Market Insights

Economy | Capital Markets

Q3 2016

Economy

While economic data generally underwhelmed in the third quarter, capital markets proved their resiliency by posting solid returns across most equity and fixed-income sectors of the market. Over the past 18 months, the domestic equity markets have had two bouts of volatility, including episodes of quick and dramatic price declines of about 10 percent. Each time, the rebound was just as impressive and resulted in fresh new all-time highs.

At present, financial markets are confounded by a plethora of uncertainties, many of which prove that sometimes truth is stranger than fiction. For instance, over one-third of European and Japanese sovereign debt has a negative yield, an unprecedented reality. The central bankers around the world have coordinated their efforts to force rates lower in the hopes of jump-starting both growth and inflation. The plan is simple: drive interest rates low enough to encourage investors to switch from painfully low-yielding but "risk-free" cash or sovereign debt to other assets that would more fully support economic growth. Most agree that these monetary policies have been quite effective so far. The concern is that such financial "medicines" have a prescribed dosage that cannot be exceeded without consequences.

On the economic front, the data remains mixed with certain positive trends generally outweighed by negative ones. A drop in corporate profits is the main takeaway from the second-quarter GDP report. The average growth rate of the last four quarters is now the lowest since mid-2013. An abrupt drop in the Institute for Supply Management's services gauge to a six-year low is the latest in a string of unexpectedly weak data. The setback in demand for services is a bit of a surprise given that households are still spending at a solid clip and home sales remain steady. Further, the latest reading on the manufacturing sector shows a contraction and a slowdown in hiring. While there is hardly any evidence that growth is falling off a cliff, the run of disappointing figures makes it tougher to argue that the underlying momentum of the world's largest economy is holding up. It also potentially complicates the task of Federal Reserve policymakers to decide when to raise interest rates.

On the positive side, both housing and employment remain key drivers of growth. The nation's unemployment rate is hovering at a cyclical low of 4.9 percent. For most of the current cycle, the unemployment rate has been surprisingly consistent in its pace of decline, falling approximately 1.0 percentage point per year. If this pace is sustained, it would put the jobless rate handily below the low-end of the full-employment range by year-end. Full employment will be a game-changer for U.S. workers because it will result in labor shortages extending beyond specific pockets of skilled workers. It might actually help the wage freeze finally thaw. The most direct impact from wage growth will be increased consumer spending, which remains the main driver of economic growth. Although wage inflation may moderately lag behind labor market performance, conditions are ripe for an acceleration. The housing sector should continue to contribute positively to growth in the coming quarters, albeit only modestly. Construction has lost some steam lately as multi-family construction growth has moderated, while the single-family sector activity saw slight acceleration. However, the combination of improving homebuilder confidence, better household income prospects, favorable financing rates and rapidly rising rental inflation is encouraging for ongoing gains in construction for the coming quarters.

In foreign markets, one of the main storylines has been the British referendum to leave the European Union in late June. While doomsayers projected an economic collapse if the country left, so far the British economy is holding up reasonably well. Retail sales figures for August show a small monthly drop of only 0.2 percent and overall consumer spending is slightly positive. However, even though it is still too soon to see any impact on official unemployment data, recent employment surveys point to the potential for further contraction ahead. Further, growth in business credit has slowed and the value of infrastructure contracts fell by 20 percent as compared to before the vote. The Bank of England cut interest rates from 0.5 percent to 0.25 percent in an attempt to support business lending and growth forecasts have been lowered from 2.3 percent to 0.8 percent in 2017. Following the vote to leave, the government and the Bank of England have been forced to use monetary and fiscal policy to try to keep growth in positive territory.

Looking ahead, investor sentiment and the strength of global growth will hinge on the efforts of central bankers to keep interest rates low. We maintain that this environment is somewhat conducive to risk assets, even though historical valuations of both stocks and bonds keep expanding to unnerving levels each day. At some point, low interest rates and undying support by central banks may not be enough to solely support economic growth and asset prices. Our internal financial market indicators continue to flash "caution". For these reasons, we remain slightly conservative in our investment stance, even as markets flirt with all-time highs and volatility measures are near all-time lows. We are acutely aware that heightened volatility and downside risks may be 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

The yield on U.S. Treasury bonds trended higher as investors believed the Federal Reserve would increase interest rates toward the end of the year. Investment-grade and high-yield sectors of the bond market posted positive results for the quarter. Most sectors of the domestic equity market posted positive returns as volatility measures collapsed and investor sentiment improved. Many parts of the international equity markets outperformed the U.S. during the quarter.

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 September 30, 2016

	3rd QTR	YTD	1 Year	Annualized 3 Year
S&P500	3.85	7.84	15.42	11.13
Dow Jones Industrial	2.78	7.21	15.46	9.20
Nasdaq Composite	10.02	7.15	16.54	13.53
Barclays Aggregate Bond	0.46	5.80	5.19	4.02
Citigroup BIG Corporate	1.54	9.38	8.91	5.66
MSCI World	4.99	6.06	12.04	6.46

Economy from a Historical Perspective

	Latest	Average*	Definition	Comments
U.S. Unemployment Rate	4.90%	6.20%	**Represents the number of unemployed persons as a percent of the labor force**	**Continues to decline at steady rate**
Consumer Price Index	1.10%	4.10%	**Represents changes in prices of all goods and services purchased for consumption**	**Has moderated recently**
U.S. Capacity Utilization	75.5%	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+	1.30%	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	1.60%	6.53%	**Yield on the current 10 year treasury bond**	**Remains historically low**
Annual Housing Starts	1,142,000	1,443,000	**New privately owned housing unit starts annualized rate**	**Steady improvement**

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