GODSEY & GIBB
WEALTH MANAGEMENT

INVESTMENT WATCH

April 2015

Volatility returns to the Financial Markets: Harsh winter weather, a strengthening U.S. dollar, geo-political uncertainty and a slow-down at the West Coast ports all weighed on the economy and markets.

In a similar fashion to 2014, much of the country was beset with severe winter weather in the 1st quarter, which along with other headwinds, led to a slowing in economic activity. In addition to the weather, a stronger U.S. dollar hurt companies that export and a shut-down of the West Coast ports led to delays in goods getting to their destinations. All of these factors reduced the pace of economic activity but much like in 2014, improvement is expected throughout the remainder of the year.

U.S. consumers are probably in the best position they have been in since the end of the last recession. Consumer confidence has reached its highest levels since 2007. The unemployment rate has fallen to 5.5% and while the under-employment rate remains near 11%, it is down from a peak of 17% in 2009. A measure of job openings available across the country shows that they have been growing consistently and are now at the highest level since 2001. This should translate to more employment gains going forward. Wages are also beginning to increase, albeit at modest levels. Finally, the consumer is benefiting from an increase in disposable income due to a lower debt burden and the effect of lower energy prices. As generally occurs with a rapid decline in energy prices, consumers have been slow to change their spending habits, instead choosing to save their income gains. However, we are now seeing an increase in spending on food service and restaurants, and that should begin to translate to other consumer goods going forward.

The Federal Reserve moved one step closer to beginning the process of normalizing interest rates. The FOMC adjusted its March policy statement, removing the word "patient". With this change, the Fed may increase short-term rates at any time, and those increases will be data-dependent. It seems likely that the Fed will raise the Federal Funds rates at some point in the second-half of the year. Unlike previous cycles, the Fed is apt to move slowly and it is not expected that they would move at every meeting given the current economic data. The Fed has a dual mandate to foster full employment and to maintain price stability. While unemployment has come down sharply over the last few years, the level of underemployed and discouraged workers remains stubbornly high. Inflation rates have remained below the Fed's 2% target since last spring. With the decline in energy prices, the consumer price index is actually down -0.1% over the last few months. However, excluding food and energy, the so-called "core" inflation rate is up 1.8% for the same time period. While this rate is still below the Fed's target, it has been accelerating at a faster pace over the last 3 months, which may influence the timing of the committee's first rate increase decision.

As expected, equity market volatility increased this year. Nearly half of the trading days in 2015 have experienced a move greater than 1%. On a monthly basis stocks fell in January, rebounded sharply in February, only to fall again in March. The market ended the first quarter only modestly higher, with the S&P 500 gaining 0.95% for the quarter. Returns were mixed across market sectors with Consumer and Healthcare related names outperforming the rest of the market while Energy and Utility companies lagged. First quarter corporate earnings will face challenges as a result of the currency headwinds, port shut down and weather. However, corporations should see growth return to trend, beginning in the second quarter.

In addition to the equity markets, oil prices have been quite volatile since the start of the year, trading in a range between $44 and $53 a barrel as near term supply outpaced demand. U.S. energy companies have been cutting capital spending and that should be reflected in lower supply levels over time. Foreign producers, particularly OPEC countries, have continued to produce oil at very high levels in an effort to gain market share. Global demand for oil is expected to increase this year as global economic growth expands at around 3%. Over time, the combination of higher demand and production cuts will bring the market back to equilibrium and price volatility should decline. Lower energy prices are a positive for consumers globally as well for manufacturers and other companies that are heavy users of oil. The U.S. energy sector has reacted quickly in the face of lower prices by cutting production and focusing on areas with the lowest cost of operation. While earnings will be lower this year than last year, our energy companies are well positioned to manage through this lower price environment.

The outlook for global economic growth has improved somewhat from last year. Foreign companies are benefitting as a weaker local currency is making goods and services more attractive on the global market. Prospects for better economic growth have also been bolstered by aggressive Central Bank actions. The European Central Bank (ECB) will be purchasing €60 billion of assets monthly until at least September 2016. This move is expected to help combat deflationary pressures and to provide additional liquidity to bolster consumer lending. It is still too early to measure the impact on the European economies, but the combination of quantitative easing and a weaker Euro has bolstered the European stock market. Outside of Europe, growth in China has slowed somewhat but is still expected to be near 7% for the year, while the success of Japanese "Abenomics" remains uncertain. The common theme for most international economies is a very accommodative central bank and weaker domestic currencies that over time should drive better growth.

U.S. interest rates have also experienced an increase in volatility this year, as market participants try to anticipate when and at what pace the Fed will change short-term interest rates. While short-term interest rates are most directly tied to changes in the Fed Funds rate, longer term interest rates tend to be more closely tied to longer term inflation and growth prospects. So far this year, the 10-Year Treasury bond has seen its yield move between 1.64% and 2.24%. At 1.88% currently, the yield is historically low, but is high when compared to other sovereign debt around the world that is being held down by QE. When the Federal Reserve begins to raise short-term interest rates, longer term rates will likely move higher as well. But given the expected slow pace of Fed rate hikes, longer term rates may stay low for a longer period of time. We are still maintaining a relatively low duration in our fixed income assets, choosing not to lock in these low yields for an extended time period. This short duration will allow us to protect principal and remain ready to move to longer term bonds when the yields become more normalized.

The volatility that we have seen so far this year is expected to continue on near term weakness in corporate earnings, the continued strength in the U.S. dollar, uncertainty in Europe, the fate of Greece's place in the European Union and the ever present geopolitical risk across the globe. In addition, with the Federal Reserve now focused on data and not the calendar, markets are likely to react strongly to every new piece of economic news that either supports near-term rate hikes or pushes them out further. This volatility will continue to be seen in equity, fixed income and commodity markets. It is important to note that while volatility is high, we believe that the underlying fundamentals of both the U.S economy and the U.S. financial markets are solid. We still believe the economy will grow at a moderate pace and that the U.S. equity market is still attractive. However, given the near-term headwinds faced by U.S. companies, it is likely that market returns this year will be lower than we have seen over the past few years. We will continue to closely monitor global events and remain poised to act when we believe that it is warranted.