Economic & Market Quarterly

Fall 2016

This summary is provided by BMT Wealth Management.

Macroeconomic Overview

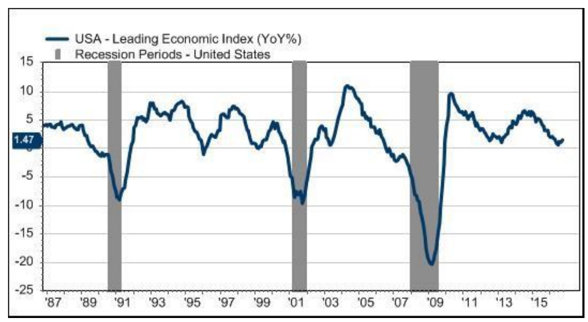
We face many potential headwinds, but the global economy has not yet shown any signs of weakening. This is in spite of continuing concerns over a number of macro factors, including Brexit, a hard landing in China, the effectiveness of negative interest rate policies, and bouts of terrorist attacks.

While economic data released in the United States and abroad has not signified a robust global expansion, neither has it weakened to the point where an economic contraction is inevitable.

During the third quarter, most countries saw modest improvement in monthly Leading Economic Indicators, as calculated by The Conference Board. This broad-based measure of economic activity assesses changes in employment, new orders for consumer and capital goods, new building permits, money supply, interest rate spreads, consumer sentiment, and stock market levels.

Here in the United States, the Leading Economic Index has not reached a low that foreshadows a recession, but it is at a level that is worth monitoring.

U.S. Leading Economic Index
Percentage Change Year-over-Year for Past 30 Years
9/30/1986 – 9/30/2016



Source: FactSet, Inc.

The essential question going forward is whether the global economy can withstand the gradual unwinding of unconventional monetary policy, which has resulted in extraordinarily low interest rates. We believe that limits of central bank intervention may be approaching a tipping point.

In order for this economic expansion to continue – and it has already been long, historically speaking – a combination of additional fiscal spending and private sector investment may very well be needed.

Equity Markets

The S&P 500 Index moved higher during the third quarter, with the Index posting a return of 3.85% for the three-month period. Most of that return was realized during the month of July, when the Index advanced 3.69%.

Over the months of August and September, the Index essentially treaded water, posting a cumulative return of just 0.16%.

Year-to-date, the S&P 500 has produced a total return of 7.84%.

Looking across the market capitalization spectrum through the first half of 2016, returns on the smaller capitalization Russell 2000 Index were meaningfully behind those of the S&P 500. That underperformance was quickly erased in July, however, when the Russell 2000 surged higher by 5.97%.

Unlike the S&P 500, the Russell 2000 Index continued to move higher during the final two months of the quarter, when it added an additional 2.90%. Its total return for the first nine months of 2016 was 11.46%.

The outperformance of the smaller cap Russell 2000 Index over the S&P 500 Index is a shift from the recent past. As the table below displays, the larger capitalization S&P 500 had the upper hand in 2014 and 2015.

	S&P 500	Russell 2000
Total Return 2014	13.69%	4.89%
Total Return 2015	1.38%	-4.41%
Year-to-date 2016	7.84%	11.46%

Still, longer-term numbers continue to favor the Russell 2000, which has generated average annual returns of 9.26% over the past 15 years, versus 7.15% for the larger capitalization-weighted S&P 500 Index.

In the developed overseas markets, the MSCI EAFE Index was higher by 6.43% during the third quarter. That said, Brexit and the general economic conditions facing much of Europe resulted in this Index being in negative territory (-4.42%) at the midpoint of 2016. Even with the strong showing by EAFE during the third quarter, the Index has only moved modestly into positive territory (+1.73%) on a year-to-date basis.

Emerging markets, as measured by the MSCI Emerging Markets Index, continued their strong performance in 2016, with the Index ahead 9.03% during the third quarter, to bring its year-to-date return to 16.02%. These markets have experienced a considerable reversal since 2015, when the Index was down -14.92%.

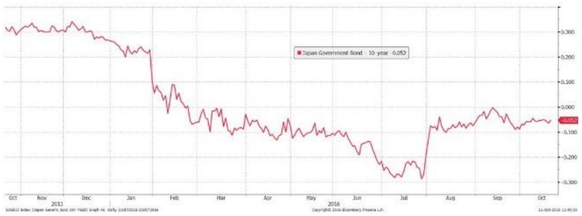
Fixed Income Markets

Monetary policy was front and center during the third quarter, as central banks around the globe offered varying degrees of accommodative monetary policy to promote economic growth and inflation within their areas of influence.

The European Central Bank (ECB) and the Bank of Japan (BOJ) maintained their negative interest rate policies, while the Bank of England (BOE) lowered its official bank rate from 0.50% to 0.25%. Concerns regarding Britain's decision to leave the European Union prompted the BOE to take action in an effort to prevent significant economic instability.

Each of these three foreign central banks continued the purchase of bonds during the quarter, while the BOJ announced its intentions to target a 0% yield on its 10-year government bond.

