Market Monthly

An analysis of the economy and the markets by Jeffrey J. Schappe, CFA, Chief Investment Officer & the Sterling Capital Asset Allocation Team

STERLING CAPITAL MANAGEMENT

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The Economy

Our outlook for the economy remains largely unchanged from last month as a recession both in the U.S. and Europe appears likely according to leading indicators we follow. Recent better-than-expected economic data are coincident or lagging indicators and not inconsistent with an impending recession. Investor confidence remains shaken by the turmoil in Europe and the potential Greek default and the ripple effects on Spain and Italy. Contagion has impacted core European banks. Ultimately, the eurozone needs a lender of last resort (ECB?), and easier monetary and fiscal policies, but it is still unclear if that will be forthcoming, although some positive steps have been taken. Manufacturing and services activity are barely expanding. Balance sheets for corporate America are strong, but there is little willingness to add new workers given the uncertain economy and policy climate in Washington. Lower commodity prices should benefit consumer spending in the coming months, but real income is declining. Meaningful economic improvement, however, hinges on global policy makers shifting to a pro-growth stance, eurozone leaders taking aggressive steps to contain Europe's crisis, and the impending global economic downturn running its course.

Challenges to the recovery remain as high unemployment and uncertain fiscal policy will produce headwinds. While the unemployment rate has shown some modest improvement, the most recent downturn is largely due to a decline in labor force participation. We anticipate core inflation will remain benign due to housing woes as well as overcapacity and lack of wage pressure. We also believe that Federal Reserve policies will continue to be supportive of a gradually accelerating economy.

Equity Market

Historically, real GDP growth of less than 2% increases recession risk. We believe contraction in the U.S. and Europe, as well as slowing China growth will eventually cause central banks to again shift toward pro-growth policies; however, more fiscal stimulus will likely be needed to create greater final demand in the economy. The "risk on/risk off" trade is still in effect. We recently lowered our equity allocation by 4% to 55% (proceeds into cash), versus our benchmark of 60% Russell Global Equities/40% Barclay's Aggregate Bond Index. In the current environment, we favor a more diversified portfolio that offers greater growth and defensive exposure. It is important to maintain a long-term perspective and to emphasize companies that exhibit both attractive financial strength and valuation. Companies with these characteristics are in a relatively strong position to increase dividends and complete accretive mergers and acquisitions.

Should the cyclical recovery accelerate, we expect equities to benefit and market leadership to become more selective. Among the strengths we find in the equity markets are strong non-financial corporate fundamentals, attractive value of higher quality companies, accommodative Fed policies and the high percentage of companies raising dividends. Our concerns focus on the slow pace of economic recovery, political risk both domestically and internationally and continued consumer and bank deleveraging.

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Fixed Income

Although recent improvements in U.S. economic data such as lower jobless claims and improved manufacturing point toward better times for corporate America, we will need to see more stability out of Europe in order to have a chance at more meaningful growth, which appears to be a remote possibility at this time. We expect more media attention over the coming months on the upcoming election and domestic issues, which will help ease the negative drumbeat coming out of Europe. Fed officials have stated they will include a forecast of the federal funds rate starting this month in an apparent effort to influence longer term interest rates lower. We continue to focus on the income carry trade via overweighting corporate bonds at the expense of Treasury and agency bonds. We are maintaining a slightly long duration position to take advantage of the relatively steep yield curve (higher income) and the roll down effect.

Among the strengths we see in the fixed income markets are strong corporate balance sheets, a Fed on hold for at least 2013, attractive credit spreads, consumer and corporate deleveraging and growing pressure to reduce government debt/spending. Numbering among our concerns include a growing budget deficit, European debt crisis strains, low absolute yields and high volatility.

Investment Strategy

We are maintaining our strategic, or long-term target, weighting to equity for all models. Although equity valuations are still attractive by historical standards, the combination of inadequate fiscal and monetary policy, political gridlock, and European debt concerns have created an unfavorable backdrop for global equities over the near-term. As previously stated, our underweight to international developed stocks continues to be our most significant tactical position.

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