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Market Update

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The Economy and Markets

Stock market performance and volatility are, over the long term, an overlay of the economy and GDP growth; over the short term, however, markets may seem to go in a different direction than the fundamentals. This is even more prevalent in today's world of global trade and U.S.-based companies that source much of their labor and manufacturing abroad.

With 26% of the S&P 500 companies having reported first quarter results, profits for the first quarter continue to come in higher than expected, but that seems to occur every quarter and is not big news. Expectations were very low going into the quarter with the strong dollar and low energy prices continuing to impact multi-national and industrial companies that had any earnings leverage to the energy sector. As an example, United Rentals continues to struggle with pump rentals in the oil patch, and the weak Canadian dollar has been no help in translating their Canadian energy earnings into dollars. Even Vanity Fair Corp. has been negatively impacted by the loss of sales of heavy outerwear to workers in the shale oil regions.

Dollar exchange rates are actually much more favorable for U.S. multi-national companies today compared to the beginning of the year, and this should take some heat off of the foreign currency translation math for this quarter. Nevertheless, on a trade-weighted basis, the dollar still remains a concern, and with Hungary now entering the bizarre world of negative interest rates, global capital in search of higher rates will likely keep finding its way to the U.S. bond market, boosting the dollar.

Our recession indicator checklist still remains positive on the economy, with no recession in sight.

Economic Indicator	Current Status	Recession Indication
Yield Curve Shape	Positive Upward Sloping	Low Risk of Recession
Leading Economic Indicators (LEI)	Currently Positive	Low Risk of Recession
Corporate Bond Spreads	Some Balance Sheet Weakness	Moderate Risk
Residential Housing	Demand Remains Strong	Low Risk of Recession
Inflation	Low, But Signs of Increase	Low Risk of Recession
ISM-Manufacturing Activity	Weak, But May Be Bottoming	Moderate Risk

Bottom Line

Not one of these indicators is flashing a red light warning signal for recession, so our conclusion is that the business cycle continues to expand, albeit at a modest pace. We can be certain that a new recession is inevitable in future years, yet barring an exogenous shock to the economy, the data now suggests that the business cycle continues upward.

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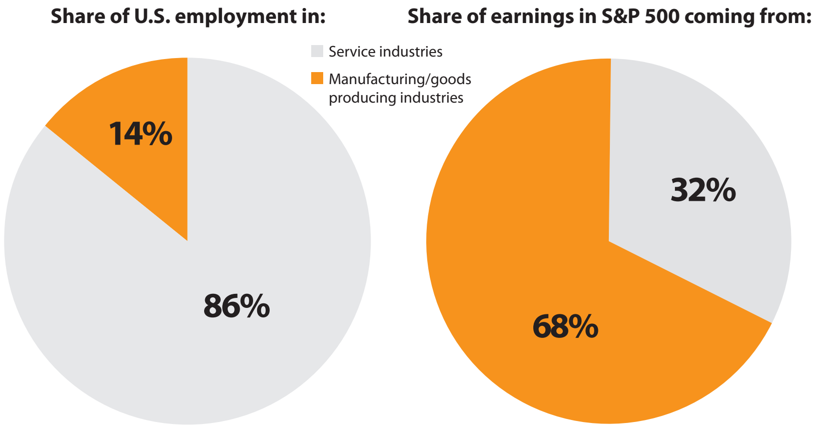
A Profit Recession?

So, how could an economy with low inflation, strong housing, and low unemployment be going through what many are calling a "profit recession"—as the S&P 500 companies have cumulatively posted negative earnings growth over the past few quarters? This goes back to the de-linking of the economy and markets due to a number of factors, with the dollar and energy prices being the big culprits, as shown below.

Impact of higher dollar and lower energy prices much bigger on S&P 500 than on GDP. As a result, we are having a profit recession without an economic recession.



Note: Service industries are: Financials, Multiline Retail, Specialty Retail, Internet & Catalog Retail, Diversified Consumer Services, Hotels, Restaurants & Leisure, IT Services, and Health Care Providers & Services. **Source:** David Bianco, Ju Wang, Winnie Nip

As shown in the chart above, the lion's share of U.S. jobs comes from the service sector, with only 14% generated from manufacturing. Yet earnings tell a different story, with 68% of profits coming from the manufacturing sector, with many multi-national firms having downsized U.S. employees in favor of building global manufacturing facilities in low-cost labor markets. So while today's employment numbers may depict an economy that is relatively strong, the earnings picture has been pinched by currency moves and washed-out energy prices that have hurt U.S. manufacturing earnings.

Looking ahead, the picture is brighter, with consensus among the analyst community calling for an improvement in earnings as we enter the third and fourth quarters of this year, and as the dollar impact lessens and energy prices stabilize. And with no information at our hands that would contradict that outlook, we are maintaining our equity allocations at present levels. In fact, with the dollar having weakened over the past three months, energy stabilizing at over $40/barrel, and positive news coming out of China, we wouldn't be surprised to see the market continue to march higher after taking a breather from the recent rally. Corrections along the way cannot be ruled out, and between our elections here at home, the upcoming vote in June on Britain's membership in the EU, and the possibility of a Federal Reserve rate hike, there will be plenty of event possibilities to fuel a market pullback.

Strength in International Markets

We continue to see strength in Europe's economy and this quarter received confirmation from General Motors and Ford Motor Company, with both companies showing positive contributions from their continental European markets. The European Central Bank (ECB) continues to pour stimulus into the

Eurozone, and we are beginning to hear talk of "helicopter money" as an actual possibility, whereas months ago it was just a theoretical conjecture. *Helicopter money* is a term that describes what may be the ECB's next step in stimulus, which would involve the actual injection of new money into individual bank accounts, or in the form of monetary credits to be used to spend and stimulate the economy. Our view is that fiscal stimulus is what is really needed, not just in Europe, but also here in the United States. For now, Mario Draghi and the ECB's aggressive monetary stance continue to favor risk assets such as stocks and corporate bonds, and we are therefore maintaining our international equity allocation.

U.S. Outlook Better than Expected

Better earnings comparisons in the third and fourth quarters should support current equity valuations. Value stocks outperformed growth names in the first quarter, and we would expect that trend to continue, especially if the Central Bank can pull off another quarter-point rate increase by late summer. Listening to recent earnings calls, we are finding that banking sector margins were positively impacted by the January rate increase, and any future rate increases would bode well for financial sector earnings.

While the market may correct on any such rate hikes, it may well set the stage for the next leg up with value stocks—led by financials—leading the way. Markets have, for the most part, left behind the worries from the start of the year. Oil prices appear to have stabilized, and the dollar has pulled back considerably from where it was last August. Even the China growth concerns have abated with many analysts now calling for an increased growth rate as the Chinese Central Bank is expected to bring added stimulus to its economy. Can the bull market run in stocks, which began in 2009, continue against a backdrop of a sluggish economy and the recent profit recession? For now, things may not be great, but they are turning out better than expectations, and investors continue to climb the wall of worry.

We continue to believe the market has not reached the euphoric stage that would cause us to reassess our allocations, and we continue to focus on building strong cash flows in our portfolios and identifying investments that have solid fundamentals, but may be overlooked by peers.

We hope you find our *Market Update* valuable and insightful. And we welcome an opportunity to meet with you and to review your investments with our team. Please visit our website for more updates, white papers, and newsletters, and connect with us online at Facebook.com/FMAAdvisory or Twitter @FMAAdvisory.

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