Beacon Trust
Quarterly
July 15, 2014

Second Half Outlook

Although temperatures across the US are now boiling, the biggest surprise in the first half was the cold weather, which contributed to a 2.9% decline in 1Q real GDP. Least surprising was the emergence of geopolitical risk in Ukraine, Iraq and several other hot spots. We continue to expect geopolitical risk will add to the stock market wall of worry for a variety of reasons including social, economic and religious. Renewed tensions between Israel and the Palestinians are a recent example. The capital markets also performed about as expected. In our 2014 Outlook commentary, we projected a 13% total return from the S&P 500 Index for the year. The stock market is half way there with a 7.1% first half gain. The fixed-income market has done somewhat better than expected with a 3.8% increase for the Barclays Aggregate. Nonetheless, our expectation that stocks will outperform bonds was realized thus far. Developed market (Japan, eurozone, UK, etc.) equities lagged the US as expected, while emerging market equities performed better than anticipated. Asset allocation performance was aided by good returns from biotechnology, high yield bonds, emerging market sovereign debt, REITs, and MLPs.

In our opinion, despite the decline in 1Q14 real GDP, the US economic backdrop remains one of modest growth and subdued inflation. Debates over how quickly and how far the Federal Reserve will hike the Fed funds rate in 2015 and beyond are already raging. Our outlook for wage rates, core inflation and the labor market suggests policy rate hikes will be gradual, although perhaps a bit more aggressive than currently implied by Fed funds futures. We continue to subscribe to an upside target of 2,075 for the S&P 500 by year-end. Fixed-income returns should continue to lag stock market results, as the low in yields has probably passed.

US Economy – Keep On Truckin'

In our opinion, the US economic backdrop remains one of modest growth and subdued inflation. Key to our thinking is the trend in the ISM Non-Manufacturing Index (NMI), which covers nearly 90% of the economy. The June reading of 56.0 missed the Bloomberg consensus estimate of 56.1; but, more importantly, the three-month moving average rose to 55.8 from 54.9 in May. As a result, nominal GDP growth could very well approach 5.5% during the second and third quarters. Real GDP growth could therefore exceed 3%. There are a few risks to this outlook that could cause real GDP growth to come in closer to 2%. Although it represents only 3% of GDP, the housing sector is facing several headwinds that challenge the near-term growth outlook. Chief among these is housing formations, mortgage rates, mortgage qualification requirements, and student loans. A second risk involves Personal Consumption Expenditures (PCE). With wage rates advancing only 2% or so year-over-year, the ability of consumers to support the economy can be questioned, particularly with possible limited support from savings or credit. Of course, high end consumers benefit from rising stock market and home prices. With slack evident in both the labor market and the overall economy, we believe wage rates and core consumer prices will remain subdued in the near-term. As a consequence of this economic slack (output gap), we expect the core CPI to average 1.8% in 4Q14, which would be equivalent to the rate of gain in April and May.

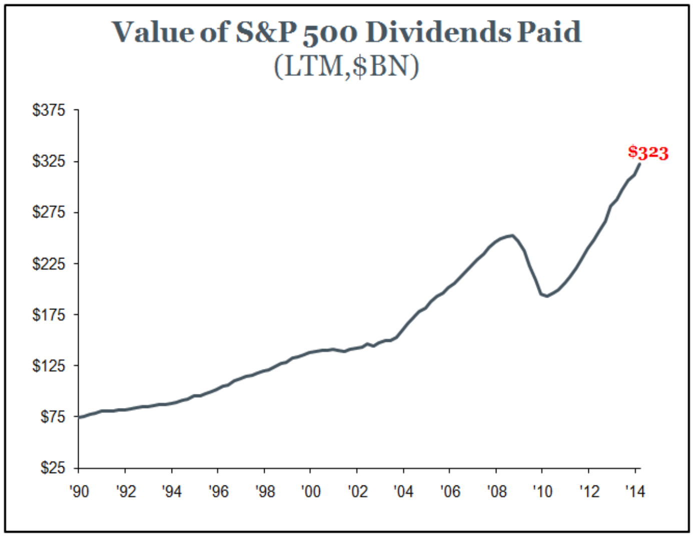
The Fed – How Friendly?

