Federated®

On Point

A Series of Industry and Investment Insights

Executive Summary

- Economic growth should accelerate, with improving fundamentals creating the foundation for equities to reach new highs.
- Job growth is expanding at its fastest pace in decades, and there are signs earnings are beginning to pick up, too.
- Manufacturing remains a source of strength, with autos playing a significant and growing role.
- Rising consumer optimism, increased savings, accelerating job growth and the "wealth effect" should underpin back-to-school and holiday spending.
- Housing remains a bit of a mystery, as sales have softened even as builder optimism has risen.
- The Fed appears set to raise its target rate next spring, if not sooner. History suggests equities should fare well in such an environment; bonds not so much.

Midyear 2014 outlook: This is more like it

2014 hardly could have started worse, with a brutal and seemingly never-ending winter bringing activity to a halt and keeping shoppers at home in much of the country. The final first-quarter estimate told the story, with real gross domestic product (GDP) contracting a much worse-than-expected 2.1%. But there's a reason the equity market shook off the number. It was, after all, so yesterday. What today and the rest of the year look like are much different, as manufacturing and jobs appear to be accelerating, auto and retail sales are on the upswing and even housing is showing some signs of pulling out of its funk. The government's estimate of second-quarter growth was a well-above-consensus 4.2%, in line with our view that the economy is settling onto a higher growth plane that will drive equities to new highs this year and into 2015.

While some question whether spring's bounce will carry over into this year's second half, Federated's macroeconomic policy committee shares no such concerns. It believes recent strong improvements in the labor market, auto sales, manufacturing and consumer spending are representative of an economy that is beginning to click on all cylinders, abetted by extremely accommodative central banks here and abroad, a slowly improving European economy, an accelerating Japan and a China that appears to have successfully navigated a soft landing.

Putting a dismal first quarter in the distant past, Federated is projecting GDP to expand at an above-trend rate for the rest of the year and into calendar 2015. This, in turn, should cause both Treasury yields and stock prices to rise significantly before year-end, enhancing Federated's recommended heavy overweight stocks/severe underweight bonds positions in its stock-bond portfolio models. Simply put, this bull has more room to run in our view, while government bonds may be enjoying their last gasp before potentially entering a prolonged sell-off.

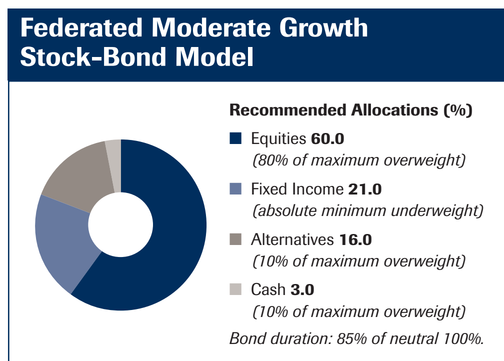
GDP on the Rise

	2014	2015
First Quarter	-2.1%	TBD
Second Quarter	4.2%	TBD
Third Quarter	3.5%*	TBD
Fourth Quarter	3.5%*	TBD
Total	**2.2%***	**3.3%***

Source: Federated.

** Federated estimates.*

Federated Moderate Growth Stock-Bond Model



Source: Federated, as of 7/29/14.

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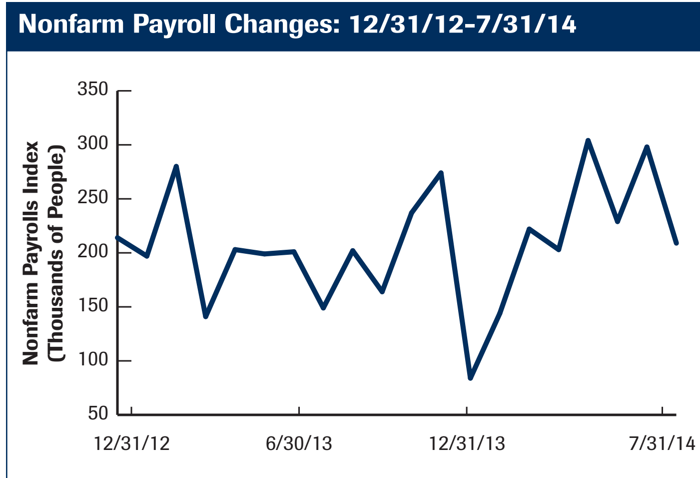
Jobs on a roll

