Market **Insights**

Economy | Capital Markets

Q4 2015

Economy

The performance of the economy and capital markets during the final quarter can be best described as both encouraging and discouraging. While several economic trends remain positive, others appear ominous and potentially disruptive to future growth and market stability. For many consumer and commodity sectors, 2015 offered a relatively supportive economic environment. For industrial and commodity-producing sectors, however, it was a year of slumping demand and declining profits. Amidst these and other mixed economic messages, the Federal Reserve (Fed) finally began to "normalize" interest rates by marginally increasing short-term interest rates on December 16 by a quarter of a percent. Although this initial move was widely anticipated by investors, the timing of additional rate hikes and the long-term ramifications on the economy and financial markets are unclear.

For months, investors have parsed statements from Federal Reserve policymakers, seeking some insight into when they might deem the U.S. economy sturdy enough to edge away from their zero interest rate policy. While low domestic inflation has reduced the urgency to normalize interest rates, the Fed wants to act before signs of inflation pick up. The anticipation of tighter financial conditions has already raised funding costs for some countries, fueled recent market volatility and led to an increase in the value of the U.S. dollar relative to other world currencies. However, concerns that marginally higher U.S. interest rates will destabilize the global economy and tip it back into recession appear unfounded, as the Fed intends to proceed with caution. Still, central bank monetary policies around the world are likely to diverge as the Fed begins the normalization process while monetary authorities in Europe and Japan advance quantitative-easing measures. Underlying these trends is the reality that much of the global economy remains in a protracted healing process following the 2008-2009 financial crisis. Global growth expectations remain mixed, with a number of developed markets gradually improving in contrast to weakness in major emerging markets, including China, Russia and Brazil.

Against the backdrop of low global growth and potentially divergent global monetary policy trends, the U.S. economy remains relatively healthy, with the turnaround in employment over the past five years the key bright spot. In fact, the economy is poised to cross an important milestone in the year ahead as the labor market will almost certainly achieve full employment. Many companies appear starved for skilled workers as the job-openings rate is currently at a record high. At the same time, applications for jobless benefits matched a four-decade low. A tighter labor market has nudged wages higher and, combined with dramatically lower gas prices, the measure of personal finances has reached the second-highest level since 2007.

Continued gains in housing and service sectors serve as additional positive aspects of our economy. In housing, the number of homes sold but not yet started rose to the highest level since July 2007. The growth in payrolls and low number of layoffs has increased demand for housing as more Americans now have the means and confidence to invest in a home. Further, the service sector index is running at the highest pace in three months, indicating solid expansion in this part of the economy.

While encouraging, other headwinds persist in the U.S. and around the globe that could potentially derail or severely impact growth and nascent prosperity. In the most recent Institute for Supply Management survey, U.S. manufacturing activity contracted at the fastest pace since the last recession. Bloated stockpiles prompted cutbacks in orders and production. The key culprits include slumping commodity prices, a strong dollar and weak global growth. These factors, along with heightened concerns about China's ability to manage its economic slowdown, triggered a sell-off in higher-risk debt including corporate high-yield, emerging market bonds and several world currencies. Many reached their weakest levels since the global financial crisis.

Looking ahead to 2016, we are cautious on our outlook for both the economy and capital markets. The equilibrium between growth and inflation appears fragile and prone to volatility and risks along the way. While global growth is projected to hover around 3 percent, we expect U.S. growth to trend lower at around 2-2.5 percent. The headwinds of higher interest rates and a weak manufacturing sector are expected to slightly offset healthy gains in housing and employment. Meanwhile, foreign economic expectations are mixed.

In this environment of modest global growth and disparate global monetary policy trends, we expect both domestic stocks and bonds to produce moderately positive returns, but with above-average volatility. We are favoring international markets as compared to domestic markets, where accommodative monetary policies and solid growth should support financial markets. Finally, we are wary of the riskier sectors of the bond and stock markets and remain selective with our fund managers and allocation tilts in the models.

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 increased as investors anticipated the Federal Reserve to move short-term interest rates higher and economy data proved adequate. The dramatic fall-off in commodity prices pushed the prices lower for higher yield and certain segments of the investment-grade market. Equity prices generally pushed higher during the quarter as investors tried to discern the direction of growth and inflation.

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 December 31, 2015

	4th QTR	YTD	1 Year	Annualized 3 Year
S&P500	7.03	1.37	1.37	15.11
Dow Jones Industrial	7.70	0.21	0.21	12.65
Nasdaq Composite	8.76	7.11	7.11	19.89
Barclays Aggregate Bond	-0.57	0.55	0.55	1.44
Citigroup BIG Corporate	-0.43	-0.74	-0.74	1.66
MSCI World	5.64	-0.25	-0.25	10.32

Economy from a Historical Perspective

	Latest	Average*	Definition	Comments
U.S. Unemployment Rate	5.00%	6.20%	**Represents the number of unemployed persons as a percent of the labor force**	**Continues to decline at steady rate**
Consumer Price Index	0.50%	4.20%	**Represents changes in prices of all goods and services purchased for consumption**	**Has fallen this year**
U.S. Capacity Utilization	76.95%	80.47%	**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+	2.00%	2.90%	**Total value of all goods and services produced indicates strength or weakness of the economy**	**Positive, but still below average**
10 Year Treasury Yield	2.27%	6.61%	**Yield on the current 10 year treasury bond**	**Low but rising recently**
Annual Housing Starts	1,173,000	1,448,000	**New privately owned housing unit starts annualized rate**	**Steady improvement**

*Average from 1966 to Present   + Annualized   *Source: Bloomberg*

Disclosures: Investments are not insured, and may lose money. Client should be prepared to bear the risks associated with investing.

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