

Market & Economic Outlook

MainStay Investments is pleased to present economic and market insights from the Portfolio Managers in the Strategic Asset Allocation and Solutions Division.

On the radar screen

1. Compensation costs are likely to be a driving force behind monetary policy, bond yields, profit margins, and generalized inflation in the quarters ahead. Potential evidence of rising cost pressures may be found in the Employment Cost Index release at the end of October and the payroll report in early November.
2. Personal consumption is a critical component of economic growth. The holiday shopping season gains traction in November, and we anticipate the strong upward trend in retail sales to persist. Watch Black Friday/Cyber Monday results.
3. Outgoing Speaker of the House John Boehner successfully delivered bi-partisan support for suspension of the debt ceiling and a constructive two year budget deal, curtailing tail risk out of Washington. Incoming Speaker Ryan may add to those victories with a highway spending/repatriation deal and progress on lifting the oil export ban.
4. The global equity sell-off in August was triggered in large part by concerns about the Chinese economy. There have been indications of stability since which we expect to persist through year end. The “hard landing” story appears invalid.

“I have been through some terrible things in my life, some of which actually happened.” – Mark Twain

False alarm. It's unlikely that anyone reading this needs to be reminded of the steep decline posted by stock market indices around the world this past summer. Exactly what factors contributed to the sell-off are a matter of debate, but weakness in the Chinese economy is one possible trigger we have heard assigned blame quite frequently. The People's Bank of China's decision to allow the Yuan to float more freely was perceived by many to be an effort to devalue the currency in the face of rapidly deteriorating economic conditions. Well, anyone harboring such fears may well have reconsidered in recent weeks. The Yuan has strengthened modestly since mid-August and trades only a few percentage points below the high it hit early in 2014. Performance within the industrial sector and earnings at the big state-owned enterprises has indeed continued to wane, but the increasingly important service sector is on a tear and the property market has stabilized nicely. That ongoing shift in emphasis from heavy industry to personal consumption is both deliberate and beneficial. Newly introduced stimulus measures, both fiscal and monetary, together with continued regulatory reform have offered a further boost to confidence. In retrospect, fears of a “hard landing” in China appear to have been exaggerated, and stock pricing has come to reflect that reassessment, bouncing sharply off late September lows.

China's not the only threat to markets that has failed to fully materialize. Looking back over the past year we can find a handful of events with the potential to destabilize markets that have, at least for the time being, dissipated. On that list we would include hostilities between the West and Russia over the sovereignty of Ukraine, Greek debt default and/or expulsion from the European Monetary Union, territorial disputes in the South China Sea, and most recently, failure to raise the U.S. debt ceiling. Free to focus on underlying fundamentals with these and other worries set to the side, conditions look favorable for an extended rise in asset pricing from our vantage point. As noted below, personal consumption is strong; inventory adjustments detracted from third quarter growth, but that's a one-time correction that's likely fully behind us; policy-makers outside the U.S. appear poised to ease monetary conditions offsetting moves by the Fed in the other direction; business capital expenditures are growing on a slow but steady trajectory; and bank lending continues to expand, pushing up monetary aggregates.

All this being so, we remain positive on equities, although the discount pricing available in late September is no longer available. Our exposure is currently skewed toward domestic issues, but we have begun to rotate into developed international markets where valuations are more attractive and the potential for earnings growth to accelerate is greater. We anticipate shifting more heavily into emerging markets at some point also, although that likely won't happen until we're some distance into 2016 and have seen the impact on capital flows after a few increases in the Fed Funds rate. Within fixed income we've become cautiously optimistic toward junk bonds as yields have widened and now appear generous vis-à-vis what we consider likely default rates on the near horizon. High-grade fixed-income remains worrisome to us, though, as a material increase in headline inflation and stronger growth over the next few quarters are likely to inflict some damage on long maturity bond portfolios, or so we anticipate.

"Once again, we come to the Holiday Season, a deeply religious time that each of us observes, in his own way, by going to the mall of his choice." — Dave Barry. Economic growth in the U.S. is propelled to a very large extent by personal spending, and real household consumption has been trending significantly higher for quite some time now. Final demand was the primary support for Gross Domestic Product (GDP) growth in the third quarter as inventory decumulation in particular otherwise weighed on results. There is every reason to believe that strength in household spending will continue into and through the all important holiday shopping season. Lending credence to that idea are the steady expansion of payrolls and accompanying indications that compensation is on the rise (i.e. people have more money to spend), debt service costs are historically low (money is left over after meeting auto payments and credit card bills), gasoline prices have fallen significantly (freeing up money to be spent on discretionary purchases), and confidence readings are elevated (people spend more when they feel good about their situation). Domestic consumption is very likely to help push GDP higher through the fourth quarter and stock prices along with it. Despite having already been a top performing sector in 2014, we see room for consumer discretionary stocks to continue their run higher. Worth keeping in mind is that what is being purchased has shifted in recent years to more heavily favor experiences (travel, dining, etc.) versus physical goods. The "where" has shifted also as internet merchants continue to steal share from brick and mortar enterprises.

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The Employment Cost Index is a quarterly report from the U.S. Department of Labor that measures the growth of employee compensation.

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