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WEALTH MANAGEMENT

INVESTMENT WATCH
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The Return to Normal Growth Delayed: Volatility increases as severe weather hampers consumer spending and economic growth, geo-political risk escalates and Janet Yellen takes over the Federal Reserve.

Volatility returned to the U.S. market as a number of factors took center stage in the 1st quarter. Geo-political risk increased as the conflict between the Ukraine and Russia escalated leading to Russia's annexation of Crimea. The polar vortex blanketed much of county in snow and ice forcing the consumer to stay home and lowering near-term expectations for economic growth. After posting high returns in 2013, the equity market struggled out of the gate falling over 5% in January. Markets rebounded in February and were somewhat range bound in March, before selling off again to start the 2nd quarter. Fixed Income markets also experienced renewed volatility as the 10-year Treasury rates fell from 3.0% to a low of 2.59%. The outlook for full year economic growth is not diminished, just likely pushed back a quarter. The pent up demand for goods and services was starting to become apparent in the more recent economic releases and we still believe that the economy will grow at a 2.5-3.0% pace this year.

The consumer appears to be in good shape heading into the rest of the year. The labor market is improving albeit at a slower pace than expected. The unemployment rate remains steady near 6.7% but the levels of under-employed and long term unemployed remain stubbornly high. The U.S economy has added back most of the 8.7 million jobs that were lost during the recession and the labor force participation rate has begun to tick up. Initial claims for unemployment insurance have declined close to levels last seen in May of 2007. Household balance sheets have improved dramatically over the last several years. Delinquencies are down significantly from the peak and household debt as a percentage of GDP is below its long term trend. Average wages are increasing and rising home prices are helping to boost household net worth. After reaching a four month low, consumer sentiment rebounded, a sign that the consumer is ready to shake off the winter doldrums and resume spending.

Businesses are also on more solid footing as companies have built up cash and paid down debt. Even in the slower growth environment of the past few years, corporations have been able to generate enough cash to fund internal operations and return value to shareholders through stock buybacks and dividends. The banking system has almost fully recovered and banks are better capitalized today than they have been in decades. Small business optimism has been improving and loans to small and mid-sized companies have been increasing, suggesting additional business investment in the future.

Janet Yellen presided over her first meeting as Chair of the Federal Reserve in early March. Generally, the markets expect the Yellen led Fed to closely resemble the policies of the Bernanke Fed. In keeping with this theme, the committee voted to

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continue the taper, reducing its purchases of U.S. Treasury and Mortgage Backed securities to $55 billion a month. At this pace the Fed should conclude this phase of quantitative easing by the end of this year. The Fed dropped its reference to a 6.5% unemployment rate recognizing that even as we close in on that target level, there remain problems in the labor market because of high levels of underemployed and long term unemployed. With the taper continuing as expected, the market turned its attention to when the Federal Reserve might begin raising short term rates. Most FOMC members and market participants expect the Fed Funds rate to remain at current levels until the latter part of 2015.

Coming into the year, the expectation was for interest rates to move higher as the economy continued to improve and the Fed slowed the pace of its bond purchases. However, the escalation of the Russian/Ukraine situation and the volatility of equity markets led investors to move into the relative safety of Treasury bonds, pushing yields lower and prices higher. This will likely reverse course as the economy picks up steam. In addition, for the past several years, the Federal Reserve has been the primary buyer of newly issued Treasury debt, acquiring as much as 70% of total new debt issued. As they continue to taper their purchases, new buyers will need to fill the gap and those investors may well demand higher yields from the Treasury.

While it is still early, there are some positive signs of economic growth across the globe. After contracting in 2013, the European economy is showing signs of improvement and GDP is expected to expand this year. Unlike the past few years, the improvements are more broadly based with both core European and peripheral countries seeing better growth. GDP in the U.K. is expected to increase 3.0% this year. Emerging economies including India, Mexico and South Africa are also expecting stronger economic growth this year. China is experiencing a slowdown in its economy with manufacturing, imports and exports all falling, but it's recently announced stimulus is expected to keep growth around 7-7.5% this year. Along with faster growth in the US, positive global growth should help drive stronger earnings for multinational corporations. While the prospects for stronger economic growth both in the U.S. and abroad should support solid gains in the equity markets this year, the level of volatility is likely to increase. Not only will the markets be faced with geo-political risk and the potential for weaker than expected 1st quarter earnings results, but as we move closer to the end of QE and the potential for the start of interest rate increases, volatility could increase further. Given the backdrop of 2.5-3.0% growth this year, equities markets are expected to perform better than bonds and cash. We continue to favor more cyclical areas of the market such as technology and consumer discretionary. The energy sector should continue to benefit from the U.S. energy boom. In fixed income, we are maintaining shorter duration positions to protect from an expected increase in interest rates.