Review and Outlook

Second Quarter 2016

Economy

The U.S. economy accelerated during the second quarter from the previous two quarters, but its performance remained mixed at the sector and industry levels. Consumer spending picked up vigorously, and is expected to lift real GDP growth above a 2% growth rate during the second quarter. Manufacturing also showed some nascent signs of recovery. However, exports, business investment and many commodity and traded goods areas have been generally below average for this point in the business cycle. Business inventories came down somewhat, but were still at elevated levels. The robust U.S. services sector and labor markets also exhibited unsteadiness during the second quarter.

The mixed economic picture is expected to continue during the second half of the year, and potentially into 2017. The economic forecast is for modest real GDP growth in the next year of 1.7%, with areas of the economy that are most dependent on U.S. consumer spending performing the strongest. A slow international economy, potentially weighed down further by the repercussions of "Brexit" on the United Kingdom and other European Union economies, is expected to maintain continued downward pressure on exports and many goods-producing sectors of the U.S. economy. Inflation excluding food and energy, known as "core" consumer inflation, is expected to follow a persistent long-term trend of around 2.0%. The energy and food components will likely remain volatile, although downside risks remain for some areas of energy, materials and traded goods. The dollar is expected to hold much of its gains obtained during the last few years against other major trading partners, due to expected relative strength of the U.S. economy with respect to the international economy.

Brexit will likely make the European Union's management of high long-term debt, budget uncertainties, weak areas in the European bank industry and the formulation of appropriate monetary and fiscal policies even more difficult in an already challenging environment. In addition to a likely recession in the United Kingdom and some of its closest trading partners, Brexit will likely slow capital investment spending in Europe and in the world economy generally. As a result of slower economic growth and elevated uncertainties, the global interest rate environment will likely remain suppressed at low levels for a longer period of time. While this "flight to quality" delays the return to a more normal interest rate environment of positive real returns for savers, borrowers in the United States will likely benefit via lower financing costs for consumer durable goods and housing in the next year. U.S. job growth is expected to stay on a moderating trend, although compensation growth should continue improving for occupations in relatively high demand. The biggest risks to the U.S. economy in the next year will likely emanate from uncertainties regarding the international economic and political environment. Hence, the arguably multi-faced economy is expected to continue.

Fixed Income Markets

The waterfall of declining bond yields continued across the globe during the second quarter. With weak global growth and uncertainty surrounding Brexit, government bond yields fell to record low levels on a massive flight to quality. Ten-year Treasury yields in the U.S. began the quarter at 1.77% and seemed range-bound until the surprise vote in Britain. The unexpected outcome unleashed a massive rally in bonds that pushed 10-year notes to record low levels to end the quarter at 1.45%. Corporate bonds lagged the trend, but only slightly. Normally, a move of this magnitude and backdrop would see risk spreads widen significantly. However, with worldwide yields considerably lower, the U.S. bond market has become one of the best values in the eyes of foreign investors seeking yield. Taken together, the Barclay's Intermediate Gov't/Credit index produced a total return of +4.07% year-to-date.

Looking ahead, the search for "safe yield" has only become more challenging for investors. We expect Brexit uncertainty to remain in the market for months to come. While U.S. growth trends remain in the vicinity of 2%, the rest of the globe is showing only marginally positive growth. Bond markets are not expecting the Fed to raise rates this year (as measured by futures markets). Thus, a range-bound market for 10-year Treasury yields of between 1.35% and 1.70% is a reasonable expectation looking ahead to 2017. Rather than reducing portfolio average maturity measures, we are watchful for opportunities to increase exposure to longer-maturity government securities should the flight to quality dissipate and Treasury yields rise toward the top of our expected range.

In terms of corporate bond positioning, we are likewise hesitant to reduce exposure to higher-yielding non-government sectors. There are many negatives on the horizon to test our posture: new corporate bond issuance is expected to reach record levels again this year; profit growth remains anemic; and overall debt levels are stretched, making servicing more difficult should rates increase. Instead of cutting exposure, we believe bond investors are better served reducing corporate bond risk and maintaining overall allocations. For bond portfolios, this means lowering the overall risk in these ways:

- Higher quality: reducing lower quality (BBB) and increasing allocation toward higher quality issuers (A or better). The yield give-up is significantly lower than cutting overall corporate bond exposure.
- Shorter maturity: buy short- to intermediate-term corporate bonds rather than 10+ year maturities.
- Non-cyclical issuers: businesses with lower cyclical exposure will fare better should global growth trends or profit growth deteriorate further. Sectors favored include consumer staples, healthcare, and utilities.
- Bank bonds: higher capital requirements leave banks in a better position to withstand unexpected events such as Brexit. Compared to previous cycles, investors also gain higher yields compared to industrial bonds of similar maturity and credit rating.
- Inflation protection: At the moment, we believe inflation protection is underpriced relative to economic trends. Treasury Inflation Protected Securities (TIPS) offer insurance against higher inflation and are of the highest quality since they are issued by the U.S. Treasury.

Equity Markets

During the second quarter, U.S. stocks, as measured by the S&P 500, increased by 2.46% despite the dramatic increase in volatility following the surprise Brexit vote. For the one-year period ending June 30th, 2016, the S&P 500 price return was +1.03%; when including dividends, the total return for the S&P 500 was +3.25%. The S&P 500 managed year-over-year gains despite:

- Starting with the second quarter of 2015, earnings declined on a year-over-year basis for the past four quarters; estimates predict Q2 earnings will decline 5.4%.
- In December we saw the Fed lift off with their first interest rate increase since 2006 and the promise of further rate hikes, only to be left waiting.
- Oil prices measured by West Texas Intermediate Crude reached a closing low of $26.21 on 2/11/2016.

The S&P 500 finished the second quarter with 206 of the 500 stocks posting negative returns for the quarter. Despite the headwinds, the S&P 500 total return was positive for the second quarter and the one-year periods. The performance in the second quarter was broad-based from a sector perspective. More sectors outperformed the S&P 500 than underperformed. Consumer Discretionary and Information Technology were the only sectors that posted negative returns for the quarter. Energy was the best performing sector, gaining more than 11%. Telecommunications, Utilities and Health Care were all up in the 6-7% range for the quarter.

Looking ahead to the third quarter of 2016 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 be modest over the next year. Consumer Durables and the housing markets are expected to remain on a moderating trend.
- S&P earnings, after the anticipated decline in the second quarter of 2016, appear ready to return to a positive, albeit muted growth trend. Earnings estimates for the S&P 500 begin to improve with the third quarter of 2016, and are expected to be a positive stimulus to stocks in the second half of the year.
- Global headlines including China economic and stock market volatility, global oil markets and Brexit have all produced sluggish world economic growth, as highlighted above, and will continue to be headwinds for U.S. investors.
- With continued risk to economic and earnings growth, investors seem poised to focus on stable dividend paying stocks, and therefore 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. 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 environment with higher volatility in 2016, and look for things to improve as we go through the year. This will allow for U.S. investors to be patient, yet maintain a positive environment for U.S. equity investors.

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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.