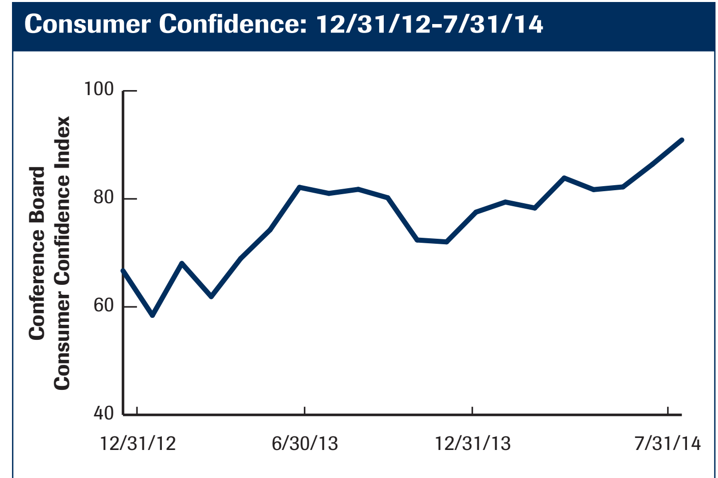
After a difficult winter that put job growth in a deep freeze, the labor market has bounced back convincingly, with monthly nonfarm payrolls expanding an average 244,000 from February through July. If this pace is sustained for the year—and there are reasons to believe it will be—it would mark the biggest annual increase since the latter stages of the go-go '90s. Importantly, the bulk of the gains continue to come almost entirely from the private sector, though there has been a pickup in state and local government hiring in recent months—a trend that if it continues should keep overall job growth running at a crisp pace.

Consumer mood brightens

The improving job market is carrying over to consumers' moods—and spending. Consumer confidence rose to a seven-year high in the summer of 2014, while spending as measured by personal consumption expenditures increased at a stronger-than-expected 2.5% in the second quarter, bolstered by the largest improvement (up 14%) in durable-goods sales in five years. Autos alone sold at an annualized run rate of 16.9 million vehicles in June, an eight-year high. At the same time, the savings rate hit a two-year high of 5.3%. All of this suggests consumers have the ammunition—savings on top of more jobs and income—to pick up the pace of spending as they head into the back-to-school and holiday seasons.



Source: Bloomberg, as of 7/31/14.



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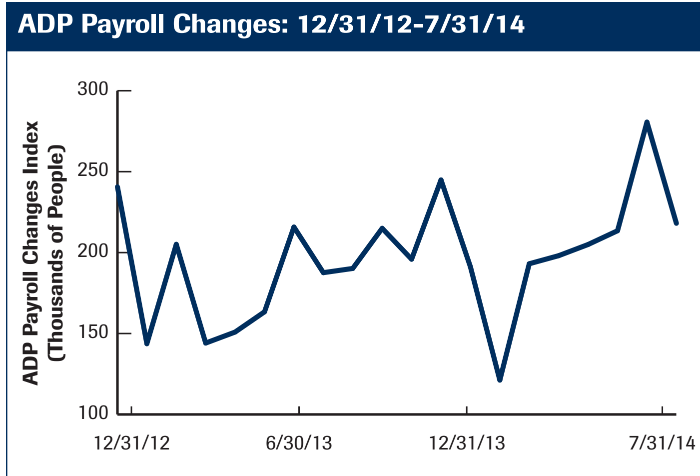

