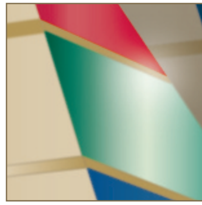

Market Update

Economic and Financial Market Midyear Update – June 2016

Sluggish Economy Could Slow Fed's Planned Interest Rate Hikes

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Market Summary

- *Economic pattern repeats – slow start to year, but some selective recovery unfolds as 2016 progresses.*
- *Consensus is building for a possible Federal Reserve (Fed) interest rate hike this summer as inflationary pressure starts to stir.*
- *Corporate earnings due to rebound, but stock valuations remain expensive.*
- *U.S. GDP grew by less than 2.5% in both the previous two years, and we would expect a similar result this year.*
- *U.S. labor reports have been an economic bright spot over the past few years, but could be peaking.*
- *Globally, sluggishness in China and the U.K.'s possible exit from the euro zone may weigh on international markets.*

ECONOMIC OUTLOOK

This year is shaping up to look very much like the past two years. The economy faced a series of bumps in its growth path early in each year and was followed by some choppy gains as the spring progressed. In the first quarter of 2016, the economy grew at less than a 1% pace. However, nearing midyear, we are now seeing some selective recovery in manufacturing, continuing gains in the service sector, and a modest reduction in our still massive global trade deficit. So while there are differences in the specifics of 2016's economic progress, as compared to 2014 and 2015, the general picture is still quite similar to what we recently witnessed. U.S. GDP grew at less than 2.5% in both the previous two years, and we would expect a similar result this year as the economy gains some traction. *(Chart 1)*

Helping things improve in the months ahead will be the recent rebound in the price of oil and other commodities. This should lift earnings in the basic materials and energy sectors, giving some support to business investment, which is still lagging. Also, ongoing resilience in housing and autos, a further decline in layoffs, some firming in the retail sector, and steady levels of consumer confidence should all help to generate some better growth in the second quarter – likely near 2.5%.

Looking more closely at U.S. employment, we see that hiring has slowed significantly in the second quarter. In fact, only 38,000 jobs were added in May, far below the 160,000 estimate. The "good" news is that the unemployment rate fell from 5.0% to 4.7%, but only because of another drop in the labor force, which contracted by 458,000 in May. As a result, the participation rate dropped back to a five-month low of 62.6%. Otherwise,

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CHART 1
REAL GROSS DOMESTIC PRODUCT

After a slow start, modest positive economic growth is starting to develop for 2016.

- Year-over-Year (YOY)
- YOY (Estimate)*
- 10-year Trend
- Sustainable Growth Trend

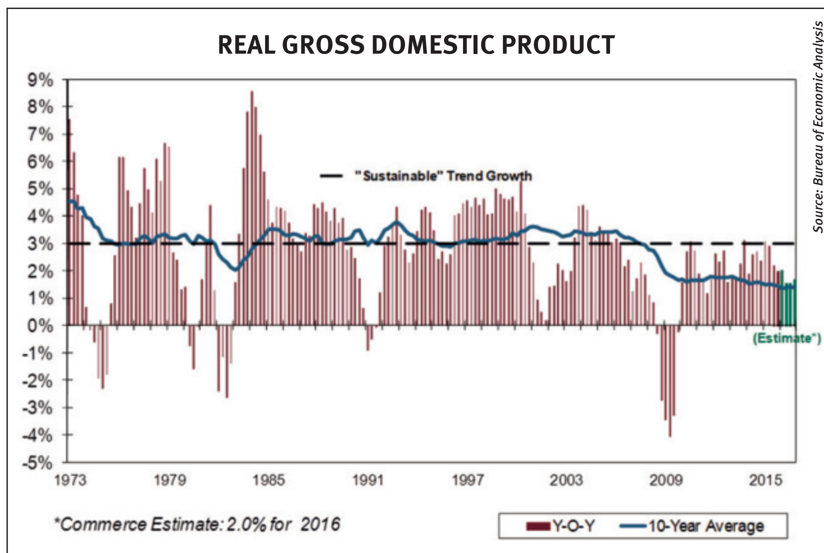
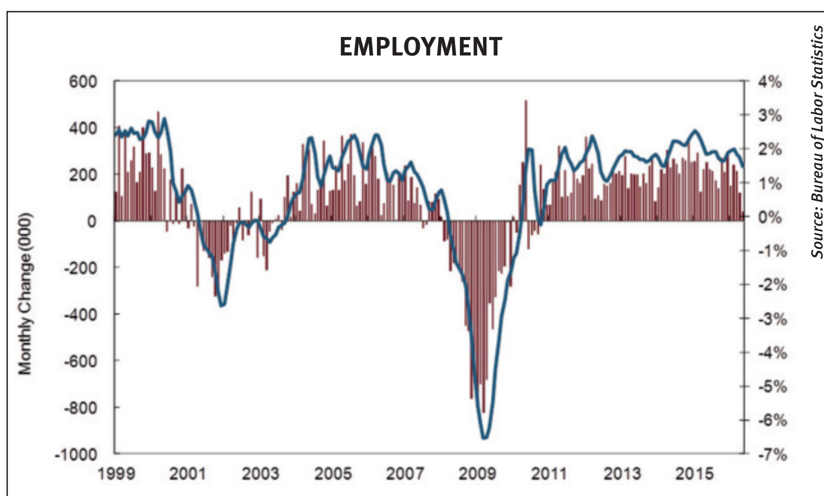


