Huntington

Review and Outlook

Third Quarter 2016

October 10, 2016

Executive Summary

The Review and Outlook, written by our research team members, examines the most recent U.S. economic, fixed income, and equity market behavior. Additionally, we discuss how the markets may act over the near-term and into 2017.

The third quarter ended with a modestly strengthening economy, range-bound interest rates, and relatively strong performance from equity markets. Not too bad. Some may consider this surprising given the seemingly endless number of investor concerns including the upcoming U.S. presidential election, Fed policy, slowing global growth, and Brexit, just to name a few.

With regard to our outlook, not much has changed. Muddle-through real GDP growth (1.5% to 2% on average) with no recession on the horizon will allow equity markets to move higher and fixed income portfolios to generate acceptable, yet modest, returns. A low inflationary and interest rate environment are also supportive of higher equity prices.

In the economic section, George Mokrzan, Director of Economics, discusses the uneven growth the U.S. economy experienced during the third quarter. He points out that employment growth, industrial production, retail sales, and ISM reports on both manufacturing and non-manufacturing showed strength in July, only to have this data weaken across the board in August. Overall, economic growth improved moderately in the third quarter compared to the slow growth registered in the first half of the year.

Economic growth is expected to continue at a moderate pace, but below the pace of the past two years. George notes that below average real GDP growth may make the U.S. economy slightly more vulnerable to economic shocks. In addition, risks emanating from global financial markets and the international economy, most likely, will be elevated next year. Interest rates and inflation are expected to edge higher based on modest acceleration in U.S. and world economic growth.

U.S. interest rates settled into a wide trading range during the third quarter. The uneven economic data, noted above, combined with uncertainty surrounding world central bank activities kept investors on edge throughout the summer. Kirk Mentzer, Director of Fixed Income, concludes in the Fixed Income section, that these factors led to the meager 0.19% return of the Barclay's Intermediate Government/Credit index for the quarter. Year-to-date total return for the index is 4.25%.

Kirk highlights our expectation that yields will gradually rise in 2017 as economic fundamentals slowly improve. In the near-term, we still expect a range-bound market for 10 year Treasury yields with next year's rate capped around 2% or so due to modest global growth and accommodative monetary policy.

We believe bond investors will be better served reducing corporate bond credit risk and maintaining overall allocations. Kirk recommends reducing risk by owning higher quality, non-cyclical, and shorter maturity (less than 10 years) corporate bonds. In addition, financial (bank) bonds appear attractive in this environment.

During the third quarter, stocks in the S&P 500 posted their best quarter of the year, driven by the strong performance in the Technology sector. Randy Hare, Director of Equity Research, notes in the Equity section that the best performing sectors year-to-date at the end of the second quarter were the worst performing sectors during the third quarter as investors sold the highest yielding sectors including Utilities, Telecom, and Consumer Staples. It appears as though investors turned their attention from stable dividend paying stocks to those representing higher earnings opportunities.

Looking ahead, Randy focuses on an improving earnings environment which may provide a welcomed tailwind for U.S. equities. An improving earnings environment should be beneficial for stocks as investors focus on growth where valuation presents attractive opportunities.

Should earnings decline again in the third quarter, it will represent the sixth consecutive quarter where quarterly EPS growth has been negative. However, with modest U.S. economic growth, as noted above, we believe the earnings recession will end soon as earnings estimates for the S&P 500 begin to improve in Q4 2016 and into 2017.

Economy

Consumer spending continued to drive the U.S. economy in the third quarter, which probably grew at its fastest pace since the second quarter of 2015. Buoyed by an unemployment rate of 5%, steadily rising real incomes and employment, rising wealth and the lowest overall financial obligations ratio since the early 1980s, spending by consumers remained at high levels, although at a more moderate growth pace than in the second quarter.

Interest rates at historically low levels supported continuation of the housing market recovery and generally strong home price gains. Despite rising home prices, residential construction investment was relatively flat overall during the third quarter.

Modest improvements in exports added to expected GDP growth during the quarter, but export prices declined sharply in August, especially for many commodities.

Private non-residential construction showed signs of growth during the quarter, although new orders for capital spending on equipment remained below the same quarter of last year. The business goods sector underwent the second consecutive quarter of inventory correction, improving the outlook for next year, but at the expense of industrial growth in the third quarter.

Government spending probably picked up some of the demand slack in the goods sector as defense spending was strong in the third quarter, although state and local spending on infra-structure slowed.

After what we suspect will be an above-average third quarter, economic growth is expected to return to a moderate pace below the average of the last 2 years. Even after the third quarter acceleration in the economy, real GDP growth is forecasted to grow only in the 1.5% to 2.0% range this year and next, below the 2.5% average growth during 2014 and 2015.

