Market **Insights**

Economy | **Capital Markets**

Q1 2016

Economy

The first quarter of the year brought renewed uncertainty about the strength of global growth and corporate earnings and, by extension, the sustainability of the seven-year bull market in equities. The extreme and sudden decline in the U.S. equity market in January proved to be the worst in history and was considered a potentially ominous sign for the remainder of the year. Yet, by the end of the quarter, the market recovered most of its early losses and was about even for the year. This heightened volatility indicates investors' anxiety around the direction of growth, particularly in China, and the pace and degree of interest rate hikes by the Federal Reserve. While growth is generally positive around the globe, with the U.S. projected to grow about 2.5 percent for 2016, the strength of several key trends are questionable and there remains a stark dichotomy between weak and strong industries.

Internationally, the big story continues to be the deceleration of growth in China. Its growth rate has slowed considerably, from about 9 percent a few years ago to under 7 percent as it wrestles with the transition to a consumer-driven economy. Fears that a further protracted slowdown could hinder the broader global recovery have ignited higher market volatility and uncertainty among investors. With China slowing, a number of emerging markets have also felt the pinch, mostly due to weak global demand and depressed commodity prices. It is important to keep in perspective that China's transition toward an economic structure more reliant on consumption may have its challenges, but it is well underway and could provide huge growth potential for many companies. In a variety of sectors, high-quality domestic and multinational firms have continued to prosper in China and have set the foundation for solid long-term success.

On the domestic side, growth trends remain good but not great. Although weakening global demand has cast a long shadow, U.S. company earnings overall appear to be in reasonably good shape. While earnings expectations have plummeted for industrial and energy-related sectors such as oil and gas drilling, a broad array of consumer-focused companies, like home improvement and internet retailers, are generating strong profits. A healthy and seemingly sustainable rebound in consumer spending has been one of the main catalysts. A very resilient and improving employment picture has translated into slightly better wage gains, reinforcing job security and encouraging Americans to spend. Further improvement in the labor market is expected as the unemployment rate hovers around 5.0 percent and labor becomes scarce.

In another positive sign, orders for U.S. capital goods in January were the most since June 2014. The increase was broad based, from cars and computers to machines and metals. It is a welcome sight that domestic demand is a source of support for manufacturers that have been battered by diminished overseas demand. Further, it appears that bloated inventory levels have started to recede and the worst may be over for the ailing industrial sector. Factory-produced goods increased at the fastest monthly pace since mid-2015.

The American economy may finally be strong enough to give companies the confidence to increase prices. Consumer prices, excluding food and fuel, rose 0.3 percent in February for the second straight month, according to the Labor Department. The last time that happened was in early 2001, signifying just how rare are consecutive moves of such magnitude. Also, over the past year, core consumer prices were up 2.3 percent, the biggest year-to-year gain since May 2012. Not surprising, the Federal Reserve ended its easy monetary policies of the past few years. In December, the Fed raised short-term interest rates and may raise them again this year and into next year should both growth and inflation tick higher.

In this environment, we are a bit more constructive on the prospects for both the economy and capital market returns. We still expect single-digit type returns for most global equities, with a slight edge to foreign developed market equities. In bonds, we expect low, single-digit returns for high-quality and multi-sector bond funds. Meanwhile, we see the potential for below-average returns in higher risk sectors of the bond market. Still, we are maintaining a slightly more conservative tilt in client portfolios until we get additional clarity from the Federal Reserve on the timing of interest rate hikes and whether global growth is sustainable.

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

U.S. Treasury yields fell sharply during the first half of the quarter as investors grew concerned about economic growth and the pace of interest rate hikes by the Federal Reserve. By quarter's end, however, the yield climbed back marginally as volatility subsided. In equities, prices fell considerably during January and part of February then made a sharp rebound toward the end of the quarter. Domestic equities generally outpaced foreign markets and value stocks trounced growth stocks.

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 March 31, 2016

	1st QTR	YTD	1 Year	Annualized 3 Year
S&P500	1.35	1.35	1.77	11.77
Dow Jones Industrial	2.20	2.20	2.08	9.25
Nasdaq Composite	-2.39	-2.39	0.66	15.68
Barclays Aggregate Bond	3.03	3.03	1.96	2.49
Citigroup BIG Corporate	3.95	3.95	0.93	3.06
MSCI World	-0.18	-0.18	-2.85	7.46

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	1.00%	4.20%	**Represents changes in prices of all goods and services purchased for consumption**	**Has moderated recently**
U.S. Capacity Utilization	75.43%	80.43%	**The greatest level of output that a plant can maintain within the framework of a realistic work schedule, accounting for normal downtime**	**Has declined recently**
Gross Domestic Product⁺	1.40%	2.80%	**Total value of all goods and services produced indicates strength or weakness of the economy**	**Positive, but still below average**
10 Year Treasury Yield	1.77%	6.58%	**Yield on the current 10 year treasury bond**	**Remains historically low**
Annual Housing Starts	1,178,000	1,446,000	**New privately owned housing unit starts annualized rate**	**Steady improvement**

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