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INVESTMENT WATCH
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U.S. Private Economy Recovering Despite Fiscal Tightening from Sequestration, Global Weakness; Fed 'Taper Talk,' Chinese Slowdown Drive Surge In Volatility; U.S. Treasury Yields Rise, Equities Gyrate, Rotate to Cyclical Leadership

The U.S. private economy is firing on more cylinders, based on renewed strength in housing, bank lending, the labor market and confidence, to name a few measures. Consumer confidence rose in May to the highest level in six years. The National Association of Homebuilders Housing Market Index reached a seven year high in June. Household wealth rose to a new record in March and the wealth effect from rising stock prices and property values is helping to lift Americans' outlook on the economy and to support domestic growth in the face of a fragile global economic environment.

In the first quarter, U.S. household net worth rose by $3 trillion to total $70.3 trillion, exceeding the pre-recession peak for the first time, according to the Federal Reserve. Household debt relative to assets is back to trend levels and for the first time since 2007, both the corporate sector and the consumer sector are borrowing. Credit creation at private financial institutions expanded at a faster pace than nominal GDP, according to Federal Reserve data, which bodes well for economic expansion in the second half of the year. According to Moody's Analytics, after 2.1% growth in the first four years of the recovery, growth will accelerate to 3% or more in 2014, marking the fastest rate of expansion since at least 2005.

Japan, the world's third largest economy, has instituted ground-breaking monetary and fiscal policies under Prime Minister Shinzo Abe to boost inflation and reverse two-decades of stagnation. Abe, who took office in December, has a three-part strategy including policy easing, government spending, and strategies to improve investment, wages, and consumer confidence. As part of the first step, the Bank of Japan has committed to significantly increase its balance sheet in order to meet an inflation target of two percent over the next two years. In April, Japan's central bank announced plans to double the money supply over two years by increasing bond purchases. Japan is also working to create special economic zones to make it easy to do business through both regulatory reforms and tax breaks. Despite the significant measures, Japan will need to effectively structure reforms to overcome substantial challenges such as its aging population, lack of immigration and high debt levels.

Growth in China will likely slow to 7.6% in 2013, the lowest since 3.8% in 1990, according to forecasts from J.P. Morgan's chief China economist Haibin Zhu, down from 7.8% growth last year, and a median consensus forecast for economic growth of 8.0% from late last year. Chinese manufacturing has weakened, slipping to contraction levels of 48.3 in June based on the HSBC manufacturing purchasing index. Short-term bank lending rates rose as the Chinese central bank made an effort to unwind excessive lending practices. Domestic demand will need to improve in order for China to offset persistent external headwinds. Industrial investment levels are being held back by rising labor costs, excess capacity, higher environmental costs and a lack of energy cost competitiveness. Chinese leaders will likely need to address these constraints, and possible incentives, to maintain a cyclical economic recovery.

In Europe, recession conditions continue, but financial conditions are much improved, and economic activity is potentially bottoming. Moreover, economic policies have moved away from austerity. In June, the IMF admitted that it failed to realize the severity of the austerity measures it imposed in Greece. More broadly in June, the European Central Bank kept the refinancing rate unchanged at 0.5 percent. ECB President Mario Draghi said that while the economic situation remains challenging, there are a few signs of stabilization. He expects a gradual recovery to take hold in the latter part of the year. Draghi remains committed to backstopping the region's banks, and indicated that the ECB has a range of measures available, if needed, to support Europe's lenders.

Regarding fiscal belt tightening in the U.S., the Congressional Budget Office estimated in May that the federal budget deficit will shrink to $642 billion for the fiscal year ending September 30, the smallest shortfall in five years and evidence that the economic recovery has begun to refill the government's coffers. At the same time, Washington has proved to be successful at slashing the deficit which has topped $1 trillion every year since the recession ended four years ago. In June, S&P increased its outlook for the U.S. to stable from negative, citing receding fiscal risks. S&P lowered its rating on the U.S. in August 2011 and maintains a AA- rating, one notch below the top triple-A rating.

Sluggish global growth, especially in China, combined with the U.S. Energy Renaissance, and a stronger U.S. dollar all helped to keep commodity price inflation muted. From the peak in 2011, oil prices are down 15%. According to the IMF, each 10% drop in oil prices lifts U.S. GDP by 0.2% in the first year. Gas prices surged at the start of the year and then retreated. As the summer driving season began, the average price of a gallon of regular gasoline cost $3.48 in the U.S., up from the $3.29 a gallon seen at the start of the year, but down from the peak of $3.78 during the week of Feb. 25. According to the Energy Information Administration, for the first time since 1996, U.S. energy production will be higher than U.S. energy imports this year. Shale oil has added 800,000 barrels to oil production over the last year and is likely to add 0.3% a year to GDP, according to Credit Suisse. Indirectly, the energy boom helps corporations with high energy needs by pushing energy costs down. Lastly, amid concerns regarding the Federal Reserve tapering, and an expanding Bank of Japan balance sheet, the U.S. dollar has strengthened, helping to dampen inflation expectations.

The Fed's so-called tapering, or slowing of its $85 billion in monthly asset purchases, will likely begin later in 2013 and conclude by mid-2014, depending on the economic data. Volatility in the global financial markets has been on the rise in recent weeks due to increased uncertainty as to whether the Federal Reserve would reduce its $85 billion in monthly bond purchases sooner than anticipated.

Volatility, which is partly a function of liquidity, typically rises at market inflection points, as market participants unwind hedged positions and transition portfolios. As markets wrestle with high volatility, we are working to not only embrace the recent spike in price movements, but also take advantage of them by making allocations in equity portfolios for increased cyclical exposure and by repositioning fixed income portfolios for a rising rate environment.

In equities, with defensively oriented industry sectors such as Utilities, Consumer Staples and Healthcare among the market's leaders through April, cyclical names appear to represent a good relative opportunity now. According to Credit Suisse global equity research, on the nine occasions since 1980 that U.S. cyclicals have underperformed defensives in a rising market, seven have been followed by a period of cyclicals outperforming defensives in the subsequent six months. The 10-year Treasury yield rose a full percent since May to the highest levels since 2011 on improved confidence in the economic expansion first and later on Fed tightening fears.

Historically, whenever the 10-year Treasury yield has been below five percent, stock prices and bonds yields have been highly correlated, according to Jeffrey Kleintop, Chief Market Strategist at LPL Financial. He also notes that during periods of rising interest rates, performance for stocks is best when longer-term bond yields were rising faster than shorter-term bond yields, referred to as a steepening of the yield curve. The current steepening suggests continued improvement for equities.

In an additional sign of economic improvement, the OECD Composite Leading Indicator for the U.S. edged up 0.1 point in May to 101.0, its highest level in over five years (since February 2008). With the improving prospects for economic growth, the dissipating likelihood of negative economic shocks, manageable levels of inflation and a steepening yield curve, we remain positive on stocks, especially cyclical securities in the industrials, technology, materials and financial services industry sectors. In fixed income, we continue to emphasize higher yielding investment grade corporate notes. Additionally, we are utilizing both multi-sector bonds, which expand the overall opportunity set and use tactical allocation to take advantage of attractive opportunities and avoid undesired risk exposures like U.S. Treasuries, and bank loan securities which offer attractive relative yield and duration characteristics.