Market **Insights**

Economy | **Capital Markets**

Q2
2016

Economy

After a rough and volatile first quarter in the financial markets, the second quarter was more subdued with a general rebound in prices and investor appetite for risk assets.

We are now seven years into a bull market, and it is important to put into perspective the rarity of this event. Since the bottom in March 2009, the market, as measured by the Dow Jones Industrials, has posted a gain of slightly more than 180 percent. It is currently the third longest bull market in history, as we have gone seven years without a 20 percent market decline. Since 1900, there have been 23 recorded periods that are considered bull markets. Only twice has a bull market made it to its seventh year, and only once to its eighth year. Needless to say, this current bull market looks long in the tooth and susceptible to the inevitable decline. Although the underlying economic fundamentals of growth, earnings and employment appear stable and somewhat supportive of current market conditions, geopolitical risks, a misstep by the Federal Reserve or a decline of growth expectations could significantly impact investor psyche and financial assets. At the end of the quarter, the British referendum to leave the European Union rattled world financial markets and highlighted these potential risks.

The U.S. economy remains stuck in a low growth, modest inflationary environment. Recent data indicate these conditions will persist for a while. Most of the data suggest an economy that is teetering between modest growth and slight contractions, depending on the sector and time period. On the positive side, activity at factories unexpectedly expanded at a faster pace, after struggling for several quarters. Twelve of the 18 manufacturing sectors reported growth in May and deliveries jumped to the highest level since December 2014. However, many producers are still battling the fallout from the plunge in energy prices, which has sapped the appetite for investment. Meanwhile, a strong dollar and lackluster global growth have weighed on exports. Further, capacity utilization, which measures the percent of a plant that is currently in use, fell to 74.9 percent in May, the lowest since February 2014. Unsurprisingly, the slowdown in manufacturing has started to impact the robust employment gains of the past few years. The May jobs report showed a disappointing 38,000 new jobs created and a downward revision in April. On the other hand, the job-openings rate reached an all-time high in the spring, which signals that the pace of hiring is likely to rebound and the recent weakness in job creation might be temporary.

In Europe, while their recovery has been gaining momentum over the past three years, its pace has disappointed in light of the decline in growth from 2008-2013. Eight years after the financial crisis, real output is still flat relative to its pre-crisis peak. In contrast, the output in the U.S. is about 10 percentage points higher. Unfortunately, prospects over the next five-year secular horizon do not look much brighter. For starters, working age population growth is slowing meaningfully, with demographics alone set to shave nearly 0.5 percentage points off growth. Further, the damage to labor markets and investments caused by the recent double-dip recession suggests that labor utilization and productivity are also likely to contribute less to growth than a decade ago. Adding it all together, the eurozone's growth potential is probably close to 1.0 percent, down from 1.75 percent a decade ago. Faced with low growth, weak inflation, high real debt, and social and political pressures, the European Central Bank (ECB) will likely maintain a very accommodative monetary policy. The central bank's quantitative easing (QE) program, which is scheduled to end in March 2017, is likely to be extended and it could broaden the range of assets it buys.

In response to the diminished growth outlooks in developed markets such as Europe, China and Russia, the International Monetary Fund (IMF) recently downgraded its global growth forecast for the next two years to around 3.2 percent. The outlook reflects slowing growth in oil exporting countries and a modest slowdown in China, where activity is shifting from manufacturing and investing to consumption. On the positive side, areas like India, Mexico and several Asian countries are showing strong growth. However, lower global growth heightens the risks of unintended consequences such as geopolitical conflicts, exchange-rate disruptions and financial turmoil. Accommodative monetary policies remain essential to mitigate these risks as well as support economic growth and lift inflation expectations in many parts of the world.

In this environment, investors are struggling with the uncertainties around the timing of global monetary policy changes. Each decision by a central banker has potential positive or negative ramifications for world economies and markets. While there are some positive economic signs, we remain concerned that investor sentiment is being driven more by the direction of monetary policy rather than the traditional valuation metrics for both stocks and bonds. Valuations still appear elevated and prone to the type of market volatility that existed in late 2015 and early 2016. At some point in this market cycle, valuations and earnings will matter again and the result could be a harsh reality for investors. For these reasons, we remain cautious in our investment stance, even as markets rebounded near all-time highs toward the end of the quarter. We are acutely aware that heightened volatility and downside risks are elevated.

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 remained a bit volatile throughout the quarter, with the general trend a bit lower than the first quarter. Concerns over economic growth and potential interest-rate hikes kept fixed-income investors anxious. In equities, the rebound in prices from the latter half of the first quarter continued into the second quarter. Value stocks tended to outperform growth stocks while domestic stocks generally performed better than most international sectors.

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, 2016

	2nd QTR	YTD	1 Year	Annualized 3 Year
S&P 500	2.46	3.84	3.98	11.60
Dow Jones Industrial	2.07	4.31	4.50	8.95
Nasdaq Composite	-0.22	-2.61	-1.58	13.91
Barclays Aggregate Bond	2.21	5.31	6.00	4.05
Citigroup BIG Corporate	3.63	7.73	7.72	5.39
MSCI World	1.20	1.02	-2.16	7.57

Economy from a Historical Perspective

	Latest	Average*	Definition	Comments
U.S. Unemployment Rate	4.93%	6.19%	**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	74.90%	80.40%	**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⁺	1.10%	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	1.48%	6.55%	**Yield on the current 10 year treasury bond**	**Remains historically low**
Annual Housing Starts	1,164,000	1,445,000	**New privately owned housing unit starts annualized rate**	**Steady improvement**

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