Review & Outlook
Second Quarter 2017

Huntington Welcome.

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Executive Summary
John Augustine, CFA, Chief Investment Officer

The second quarter of 2017 provided financial market investors with decent returns:

- Major domestic stock indexes gained in the 1-3% range – led higher by healthcare stocks. Major international stock indexes achieved gains in the 6% range.
- Bond investors generally saw small gains in the 1% range for the major averages. Some of the specialized bond indexes – like TIPS – produced little gain, while bond investors still generally favored high-yield bonds in the low-interest rate environment.
- Commodities were much more of a struggle with energy, soft goods and many metals prices falling from a variety of supply/demand issues.
- The U.S. Dollar Index fell 4.8% amid concerns that the Trump Administration would not be able to forward its economic agenda this year.

From an economic perspective, the reports regarding housing were generally strong in the quarter. Auto sales and general consumer spending saw weakness developing, which will be an area of focus in the third quarter.

Perhaps the 'newest news' in the quarter was that the Fed got hawkish at its June 13/14 meeting. They exited that meeting with renewed resolve to raise short-term interest rates and begin to wind down their $4.5 trillion balance sheet at the same time later this year. That spooked markets and took much of the air out of investor returns for the balance of the month.

Huntington will continue to invest with the odds of higher inflation versus concerns of the recession over the next 6-12 months.

For more insights, please read what these key contributors have to say:

The Economy
George Mokrzan, Ph.D., Senior Vice President, Director of Economics

Fixed Income Markets
Kirk Mentzer, Senior Vice President, Director of Fixed Income

Equity Markets
Randall Hare, Senior Vice President, Director of Equity Research

The Economy

George Mokrzan, Ph.D., Senior Vice President, Director of Economics

Our macroeconomic viewpoints for the coming year:

- The U.S. economy had a strong second quarter overall after another slow start to the year in the first. If current trends continue as expected, real GDP is on track to grow at a moderate pace between 2% and 2.5% in 2017, up from only 1.6% in 2016.
    - In contrast to 2016, contributions to growth will likely include increases from private investment and from exports overseas.
    - Consumer spending growth is expected to moderate from previous years of the current economic expansion. Pent-up demand has largely been met by several years of strong consumer spending. Consumer preferences have been shifting towards on-line convenience and larger vehicles, creating challenges in the meeting of new demands. Consumer installment debt levels has also been rising. However, a number of positive factors support consumer spending including high consumer confidence, jobs growth and wealth creation.
    - Housing is positioned to have a strong year as home prices have been rising steadily since the second half of 2012.
    - Business spending and exports have also begun to rise after a 2 year hiatus. The international economy is generally expected to gain strength after a slowdown that began in China and large energy producing countries in 2015.
    - U.S. labor markets should sustain continued steady improvements as the official unemployment rate at 4.4% in June matches low unemployment rates prior to the 'Great Recession.'

- Inflation started the year sharply upwards, but slowed significantly in the second quarter as energy prices flattened headline inflation. After average annual inflation of nearly 0% in 2015 and just over 1% in 2016, inflation is forecast to return to 2% going forward with risks to the upside in 2018. We could see a bumpy ride in the expected inflation rate to develop over in the second half of the year.

- Along with inflation and stronger economic growth, the 10-year Treasury yield is showing increased volatility in both up and down directions.
    - Long-term interest rates are expected to follow the uneven path of inflation in the next year, but ultimately end around 2.7% by year-end. As long as the economic expansion continues, long-term interest rates should remain on a gradual upward trend overall even as they pass potentially steep hills and valleys along the way.

