

# Economic Slowdown Has Not Weakened Share Prices



## WEEKLY INVESTMENT COMMENTARY

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U.S. equities rebounded last week as the S&P 500 increased by nearly 1.8%,<sup>1</sup> despite continued weak economic data. We believe recent data is not yet weak enough to change forecasts. The relative stability of data and forecasts - supported by stimulative monetary policies, an improving U.S. housing market and fading political polarization in the U.S. and Europe - sends a message of reasonably low volatility and manageable downside risks.

### Slow but Steady Momentum

Since monetary policy remains supportive and there have been no further austerity efforts, recent weakness appears to be more noise than signal. The slow fading in risk perceptions (i.e. fear) is quite normal, and to us this seems like the mid-point of the business cycle. Four years after the global recession there seems to be little on the horizon to suggest another recession over the next year or two. We believe that U.S. nominal GDP is on track for roughly 4.5% growth with real GDP of 2-2.5%, both close to 50 basis points higher than 2012.

### Weekly Top Themes

- 1. Real GDP expanded at a 2.5% annual rate in the first quarter<sup>2</sup>:** This is significantly faster growth than the prior quarter at 0.4% but 0.5% slower than expectations. Much of the disappointment is from a 4% contraction in government spending. Consumer spending increased at 3.2% for the quarter, the fastest pace in over two years. The quarter in aggregate overlooks that consumption was strong in January and February but weaker in March. The falloff in March will potentially set the tone for the second quarter and rest of the year. In our opinion, growth will continue to be on-again, off-again.
- 2. First quarter earnings are tracking higher than consensus by approximately 4%:** Also, around 70% of companies are beating estimates. In contrast, revenues have missed by around 1%, with only 35% of companies exceeding estimates. The reports are based on over 50% of the companies in the S&P 500 (represents two-thirds of market capitalization) that have reported earnings.<sup>3</sup> Expectations for the balance of 2013 are falling based on weaker guidance.



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## The Big Picture

Global equity markets continue to churn, and the recent sloppy action is probably not over. A downward bias exists in countries where economic activity is weak or disappointing, while the U.S. and Japan are holding near their highs. We believe the 6- to 12-month outlook is supportive for stocks, especially given the benign backdrop for bonds, equity valuations, political policy and investor positioning. Although the setback in commodity and energy prices is causing concern, we see this as improving the odds of better growth since the recent triggers were probably not demand-driven. A cautious message has been given by the percentage of stocks above their 200-day moving average, which has rolled over after breaking out of a downward-sloping trend. The valuation gap between bonds and stocks remains favorable for stocks, although the bears will claim bond yields have been suppressed by central banks. We expect the Fed to be slow to end its accommodative stance and gradual in its tightening. Thus, Fed policy is unlikely to be a risk factor for equities for the foreseeable future.

Investors may be ignoring the strength in global leading economic indicators because of the unprecedentedly subdued U.S. expansion, the broad U-shaped growth profile in emerging markets and the ongoing recession in Europe. Generally, the primary time to avoid equities is when costs increase and inflation hurts the real value of earnings and productive assets. This normally happens after a period of rapid growth in private sector credit, after which the central bank increases real interest rates and regulators reign in credit. More recently, stock prices have been rising due to earnings growth and an increase in the price-earnings multiple, rather than rapid credit creation. However, some of the profit growth probably won't recur, including the rapid decline in borrowing costs, cost cutting after the 2008 financial crisis and fast growth in the dollar value of foreign earnings. Also, weaker currencies in Japan and possibly Europe will hurt revenues and earnings.

## 2013 Performance Year to Date

	Returns	
	Weekly	YTD
S&P 500	1.76%	11.65%
MSCI World Ex U.S.	3.53%	7.92%
MSCI Emerging Markets	1.16%	-2.49%

Source: Morningstar Direct, as of 4/26/13. All index returns are shown in U.S. dollars. Past performance is no guarantee of future results. Index performance is shown for illustrative purposes only. Index returns include reinvestment of income and do not reflect investment advisory and other fees that would reduce performance in an actual client account. All indices are unmanaged and unavailable for direct investment.

*"We maintain a positive intermediate-term outlook for equities, but recent market fluctuations may continue."*

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**1** Source: Morningstar Direct, as of 4/26/13. **2** Source: Bureau of Economic Analysis, "National Income and Product Accounts Gross Domestic Product, First Quarter 2013 (advance estimate)," April 26, 2013, <http://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm>. **3** Source: Thomson Reuters, "Proprietary Research Earnings Aggregates," April 19, 2013.

The **S&P 500 Index** is a capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy. The **MSCI World Index ex-U.S.** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets minus the United States. The **MSCI Emerging Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

### RISKS AND OTHER IMPORTANT CONSIDERATIONS

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