CHART 2
EMPLOYMENT

Jobs data had been meeting expectations until the May 2016 number was reported.

- Monthly Increase (Left Axis)
- 3-month Change (Right Axis)



the average weekly hours worked was unchanged at 34.4 and the annual wage growth rate remained unchanged at 2.5%.

Overall, the job market has been a bright spot in the economy for the past few years. However, several weak economic reports, including lackluster GDP growth, have caused some concern over lost momentum in the labor market. Also, recently lower corporate profits could continue to weigh on hiring and wages. *(Chart 2)*

The Institute for Supply Management (ISM) Manufacturing Index climbed to 51.3 in May from 48.0 at year-end 2015. Manufacturing has been sluggish, but it remained in expansionary territory for the third consecutive month. The strong dollar and collapse in oil have been a major headwind for U.S. manufacturing over the past year, but the dollar's strength has slowed (helping exports) and oil prices have stabilized and risen since February. So while manufacturing did improve, it did so modestly.

The much larger service sector of the economy had weaker growth in May. The ISM Non-Manufacturing Index declined to 52.7 in May from 53.8 at year-end 2015. The report details pointed to a muted pick-up in the economy after a lackluster start to 2016. However, the service sector has remained relatively resilient and this should help economic growth in the coming quarters.

Given this mixed bag of data as a backdrop, the Federal Reserve is likely to move cautiously on monetary policy. Any move to raise interest rates will likely be held off until midyear or later. Global economic concerns have lingered, especially related to China and the United Kingdom's euro zone exit vote (scheduled for June 23). As such, rate hikes will likely be exceptionally gradual, with only one or two incremental moves projected for the year.

EQUITY OUTLOOK

The main bullet point for equities in our 2016 Market Outlook was, "We don't see equity prices having much upside in the first half of 2016, and stocks could easily experience a 5% to 10% correction." As we enter June, the S&P 500 has risen 3.5% after experiencing a 10.5% decline at the beginning of the year. For the remainder of 2016 the bullet point above still applies — just substitute the second half for the first half.

In January, we moved to a slight underweight for equities in portfolios on stock valuation concerns. Valuation levels as measured by the S&P 500 Price/Operating Earnings (P/E) ratio have only gotten worse since the beginning of the year, moving from 20 times to 21 times trailing earnings. The long-term norm is 16 times and we view a P/E above 18 times as an expensive market.

Valuations moved higher because earnings declined 11% in 2015, more than was anticipated. In 2016 we do expect earnings to rebound 14%, as energy and multinational company earnings bounce back. If the S&P 500 Index remains at current price levels and earnings do indeed increase, the P/E will still be above 18 times at year-end. So it is difficult to make a case stocks can stage a strong rally from here. When markets trade at high valuation levels, they are susceptible to corrections like the two 10% declines over the last 12 months.

There is no shortage of events that could impact stock prices to

the downside. Concerns range from a Federal Reserve determined to increase short-term interest rates, political uncertainty surrounding the upcoming presidential election and rising inflation. Our last concern is that the 14% jump in S&P 500 earnings growth (it was 23% in early January) decreases as world economic growth continues to weaken.

