Economic Update

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Stocks managed to eke out another month of gains in May. The S&P 500 finished up 1.8% for the month and is up 3.6% year-to-date through the end of May. The Small Cap Russell 2000 index gained 2.2% for May and is up 2.3% year-to-date. International stocks are still struggling relative to domestic stocks with the MSCI EAFE index down -1.5% for the month and -2.8% year-to-date. The ten-year US Treasury yield was virtually unchanged at 1.83%.

First quarter GDP growth was revised to a slightly higher growth rate of 0.8% vs. the 0.5% rate initially reported. The slow growth trend we have seen since the recovery began in 2009 is still in place. The deflationary scare that occurred earlier this year has not materialized as expected so the Fed is beginning once again to signal that the resumption of Fed Funds rate increases is back on the table. Some believe the first increase could come as early as later this month but the consensus believes that it will occur later in the year. That will likely put upward pressure on the dollar which could create some disruption for stocks.

Corporate earnings for the first quarter 2016 fell 2.8% versus the same quarter of 2015 but increased slightly by 0.6% relative to last quarter. This is the fourth quarter in a row with negative growth year-over-year. In recent months, oil prices have strengthened significantly; since oil company losses have been a major drag in earnings we expect year-over-year comparisons will begin to improve in the coming quarters.

After reaching a 12-year low in January below $27 per barrel, the price of oil rebounded strongly and reached $48 per barrel in April. Oil stabilized in May and finished the month close to $50. After such a powerful rebound we wouldn't be surprised if we saw a short-term pull back. However, we do believe over the longer-term, oil prices will gradually move higher.

As the Fed began to shift their tone to prepare markets for a resumption in rate hikes, the dollar has responded by rising over the past few weeks. So far the markets have taken the stronger dollar in stride, signaling that the market may believe that the appropriate time for another rate hike is approaching.

Economically speaking, there is not currently a great deal of evidence that the economy could not handle higher short-term rates. Even though the economy is growing at a slow pace, it is still growing enough to get off of "crisis level" interest rates. Many people who depend on interest income badly need a "raise" and higher rates give the Fed more flexibility to act if the need arises.

Stock valuations have become stretched but stronger earnings growth which we believe will be coming this quarter should provide support. The upcoming election also creates uncertainty for future economic policies. Bond yields have stayed close to their lows for the year indicating that bond investors are currently more cautious than stock investors. Diversification continues to be a prudent strategy. If you have questions regarding the strategy in your account, please do not hesitate to contact your advisor.

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