ECONOMIC OUTLOOK

Summary

There has been a lot of discussion in the business news about how strong the economy is right now and whether financial markets are way ahead of the fundamentals. Another way of phrasing the debate is to ask how much weight should be given to the "hard data" vs the "soft data" when judging the strength of the U.S. economy and estimating a fair value for the financial markets. The reference to hard data implies looking at actual economic data releases on a monthly basis, durable goods orders for example, as opposed to actual survey data, like the Conference Board's Consumer Confidence Index. Soft data is about how companies or consumers are feeling, as compared to what they are doing with their money.

Not surprisingly, the soft data has painted a very healthy and vibrant picture for the economy, while the hard data shows a slight uptick from the run rate experienced over the last 12 months. The ISM manufacturing survey data has been super strong over the last few months while production has lagged. Consumer Confidence survey data was at the highest level in over 15 years while income and consumption statistics did not even keep up with inflation over recent survey periods. How does one make sense of this??

The answer may be that markets are discounting mechanisms and the magnitude and scope of potential changes in Washington are overwhelming the modest reporting of current economic hard data. If business executives and investors truly believe that their operating and investment climate will be so much better than the recent past, they will spend real money on projects that will turn strong soft data into meaningful hard data. One only needs to be reminded that there has been three times since 2010 where buoyant ISM manufacturing survey data, led a decent acceleration in production data by about 12 months. The key ingredient here is that the President has to deliver the goods or the markets may have gotten ahead of themselves.

Positives

- Philadelphia Fed Business Confidence Index at 43.3 vs 18 expected
- First time claims for Unemployment Insurance hit a 40-year low
- Factory orders up over 1.0% for two months in a row.

Negatives

- Capital goods orders, non-defense ex aircraft -0.4% vs 0.5% expected
- Advanced goods trade balance -$69 Billion vs -$66 Billion, deducting from GDP
- Construction spending month over month down 1.0% vs 0.6% expected

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EQUITY OUTLOOK

Summary

The Regulatory Rollback Rally in stocks continued unabated last month, as the broad market indices set all-time records. The Dow Jones Industrial Average led the way, gaining 5.1%, followed by the S&P 500, up 3.9%, and the Nasdaq Composite up 3.7%.

Market leading sectors included health care, utilities, financial and technology, all gaining better than 5%. Telecom and energy sectors lost ground absolutely, falling 0.4% and 2.2% respectively.

Year over year, portfolios have rolled off the steep decline in stock prices recorded in January and February 2016. Now, investors are looking at solid gains in their equity portfolios year over year. In fact, we find investor's portfolios have drifted above an acceptable tolerance for stock exposure and have been actively rebalancing such.

On the corporate earnings front, profit expectations were lowered across a broad spectrum of the economy in 2016. True to form, reports for the year were a little better than estimates and guidance for 2017 has been modest.

Markets are discounting very optimistic forecasts for dramatically improving earnings this year which could result from revised tax codes, financial deregulation and windfall gains in infrastructure projects. Clearly, there is a lot riding on the implementation of conservative economic tenants. As of this date, however, few, if any, concrete proposals have surfaced in legislative or executive musings.

Other than this economic optimism, there seem to be scant signs of excess in various economic indicators. None-the-less, odds are stronger today that the Federal Reserve Board will take advantage of current conditions to continue unwinding extreme monetary measures, that is, to raise short interest rates again.

After three months of nearly unrelenting stock market gains, a pause is expected and in some ways welcome. Time for investors to step back and assess valuations in light of unknown outcomes in administrative economic policies.

Positives

Underlying economic backdrop

Consumer and small business confidence's are positive

Negatives

Interest rates will be on an upward trajectory

Unknown

Actual impact of strong nationalist economic policies

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FIXED INCOME OUTLOOK

Summary

Most of the bond market once again traded in a relatively narrow range during the month of February as investors continued to await more details on the lengthy Trump administration agenda. Despite investors' policy skepticism, the Fed has been clearly communicating that it has no intention of waiting much longer before taking the next step towards normalizing the overnight lending rate. Because they are more closely linked to Fed policy, shorter maturity bonds reacted much more to the guidance than the longer dated bonds and the entire yield curve flattened. For the month, the 2-year note increased 6 basis points to end the month at 1.26%, which is the highest level since the summer of 2009. The yield on 10 and 30-year bonds dropped by 6 basis points to end the month at 2.39% and 3.00%, respectively.

After the big increase in interest rates following the Presidential election in November, most forecasters and economists have been at a loss to determine the impact the President's policies will have on the level of economic growth and inflation. Clearly the dramatic increase in small business optimism and consumer sentiment should lead to faster growth than would have otherwise been expected. Yet the absence of details on regulations, trade, immigration, infrastructure spending and all levels of taxation leave forecasters little to go on. What we can reasonably assume is that at the margin, growth will accelerate, even if only temporarily and that inflation should continue to rise towards the Fed's 2% target, and maybe even higher.

That seems good enough for the Fed to say that there are few, if any, reasons to wait before increasing the Fed Funds rate toward the level that they believe to be "neutral" as opposed to the currently accommodative rate. As of early February, the market had priced in less than a 25% chance that the Fed would increase the overnight rate in March. Currently the market has a 96% probability of it happening. The Fed had tried to put the market on notice that they intend to increase the funds rate three times per year for each of the next three years. While we think that a March hike is in the bag, the Fed's aggressive posturing is unlikely to come to fruition. We think longer rates can and will trend slightly higher but not move sharply higher without impacting growth. The flattening trend experience should continue as these dynamics play out over the remainder of the year.

Positives

Demographic headwinds of aging populations continue in most developed countries

U.S. bonds still offer significantly higher yields than in other developed nations

Asset allocation changes if bonds begin to offer higher yields and stocks become pricier

Negatives

Higher short rates could spook the long end higher as well

Budget busting policies being discussed by new administration

Alienating foreign purchasers of U.S. Treasury debt

Inflationary expectations have risen with the threat of tariffs

Unknowns

Trump: regulation, immigration, trade, taxes....Twitter

Populist and nationalist movements, possibility of a "Frexit"

Bad debt and capital inadequacies in the European banking system

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