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ECONOMIC AND INVESTMENT FORECAST
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With the summer behind us, and second quarter earnings results revealed, investors find themselves with satisfying returns in both the equity and fixed income asset classes for 2014. Our cautiously optimistic leaning has proven correct, as the U.S. economy shook off the harsh winter weather and regained its footing. U.S. GDP growth registered a strong 4% gain in the 2nd quarter, supported by a three year high in manufacturing activity. In addition, the largest American corporations delivered robust business results that have surpassed both the top line (revenues) and bottom line (profits) in most cases.

On the back of strong earnings results, the S&P 500 U.S. stock benchmark has enjoyed a steady rise, recently eclipsing 2000 without having a formal correction (fall of greater than 10%) in over 1,000 days. Despite the climb in stock prices, the broader equity market appears reasonably valued when measured by traditional valuation metrics. For example, the price-to-earnings ratio (P/E ratio) for the S&P 500 recently registered 16x this year's earnings, only slightly higher than the longer term average.

While there is less media focus today on the dysfunctional political system here in the U.S., more attention is being paid to the geopolitical risks that exist in Europe and the Middle East. In Europe, brewing military conflict involving Russia and Ukraine is making headlines, to go along with fluid monetary policy deliberations by the European Central Bank (ECB). The ravages of deflation are a great concern of the ECB's, and a condition that would be damaging to debt-laden European Union members. In response to this risk, ECB Chairman Mario Draghi has queued a major easing of monetary policy (a European version of QE) to ward off falling prices. With major European economies, like Germany and Italy, registering negative GDP growth in the second quarter, the likelihood of an imminent policy response by the ECB is high.

Despite the turmoil internationally, a major theme in 2014 has been for U.S. domiciled companies to merge with or acquire major foreign corporations, thus taking advantage of lower offshore tax rates. Known as tax inversions, there have been at least 20 transactions greater than $10 billion each this year. This significant volume of corporate activity has garnered the attention of Treasury Secretary Jack Lew, Congress, and President Obama. U.S. politicians are quickly drafting regulations in response to this trend, in an effort to slow down these kinds of tax driven deals. A bi-partisan response to tax inversions would be welcome, particularly if focused on simplifying the tax code and lowering the existing corporate tax rate of 35%, which is double that of many other developed countries.

While the decline in interest rates year to date has surprised most investors, a reversal of that trend seems imminent. One reason is that the Federal Reserve is concluding its bond buying program next month, as they begin the transition to tighter monetary policy. The diversified American economy has once again proven both resilient and innovative, giving the Fed confidence to pivot towards a more normal interest rate regime. This endorsement of the economic recovery by the Fed is a tribute to the multiple drivers of this upswing, including U.S. exports, real estate, employment, and consumption. In an unusual twist, even the U.S. dollar has enjoyed newfound strength, after years of depreciating against foreign currencies. Because markets are global and intertwined, it will be imperative for other global economic engines (i.e., Asia, Europe) to find their stride as well. Re-establishing growth in overseas markets is a major key going forward, given the influence it can have on future investment returns, market volatility, and the longevity of the U.S. expansion.