New Albany
Investment Management

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Market Insight: It's "Back to the 50's"
Fed Shifts, Expects Slower Growth & Rate Moves

Following last week's Federal Reserve policy meeting, Chairman Janet Yellen communicated the plan to raise interest rates even more slowly than previously predicted sighting slower economic growth. The fed funds rate will be raised only slightly later this year, but after that, future rate hikes will be small and gradual over the next *several* years. The Fed now expects rates to rise to 1.75% by the end of 2016 as compared to previous forecast of 2.5%. And their new economic forecast predicts the US economy to only grow by 1.8% to 2% this year, as compared to their previous forecast just three months ago of 2.3% to 2.7%. It appears to be "back to the 1950's" as far as the economy and interest rates go, but the Fed has a very different mandate. What did it look like then and what can we expect for the market today? Let's take a look.

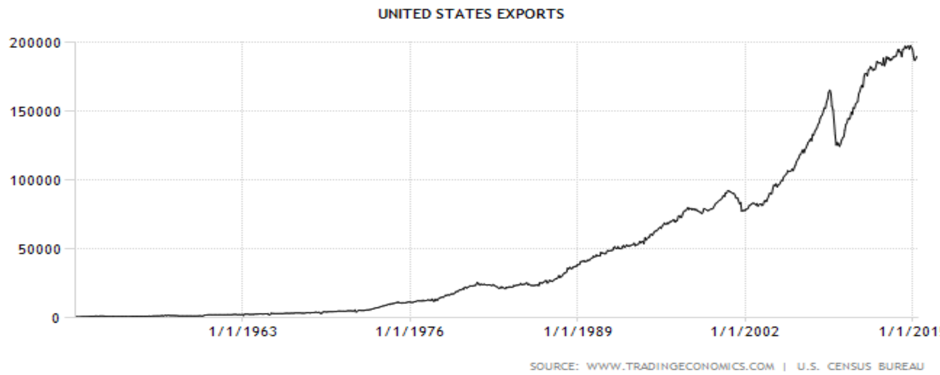
Look back to the 50's: Price stability and a sound dollar were the prime monetary objectives of the Fed. From Eisenhower to JFK, short rates averaged between 1 and 2 percent, inflation was roughly 1.5 percent, long Treasuries ranged 2 to 3 percent, and GDP was only 2.5 percent. (Just like now) Back then gold was tied to the dollar (not the case today) and oil price spikes led recessions (today energy is in a downward price cycle). The top personal tax rate was 91 percent and the top corporate tax rate was over 50 percent. (Wow!) During the 50's the economy was heavily regulated. Sound a *bit* similar? It wasn't until the'60s that JFK slashed tax rates and launched a huge economic and stock market boom. During that time, the stock market roughly doubled (from very low levels).

Present Day: Today, the Fed's key objectives are lowering unemployment and raising inflation. Despite six years of zero short term interest rates, the Fed has yet to meet their target objectives. Below is a chart showing where these key measures stand in relation the Fed's target.

	Current Level	Year End Forecast	Long Term Target
Inflation Rate	1.2%	1.5%	2.0%
Unemployment Rate	5.5%	5.3%	5.0%
GNP Growth	-0.7% (First Quarter)	1.8%	3%

Part of the reason for not meeting these targets and a short fall in economic growth is because of what's happening on the global stage. Unlike the 50's, the US economy is much more dependent on the global economy. Back then, exports accounted for only 3% of GDP, whereas today, exports contribute over 15%. That's a huge difference!

The chart below shows the rise in US exports from 1950 to present.

