

Market Insights

Economy | Capital Markets

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2016

Economy

The long, acrimonious and often unconventional campaign season concluded with Donald Trump defying most polls and pundits to become the president-elect. Just as surprising, the Republican Party retained control of both houses of Congress. In the wake of the election, the U.S. equity markets rallied markedly while bond yields spiked higher. Now, most investors and citizens wonder what's next, for both the economy and capital markets.

After bottoming in July at 1.36 percent, U.S. Treasury yields have jumped to around 2.5 percent today. The move higher partially reflects investors' expectations for greater fiscal stimulus in the form of tax cuts, infrastructure spending and deregulation. As yields climbed, the U.S. dollar rose and the Federal Reserve hiked short-term interest rates in December. However, yields are only slightly higher today than at the beginning of 2016, and the dollar index is about 2 percent higher over the same period. Meanwhile, all four major stocks indices hit record highs following the election. For instance, the S&P SmallCap 600 Index catapulted about 20 percent since early November while the S&P 500 Index is up around 8 percent. Despite the uncertainty surrounding the incoming Trump administration, investors appear focused on the promises of expansionary fiscal measures and expectations of higher economic growth.

Amidst the volatility in the capital markets since the presidential election, the U.S. economy continues to show modest growth. The latest picture on growth had the economy expanding at a 3.2 percent annual rate, the fastest in two years. While business investment remains a weak spot, solid labor-market gains and steady household purchases kept growth on a positive trend. In November, the U.S. jobless rate fell to its lowest level in nine years, falling to 4.6 percent. Yet, the labor participation rate declined to 62.7 percent and remains at its lowest level in about four decades. Some 95 million working-age Americans are not in the labor force, including retirees and students. The Congressional Budget Office estimates that the participation rate will decline to around 60 percent over the next 10 years.

A faster growing economy along with an improvement in skills should help bring discouraged workers back into the labor force over time. An overall healthier jobs picture will boost consumer confidence and spending. Another positive sign is the greatly improved manufacturing conditions in the Midwest, highlighted by an acceleration in new orders. Further, post-election optimism was evident in the latest Philadelphia manufacturing survey, as several areas showed a glowing picture of current conditions. Yet, the 13-year high in the U.S. dollar, rising interest rates and general export softness is expected to temper some of the recent optimism.

Globally, the economy has entered its sixth year of stagnation, with growth projected to recover slightly from 3.1 percent for 2016 to 3.4 percent in 2017, according to economists at the International Monetary Fund (IMF). In Europe, the growth rate is stuck in the 1.5-1.7 percent range as political uncertainty is elevated in several countries amidst crucial upcoming elections and fallout from the Brexit vote last June. Growth in China in the first half of 2016 eased to 6.7 percent from 7 percent the prior year, as reforms to restructure the economy away from export-led growth toward consumption continued.

Our outlook for both the economy and capital markets in 2017 remains a bit complex and somewhat uncertain. In this new world where Donald Trump is the president-elect, the Federal Reserve is raising interest rates, England has voted to leave the European Union, and equity valuations are elevated, it feels a bit like we are living in an alternate universe (not to mention the Chicago Cubs won the World Series). Our base expectation calls for the economic expansion, now in its eighth year, to continue and become the third-longest in postwar history in March. This is predicated on a fiscal policy that becomes more supportive through corporate tax reform, infrastructure spending and softening of business regulations. Further, the Federal Reserve largely maintains its stimulus and only raises short-term interest rates as necessary. Finally, trade wars are avoided and the president-elect backtracks on some of his hardline issues. However, if there are any missteps or delays in these policy measures, or if populism and nationalism gain further ground around the world, this more optimistic economic outlook could falter.

In the capital markets, the prospects of higher inflation and interest rates do not bode well for most domestic sectors of the bond market. Our outlook for equities has moved a bit higher. The markets have emerged from a deep earnings slump over the last few years and the prospects of improved earnings growth seems positive, given likely corporate tax reform and a more business-friendly environment expected with the new administration. Although a bit more optimistic, we are acutely aware that domestic equity valuations are elevated and heightened market volatility is possible in this new environment. With that, we may look to further reduce the interest-rate sensitive portion of bonds in the portfolios and slightly add to stock exposure, both domestic and international, as conditions warrant.

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 spiked higher during the quarter from expectations of higher growth and inflation in the years ahead. International fixed-income securities generally held up better than domestic. Most sectors of the domestic equity market posted very solid returns as investor enthusiasm returned after the presidential election. Many sectors of the international markets were mostly positive while emerging markets generally struggled.

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 30, 2016

	4th QTR	YTD	1 Year	Annualized 3 Year
S&P500	3.82	11.95	11.95	8.86
Dow Jones Industrial	8.66	16.50	16.50	8.71
Nasdaq Composite	1.69	8.97	8.97	10.25
Barclays Aggregate Bond	-2.98	2.65	2.65	3.03
Citigroup BIG Corporate	-3.01	6.09	6.09	4.21
MSCI World	1.99	8.18	8.18	4.43

Economy from a Historical Perspective

	Latest	Average*	Definition	Comments
U.S. Unemployment Rate	4.60%	6.10%	Represents the number of unemployed persons as a percent of the labor force	Continues to decline at steady rate
Consumer Price Index	1.70%	4.10%	Represents changes in prices of all goods and services purchased for consumption	Has risen, but still below average
U.S. Capacity Utilization	75.00%	80.30%	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†	3.50%	2.90%	Total value of all goods and services produced indicates strength or weakness of the economy	3rd quarter GDP was highest in 8 quarters
10 Year Treasury Yield	2.45%	6.47%	Yield on the current 10 year treasury bond	Remains historically low
Annual Housing Starts	1,090,000	1,437,000	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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