Market Insights

Economy | Capital Markets

Q1 2017

Economy

Since the Republican sweep of U.S. elections last November, investors' expectations have shifted in favor of a higher growth and inflationary environment. This change in sentiment opens the door to a new trajectory for corporate investment and paves the way for a raft of new policy initiatives that could be implemented soon. The possibility of above-trend growth both domestically and abroad is supported by the prospects of meaningful fiscal stimulus, tax and regulatory reforms, the end of deflationary effects from lower oil prices, and still historically low global interest rates. Although investors seem elated at these prospects, a few lingering questions remain. Has the potential for growth really changed? Are even higher interest rates to come? If so, are there still opportunities for investors?

We think the answer to these questions is likely yes. Even before the elections, growth was trending higher in about two-thirds of the world's economies, including Europe, China, Japan and the U.S., and inflation was ticking up. The latest read on real (inflation-adjusted) U.S. Gross Domestic Product (GDP) growth through December showed the annualized rate of growth at 1.9 percent, up from a recent low of 1.3 percent through June of last year. Consumer spending added an estimated 2.0 percent to growth, while a decline in both business spending on fixed investments as well as state and local government outlays slightly detracted from it. Growth for the first quarter of 2017 is expected to come in around 2.0 percent, while full-year growth expectations have ticked slightly higher to around 2.5-3.0 percent. Overseas, European growth is expected to hover around 1.0-1.5 percent as political uncertainty remains elevated ahead of crucial elections in France, Germany, the Netherlands and potentially Italy. Meanwhile, the Chinese economy expanded at 6.8 percent year-on-year in the fourth quarter of 2016, slightly better than the previous three quarters. While full-year 2016 marked the weakest growth in China since 1990, it was within the government's target range as policymakers prioritize financial stability over economic stimulus.

On the inflation and interest rate front, capital markets have quickly factored in the expectations of better economic growth and new stimulus programs from the Trump administration along with the corresponding reduction in corporate regulations. Since mid-2016, the year-over-year Consumer Price Index (CPI) jumped from 1.0 percent to over 2.5 percent today. The cost of services -- everything from doctor visits to auto insurance and housing -- was 3.2 percent more expensive according to the most recent report, the largest increase since November 2008. The yield on the 10-year U.S. Treasury bond responded accordingly to this rise in inflation. The yield jumped from a recent low of around 1.4 percent to about 1.8 percent on the eve of the presidential election. Since then, the yield pushed even higher to around 2.5 percent, which illustrates investors' expectations that inflationary pressures could continue in the near future.

One of the key areas in the economy that can influence inflation is the labor market, including wage growth. The most recent data release shows the three-month moving average payroll gain at 200,000 per month, up from about 150,000 in December. Highlighting the report was the biggest gain in construction jobs since before the financial crisis in 2008. With the nation's unemployment rate hovering at a post-crisis low of 4.7 percent, the labor participation rate is starting to improve. For many years, long-term unemployed and disgruntled individuals dropped out of the labor market, which pushed the labor participation rate to a multi-decade low. Since reaching that point in September 2015, the rate has steadily climbed, even more noticeably since last November. Finally, better economic growth and a tightening labor market has nudged wages close to a 2.8 percent annual growth rate per year, a mark it hasn't reached since 2009.

All this relatively "good news" has not gone unnoticed by the Federal Reserve. After several years of an accommodative monetary policy, it has started moving interest rates back toward "normal". They have already raised interest rates twice in the past year and have guided investors to the possibility of 3 or 4 more increases over the next year. For savers, this is welcome news after many years of financial repression and zero interest on their bank accounts. For borrowers and bond investors, however, it means higher costs and potentially lower returns. With valuations stretched for both bonds and stocks, along with the reality that this current bull market is the third longest in history, are there still opportunities for investors?

The short answer is yes, in select markets and in certain areas around the world. Consider the potential outcomes from the Trump administration's policies. On one hand, deregulation coupled with tax reform could unleash a burst of productivity-boosting investment that may lead to sustained higher growth rates and corporate profits. On the other hand, trade wars, tariffs and geopolitical conflicts could depress growth and even tip the economy into a recession. We continue to believe that interest rates will trend slightly higher, to the detriment of core fixed-income and longer duration-type assets. Further, we continue to favor equities over core fixed-income, and within the equity sector we expect international equities to outpace domestic due to their relative valuation advantage. Overall, we expect a balanced portfolio to produce modest gains, possibly below the above-average trends of the past few years.

Capital Markets

The yield on U.S. Treasury bonds spiked higher during the early part of the quarter and reversed course a bit toward the end. Corporate and high-yield bonds generally produced better results than those more heavily invested in government debt. Larger domestic stocks and those tilted toward growth tended to outpace smaller stocks. Further, international and emerging-market stocks returned some of the best equity returns for 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 March 31, 2017

	1st QTR	YTD	1 Year	Annualized 3 Year
S&P500	6.07%	6.07%	17.16%	10.34%
Dow Jones Industrial	5.19%	5.19%	19.91%	10.59%
Nasdaq Composite	10.13%	10.13%	22.95%	13.51%
Barclays Aggregate Bond	0.82%	0.82%	0.44%	2.68%
Citigroup BIG Corporate	1.27%	1.27%	3.35%	3.64%
MSCI World	6.53%	6.53%	15.45%	6.14%

Economy from a Historical Perspective

	Latest	Average*	Definition	Comments
U.S. Unemployment Rate	4.70%	6.20%	Represents the number of unemployed persons as a percent of the labor force	Continues to decline at steady rate
Consumer Price Index	2.70%	4.10%	Represents changes in prices of all goods and services purchased for consumption	Has jumped higher over the past year
U.S. Capacity Utilization	75.40%	80.36%	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, but steady
Gross Domestic Product+	2.10%	2.80%	Total value of all goods and services produced indicates strength or weakness of the economy	Positive, slightly below average
10 Year Treasury Yield	2.39%	6.48%	Yield on the current 10 year treasury bond	Jumped higher over the last six months
Annual Housing Starts	1,288,000	1,441,000	New privately owned housing unit starts annualized rate	Continued steady improvement

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

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