Market **Insights**

Economy | Capital Markets

Q2
2015

Economy

Almost seven years removed from one of the most violent market and economic downturns in history, we are constantly reminded that returning to a more "normal" environment is not easy or without obstacles. The massive support provided by the Federal Reserve in the wake of the financial crisis has diminished and the historically low interest rate environment appears to be coming to an end. The most immediate concerns are whether the economy can withstand higher interest rates and how investors' psyches might change in light of this new reality. At the same time, uncertainties in several European countries and other problem spots around the world create added anxiety for investors.

In the most recent world economic outlook, the International Monetary Fund (IMF) materially reduced its estimates of potential growth in both developed and emerging economies from 3.1 percent to 2.5 percent in 2015. The IMF cited "significant uncertainties as to the future resilience of economic growth" as the main issue. It also cut its 2016 forecast down slightly to 3.0 percent. While the IMF is concerned about mounting fears surrounding the strength of the U.S. recovery after weaker than expected growth in the first quarter, it also sees improvements ahead. It projects growth picking up later in the year as temporary negative factors, including bad weather and the West Coast port strike, begin to fade. Still, the IMF remains uneasy about the consequences for countries outside the U.S. Many of these countries have benefited from the flood of cheap money over the past few years. With the Federal Reserve prepared to begin raising interest rates, the result could lead to higher volatility and financial instability around the world. Consequently, world economies continue to grow, but at different rates.

Domestically, many of the constraints on growth that were prevalent in the aftermath of the credit crisis are dissipating. While not altogether gone, the deleveraging cycle is much less of a drag on growth than a few years back. Although the U.S. can now grow above trend, the potential trend rate of growth has been declining for several years due to lack of investment in both physical and human capital. Combined with poor demographic trends, additional regulation and tighter credit standards, the potential trend level of real growth is now below 2 percent.

During the second quarter, economic data proved a bit perplexing to decipher. Employment gains continued and job creation remained solid, but household spending and retail sales fell short of estimates for most of the year. Further, the recent gains in manufacturing have stalled from the impact of the stronger dollar and cuts in the energy sector that haven't fully worked through the system. Yet, the recent Institute for Supply Management (ISM) factory index report showed a three-month high of 52.8 in May. A pickup in bookings, and the strongest reading for order backlogs since November, points to a rebound in production in the months ahead.

During the quarter, mixed economic data and expectations that the Federal Reserve will hike interest rates sometime this year provided some additional uncertainty, particularly in fixed-income markets. The yield on the 10-year U.S. Treasury jumped 0.50 percent, which resulted in a meaningful decline in bond prices. Equity markets started the quarter strong, faded toward the middle and picked up again at the end.

For the remainder of the year, we expect stronger, albeit tempered, growth in the U.S. After a disappointing start to the year due to weather, the West Coast port strike and flawed government data adjustments, the second half should be highlighted by improved consumer spending. While the dramatic decline in oil happened quickly, the benefits for consumers tend to accrue more slowly. As a result, these gains from higher real disposable incomes were generally saved over the past few quarters. The combination of growing employment, firming wages, low inflation and a rising stock market should propel consumer spending over the last six months of the year. Other positive growth trends include a reduction in the personal and business deleveraging cycle and pent-up demand for business capital and infrastructure spending. Further, the shrinking backlog of delinquent mortgages and the declining number of home vacancy rates point to gains in new home construction and firmer prices. Lastly, the U.S. continues to be a hotbed of new innovations, such as the shale oil and gas revolution and Silicon Valley technologies.

This stabilization of economic activity is somewhat mitigated by expectations that the Federal Reserve is on course to raise interest rates by the end of the year. While still historically low, rising interest rates should continue to strengthen the dollar versus other world currencies and bring capital flow back to the U.S. In this environment of higher interest rates and modest growth, investors are challenged with determining the appropriate valuations for both stocks and bonds. Particularly, since the current bull market is already the fourth strongest in terms of gains over the last eight decades. We continue to expect slightly higher interest rates throughout the remainder of the year and into 2016, to the detriment of traditional fixed-income securities. In equities, while the bull market may continue, we are growing concerned that valuations are stretched and earnings growth will underwhelm, leading us to a more cautious investment stance.

As always, investing in the capital markets comes with some risk and uncertainty. We thank you for your continued support of our investment process as we work hard to deliver positive risk-adjusted portfolio returns to our clients. Should you have any questions, please do not hesitate to reach out to your financial adviser.

Capital Markets

During the quarter, bond yields rose significantly (prices fell) as expectations grew of an impending interest rate hike by the Federal Reserve later in the year. Although equity prices were a bit volatile during the quarter, prices trended higher across most sectors with domestic equity markets generally outperforming European markets.

Disclosure: It is not possible to invest directly into an index. The indices listed above are unmanaged and are not affiliated with the Advance Capital Companies.

Market Index Performance(%)
As of June 30, 2015

	2nd QTR	YTD	1 Year	Annualized 3 Year
S&P500	0.28	1.23	7.42	17.27
Dow Jones Industrial	-0.29	0.03	7.21	13.75
Nasdaq Composite	2.06	5.99	14.61	20.98
Barclays Aggregate Bond	-1.68	-0.10	1.86	1.83
Citigroup BIG Corporate	-2.90	-0.74	0.93	3.37
MSCI World	0.47	2.97	2.06	14.98

Economy from a Historical Perspective

	Latest	Average*	Definition	Comments
U.S. Unemployment Rate	5.57%	6.21%	Represents the number of unemployed persons as a percent of the labor force	Continues to decline at steady rate
Consumer Price Index	0.00%	4.20%	Represents changes in prices of all goods and services purchased for consumption	Remains low
U.S. Capacity Utilization	78.10%	80.56%	The greatest level of output that a plant can maintain within the framework of a realistic work schedule, accounting for normal downtime	Near historical average
Gross Domestic Product+	2.40%	3.00%	Total value of all goods and services produced indicates strength or weakness of the economy	Positive, but still below average
10 Year Treasury Yield	2.35%	6.65%	Yield on the current 10 year treasury bond	Trending higher recently, still historically low
Annual Housing Starts	1,005,000	1,449,260	New privately owned housing unit starts annualized rate	Steady improvement

*Average from 1966 to Present   + Annualized

Source: Bloomberg