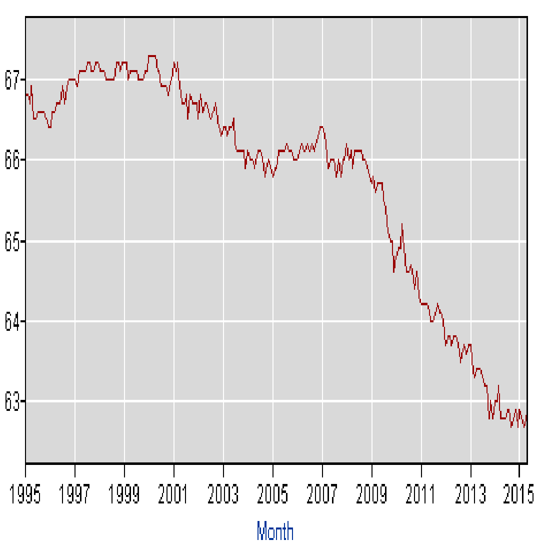


Headwind to Growth: Over the past year, two factors have become a major headwind for the Fed and the economy to overcome: weak foreign economies and a strengthening dollar. As growth in Europe, China and Japan stalled, demand for US products declined. At the same time, with the Fed on the verge of raising rates (in sharp contrast to the easing policies of major central banks in Europe and Asia), the dollar is strengthening, which has exacerbated the already weak demand for US exports. So for the Fed, its two steps forward, one step back in getting the US economy back to a 'normalized' growth pace.

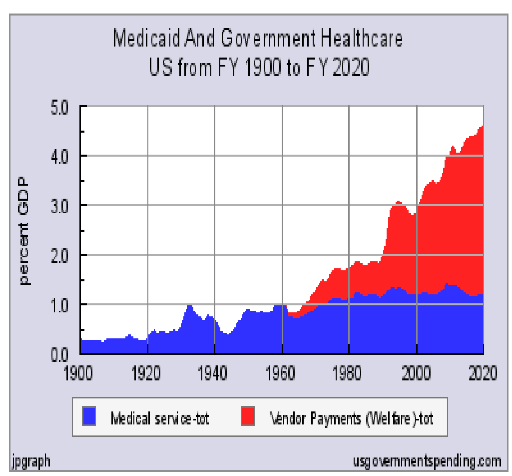
Fiscal (Drag) Policy: Unlike the 50's where fiscal policy took the lead to stimulate the economy, today Washington has made little progress and by some measures has even been a detractor to growth. The rise of government welfare-assistance program, Obamacare, and the corporate tax structure have inhibited both those seeking employment and businesses to create jobs. All of these factors have contributed to a fall in the labor-force participation rate. It is difficult to get the economy to accelerate if the labor force continues to decline.

The charts below show the fall in the labor participation rate and rise in government programs.

Labor Participation Rate



Government Assistance Programs



Monetary policy (the Fed) has done its job, it's now up to Fiscal policy (Washington) to take the lead in creating policies that will promote capital investment and ultimately jobs**. A huge potential pro-growth policy change could be in the form of corporate tax reform—**cutting tax rates and moving to a territorial system that would bring home roughly $2 trillion stashed overseas. Currently, the U.S. has a worldwide tax system, which means business income is taxed at the U.S. rate no matter where it is earned – at home or abroad. However, companies can defer paying U.S. tax on active foreign income until it is brought home. Not only does it make US companies less competitive in countries with lower tax rates but it has in effect of 'locking' capital in foreign countries, and encourages investment outside of the US. If this capital were brought home, the impact on business investment and jobs would be significant.

Lukewarm Markets: With the Fed now on the sideline, stimulus must come from the fiscal side here in the US or from growth in foreign economies. Until we see progress on one or both, the investing environment will likely remain lukewarm. No bust but no boom. Slow growth means slow earnings growth which leads to mediocre stock market returns. This explains the why the markets have made little progress so far this year and have traded in a very tight range. History has shown when a market trades in such narrow range, stock gains for the year have averaged 4.9%.

The Bond market is struggling even more than stocks as global rates have risen (prices fallen) on expectations of stronger European growth and Fed action. Even with the Fed stating a slower pace of rate rises, the bond market in general, has been unable to make any gains so far for the year.

Portfolio Strategy: Don't despair, there is still opportunity for return! Broad diversification across multiple sectors and economies has been the key to solid performance in the portfolios. For stocks, sectors such as Healthcare, Mid & Large Cap Growth, and European stocks have been strong leaders. In bonds, high yield and floating rate are nicely positive for the year.

As always, please contact me with any questions or concerns.

Kind Regards,
Barbara

Barbara HS Huff
CEO & President
New Albany Investment Management
614-216-6139
www.newalbanyinvestment.com