Although the effectiveness of activist monetary policy probably declines at extremely low interest rate levels, highly activist central banks, virtually worldwide, will likely provide plentiful liquidity to the international economy overall in the next year.

Our forecast incorporates a gradual pick-up in aggregate inflation with sustained upward movement in services inflation and some eventual price increases in energy and non-energy commodities.

The Federal Reserve is forecast to raise the Fed Funds rate target in December, when inflation and labor market fundamentals are expected to be somewhat stronger and policy uncertainty somewhat lower. Long-term interest rates are also expected to edge higher based on the forecast for a modest acceleration in world economic growth and inflation next year. However, slow growth momentum in the U.S. economy overall may make the U.S. somewhat above average in its vulnerability to economic shocks next year.

Highlights of the Economy in the third quarter of 2016:

- Despite significant volatility from month to month, average monthly payroll growth in the U.S. during the third quarter was a solid 192,000 persons. Average hourly earnings were up a steady 2.6%. The official unemployment edged higher from 4.9% to 5.0% as the labor force participation rate rose somewhat faster than rate at which willing workers were absorbed into the workforce. The U-6 underemployment rate also remained somewhat elevated at 9.7%. On net, both hawks and doves on the FOMC will likely find points in the third quarter employment reports to support their respective positions, but the direction of labor market conditions was generally upwards.
- Industrial production, retail sales and the ISM reports on manufacturing and non-manufacturing showed considerable volatility during the third quarter, but the ISM non-manufacturing report, largely a reflection of the massive U.S. services sector, finished the quarter on a strong note. While the goods sectors of the economy were largely mixed during the third quarter, services overall sustained the U.S. economic expansion that began in July 2009.
- Inflation as measured by the CPI remained relatively tame, rising only 1.1% in the year through August. Excluding food and energy, inflation was 2.3% with services inflation putting upward pressure on "core" inflation. A general excess supply of goods in the world economy will likely continue to put downward pressures on tradeable goods prices generally in the next year. However, energy prices should begin to gain some support from OPEC's first agreement since 2008 to control the supply of petroleum to world markets. The details of the agreement will be released at the formal OPEC meeting in November. The final plan is expected to include only modest supply reductions in total. The ability of OPEC to hold its individual members to production targets will probably also be challenging given the high levels of stress incurred by large oil exporters in the last 2 years. However, if the OPEC efforts revive supply controls, then energy prices could begin to rise measurably from current levels.
- Brexit imposed a predictable sharp devaluation of the pound, thereby shocking the United Kingdom's economy and increasing inflation in the island country, but it did not seriously disrupt world financial market functioning. The near term impact on the United Kingdom economy was not as severe as initially expected by the Bank of England, and the sharp devaluation even improved prospects for some of the United Kingdom's export-oriented businesses, but monetary policy was ultimately eased to counter the still serious economic shock. Going forward, Brexit may increase the risk that other strong EU countries leave the EU, potentially putting new pressures on a European financial system already stressed by high sovereign debt levels, weak banks in various countries and other long-term structural economic growth challenges. Long-term adjustments to the new post-Brexit order within Europe, including the question of how easily financial companies domiciled in the United Kingdom will be able to operate on the continent, will maintain high levels of uncertainty until they are defined in the

coming months and perhaps years. U.K. Prime Minister Mrs. Theresa May has set March 2017 as the deadline for triggering Article 50 to exit the European Union. We expect considerable uncertainty until that time, and potentially afterwards.

- Our outlook calls for continued modest economic growth, a gradual rise in overall inflation from low rates, and gently increasing short and long-term interest rates. A total of 2 Fed Funds rate increases totaling no more than 50 basis points are forecasted to occur by the end of next year. Mixed economic data kept the Fed Funds rate target on hold during the quarter, but rising dissents on the FOMC indicate interest rate propensity is probably upwards. Despite this relatively benign forecast, risks emanating from financial markets and the international economy are elevated in the next year. Policy uncertainty catalyzed by a large national election poses another possible dynamic in the economy that will only be determined with time.
- Struggling with a continuing weak economy and deflation, the Bank of Japan (BOJ) announced a change in its monetary policy towards explicitly targeting the interest rate on long-term government bonds at zero -- the first explicit central bank policy targeting of a market determined interest rate in the advanced economies in this millennium. The BOJ holds a large and growing portion of Japan's government debt, and from its statements is apparently at the point where it is confident that it can target the rates on that debt accurately. In addition to the zero rate target on long-term bonds, the BOJ also kept its negative interest rate policy in place on high-powered commercial bank deposits at the central bank, and kept its options open to reduce that controversial policy rate further to meet a highly publicized 2% inflation target. The BOJ is attempting to drive inflation upwards in part by increasing market expectations of higher inflation, but it will likely have enormous difficulty in this effort. Japan's CPI was at its lowest in July since May 2014.

