Market **Insights**

Economy | Capital Markets

Q3
2015

Economy

Although most of the economic data and trends remain positive, the abrupt volatility experienced in the capital markets during the third quarter was another reminder that there is a small margin of error in this environment. Any unexpected event has the potential to negatively impact both growth and investor psychology around the world. Further, the much anticipated and uncertain timing to the start of the Federal Reserve's interest rate increase has put pressure on world currencies and domestic corporate earnings as well as strained investors' confidence. The question of whether the economic fundamentals are strong enough to overcome these headwinds and how investors might react is expected to be answered over the coming quarters and years.

Janet Yellen and her colleagues at the U.S. Federal Reserve (Fed) have spent months contemplating the timing of an increase in short-term interest rates. While the cynic might describe the Fed's behavior as "reactionary," the Fed itself prefers the term "data-dependent." The Fed continuously monitors incoming economic data for signs of overall strength and any associated inflationary pressures in the system. The Fed appears to have found a two-speed economy with the general health of the consumer improving markedly while the industrial side of the economy continues to struggle.

One reason for this apparent disconnect in economic data is the dramatic fall in energy and commodity prices. Over the past year, the price per barrel of oil has fallen about 50 percent, Copper is down 27 percent and Aluminum is off about 22 percent. The substantial slowdown in demand from China is the main culprit behind these declines. The plunge in oil prices has led to a drop in average gasoline prices, from approximately $3.70 per gallon last June to around $2.50 a gallon today. With more money in their pockets, consumers have felt somewhat better about their financial health. Correspondingly, the University of Michigan Consumer Sentiment Index recently neared a five-year high. While the dramatic decline in oil prices has been well received by consumers, it's been bad news for many industrial companies. Oil and gas is an important end market for capital goods and equipment manufacturers. For instance, North America exploration and production companies have already cut spending by roughly 35 percent this year, which has had a ripple effect throughout the industrial sector and a negative impact on employment.

Still, the three keys to sustainable economic growth remain: employment, manufacturing and interest rates. Since the depths of the financial crisis, the U.S. economy has added approximately six million new jobs, which has pushed the nation's unemployment rate to 5.1 percent. Further, the job openings rate is the highest in 15 years. In manufacturing, robust car sales and a recent rebound in investment in new equipment has helped offset weak demand in emerging market countries such as China. Growth in the service sector, from retailers to restaurants, is nearly the strongest it has been in a decade. Finally, although interest rates have ticked higher recently, they remain historically low, and the Fed has made their intentions clear to keep rates low for an extended period of time.

The general uncertainties surrounding growth and the direction of interest rates led investors to readjust their appetite for risk during the quarter. As a result, the broad equity market indices declined significantly, with losses generally across the market cap spectrum. Higher quality and longer dated fixed-income securities benefited as interest rates declined markedly during the quarter.

Looking ahead to the remainder of the year and into the next, the underlying fundamentals of the economy appear on solid footing with reasonably positive trends. The growth in the U.S. economy has been steady, albeit slowing over the past few years, and we expect that trend to continue, barring an unforeseen shock. Activity in the housing sector and gains in the service sectors should provide stability as other areas of the economy face headwinds. The dramatic decline in commodity prices, while good for consumers, will prove problematic for certain industrial sectors reliant on positive or stable prices. Further, we expect gains in the labor markets to continue, with a corresponding uptick in wages along the way at some point over the next few quarters. Finally, the deceleration of China's growth rate will send ripple effects through the global economy, proving particularly problematic for those sectors directly tied to its economy and commodities in general.

Against this backdrop of modest domestic growth and reasonable fundamentals is a growing sense of uncertainty in the capital markets. The combination of weak top-line corporate revenue growth, expectations of higher interest rates and relatively high stock and bond valuations has investors reassessing their appetite for risk. We still expect interest rates to trend slightly higher over the coming quarters and years, resulting in modest returns for most fixed-income investments. After several years of above-average equity returns and a bull market that is long in the tooth, we expect equities to remain under pressure in this more uncertain and volatile environment. We expect positive, yet below-average historical returns in equities over the next few years.

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, U.S. Treasury yields declined as investors sought safer assets amidst higher market volatility and concerns about a potential economic slowdown. Higher risk bonds, such as investment-grade and high-yield bonds, generally underperformed. Equity prices were quite volatile in the quarter, with prices down substantially across most market sectors and indices.

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

	3rd QTR	YTD	1 Year	Annualized 3 Year
S&P500	-6.44	-5.29	-0.62	12.37
Dow Jones Industrial	-6.98	-6.95	-2.11	9.25
Nasdaq Composite	-7.09	-1.52	4.15	15.60
Barclays Aggregate Bond	1.23	1.13	2.94	1.71
Citigroup BIG Corporate	0.43	-0.31	1.45	2.18
MSCI World	-8.32	-5.60	-4.51	9.26

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.

Economy from a Historical Perspective

	Latest	Average*	Definition	Comments
U.S. Unemployment Rate	5.10%	6.20%	Represents the number of unemployed persons as a percent of the labor force	Continues to decline at steady rate
Consumer Price Index	0.20%	4.20%	Represents changes in prices of all goods and services purchased for consumption	Has fallen this year
U.S. Capacity Utilization	77.62%	80.48%	The greatest level of output that a plant can maintain within the framework of a realistic work schedule, accounting for normal downtime	Has declined slightly
Gross Domestic Product+	3.70%	6.60%	Total value of all goods and services produced indicates strength or weakness of the economy	Positive, but still below average
10 Year Treasury Yield	2.04%	6.62%	Yield on the current 10 year treasury bond	Remains historically low
Annual Housing Starts	1,126,000	1,447,000	New privately owned housing unit starts annualized rate	Steady improvement

*Average from 1966 to Present + Annualized

Source: Bloomberg