Domestic equities still remain overweighted in portfolios versus international equities. We are monitoring closely for an opportunity to increase our exposure in international equities due to their attractive valuations, high dividend yield and three and a half years of underperformance. Emerging market equities continue to be unappealing as the slowing Chinese economy will restrain commodity prices, much of which is produced by emerging market countries.

ALTERNATIVE INVESTMENTS OUTLOOK

It has been a volatile year for the energy sector as oil (WTI) traded as low as $26.21 on February 11 and rebounded to $48.35 in early June. Cutbacks in U.S. oil production helped curtail supply, but demand remains steady. Energy infrastructure and MLP investments recovered as the supply/demand balance improved. Income distributions remained steady for the majority of MLP investments.

REITs performed well in the low interest rate, slow growth environment. REITs are often compared to bonds and both are sensitive to interest rate changes. Rising rates affect borrowing and refinancing costs of REITs, but they also signal a strengthening economy that may lead to greater demand for properties, rising occupancies and higher rental rates.

Hedge fund managers have had a challenging year being on the right side of the volatile markets they invest in. The stock market, the energy sector and high yield bond market all plunged in the first six weeks of the year and then sharply reversed course through April. Few hedge fund managers were able to be on the right side on both trades and the HFRI Fund of Funds Conservative Index returned -1.80% year-to-date through April.

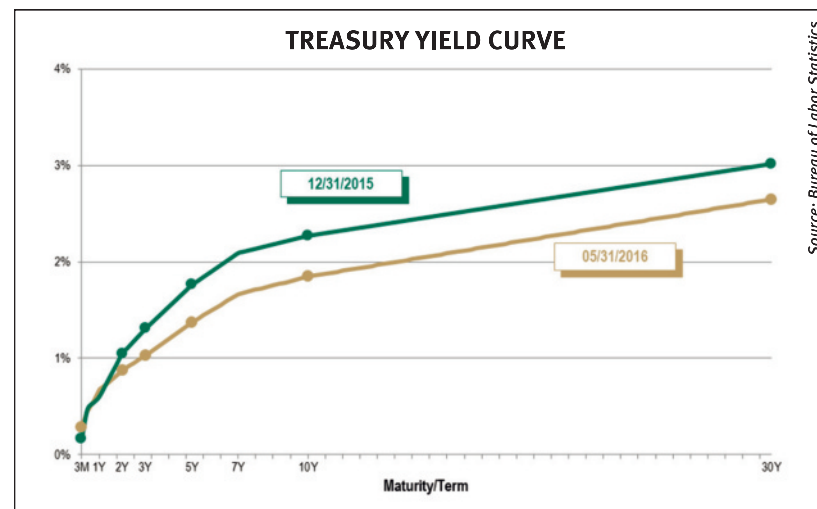


CHART 3
TREASURY YIELD CURVE

Treasury yields decreased, leaving a flatter yield curve.

- 12/31/2015
- 5/31/2016

FIXED INCOME OUTLOOK

As this economic cycle approaches the later innings, bond investors started the year with apprehension. A drop in oil prices and a slowdown in business activity at the outset of the year elevated concerns about the economy. The next Fed rate hike was being discussed but it appeared it would be later rather than sooner. As this year progressed, global growth concerns abated and domestic economic data gradually provided better news, resulting in the risk premium (i.e., credit spreads) to tighten through levels present at the start of the year. By the end of the quarter the Federal Reserve's "policy normalization" discussion was back on the table.

