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ALLEN MOONEY BARNES

**Economic and Portfolio Outlook 3rd Quarter 2014**

*(Released July 2014)*

Our economic outlook for the second half of the year for the U.S. continues to be slow growth; however, we now expect rising inflation which could change our slow growth/recession forecast to possible stagflation. The core Consumer Price Index (CPI) escalated the most in three years with an increase of 0.4% versus expectations of an increase of 0.2% during the second quarter. In addition, the food index posted its largest increase since August 2011, with the index for food at home rising 0.7%. However, Federal Reserve Chairman Janet Yellen classifies the recent inflation data as "noise," stating that inflation is rising in line with the central bank's expectations. If she is wrong, stagflation—a combination of high inflation, high unemployment and slow economic growth—could be the next headwind for the U.S. economy. The last time the U.S. experienced stagflation was during the 1970s.

The latest GDP revision, the most significant indicator of U.S. growth, decreased at an annual rate of 2.9% in the first quarter of this year, reflecting a downturn in exports, a larger decrease in private inventory investment, a deceleration in personal consumption expenditures, as well as a downturn in nonresidential fixed investment. The Institute for Supply Management Producer Manufacturing Index (PMI) registered 55.3% in June compared to 55.4% in May, but still indicating expansion in manufacturing for the thirteenth consecutive month.

The data from the Bureau of Labor Statistics was a bit more encouraging, reporting that unemployment dropped to 6.1% as of the end of June, the lowest rate since September 2008. The Bureau reported that nonfarm payrolls grew by over 288,000 for the month of June and issued a strong upward revision for May to 300,000 new jobs.

**Equities**

The S&P 500 rallied in the second quarter posting a 5.24% gain and finishing the quarter at a new all-time high. The top three performing sectors were Energy, Utilities and Information Technology. The three sectors that detracted from the Index's performance were Telecommunications, Consumer Discretionary and Financials.

As of the June 30, 2014, the S&P 500 Index had gone 1,000 days without a 10% correction—the fifth longest winning streak since 1928. The last one ran from July 1984 to August 1987. Major bull markets have historically run for a 64-65 month cycle. We are currently in the 65$^{th}$ month of the 64-65 month cycle, so a change of character in the market in the near future may be possible. There remains a remarkable issuance of new stock due to the global escalation in Initial Public Offerings (IPOs) as firms seek to capitalize on strong equity markets. IPO activity could be reaching a level of exuberance (one might even say "irrational exuberance"). In light of this data, we are anticipating corrective activity in the second half of 2014. We will continue our defensively positioned equity strategy as we move forward into the last half of the year.

**Fixed Income**

At the start of the year, analysts were expecting interest rates to increase, but the exact opposite has occurred. Rates moved lower by 50 basis points over the course of the last six months. We believe this retracement is due to recent economic data being released by the U.S., the most significant of which is the previously stated first quarter GDP of -2.9%. Another driver of lower yield is the supply/demand equation. With the Federal Reserve owning 20% of Treasury issuance and continuing to buy, demand is now outpacing supply which is driving yields lower.

Federal Reserve monetary policy continues to be a leading macro factor affecting the economic and investment outlook for 2014. In June, the Federal Reserve reduced its monthly purchase of Treasuries and Mortgage-Backed Securities (MBS) to $35 billion ($20 billion Treasuries and $15 billion MBS). At this pace, the program is expected to end in October of this year, assuming their economic factors remain on track. They issued no guidance on when short-term interest rates will increase; however, analysts are projecting that will occur in mid-2015.

We anticipated at the beginning of the year that Municipal bonds would be the bright spot in fixed income for the first half of the year, and that has proven to be the case with a return of approximately 6.0% year-to-date as of June 30, 2014. Their outperformance has been led by a reduction in supply of Municipal issues and investors chasing yield. The reach for yield is also forcing investors into riskier assets like junk bonds, pushing some credits to their tightest levels in 23 years. As a result, we have growing concern over the froth in the credit markets overall. On the short end of the curve, investors are no longer being paid for the additional risk in municipal and corporate issues. This has moved us into a heavier weighting in Treasuries. The current fixed income activity points toward lower long-term rates at the beginning of 2015, which aligns with our overall outlook on the economy. Therefore, we will continue our conservative approach and look for credits that offer proper compensation for the underlying risks for all of our client portfolios.

## CAPITAL MARKETS SNAPSHOT

| EQUITY | As of 6/30/2014 | 2Q2014 | YTD | 12-Month Return |
|---|---|---|---|---|
| DJIA | 16,826.60 | 2.83% | 2.68% | 15.56% |
| S&P 500 | 1,960.23 | 5.24% | 7.14% | 24.61% |
| NASDAQ | 4,408.18 | 7.42% | 7.87% | 34.15% |
| MSCI EAFE | 1,972.12 | 4.09% | 4.78% | 23.57% |

| RATES | As of 6/30/2014 | As of 3/31/2014 | As of 6/30/2013 |
|---|---|---|---|
| Fed Funds Target Rate | 0.25 | 0.25 | 0.25 |
| 3-Month Libor | 0.23 | 0.23 | 0.27 |
| 6-Month CD | 0.35 | 0.26 | 0.41 |
| 2-Year Treasury | 0.46 | 0.42 | 0.36 |
| 10-Year Treasury | 2.53 | 2.72 | 2.49 |
| 30-Year Mortgage | 3.36 | 4.40 | 3.50 |
| Prime Rate | 3.25 | 3.25 | 3.25 |
| **COMMODITIES** | **As of 6/30/2014** | **2Q2014** | **12-Month Return** |
| Gold | $1,315.00 | 1.80% | 10.32% |
| Crude Oil | $105.37 | 3.73% | 9.12% |

### Foreign Markets

The European Central Bank (ECB) has made unprecedented policy moves in recent months to stimulate bank lending and revive the euro-zone economy. The ECB also cut main refinancing operations to 0.15% from 0.25% and marginal lending facility to 0.40% from 0.75%. On June 5, 2014, the ECB lowered Deposit facility rates to -.10 %. Annual euro-zone inflation was 0.5% in June, and there is speculation it will drop to 0.3% over the summer, pushing it well below the ECB's target of just under 2.0%. The ECB said it would offer banks cheap loans with four-year maturities, starting in September, provided they extend more credit to the private sector. If these measures should prove to be ineffective, the ECB will likely implement their own round of quantitative easing through large scale purchases of public and private debt.

In an effort to overcome its long economic drought, Japan continues its quantitative easing program through a large scale cash infusion totaling $1.4 trillion by the end of 2014. In April, the country raised its consumption tax from 5.0% to 8.0%, which could pose a challenge for

Prime Minister Shinzo Abe's goal of forcing the country out of deflation and into serial recession. This highly unpopular increase marked the first in 17 years. It is scheduled to be raised again to 10.0% in October 2015.

While central banks of Mexico and Turkey also cut interest rates during the second quarter, the central banks of Russia and New Zealand raised rates, and the Bank of England signaled it may make history by becoming the first major advanced economy central bank to raise rates from record lows.