Just a Temporary Soft Patch

Rod Smyth
CHIEF INVESTMENT STRATEGIST

The first quarter began with strong reports from the labor market and upward revisions for the last three months of 2014; it ended with the opposite. The payroll data for March came in at just 126,000, and with revisions the quarter created 591,000 jobs compared to more than a million in the previous quarter. To be fair, the average pace throughout this recovery has been similar to the first quarter's pace at around 600,000, but there has clearly been a deceleration from the strength of late 2014. We should also remember that 2014 started in a similar fashion.

As with last year, weather played a role, along with the labor dispute in West Coast ports, which saw Los Angeles (the nation's busiest port) handle 29% less cargo in January than it did in January 2014. The dispute was resolved in mid-February.

Beyond these more temporary effects, the US economy spent the first quarter adjusting to two longer term economic headwinds – lower oil prices and a stronger dollar. As one of the world's top 3 oil producers, US companies are slashing oil exploration budgets and hiring plans in light of continued weakness in oil prices. Similarly, the dollar's sharp rise in recent months has pressured exports and made imports more price competitive. The combination of these factors led to flat manufacturing employment numbers in March.

The US economy spent the first quarter adjusting to two longer term economic headwinds – lower oil prices and a stronger dollar. The combination of these factors led to flat manufacturing employment numbers in March.

Although job gains were disappointing, wage growth showed a slight acceleration. When combined with much publicized wage increases from some of the largest employers in the country (e.g., McDonalds, Wal-Mart, Target, and Starbucks), signs are building that worker pay is finally increasing. Higher compensation for workers, combined with the benefit of low oil prices to consumers and many companies, sets the stage for more sustained economic growth over the rest of the year and into 2016, in our view.

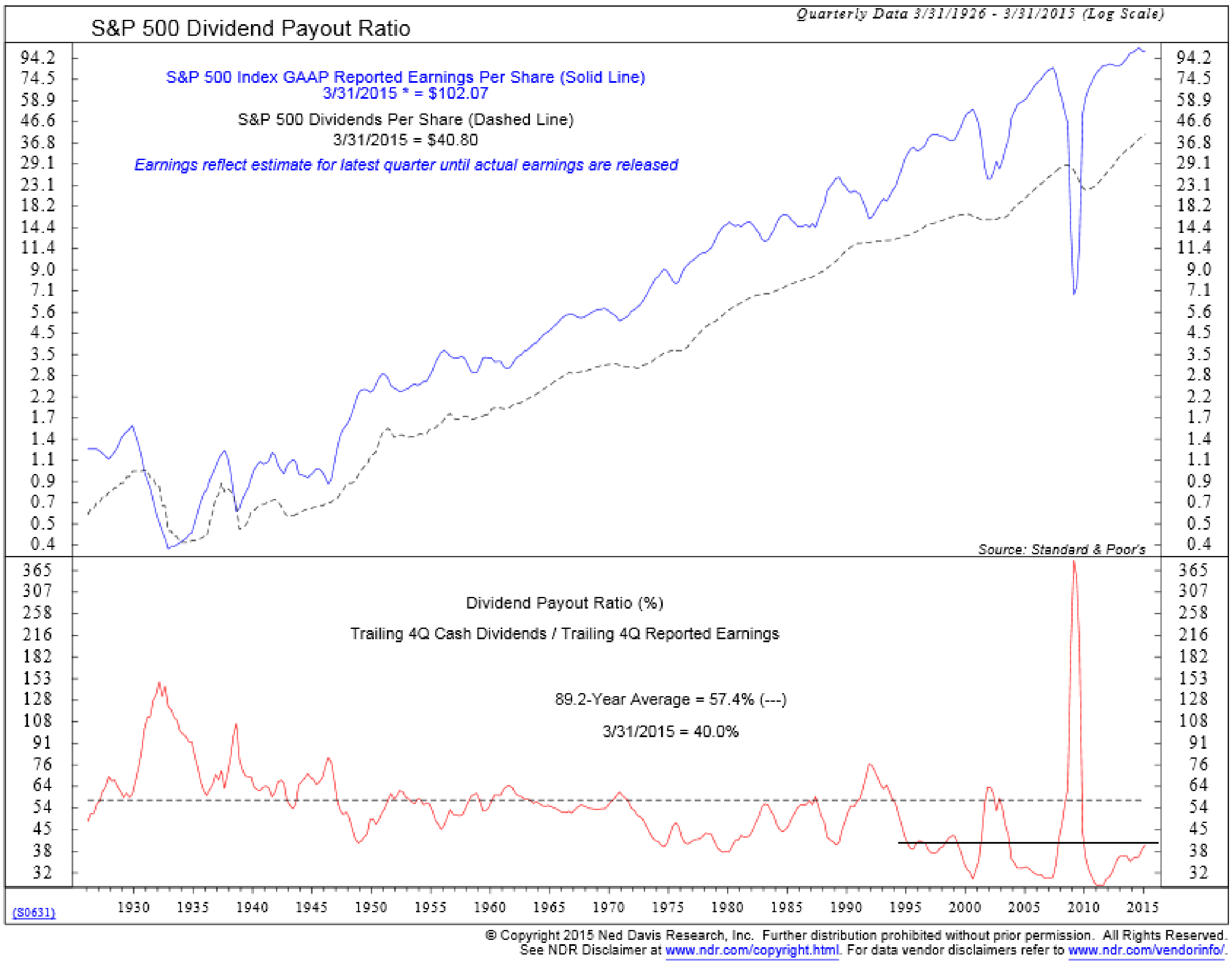
We think the primary market impact of the weak nonfarm payroll data is to keep the Fed on hold for a longer period of time. We think financial markets will generally celebrate this; hence our tilt toward risk in our current portfolio positioning. The primary headwinds faced by the US economy (low oil prices and a strong dollar) are tailwinds for developed international equities, reinforcing our conviction in our overweight to these markets.

