Review & Outlook

First Quarter 2017

Huntington Welcome.

April 18, 2017

Executive Summary

The 2017 1st Quarter rewarded investors in balanced portfolios with respectable returns. According to Lipper, the average balanced mutual fund returned 4.17% during the quarter. U.S. stocks, as measured by the S&P 500, returned approximately 6% for its six consecutive quarter of positive returns. For fixed income investors, the Bloomberg Barclays Intermediate Gov't/Credit index produced a total return just shy of 1%. While GDP growth in Q1 2017 will most likely be lower than 2016 Q4, overall, we do expect GDP growth in 2017 to outpace the estimated 1.6% GDP growth in 2016.

Our team of investment professionals and analysts continue to forecast higher interest rates and inflation as we move through 2017. In the economic section, George Mokrzan, Director of Economics, forecasts stronger economic growth supported by an improvement in business spending and exports. George notes that the Federal Reserve is forecast to raise the Fed Funds rate target 3 times in 2017, upwardly revised from 2 times in the previous quarter. However, the risks for the Fed Funds rate target and overall market interest rates are to the upside. The net stimulatory impact of potential fiscal policy change by the new administration and Congress will drive those risks.

Sometime this year, the Federal Reserve may move to gradually reduce the size of its $4.5 trillion balance sheet, which has ballooned from less than $1 trillion before the Great Recession. Kirk Mentzer, Director of Fixed Income, notes in the fixed income section that when the Fed says they wish to shrink their balance sheet, they are simply taking away another source of market demand which should reduce downward pressure on yields. Therefore, we expect the 10-year Treasury yield to gravitate towards 3% by year-end.

Again, Kirk provides sound and prudent strategic advice to our portfolio managers and clients with regard to managing and positioning fixed income portfolios in a rising interest rate environment.

Randy Hare, Director of Equity Research, notes that stronger U.S. economic growth and higher corporate profitability provide a favorable backdrop for equity prices. However, headline risks continue to focus on the proposed fiscal stimulus. Depending on the outcome of these efforts, combined with sound, non-disruptive monetary policy, we could see the U.S. equity markets viewed as favorable global investments relative to global markets.

Given the uncertainty around the timing of higher rates, the reduction in the Fed's balance sheet, and the possible emergence of faster economic growth, we believe this is not the time to be aggressively buying or selling portfolio holdings, only trimming or adding where portfolio excesses or deficits exist.

The Economy

Our macroeconomic viewpoints for the coming year:

- The U.S. economy is forecast to continue to grow at a moderate pace of 2.1% in 2017, up from slow estimated growth of 1.6% in 2016. Consumer spending growth is expected to moderate from previous years of the current economic expansion. However, business spending and exports are forecasted to grow solidly in 2017 after a 2 year hiatus. The international economy is also expected to gain strength after a 2-year period of subpar growth. U.S. labor markets should maintain continued steady improvements.
- Inflation started the year with a sharp burst in January. After average annual inflation of nearly 0% in 2015 and just over 1% in 2016, inflation is forecast to broaden and widen to 2.5% in 2017.
- Along with rising inflation and somewhat stronger economic growth, the 10-year Treasury yield is projected to continue on a rising trend that probably reaches 3.0% by year-end.
- The Federal Reserve is forecast to raise the Fed Funds rate target 3 times in 2017, upwardly revised from last quarter. This forecast follows unusually high inflation to start the year, and corresponds to the Federal Reserve's median forecast of policy makers after the March 2017 FOMC meeting. As projected policy interest rates rise in the next year, the Federal Reserve will likely move closer towards the implementation of a plan that gradually reduces the size of its balance sheet built up during the years of aggressive monetary stimulus following the Great Recession.

With respect to the Federal Reserve and interest rates, our view is that the risks for the Fed Funds rate target and overall market interest rates are to the upside, which will largely depend on the net stimulatory impact of potential fiscal policy change by the new administration and Congress.

For additional discussion regarding the U.S. economy, we are pleased to provide *the Huntington Wealth and Investment Management Economic Outlook* publication of March 27, 2017 upon request.

Fixed Income Markets

Bond markets settled down during the first quarter of 2017 after a tumultuous end to 2016.

- 10-year Treasury yield remained within a well-defined range of 2.31% to 2.63%, but ended the quarter about where it started at 2.39%.
- The combination of low European yields and stalled domestic policy initiatives provided enough uncertainty to keep yields on the low end of the yield band. Concurrently, it was this concern over future growth that drove a rotation within corporate sectors from commodity related issues to more defensive areas (especially health care) of the bond market.
- The stand-out event during the period was record corporate bond issuance which was readily absorbed by investors seeking incremental yield. Despite the heavy supply, corporate bonds continued their strong relative performance, beating Treasury issues by over 60 basis points.
- Taken together, the Bloomberg Barclays Intermediate Gov't/Credit index produced a total return of +0.78% last quarter.

Looking ahead, we expect the balance of evidence to weigh towards higher yields as the year progresses. As mentioned above, we anticipate stronger economic growth, rising inflation, and an active Federal Reserve intent on raising interest rates along with reducing the size of their balance sheet. When the Fed says they wish to shrink their balance sheet, they are simply taking away another source of market demand which should reduce downward pressure on yields. As a result, we expect the 10-year Treasury yield to gravitate towards 3% by year-end.