- The Federal Reserve raised the Fed Funds rate target twice in the first half of 2017, bringing the Fed Funds rate target up into the 1.0% to 1.25% range.
    - Our forecast calls for one more quarter point increase in the second half of the year, probably towards the end of the year.
    - As long as economic growth continues at a moderate pace of 2% in 2018, additional increases would likely occur next year, as well.
    - The Federal Reserve announced its plan to reduce its long-term assets, and gradually phase out what has been known as its quantitative easing or "QE" program. Downsizing will be accomplished by reducing reinvestment of principal payments on its Treasury and Mortgage-backed securities, and will likely take years to complete according to the proposed schedule released after the June FOMC meeting. [Principal repayments will only be reinvested in securities if they exceed gradually rising caps.] Reserves in the banking system will be simultaneously reduced as large quantities of the Federal Reserves' securities were purchased with reserve creation.

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.

Fixed Income Markets

Kirk Mentzer, Senior Vice President, Director of Fixed Income

Bond markets settled into a lower range last quarter, but within the context of a longer-term pattern. Inflation trends, weaker economic trends, and fiscal policy uncertainty contributed to the down shift. In general, the period could be broadly characterized as low volatility, positive return environment for fixed income investors.

<u>Here are the key highlights for the second quarter:</u>

- Treasury 10-year note yield remained within a well-defined long-term range of 2.12% to 2.63%, but moved the lower elevations before ending the period at 2.30%.
- U.S. government agency debt continued its relative outperformance, beating their Treasury counterparts by 40 basis points. Callable agency notes added another 9 basis points to that figure thanks to the incremental income offered by this structure.
- Investment grade corporate bond performance continues to outpace government sectors with a strong +110 basis points (1.1%) of excess return compared to Treasury securities. Year-to-date, the advantage expands to +174 basis points.
- Sector performance favored Media, Telecom, and Financials while Energy, Autos, and Retail lagged.
- Volatility declined further last quarter and is nearing 10-year low levels.
- Bloomberg Barclays Intermediate Gov't/Credit index produced a total return of +0.92% in the quarter.

Looking ahead, our economic outlook suggests 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 higher by year-end. Given our view that interest rate volatility is set to increase, the bond market may have seen its lows for the year, absent a Black Swan event. Therefore, we are tempering our enthusiasm for callable agency notes which have outperformed non-callable securities by 20 basis points in 2017.

In terms of our allocation towards investment grade corporate bonds, we remain cautiously optimistic. The combination of reduced issuance, strong earnings growth, declining corporate defaults, and steady outperformance have pushed yield premiums to cycle low levels. Our overweight to this theme recognizes a few risks that are building. Our chief concern is world central banks collectively tightening credit too rapidly. Also, ratings actions have tilted negatively all year with the upgrade/downgrade ratio below 1. Consequently, we favor higher quality credit issuers with strong or improving metrics while shying away from the lower rated credits. Energy in particular is a space that we believe poses risks to client portfolios. Upgrading portfolio quality requires little yield sacrifice and produces a more stable portfolio. The banking industry is a good example of strong balance sheets and rising earnings growth as yields normalize.

Equity Markets

Randall Hare, Senior Vice President, Director of Equity Research

During the second quarter, U.S. stocks, as measured by the S&P 500, returned 3.09% for the seventh consecutive quarter of positive stock returns.

- The S&P 500 is up 14.79% since the election. However, we witnessed a tapering of the post-election rally in March as the S&P 500 was up 11.8% through early March and has only returned 2.67% over the past 4 months.
- In addition, oil prices are now down on a year over year basis. Oil prices have declined 14% YTD and declined 4% over the past year. These oil price declines have been putting pressure on the Energy sector stocks.
- Healthcare, up 7.1% for the quarter, was the best performing sector. While Energy and Telecom declined 6.35% and 7.05%, respectively.

Looking ahead to the third 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 12.7% in Q1-2017 from the year ago period. For Q2-2017, estimates are for more moderate growth of 6.3%. For calendar year 2017 EPS growth estimates remain at 11% growth from the previous year. This earnings growth has and should continue to provide a favorable environment for stock investors.
- 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 U.S. viewed as a favorable global investment relative to global economies or not. This is a major reason why the ex-US stock indexes outperformed in the second quarter.
- 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 positive returns in the second half of the year.

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. International markets still make good sense for diversification of equity portfolios.

Huntington
Welcome.