The primary headwinds faced by the US economy (low oil prices and a strong dollar) are tailwinds for developed international equities, reinforcing our conviction in our overweight to these markets.

The only element of our strategy called into question by Friday's nonfarm payroll data is our hedged positioning for international currencies. Last week, we re-stated our position as dollar bulls, and we recognize that better economic data in the quarters to come is needed to validate our view. We are less confident that the dollar will rise against the yen; indeed, our most recent purchase of Japanese stocks was un-hedged. The European Central Bank (ECB), however, is in the opening weeks of an 18-month quantitative easing program, making a sustained rally in the euro fairly unlikely, in our view. Greece's current inability to reach a conclusive agreement for procuring additional funding provides another reason for maintaining our euro hedges at this time.

Strong quarter for dividend growth: Dividend increases typically lag earnings. Companies don't like to cut dividends; therefore, they are usually conservative in the amount paid out. However, once an earnings recovery is well established, dividends typically catch up until the payout rate recovers to a more normal level. The challenge is that the payout ratio has changed over time, especially as S&P 500 companies now spend as much on share buybacks as they do on dividends. The dividend yield on the S&P 500 has remained consistently around 2% for the last five years, which means that dividends have kept pace with the impressive growth of stock prices. However, as the chart below shows, earnings have slowed. Turning to the bottom panel, the payout ratio has risen to 40%. This is low by the standards of the last 89 years, but is typical of non-recessionary times over the last 20 years (see horizontal line). Share buybacks became popular in the late1980s and have grown in popularity since then. With a combined net payout yield (dividends plus share buybacks) of more than 4%, representing some 80% of reported earnings, we expect dividends to slow to the pace of earnings growth unless companies chose to increase dividends at the expense of share buybacks. *Dividends are not guaranteed and are subject to change or elimination.*

THE WEEKLY CHART: DIVIDENDS CATCHING UP, BUT PACE TO SLOW



Past performance is no guarantee of future results.