How should fixed income investors position themselves in this environment? Our general suggestions are to adjust portfolios with these strategies:

- Buy individual bonds rather than bond mutual funds.
- Active managers may offer advantages that indexed products cannot provide.
- Match the bond maturities to specific expenditures to minimize market risk. For instance, clients paying for college education could have bond maturities match tuition payments, thereby eliminating any worry about market conditions when bills come due.
- Keep a long-term mindset to avoid making mistakes based on short-term market changes.
- As yields stabilize and begin to move to the higher end of the range noted previously, buy inflation protected bonds – they will insulate the portfolio from higher consumer prices.
- Sell fundamentally unsound investments to take advantage of narrowed yield differentials.
- Increase coupon yield (i.e. – premium bonds) to buffer against potential market volatility (see below).

Employ strategies aimed to increase income, such as:

- Use a dollar cost averaging strategy. As interest rates rise, buying additional bonds allows the portfolio to generate higher income. Disciplined investors employing this strategy generally have better returns than those attempting to time the markets, especially if interest rates decline unexpectedly.
- Buy quality corporate bonds – with earnings growth expanding and default rates peaking, higher grade corporate bonds offer better income with only slightly higher credit risks than government issued bonds. The key is to stay diversified across names and industries.
- Buy callable agency securities – investors trade the certainty of maturity date for a higher income stream.
- Buy actively-managed, diversified portfolios for the highest risk segments of the market and keep the position size in check. For example, there are several ways to invest in the non-investment grade bond markets such as high yield, senior loan, and emerging markets. Each have their own unique risk profiles, but adding a small allocation can help diversification and potentially generate higher income. Just be aware these three markets have performed extraordinarily well recently and could be volatile if the expected investment environment changes.

Equity Markets

During the first quarter, U.S. stocks, as measured by the S&P 500, returned 6.06% for the sixth consecutive quarter of positive stock returns.

- The S&P 500 is up 10% since the election. However, we witnessed a tapering of the post-election rally in March as the S&P 500 only returned 0.12% for the month of March. In addition, oil prices while up 36% over the past year declined in the first quarter by 6.5% putting pressure on the Energy sector stocks.

Looking ahead to the second quarter of 2017 and the remainder of the year, some of the factors that we are keeping our focus on at Huntington include:

- U.S. economic growth, as noted above, is expected to increase over the next year. As will inflation, interest rates and profits.
- S&P 500 EPS increased just over 5% in Q4-2016 from the year ago period, this is better than the 3.1% growth expected at the end of the quarter. This earnings growth, combined with a year-over-year gain from Q3-2016 represented the first back-to-back quarters of year-over-year profit growth since Q4-2014 and Q1-2015.
    - According to the latest earnings estimate, blended growth rate for Q1 S&P 500 EPS currently stands at 9.5%. If this rate holds, it will mark the best y/y growth since Q4 2016. Energy is expected to be the biggest contributor to Q1 earnings growth, followed by tech and financials. Industrials, consumer discretionary and telecom are the sectors expected to be a drag on growth.
- Headline risks to domestic equity markets continue to focus on the proposed fiscal stimulus. Depending on the outcomes of these efforts, we could see the US viewed as a favorable global investment relative to global economies.
- Given the uncertainty around the timing of higher rates and faster growth we believe this is not the time to be aggressively buying or selling portfolio holdings, only trimming or adding where portfolio excesses or deficits exist. However, we now begin to shift our focus on accelerating earnings growth where valuation presents attractive opportunities. Staying "market nimble" is likely to provide investors with the best opportunity to achieve their portfolio objectives.

Weighing the headwinds and tailwinds, we see an improving earnings environment which should be beneficial for stocks. This will allow for U.S. investors to be patient, yet maintain a positive environment for U.S. equity investors.

Key Contributors

Daniel P. Crawford, CFA, Senior Vice President, Director of Investment Strategy
Randall Hare, Senior Vice President, Director of Equity Research
Kirk Mentzer, Senior Vice President, Director of Fixed Income
George Mokrzan, Ph.D., Senior Vice President, Director of Economics

Huntington
Welcome.

This publication contains general information. The views and strategies described may not be suitable for all investors. Any forecasts presented are for illustrative purposes only and are not to be relied upon as advice or interpreted as a recommendation. Individuals should consult with their investment adviser regarding their particular circumstances. This material has been prepared for informational purposes only, and is not intended to provide, and should not be relied on for, accounting, legal or tax advice. Contents herein have been compiled or derived in part from sources believed reliable and contain information and opinions that are accurate and complete. However, Huntington is not responsible for those sources and makes no representation or warranty, express or implied, in respect thereof, and takes no responsibility for any errors and omissions. The opinions, estimates and projections contained herein are as of the date of this publication and are subject to change without notice. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Investing in securities involves risk, including possible loss of principal amount invested. Past performance is no guarantee of future results.

International investing involves special risks including currency risk, increased volatility of foreign securities, political risks, and differences in auditing and other financial standards. Prices of emerging markets securities can be significantly more volatile than the prices of securities in developed countries and currency risk and political risks are accentuated in emerging markets.

Bonds are affected by a number of risks, including fluctuations in interest rates, credit risks, and prepayment risk. In general, as prevailing interest rates rise, fixed income securities prices will fall. Bonds face credit risk if a decline in an issuer's credit rating or credit worthiness, causes a bond's price to decline.

The Huntington National Bank is an Equal Housing Lender, Member FDIC and a wholly owned subsidiary of Huntington Bancshares Incorporated.

® and Huntington® are federally registered service marks of Huntington Bancshares Incorporated. ©2017 Huntington Bancshares Incorporated. Huntington® Welcome.™ is a service mark of Huntington Bancshares Incorporated.