running at the fastest pace since the fourth quarter of 2003. It is possible that the economy has finally shifted into a higher gear which could lead to above-average growth potential in the coming quarters.

One recent piece of economic news seems to be providing an early indication that fourth quarter economic forecasts may be too conservative. The manufacturing ISM index is closely correlated (approximately 75 percent) with overall economic growth. In each of the past two years, this index accurately forewarned of impending weakness in the economy, as the lowest quarterly reading for the year corresponded to the weakest growth number. At present, the manufacturing ISM is pointing to even faster growth relative to the last two quarters and the latest reading is on track to reach a fifteen quarter high.

The data from the homebuilding sector is a mixed bag. Sentiment among builders is running at a post-recession high, while the actual pace of construction remains significantly depressed relative to history. Even though the current rate of production is virtually double the pace of 2009, which was the worst year on record, homebuilding activity remains well below the long-term average of closer to 1.5 million units over the last 50 years. Homebuilding accounts for a relatively small share of GDP at just three percent, but a normalization of output would mean a significant growth rate, and hence, a material net impact on overall GDP growth. From a supply perspective, there is a compelling case for a pickup in construction. The inventory of new homes for sale is extremely low. In fact, the supply of newly built homes is lower now than at any point from 1969 through 2010. Furthermore, the data also show that the excessive inventory of existing homes has been significantly decreased. Given these conditions, it should come as little surprise that a three-month moving average of home builder sentiment is now at a post-recession high, as home-builders are sensing better times ahead.

Finally, the November payroll report showed a broad-based hiring surge, ranging from factories to offices and retailers, to create the largest number of jobs in almost three years—potentially leading to higher wage gains in the months ahead. The gain was the most since January 2012 and marked the tenth straight month that employment has increased by at least 200,000, the longest stretch since March 1995. While the nation's unemployment rate was unchanged, the breadth of job creation and overall impact on aggregate income is a strong indicator for GDP growth in the current quarter.

The relatively positive economic data and upbeat sentiment propelled the capital markets during the quarter. After a quick and sudden decline early in October, the S&P 500 Index came roaring back to produce a 4.93 percent return, while the S&P 400 Index produced a 6.34 percent return. In bonds, the yield on the 10-year U.S. Treasury bond fell from 2.49 at the beginning of the quarter to 2.17 at the end, producing above-average returns.

Our outlook for the next few quarters and into next year remains upbeat on the economy and somewhat cautious on the capital markets. Despite the fact that this economic recovery has lagged others in history, positive trends in housing, manufacturing and employment should continue to strengthen the foundation and provide a catalyst for growth—with a minimal chance of a recession next year. The question of whether these positives are already incorporated into current market valuations is unclear. Valuations on many U.S. equities have reached above-average levels while bond yields are at record lows. Any miscalculation or economic stumble along the way might negatively impact both stock and bond prices into 2015.

As always, investing in the capital markets comes with some risk and uncertainty. We thank you for your continued support of our investment process as we work hard to deliver positive, risk-adjusted portfolio returns to our clients. Should you have any questions, please do not hesitate to reach out to your financial adviser.

Capital Markets

During the quarter, equity volatility jumped to the highest level in about three years as investors turned cautious in light of falling commodity prices, slower growth in China and the Federal Reserve's reduction in their bond purchasing program. In fixed income, U.S. Treasury bond yields declined as investors looked for safer assets. For the quarter, higher quality bonds produced solid returns while riskier ones lagged. While volatility returned to equities, performance was still quite positive for most sectors of the markets.

Market Index Performance (%)

As of December 31, 2014

	4th QTR	YTD	1 Year	Annualized 3 Year
S&P 500	4.93	13.68	13.68	20.34
Dow Jones Industrial Average	5.20	10.04	10.04	16.25
Nasdaq Composite	5.76	14.83	14.83	23.69
Barclays Aggregate Bond	1.79	5.97	5.97	2.66
Citigroup BIG Corporate Bond	1.77	7.49	7.49	5.19
MSCI World	1.16	5.64	5.64	16.23

Disclosure Note: It is not possible to invest directly into an index. The indices listed above are unmanaged and are not affiliated with the Advance Capital Companies.

Economic Statistics

Economy from a Historical Perspective

	Latest	Average*	Definition	Comments
U.S. Unemployment Rate	5.80%	6.20%	Represents the number of unemployed persons as a percent of the labor force	Continues to decline at steady rate
Consumer Price Index	1.30%	4.30%	Represents changes in prices of all goods and services purchased for consumption	Remains low
U.S. Capacity Utilization	80.10%	80.60%	The greatest level of output that a plant can maintain within the framework of a realistic work schedule, accounting for normal downtime	Steadily improving
Gross Domestic Product+	3.90%	2.90%	Total value of all goods and services produced indicates strength or weakness of the economy	Rebounded and positive trending
10 Year Treasury Yield	2.17%	6.70%	Yield on the current 10 year treasury bond	Remains low and in trading range
Annual Housing Starts	1,028,000	1,455,000	New privately owned housing unit starts annualized rate	Continues to improve

*Average from 1966 to Present
+ Annualized
Source: Bloomberg

Disclosure Note: Portfolio holdings and percentages may fluctuate based on market conditions. Past performance is no guarantee of future performance. Investments are not FDIC insured and may lose money. Investors should be prepared to bear the risks associated with investing.