10-Year Japanese Government Bond
10/21/2015 – 10/21/2016:
BOJ Targeting a 0% Yield



Source: Bloomberg Finance L.P.

In the United States, the Federal Reserve (the Fed) voted to leave interest rates unchanged in the third quarter, but it left the door open for a possible increase before the end of the year.

As of Sept. 30, investors applied a roughly 60% chance that the Fed will move its target range up 25 basis points (+0.25%) at its December meeting, which is scheduled for Dec. 13-14.

Short-term bond yields shifted higher during the quarter. To a much lesser extent, longer-term yields increased, as well.

The two-year U.S. Treasury yield increased 18 basis points (+0.18%) and ended the quarter at 0.76%, while the 30-year U.S. Treasury increased a modest three basis points (+0.03%) to end the quarter at a yield of 2.32%.

Overall, the slope of the U.S. Treasury bond yield curve ended the quarter about 15 basis points (0.15%) flatter, as measured by the difference in yield between the two-year and 30-year Treasury bonds.

For the quarter, the Barclays Capital Intermediate Government Credit Index returned 16 basis points (+0.16%), led by intermediate corporate issuers and, more specifically, industrial companies. The Industrial sector returned 0.95%, compared to the intermediate U.S. Treasury securities return of -0.26%.

Investors were comfortable taking on credit risk during the quarter, as noted by the decline in credit spreads. Debt securities of financial and utility companies generated positive returns of 0.86% and 0.44%, respectively.

U.S. bond yields have been trending higher over the past few months, coinciding with increased investor demand for corporate issuers. Given the low interest rate environment, yield searching has become a familiar theme for fixed income investors.

What to Expect for the Balance of 2016

With relatively few days remaining in 2016, there are a number of potential market-moving macro events in play. Actions taken at the upcoming global central bank meetings, policy decisions made surrounding Brexit, the results of Italy's referendum on constitutional reform, and the outcome of the highly contentious U.S. presidential election all could have serious implications for market direction, at least in the short term.

The current political campaigns in the United States have injected an additional level of volatility into the markets. Investor concerns focus around the economic policies of the two major party presidential candidates. Further, markets have been wrestling with the implications of a possible change in control in one or both houses of Congress. Currently, the Republicans hold a slim majority in the Senate and a wider margin in the House of Representatives.

Despite all of the political and monetary policy headlines, the third quarter earnings season is off to a promising start.

With 58% of S&P 500 companies having released third quarter earnings as of Oct. 28, FactSet, Inc. says that companies are reporting earnings increases of 6.7% above estimates, exceeding the five-year average increase of 4.4%.

More importantly, in our view, the early reports indicate that companies are reporting sales growth at +2.7%. The Consumer Discretionary, Real Estate, and Healthcare sectors are reporting the largest increases in sales (revenues). The last quarter of positive sales growth was nearly two years ago, in the fourth quarter of 2014 (+2.0%).

A Look into 2017

The aging of the current economic expansion elevates the risks associated with continued sources of growth and market pricing.

We expect that fiscal spending will increase with the new Congress, regardless of the composition of the executive and legislative branches of government. The complexion of this spending – the size and scope of tax breaks, repatriation issues, duration, etc. – will vary, however, depending on the outcome of the November elections.

In our view, the net effect should be stimulative to domestic economic growth.

Interest rates should rise due to the combination of increased fiscal spending, improving wage growth (+2.6% year-over-year), and a shift to a less stimulative monetary policy. We see the rise in rates as being gradual, with the Fed remaining data dependent. Further, we expect interest rates to remain low on a nominal basis into the foreseeable future.

The rise in wages and inflation may provide an opportunity for the corporate sector to raise prices and elevate, or at least maintain, profit margins, assuming there is some improvement in productivity. Crude oil prices are well off their lows of February, and we see a range centered around $50/barrel, which should provide some measure of controlling feedstock costs to the Industrial sector and aid in capital spending plans. The strength of the U.S. dollar will challenge the earnings of U.S.-based multinational companies.

Issues remain in overseas economies, particularly in the developed markets of Europe and Japan. Brexit will continue to weigh on the United Kingdom – it has already had significant effects on the British domestic economy – and it will further affect trade with the Eurozone and Asia.

Depending on the integrity of the data, it appears that economic growth in China has leveled off at 6.7%, based on third quarter reports, which may mitigate one area of concern globally.

In the United States, the "advance" estimate of third quarter GDP indicates an increase of 2.9%, fueled by strong consumer spending, exports, and inventory building by the private sector. This is a significant increase over the 1.4% rise in second quarter U.S. GDP, and if this positive economic momentum continues, it would be supportive of further increases in revenues and margins – and, therefore, earnings – into 2017.

Over the long term, corporate profitability is the key determinant of equity prices and valuations. In our view, equity markets will be challenged by the issue of marginal growth in an aging economic expansion, as valuation will remain our focus.

In the fixed income markets, we continue to center our attention on high-grade issuers within the short- to intermediate-term part of the yield curve, with careful consideration given to the risk profile (duration, structure, credit) of each security.

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