Huntington

Review and Outlook

First Quarter 2016

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Economy

After slow actual or expected real GDP growth of 1% for two consecutive quarters, the U.S. economy is forecasted to return to a moderate pace of 2% real GDP growth in Q2 2016 through Q4 2016. Despite headwinds in goods producing areas of the economy, overall labor market conditions have continued to improve with average net employment growth somewhat above 200,000 per month, aggregate wages showing nascent signs of acceleration, and labor force participation beginning to rise. Although the pace of labor market improvement is expected to moderate somewhat in the coming quarters, overall consumer fundamentals remain sound as exemplified by a low overall household financial obligations ratio, generally improving consumer finances and increasingly healthy housing markets.

In conjunction with normal financial conditions (access to credit, low inflation and reasonable interest rates) in most areas and the expectation for supportive monetary policy from the Federal Reserve, consumers are expected to drive overall economic growth this year with broad-based spending and continued housing investment.

- Although the international background for exports, energy and many other commodities will likely remain challenging in 2016, some price stabilization and moderate increases are expected to emerge gradually as the year progresses.
- Elevated inventory-to-sales ratios are also expected to stabilize and begin gradual but welcome declines in the second half of the year.
- Corporate profits are forecasted to bottom and begin a moderate growing trend from the recent "profit recession."
- Capital investment should gain some support from favorable legislation in the most recent Federal budget.
- Consumer inflation is forecasted to return to intermediate trends around the overall inflation of 2% favored by the Federal Reserve.
- The Federal Reserve is expected to raise the Fed Funds rate target cautiously in 2016 so as not to jeopardize the current economic expansion, but the forecast for modestly accelerating economic growth and inflation incorporates 2 quarter point increases in the Fed Funds rate target by year-end.

The risk of a mild recession is still present in 2016 given modest and variable overall U.S. GDP growth and uncertainties in the international economy, but the risk of recession has declined since the beginning of the year.

Fixed Income Markets

The fixed income market was volatile during the first quarter as the 10-year treasury started the year at a 2.27% yield and the 2-year started at 1.02% - but both ended the quarter noticeably lower than these levels. With weaker economic numbers and oil prices trading as low as $26.00 per barrel, and additional continued economic weakness in China, we saw yields decline during the quarter.

During the quarter, the Federal Reserve cut its number of anticipated rate hikes from four to two, primarily due to global weakness. The 2-year Treasury traded as low as 0.66% before ending the quarter at 0.75%. The 10-year traded as low as 1.66% and ended the quarter at 1.78%. The Barclay's Intermediate U.S. Government/Credit index had a year to date total return of 2.45% with the best individual sector returns coming from U.S. Credit Corporates and U.S. Treasuries, which posted returns of 2.70% and 2.53% respectively.

As discussed in the Economics section, we are anticipating a slowly improving economy with little unusual inflation pressure this year. In the second quarter we would look for the bond market to trade in a narrow trading range due to a cautious tone from the Federal Reserve Chair in March, and Federal Reserve policy makers signaling fewer increases in 2016 than they previously forecasted. However, the potential for a Fed Funds increase will be data dependent, especially if commodity prices and inflation stay low in the second quarter.

We view that both high grade corporate bonds along with municipal bonds offer good value. Corporate spreads are down from their highest levels last Fall, but are still higher than at the beginning of the year. We would look at TIP's as a defensive trade if commodity prices and inflation pick up in the second half of the year.

Here are several things to watch in the second quarter that are likely to affect the fixed income market:

- The Global economy will continue to remain weak in the quarter. China's economy will likely continue to create headwinds to its trading partners.
- The rally in Oil prices has taken pressure off the High Yield market, and we are seeing money coming back into the High Yield space.
- Issuance of Corporate Bonds should be about the same as last year in the second quarter.
- The U.S. dollar has declined in recent weeks, but is not expected to weaken significantly further. Hence, a strong U.S. dollar will likely continue to influence treasury yields, with a higher Dollar putting downward pressure on treasury yields.
- We now expect the Federal Reserve to stay on hold for the first part of the second quarter, and be very data dependent & deliberate overall in 2016.

Equity Markets

During the first quarter, U.S. stocks, as measured by the S&P 500, increased by 1.35%, erasing all of the declines occurring in the first half of the quarter. The S&P 500 managed to finish the quarter in positive territory despite a number of headwinds, including:

- During Q4 we saw S&P 500 earnings decline 4.5% on a year over year basis; estimates predict Q1 earnings will decline 9.5%.
- In the quarter the Federal Reserve lowered their forecast for Fed Funds increases from 4 increases in 2016 to only increasing rates twice in 2016.
- Oil prices, as measured by West Texas Intermediate (WTI), traded as low as $26 per barrel before recovering to $43 by the end of the quarter.

The performance in the fourth quarter was driven by defensive sectors outperforming with Telecommunications and Utilities leading the market with double digit gains. Financial stocks as well as Healthcare stocks led the market lower. From a stock perspective, 292 stocks outperformed the S&P 500 while the remaining underperformed for the quarter.

Looking ahead to the second quarter of 2016 and the remainder of the year, here are some of the factors that we are keeping our focus on at Huntington:

- U.S. economic growth, as noted above, after a period of below trend growth is expected to return to a more moderate level of growth.
- S&P earnings, after declining since the second quarter of 2015, are projected to continue this trend for the first half of 2016. Estimates for the S&P 500 begin to forecast positive growth returning in the third quarter of 2016 and could be a positive catalyst for stocks in the second half of 2016.
- Global headlines including China economic and stock market volatility, global oil markets and sluggish world economic growth, as highlighted above, will continue to be headwinds for U.S. stocks.
- Despite risks early in 2016, stocks should be influenced by our improving economic outlook and stable inflation, and therefore this is not the time to be aggressively buying or selling portfolio holdings, only trimming or adding where portfolio excesses or deficits exist. Staying “market nimble” is likely to provide investors with the best opportunity to achieve their portfolio objectives.

Weighing the positives and negatives, we see an environment with higher volatility earlier in 2016, and look for stock market conditions to potentially improve as we go through the year. This will require U.S. investors to be patient for a positive environment to develop as macro and micro headwinds calm.

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