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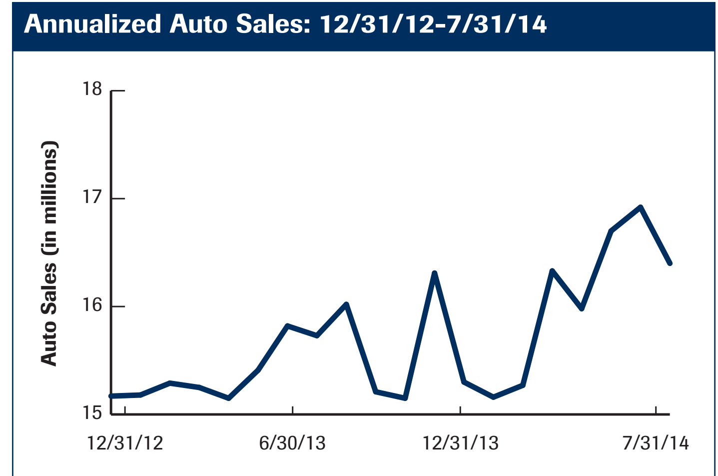
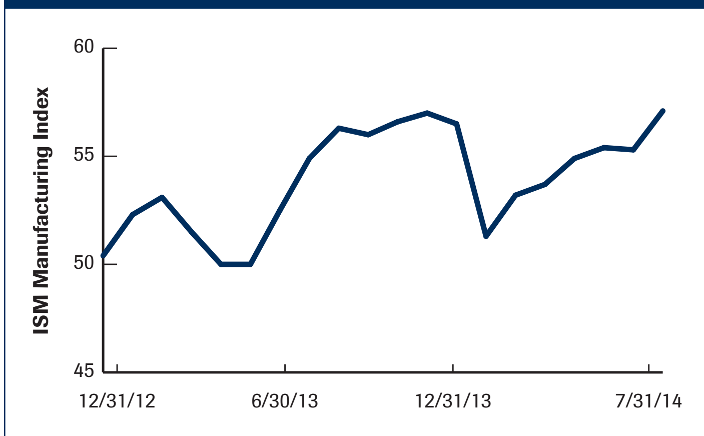


Source: Bloomberg, as of 7/31/14.

Manufacturers busy

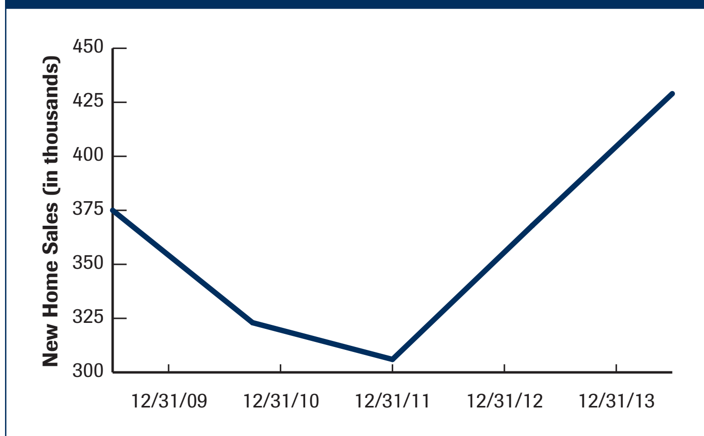
The pickup in auto sales is helping buttress manufacturing, which has snapped back strongly from winter's chill. The national ISM manufacturing index surged to a three-year high of 57.1 in July, substantially better than the "contraction" reading of 49.0 in May 2013. That helped to drive a powerful inventory restocking cycle in the second quarter, as businesses nearly tripled their inventories. Industrial production enjoyed its strongest second quarter in four years, and capacity utilization has been running at roughly a six-year-cycle high for the past four months. Capital goods shipments (non-defense ex-aircraft), which feed directly into GDP, were up a robust 1.4% in June after slipping the prior two months. We anticipate CAPEX will pick up further as businesses feel more confident about the economy and their own needs to address capacity and enhance productivity.

Manufacturing: 12/31/12-7/31/14



Source: Bloomberg, as of 7/31/14.

New Home Sales: 12/31/11-12/31/13

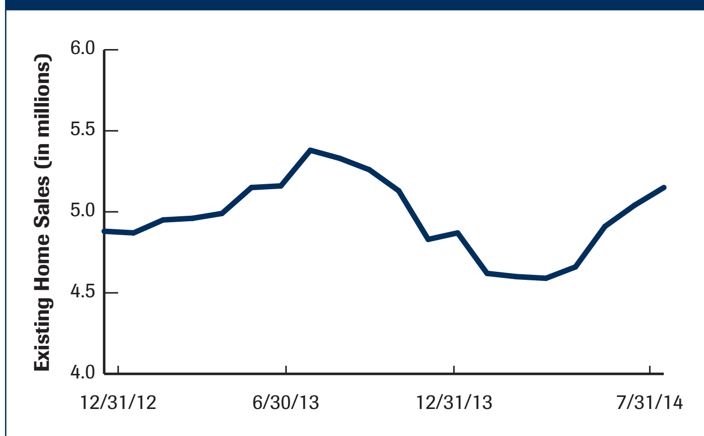


Source: Bloomberg, as of 12/31/13.

