GODSEY & GIBB
WEALTH MANAGEMENT

INVESTMENT WATCH

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As The Cold Weather Retreats the Economy Gets Back on Track: Volatility declines, geo-political risk increases and financial markets rally.

The economy appears to have gotten back on track in the 2nd quarter following the worse than expected, weather-induced 2.9% GDP contraction in the 1st quarter. Pent up demand was evident in the increased consumer spending that began in March and continued throughout the 2nd quarter. Retail sales are up 2.8% since March and consumer confidence hit a 6-year high in June. Auto sales are on pace to reach levels not seen since before the recession. The forward looking index of leading indicators rose for the 4th consecutive month in May indicating a continued expansion of economic activity. A pattern of moderate growth is expected for the remainder of the year, but even with a stronger 2nd half, full year GDP growth is not likely to exceed 2.0%.

Against that backdrop, the equity markets performed well, with the S&P 500 up 7.1% for the 1st half of the year. While all sectors of the market were positive, the utility sector provided the strongest returns followed by energy and healthcare. Consumer discretionary stocks were the laggard as the severe weather in the early part of the year weighed on company earnings. Despite the stronger economic activity and the reduction in bond purchases by the Federal Reserve, interest rates continued to decline with the yield of the 10-year Treasury bond falling to a low of 2.4% in late May.

The labor market continued to strengthen with non-farm payrolls expanding at an average of 230,000 per month for the first 6 months of the year. With these recent gains, the economy has finally recovered all of the 8.7M jobs lost in the financial crisis and recession. The unemployment rate fell to 6.1% in June, the lowest level in six years. However, there are still areas of concern in the labor market. Nearly one-third of the currently unemployed have been out of work for 6-months or more. Additionally, the number of people working part-time that want to work full time remains elevated as is the number of people who would like to work but are not actively looking. Finally, the labor force participation rate is at its lowest point since 1972. Despite the headline unemployment rate, the slack in certain areas of the labor market has helped to keep wage inflation in check and allowed the Federal Reserve to maintain an accommodative monetary policy.

After weakening earlier in the year, both new and existing home sales have improved across all regions of the country. The price of the median home is still rising but the pace of that increase has recently been slowing. The housing market has stabilized and is experiencing some moderate improvement, but there does not appear to be enough of a sustained recovery sufficient to push economic growth outside of its current range.

The boom in the U.S. energy sector is helping to support economic growth and job gains. U.S. production of oil and gas has risen 55% in the past 3 years. In addition, the manufacturing sector is seeing resurgence as some high tech manufacturing jobs are coming back to the U.S. Industrial Production was up strongly in the 2nd quarter, the fastest pace of growth in 4 years. Motor vehicle sales grew at the fastest pace in 8 years and a pickup in bookings for business equipment all point to further gains. The improvement in capital spending by corporations, including investments in new technology will allow for greater efficiencies that will help profit growth. However, it will likely take a sustained increase in aggregate demand before we see a significant boost in capital spending across all sectors. In the meantime, companies are returning profits to shareholders in the form of share buybacks and dividend payments.

The Federal Reserve's tapering program continues with purchases of U.S. Treasury and Mortgage securities down to a current level of $35B a month. At this pace, they are expected to remove the last $15B of bond buying at the October meeting. With the tapering well on its way, the Fed's focus is shifting to when to raise short term interest rates and how to manage the 4.3 trillion in assets they have purchased over the last few years. Fed Chair Janet Yellen has been clear that any change in interest rate policy will be dependent on the state of the economy, labor markets and the level of inflation. The market is currently expecting rate hikes to begin in the 1st half of 2015 and for the Federal Funds rate to approach 1.0% by the end of next year.

Economic growth has been mixed across the globe. Europe has recently been showing some signs of weakness, while the United Kingdom has been seeing growth more in line with that of the U.S. For the last several years we have seen synchronous global easing by central banks but that trend is ending. While the ECB is still easing, the U.K. and U.S. central banks are on the path to remove quantitative easing and reduce policy accommodation by raising short-term interest rates. Japan appears to be making headway in its efforts to fight deflation and increase economic growth. Emerging market economies are expanding, albeit at a slower pace. An increase in government spending helped to push China GDP's to a 7.5% annual pace in the 2nd quarter. The global economy should continue to expand at a moderate pace with the support of active Central Banks where required.

Market volatility has been declining throughout the year and remains near historically low levels, despite the increase in geo-political risk. In addition to the unrest in Ukraine, we have seen escalating violence in the Middle East, and particularly in Israel, which could weigh on oil markets. However, the U.S. energy boom is helping to offset concerns of disruption in the global energy markets. In addition, Libyan production is increasing, and most of Iraq's oil production is in the south, away from insurgent fighting. It would not be surprising to see volatility increase over the next few months in part due to geo-political factors, as well as to the up-coming mid-term election. It is possible that we could see a pullback in the equity market driven by an inflation scare, evidence of higher interest rates, or other global events.

Interest rates have remained low in response to strong global demand for yield. It is still likely that rates will trend higher this year as the economy expands. With continued slack in the labor market, moderate consumer spending, and inflation near the Fed's 2.0% target, we do not expect a significant spike in interest rates this year. Accordingly, we still favor fixed income investments that offer an attractive current yield but are less sensitive to changes in interest rates.

While markets may go through short-term periods of volatility, it is more important to focus on long-term fundamentals. Despite the strong equity market returns of the last 18-months, stock valuations are still attractive by historical standards. Companies are showing moderate growth in top-line revenues, while earnings are growing faster as companies manage costs and improve efficiencies in their businesses. Corporate cash balances remain strong and anchor continued share-buybacks, dividend increases and merger and acquisition activity. We believe that these factors, in combination with moderate GDP growth, low interest rates and low inflation provide the means of support for further gains in equity prices.