Fixed Income Markets

Following a massive rally in global bonds from the second quarter, U.S. interest rates settled into a volatile range for the third quarter. The mixed economic data described above combined with uncertainty surrounding world central banks kept investors on edge for the summer months. The Federal Reserve's, sometimes conflicting, statements were offset by dovish comments from other developed markets central banks. Yields fluctuated between 1.35% and 1.73% for the 10-year Treasury. Likewise, the Treasury yield curve (10-year minus 2-year) vacillated between 75 and 96 basis points. Corporate bonds performed well during the quarter, albeit at a slower pace than the past year has witnessed. The best performing sectors included Energy, Basic Industry, and Media. In fact, the Energy space has completely reversed the carnage from earlier this year and is now ahead of the overall corporate index for the past 12 months. As for third quarter laggards, Financials and Utility sectors struggled to keep up with the higher risk areas of the market. Taken together, the Barclay's Intermediate Gov't/Credit index added only 0.19% last quarter to bring its year-to-date total return to +4.25%.

Looking ahead we expect yields to gradually rise in 2017 as economic fundamentals slowly improve. The two Federal Reserve rate increases discussed earlier will likely result in upward pressure for the 10-year Treasury. In the near-term, we still expect a range-bound market for 10-year Treasury yields of between 1.40% and 1.75%. However, slow global growth and accommodative monetary policy globally should cap yields at 2% next year.

In terms of corporate bonds, the search for "safe yield" is becoming a familiar refrain for fixed income investors. Low yields combined with rising risks make the environment especially challenging. While record levels of new corporate issuance have been well received by investors this year, the by-product of this increased leverage could bring problems later. Just last month, the upgrade to downgrade ratio plummeted with seven times as much debt being downgraded as upgraded. Given our outlook for positive economic and profit growth, the credit risks are muted for next year. Longer-term, investors need to be mindful of default risk and resist the temptation to overstay their time in higher risk segment s of the corporate bond market. Instead of cutting exposure at this time, we believe bond investors are better served reducing corporate bond credit 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.
- 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.
- Non-cyclical issuers: businesses such as Consumer Stables and Utility sectors have lagged the "risk on" move for 2016. A "risk-off" moment would benefit this lower volatility area.
- Shorter maturity: buy short- to intermediate-term corporate bonds rather than 10+ year maturities.

Equity Markets

During the third quarter, U.S. stocks, as measured by the S&P 500, marked their best quarter of the year, increasing by 3.85%. For the one-year period ending September 30th, 2016, the S&P 500 price return was +12.93%; when including dividends, the total return for the S&P 500 was +15.26%. The S&P 500 managed year-over-year gains despite:

- Five consecutive quarters where quarterly EPS growth has been negative; estimates predict Q3 earnings will decline 1.5%.
- In December we saw the Fed lift off with their first interest rate increase since 2006 and the promise of further rate hikes, turn into a one and done event for the time being.
- Oil prices measured by West Texas Intermediate Crude reached a closing low of $26.21 on 2/11/2016 and are now up on a year over year basis, with prices hovering around $50/barrel.

The S&P 500 finished the third quarter with only 201 of the 500 stocks posting negative returns for the quarter. Hence, market breadth was fairly robust to allow the S&P 500 to produce a positive total return for the third quarter, as noted above. The performance was driven by the strong return in the Technology sector. The only other sector to outperform the S&P 500 was in the quarter was Financials. In September, S&P Index services removed the Real Estate Investment Trusts sub-sector from the overall financial sector and created an 11th sector.

Interestingly, the best performing sectors year-to-date were the worst performing sectors in Q3 as investors sold the highest yielding sectors of Utilities, Telecom and Consumer Staples. Looking ahead to 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. Given this, consumer durables and the housing markets are expected to remain on a moderating upward trend of earnings growth.

- Global entities, from the IMF to the World Bank continue to cut their GDP estimates for 2016. This could produce headwinds for some U.S. industrial companies and other export companies – though we do note that some valuations are getting more attractive here.
- S&P earnings are anticipated to decline overall in the third quarter of 2016. However, we are not so sure. We suspect quarterly earnings may rise if the Energy and Financial sector companies can give more contribution to earnings than sellside analysts now expect.
- Into 2017, S&P 500 earnings are then expected to accelerate to a double-digit pace, which is aggressive, but doable if the Energy and Financial sectors participate.

If we are correct and earnings growth begins to turn positive on a more positive economic tone, which, in turn, allows some central bankers begin push rates mildly higher, investors will turn their focus from stable dividend paying stocks to stocks representing higher EPS growth opportunities. Hence, staying "market nimble" in this transition is likely to provide investors with the best opportunity to achieve enhanced returns.

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 and deliberate in their equity investment approach.

Key Contributors

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