Industrial Production: 12/31/12-7/31/14

Source: Bloomberg, as of 6/30/14.

Existing Home Sales: 12/31/12-7/31/14

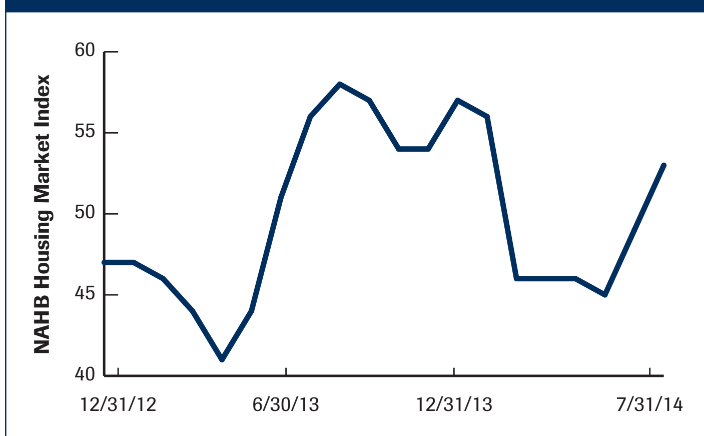


Source: Bloomberg, as of 7/31/14.

Waiting on housing

A housing market that appeared to be gearing up last year before getting walloped by the winter continues to stagger. New and existing home sales slipped three of the first six months of this year, and starts & permits have been drifting down, with the bulk of activity concentrated in multifamily construction that tends to have a much smaller multiplier effect than does single-family construction. On the plus side, after plunging during winter, builder sentiment has been climbing, reaching a six-month high in July. The big question overhanging housing is if and when will Millennials begin to enter the home-buying market? The one-two punch of student loan debt and a tough job market has many on the fence, and there are some suggestions they may be just as happy renting as opposed to owning for years to come—a potential socio-demographic shift that would have significant implications for housing.

NAHB Housing Market Index: 12/31/12-7/31/14



Source: Bloomberg, as of 7/31/14.

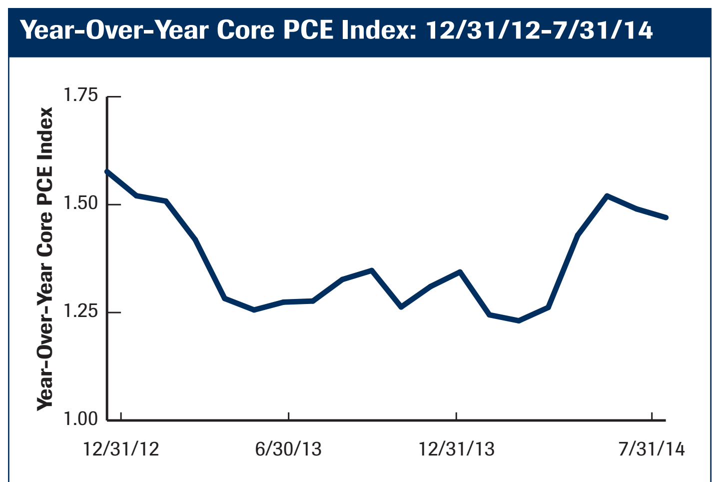
What will the Fed do?

There's no doubt the Federal Reserve's ultra-accommodation of the past five years propped up the economy's recovery from the Great Recession. But there have been some fairly public rumblings of late among key policymakers that suggest a widening rift between the majority doves headed by Chair Janet Yellen and the minority hawks led by Philly Fed President Charles Plosser, with the latter pushing for tightening sooner. Driving this debate have been concerns that core inflation is closing in on the Fed's 2% target and unemployment has improved to an extent that extraordinary stimulus no longer is merited. How this internal struggle plays out could determine whether the target funds rate rises before the late-spring 2015, a move currently priced into the market. There is full agreement, on the other hand, that tapering will continue on course to bring an end to quantitative easing by late this fall.

