Review and Outlook

Fourth Quarter 2016

January 18, 2017

Executive Summary

Our team of investment professionals aptly referred to 2016 as the "roller coaster" year. Stocks began the year with a modest sell-off yet finished strong. Fixed income securities rallied during the first half of 2016 only to come under pressure as the year came to a close. On balance, 2016 rewarded investors who stayed the course with respectable investment results.

Clearly, the Trump presidential victory surprised the financial markets with equity markets rallying and bond prices falling. Expectations are now high for the new administration to deliver on policies that will spur economic growth, such as increased fiscal spending, easing of unfriendly business regulations, and reducing corporate and personal income tax rates.

During the fourth quarter of 2016, we saw economic data improve, interest rates rise, and consumer and business confidence increase. In the economic section, George Mokrzan, Director of Economics, expects U.S. GDP growth, inflation, the 10 year Treasury yield, and the Fed Funds rate to all move higher in 2017 from 2016's levels. However, he points out that risks to his interest rate outlook are to the upside and are largely dependent on the net stimulatory impact of potential fiscal policy change by the new administration and Congress.

Thanks to a surprise election outcome that resulted in a sudden turn in investor sentiment, U.S. Treasury yields abruptly moved higher during Q4 2016. Kirk Mentzer, Director of Fixed Income, notes in the Fixed Income section that 2016 was a bumpy ride for investors as the 10 year Treasury began the year at 2.27%, dropped to 1.36%, and finished the year at 2.45% for a net change of 18 basis points.

Kirk suggests that fixed income investors in 2017 adjust their strategy. Rather than 'searching for safe yields", investors should focus on "safe capital strategies" given our expectation for higher yields in 2017. He presents several strategies to adjust portfolios without too much disruption.

Randy Hare, Director of Equity Research, observes in the Equity Markets section that U.S. stocks, as measured by the S&P 500, posted four quarters of remarkably consistent performance to finish 2016 up 11.95%. However, sector performance results varied as investors rotated sectors quarter to quarter as investment trends failed to be long-lived.

Randy notes that the end of the S&P 500 earnings recession in 2016 will be a positive stimulus for stock performance in 2017. He outlines several factors we will focus on throughout 2017. Overall, it appears as though the tailwinds outweigh the headwinds for the U.S. equity markets which should provide a positive environment for U.S. equity investors.

The Economy

Here are our macroeconomic thoughts:

- The U.S. economy is forecast to continue to grow at a moderate pace of 2.2% in 2017, up from slow estimated growth of 1.6% in 2016.
- After average annual inflation of nearly 0% in 2015 and just over 1% in 2016, inflation is forecast to broaden and widen to 2.4% 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 2 times in 2017.

With respect to the Fed 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 upon request.

Fixed Income Markets

2016 will likely be remembered by Fixed Income investor as the “roller coaster” year. Just like a roller coaster, bond yields started and stopped at the same point, but the thrill came from the extreme ups, downs, and twists in between. While the 10-year Treasury yield rose from 2.27% to 2.45% or only 0.18%, investors went on wild ride from a record low yield of 1.36% before returning to the starting point. A related twist was investor demand for incremental yield that drove corporate bond yields lower as well. In fact, it was the best full year relative performance for corporate bonds since 2012. The energy sector came roaring back from a scary 2016 start to finish the year in second place, just behind the materials group.

However, the year had its share of “lows” as well thanks to a surprise election outcome that resulted in a sudden turn in market sentiment that pushed Treasury yields abruptly higher in the fourth quarter. The 10-year Treasury began the quarter at 1.6%, rising gradually at first before thrusting higher to 2.6% in mid-December. Why the turn of events? Investors began bracing for acceleration in fiscal spending, less Federal Reserve accommodation, higher inflation, and stronger economic growth prospects in the coming year. Corporate bonds offered some protection from the wild ride by providing 158 basis points of positive relative performance. No surprise, energy space was a strong performer along with insurance and basic industry. Laggards included automotive, consumer goods, and telecommunications areas. Despite a strong showing in corporate bonds, the Barclay’s Intermediate Gov’t/Credit index produced a total return of -2.07% last quarter to bring its year-to-date total return to +2.08%.

Looking ahead, we expect yields to rise more gradually in 2017 as the Trump administration develops their new policies and economic fundamentals slowly improve. The two Federal Reserve rate increases discussed earlier will likely result in upward pressure for the 10-year Treasury. For the year, we expect the 10-year Treasury yield to gravitate towards 3%. However, the path can be expected to be as unpredictable as the process of enacting new legislation.

A new dilemma faces fixed income investors in 2017. Instead of "the search for safe yield", investors are seeking "safe capital strategies" given the price declines experienced last quarter. Our general advice is to adjust portfolios without causing more harm. These include:

- Buy individual bonds rather than bond mutual funds.
- Active managers may offer advantages 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.
- 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 portfolio yield to buffer against potential market volatility (see below).

Find ways to increase income:

- 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 – 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 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 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

For 2016, U.S. stocks as measured by the S&P 500 put together four quarters of remarkably consistent performance to finish the year up 11.95%. The year started with a 10% correction on the heels of the Federal Reserve's December move to increase interest rates. In addition, oil prices continued their two year decline from $100+ prices down to $26 a barrel for West Texas Intermediate on Feb 11, 2017. The second market headwind occurred in June after Britain voted to exit the European Union. Stunned market participants sold the S&P 500 for a 5.3% decline from June 23rd through June 27th. Despite these headwinds, the S&P 500 produced 4 quarters of positive returns. Sector returns varied from quarter to quarter as stock markets moved from a focus on caution at the beginning of 2016, to yield in the middle of the year, then to growth and cyclical group post-election.

Looking ahead to the first 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 along with inflation and interest rates.

- S&P earnings exited an earnings recession in the third quarter of 2016. Earnings now appear ready to return to a positive albeit muted growth trend as companies report fourth quarter results. Earnings estimates for the S&P 500 begin to improve throughout the year, and are expected to be a positive stimulus to stocks heading in to 2017.
- Global headline risks will begin to shift to domestic policy changes. If the incoming administration follows through with their promise of increased US job growth and decreased regulations, we should see investment in the U.S. viewed favorably relative to global economies.
- If earnings growth increases and central bankers begin to push policy interest rates mildly higher, then investors will likely turn their focus from stable dividend paying stocks to stocks representing accelerating EPS growth opportunities. 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, but only trimming or adding where portfolio excesses or deficits exist. However, we begin to shift our focus towards accelerating 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

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