2014 – The Road to Normalcy: U.S. Economic Expansion Gains Speed, Equities Produce Strong Rally; But As the Cycle Matures, Higher Rates and Debt Service Costs May Present Challenges, Volatility

The economy and financial markets have come a long way in the five-years since the global financial crisis. As a result, 2014 is increasingly looking like the year the U.S. economy could leave the extended period of sub-par growth, or the new normal, behind. The U.S. economy was able to shake off numerous uncertainties in 2013, including Europe, emerging markets, Syria, the government shutdown and Fed taper, and deliver incremental growth on multiple fronts. The U.S. economy ended the year on a roll and has 3% annual GDP growth, escape velocity, in its sights.

Renewed optimism in the economy spilled over in spades into the U.S. equity markets in 2013, with broad stock indices finishing the year at record highs. In 2013, the Dow Jones Industrial Average surpassed its inflation-adjusted high from 2000, and closed at record levels over 50 times. All ten industry sectors in the Standard & Poor's 500 Index finished in positive territory for the year, led by cyclical areas, in a sign of the broad nature of the rally in equities. The 10-year U.S. Treasury yield, which moves inversely to its price, ended the year near the highest level in two years, slightly above 3.0%, having more than doubled since its record low in July 2012.

Considerable progress has been made in the U.S. housing market, with prices and new starts near seven-year and five-year highs, respectively. With a more normal business cycle, the housing sector, including construction of new homes, which has been slow to recover, could return as an engine of growth and make an even larger contribution to the overall economy in the new year.

With stock prices up and house prices rising, household wealth continues to climb. U.S. household deleveraging over the last several years has led to balance sheet repair. Retail sales are also picking up as a result, which bodes well for continued growth in 2014.

Manufacturing is also contributing to the economic expansion. U.S. manufacturing has expanded for seven consecutive months, with underlying growth in new orders and employment. Total vehicle sales for the year rose to 15.6 million, up 7.6% from 2012, marking the strongest volume since 2007. U.S. vehicle sales averaged 16 million units per year between 1998 and 2007 before bottoming out in 2009 at 10.4 million vehicles.

Labor market indicators are also much improved from the 2007 – 2009 downturn. In October and November nonfarm payrolls increased by 200,000 and 203,000 jobs, respectively. Over the past two-years, the unemployment rate has fallen from 8.3% to 7.0%. Initial jobless claims fell to 338K for the week ended December 26, reflecting the improvement in labor market conditions. However, we will be closely monitoring under-unemployment, which remains persistently high at 13.1%.

All of these factors are helping to boost consumer confidence back toward normal levels. In 2013, U.S. consumers were more upbeat than at any other time in the previous six years, with improved views on the economy, finances and the buying climate, according to a survey by Bloomberg.

With the recently passed Bipartisan Budget Act of 2013, budget policy is returning to normal in Washington. Congress reached a bipartisan budget deal in December, crafted by Senator Patty Murray, a Democrat from Washington state, and Representative Paul Ryan, a Republican from Wisconsin. They headed a 29-member committee, which was the fifth bipartisan commission formed over the last three years to deal with federal debt and deficits. The $1.01 trillion budget deal, which marked the first bipartisan budget produced by a divided government in 27 years, set forth the level of federal spending for the next two years. While the agreement did not contain any structural reforms to taxes or entitlements, the deal partially relaxes some of the automatic spending cuts known as sequestration. The agreement reduces the level of fiscal drag by the federal government by slightly increasing spending in 2014. Overall, we think the deal represents a positive, small step in the right direction, especially when compared to the recent past.

With the real economy standing on more firm footing, and a two-year budget in place, the U.S. central bank began to stand down by announcing a $10 billion per month reduction in its bond purchasing program, split equally between U.S. Treasury and mortgage-backed securities, starting in January. Thankfully, the actual taper event in December generated less market volatility than the discussions about it, known as taper talk, this past spring and early summer. The Fed has emphasized that it will likely maintain the federal funds rate at near-zero levels for a considerable period. Incoming Fed Chair Janet Yellen has indicated that the improving labor market is still operating under its full potential, requiring low rates for longer. Given the current signs of economic momentum, and assuming a continuation of the initial $10 billon per month in reductions, the Fed's bond purchase program known as quantitative easing (QE) could be phased out by October of this year.

Central bank action in 2014 will be of critical importance to financial markets. As the economy continues to strengthen, we believe it is a long-term positive step for the Fed to do less in the way of intervention. However, the end of the ultra accommodative asset purchase program (QE) does present the potential for new risks in the intermediate term. Rising interest rates will have important implications for the global economy and capital markets. These side effects include the potential for: increased volatility, higher government debt service costs, higher household debt service costs, spillover effects on other economies including outflows and currency depreciation, and increased bond market losses due to rising yields.

While the Fed believes that it is right to begin to rein in its asset purchases given the improvement in the economy, and we believe the taper is a step in the right direction, we think any unexpected change in central bank policy remains the most likely trigger to imperil the continuation of the bull market. Having said that, we expect the normalization of Fed policy over the next year to be moderate enough in scope to be digestible by the stock market, and we remain positive on the outlook for global equity prices.

In addition to a stronger economy and improvements in corporate earnings, we see other likely catalysts for the equity markets. These include corporate cash balances, which remain at record high levels and bode well for buybacks, dividends, capital spending and merger and acquisition activity. We also see the potential for investors to rotate more assets from bonds to stocks. Additionally, individual investors could begin to move cash from the sidelines and back into stocks.

Going forward, we believe that global economic growth will be tilted toward developed markets. We also see equities as fairly valued which could lead to returns that are more historically normal. Nevertheless, we still favor equities over bonds or cash, with an emphasis on cyclical areas such as financial services, industrials and consumer discretionary. In fixed income portfolios we are closely managing duration as we expect interest rates to incrementally move higher.