The doves-hawks debate aside, we do expect longer—and shorter rates—to begin reflecting an upward bias going into the second half of this year and into 2015, but not in a runaway fashion. This move up should reflect positive fundamentals—faster growth in the U.S., a broadening recovery in Europe and Japan, and a China that will have successfully maneuvered a soft landing. To be sure, once the Fed starts tightening, rates will react—particularly we think on the short-to-intermediate part of the curve—but the reasons for that will be because of economic strength, not weakness. Moreover, even as the Fed eases off the pedal, we think the actions of the Bank of Japan and the European Central Bank, which are undertaking the sort of extraordinary ultra-accommodation the Fed is beginning to end, will serve as countervailing forces that will inhibit longer rates from moving too far, too fast.

The bottom line

Rising rates, particularly if the Fed acts sooner than expected on the target funds rate, could cause some indigestion for equities. However, history tells us that rising rates as a result of a strengthening economy tend to be positive for stocks over the longer run, with temporary hiccups typically followed by a renewed rally higher, which is what we are expecting to be the case this time as well. Bonds, of course, don't fare as well when rates are rising, which is why we are at a minimum allocation on bonds in our stock-bond model—and near maximum on equities.



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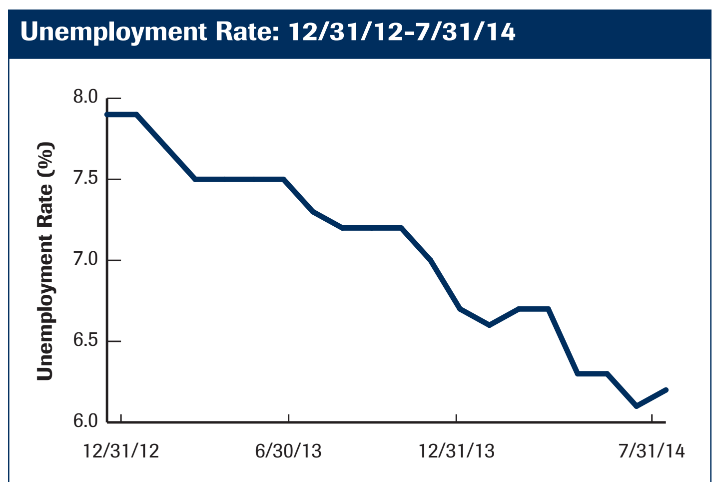

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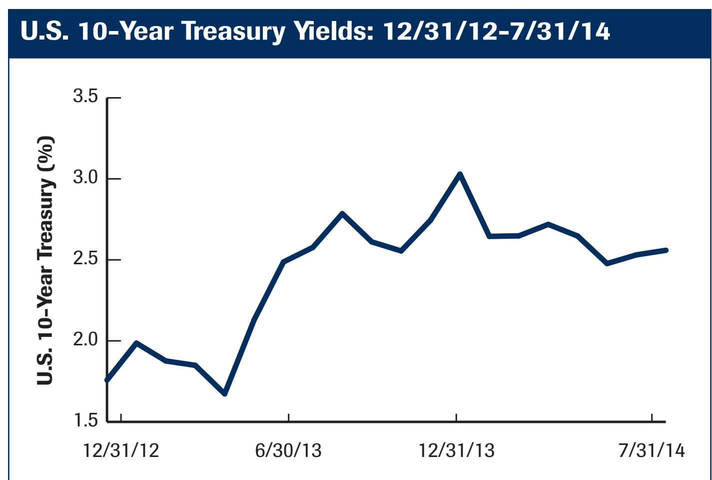

Source: Bloomberg, as of 7/31/14.

Views are as of 7/29/14 and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

Investments are subject to risks and fluctuate in value.

While stocks offer the potential for greater returns than bonds, they tend to be more volatile.

Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

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Federated Investment Counseling

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