Hardenbergh Financial Services **Newsletter**

State of the Economy July 2014

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Slow and steady. Slow and steady. That seems to be pace of the stock market so far in 2014, much to the delight of the investor. The stock market hits a new record practically every week. The question is, how long can this go on? The US economy suffered a major contraction in gross domestic product in the first quarter of 2014. Despite this knowledge, investors remained undeterred. The US economy shrank more in one quarter than any other quarter since 2009, but investors focused on other data. An investor may have the impression that the biggest threat to the market would be an unexpected event.

Even though stocks are at their highest prices in market history, the Federal Reserve is refraining from increasing interest rates until 2015, at the earliest. During its two-day policy meeting in mid-June, the Federal Reserve announced it will scale back its bond buying program from $45 billion a month to $35 billion a month. However, Fed Chair Janet Yellen reiterated the Fed will continue to support the economy's efforts for growth after output shrank in the first quarter of this year. Yellen did point out that the outlook is improving this quarter and expects economic activity to expand faster in 2015 and 2016. Her optimism is attributed to a better labor market, reduced household debt, rising stock, and rising home prices. If this holds true, the Fed's decision on interest rates will be crucial for keeping the economy moving forward. If the Fed maintains such low rates for too long, it could spark inflation or financial instability. But, if the Fed raises them too quickly, it could derail a fragile economy.

The stock market's continued surge towards new records is not solely dependent on the backing of the Federal Reserve. First, US payrolls in May hit an all-time high after the first four-month stretch of job creation above 200,000 since the 1990's. The jobless rate remains at 6.3% which is the lowest level since September 2008. Second, auto sales were another area which had a huge month of May. May's seasonally adjusted annualized rate (SAAR) of new car sales, were up 4.1% from a year ago and had the highest May SAAR since 2007. Third, home sales reached a six year high last month as sales ballooned by 18.6%. This was the highest jump since May of 2008. Additionally, the Institute for Supply Management reported that its purchasing manager's index of manufacturing reached a five month high. Lastly, consumer confidence rose to its highest level since January of 2008.

Does all of this positive economic news guarantee enhanced stock market returns going forward? The short answer is no. The S & P 500 index has gained 6.1% this year, as of Friday's close. The market is not undervalued compared to earnings. Therefore, investors will have to pay more for equities or profits will have to surpass estimates for the rest of the year. Both of these outcomes are possible but not a sure thing.

When reviewing the US economy as a whole it is important to look outside the US. The issues in the Middle East continue to be prevalent as the Iraq situation seems to be boiling over. This situation could result in higher oil prices while adversely impacting stock prices by gripping investors with fear. In

Europe, the European Central Bank has decided to start charging banks for reserve deposits due to lack of growth and lending. Mario Draghi, the President of the ECB, continues to do whatever it takes to save the euro. Subsequently, bond rates have dropped throughout Europe and inflows have increased into US treasuries.

We remain cautiously optimistic on equities for the rest of 2014 while disfavoring bonds based on anticipated rises in interest rates. As for the economy, it seems more evident that a recession is unlikely in the near future.

Have a safe and happy Independence Day!

Sincerely,

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