Based on our outlook for wage rates, core inflation and the economy, we view a major negative surprise from the Fed as unlikely in the short run. The Fed's expectations for wage rates and core inflation seem reasonable. In fact, the Fed seems willing to tolerate an inflation rate above its 2% target for a while. Looking at 2015 and beyond, there is a chance that rate hikes may come a bit sooner than generally anticipated and go a bit higher. This is not a major concern on our part, but it could impact markets temporarily. The basis for this assumption is our Fed funds rate model which forecasts the funds rate based on core CPI and the unemployment rate gap. This latter variable is derived from the difference in the unemployment rate (6.1%) and the natural rate of unemployment (5.8%) as calculated by the Congressional Budget Office. Obviously, the unemployment rate gap is a narrow 0.3%. The model suggests that the Fed funds rate should be at 3.25% by year-end 2016 versus 0.00%-0.25% currently. The Fed is anticipating a rate of 2.5%, and a Wall Street Journal consensus estimate is 2.4%. In the main, however, the Fed should remain friendly.

Market Expectations – The Durable Dynamic of Dividend Return

A major reason for our stock market bullishness since January 2013 is dividend return. Since 1990, dividend return has been responsible for half of the total return from the S&P 500. In early 2013, we identified an accelerating trend in growth of dividend return as corporations have returned cash to shareholders or even borrowed to pay dividends. Dividend return is the most influential component of our S&P 500 model, which also incorporates corporate credit spread and Fed funds rate. During the first half, dividend return represented 1.1% of the S&P 500 total return of 7.1%. We expect dividend return will continue to be a strong anchor to the stock market's total return. As the accompanying charts demonstrate, dividend payout ratios are below the average level since 1936. At the same time, the number of stocks paying dividends is increasing, and value of dividends paid is at an all-time high. Bottom line, this important variable underscores our expectation for the S&P 500 reaching 2,075 by year-end.

Our outlook for fixed-income is unchanged compared to the beginning of the year. The projected yield range for the 10-year Treasury remains 2.50%-3.25%. Higher short rate expectations and the end of quantitative easing are somewhat offset by low inflation and a favorable supply/demand balance. Although the Barclays Aggregate Bond Index was up 3.8% in the first half, we still forecast flattish returns from the fixed-income market in 2014.



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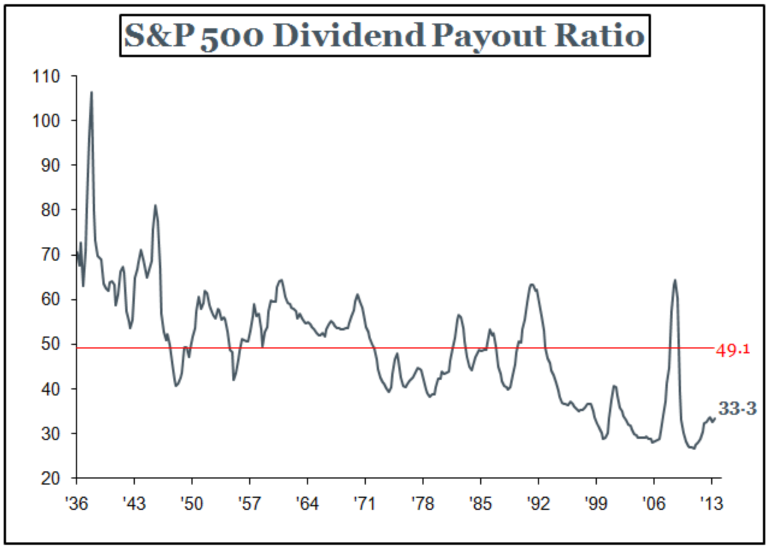

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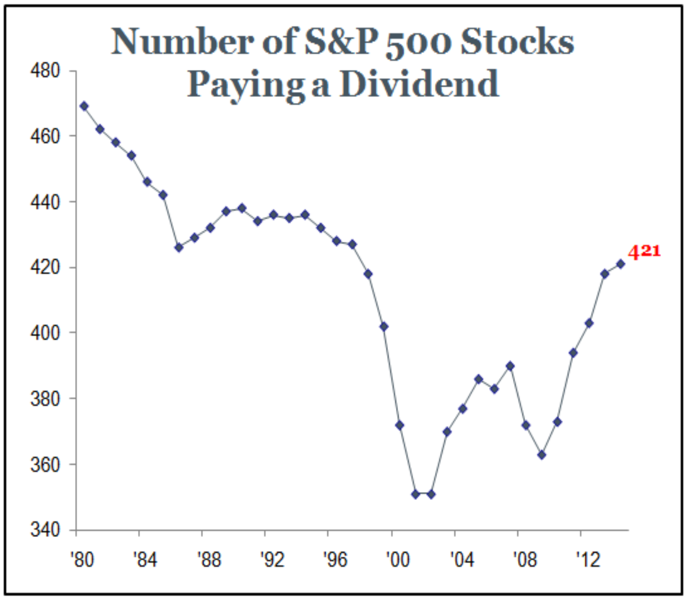

Source: Strategas Research

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