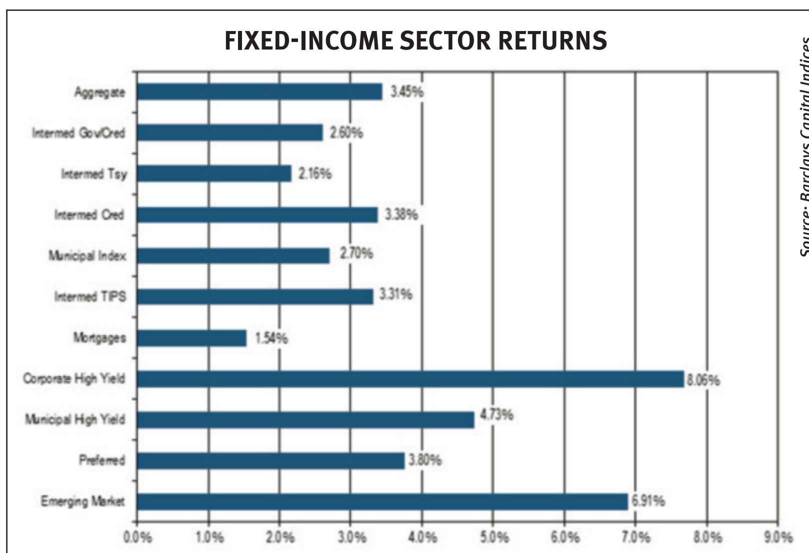
Inflation pressures are starting to stir as reflected by the Consumer Price Index (CPI) and Core-CPI (excludes fuel and food price changes). The Fed monitors Core-CPI more closely and at 2.1% year-over-year the index is slightly above the Fed's target inflation number. Further upward moves will put downward pressure on bond prices and enable the Fed to advance its rate-hike plans.

The 10-year U.S. Treasury note yield spent January declining and for the past four months remained range-bound between 1.65% and 2.00%, finishing May at 1.85%. With yields on the short maturity end of the Treasury yield curve highly sensitive to expected changes in the Fed Funds rate, the yield curve flattened to a degree not seen since 2007. Yields on the short end declined less than yields for intermediate and long maturities. *(Chart 3)* Lack of yield in overseas bond markets (i.e., Japan, Europe) helped keep demand for U.S. bonds strong, placing downward pressure on long maturity yields.

As mentioned above, falling oil prices in January and February along with slowing global economic growth concerns led to a rough start as corporate spreads widened in reaction to the market turmoil. As we progressed further into the year, oil prices and commodity prices stabilized. Positive economic data helped attract bond investors back into investment grade and high yield bond markets. The investment grade corporate bond market received a boost from the European Central Bank's (ECB) announcement that euro-denominated U.S.

CHART 4
FIXED-INCOME SECTOR RETURNS YEAR-TO-DATE (AS OF 5/31/2016)

All fixed-income sectors are generating a positive return year-to-date.



corporate bonds were eligible for the ECB's purchasing program. Spreads tightened and along with lower interest rates helped produce positive returns across all of the fixed income sectors. The Barclays Aggregate Bond Index generated a 3.45% year-to-date return (through May 31, 2015).

The Barclays Municipal Bond Index is up 2.70% year-to-date. Higher quality municipal bond yields are starting to approach all-time lows. *(Chart 4)* Municipal bonds have posted 11 consecutive positive months. Robust demand and manageable supply have contributed to the streak. Puerto Rico and Chicago remain among the few unfavorable factors affecting this sector. Near-term performance may be challenged given the sector's strong performance and the threat of negative headline news regarding the struggle with state pension issues and Puerto Rico.

Going forward, some upside remains in the taxable bond market. Growing inflationary pressure may hamper some of the improvement. If worldwide yields remain low, overseas foreign demand could help keep Treasury yields from rising significantly, even if the Fed starts raising the Fed Funds rate. The likely result is modest returns for the remainder of the year.

In fixed income portfolios in general, we plan to maintain our exposure to the non-government sectors, while gradually improving quality and liquidity. We also tend to favor portfolio durations that are moderately short to neutral relative to their corresponding benchmarks.

CONCLUSION

Perhaps this newsletter issue could be titled "The Shampoo Economy: Lather, Rinse, Repeat." Indeed, we are seeing some repetition in what has definitely been a range-bound stock market. Mix equal parts of slow and steady GDP growth, continued concerns about equity valuations despite improving earnings, geopolitical uncertainties and sluggishness in China, and a delayed interest rate hike by the Fed, and you have the main elements laid out for our current economic picture.

What will change the mix in the coming months? Is there another market break-out waiting around the corner or has the air gone out of the sails in the six-year bull run? We believe some of these questions will be answered by events that have not yet unfolded. The results of the November presidential elections will certainly affect any outcomes. And any possible Fed interest rate hikes to "normalize" will test the economy, but hopefully draw a better reaction than the first effort.

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JUNE 13, 2016

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