# Review & Outlook
## Third Quarter 2017

Huntington
Welcome.℠

October 11, 2017

## Executive Summary

***John Augustine, CFA, Chief Investment Officer***

The third quarter of 2017 provided investors with generally above-average returns, adding to gains for the year:

- Major domestic stock indexes gained in the 3-5% range – led higher by technology stocks. Major international stock indexes achieved gains in the 5-8% range – led by emerging markets.
- Bond investors generally saw flat markets and little change in the major averages. The U.S. 10-year Treasury yield has stayed very range-bound since April, while overseas bonds are seeing some gains as those coupons are translated back.
- Commodities were very active in the third quarter with double-digit gains in much of the energy complex and industrial metals complex. However, livestock and food prices fell, some in double digits. That news is good for consumers, but bad for farmers.

From an economic perspective, we saw three areas of plateauing in the quarter – auto sales, housing starts and retail sales. Business investment and exports continued to be robust. The hurricanes will impact Q4 and likely bring a pick-up in the three areas mentioned above.

Perhaps the 'newest news' in the quarter was that the global economy sprang to life during the summer. The Eurozone, Russia, Canada, China and India (among the major economies) are all growing faster than the U.S. on a year-over-year basis through the end of the second quarter. In general, the U.S. has been leading all except China and India since the Great Recession, so this is something new. The U.S. Dollar Index (DXY) was down 2.6% in the third quarter, reflecting this change in relative economic growth rates.

We made some slight adjustments in portfolios during the third quarter to lower some stock allocations that were bumping up against the top end of the ranges in which we operate for the various asset allocation objectives. We also moved some allocation to emerging markets, due to their renewed growth. 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***

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## The Economy

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

Our outlook on the economy:

- After a strong second quarter, the economy in the third quarter returned to the moderate, mixed pace typical of the current economic expansion. Restarting and rebuilding after the intense hurricane season, especially from the flooding destruction created by Hurricane Harvey in the Houston area, will likely provide added economic stimulus in the fourth quarter and the first half of 2018. Overall growth in 2017 will likely be in line with our 2.2% forecast.
- Consumer spending slowed in the third quarter from a broad-based acceleration in the second quarter. Overall indicators for the consumer remain positive, including strong consumer confidence, a historically low financial obligations ratio and an overall unemployment rate of 4.2%. However, pent-up demand for spending has been reduced by several years of recovery. Personal income growth has also been slowing, and employment growth in the next year will likely slow as labor shortages become increasingly prevalent. The outlook is for continued moderation in overall consumer spending growth in 2018.
- Supported by improvements in international economic growth and energy markets, exports and business equipment investment continued recoveries in the third quarter that began in the third quarter of 2016. Manufacturing in 2017 YTD continued to recover from two subpar years as well, with its strongest growth since 2014, and its largest employment growth since August 2013. Industrial production is expected to show solid growth in the second half of 2017.
- Inflation will likely bookend 2017. After a sharp acceleration in the first quarter, consumer inflation slowed in the second and third quarters. With added supply pressures created by the disruptive hurricanes, inflation is expected to be above average in the fourth quarter. Overall annual inflation in 2017 appears to be close to our original estimate of 2.0%, which is just under our initial view of 2.2% for 2018.
- During the third quarter, the Federal Reserve decided to hold the Fed Funds rate target steady at 1.0% -1.25%, and begin to implement its asset downsizing plan. The plan commences in October with the non-reinvestment of up to $6 billion per month in Treasury securities and $4 billion in mortgage-backed securities (MBS). The monthly amount not reinvested will rise until it reaches $30 billion in Treasuries per month and $20 billion in MBS per month in one year's time. Subsequently, the amount will stay at a total of $50 billion per month, or $600 billion per year. It is our view that this sizeable increase in bond supply in markets will likely put gradual, but sustained upward pressures on long-term interest rates, holding all other factors constant.
- Our forecast calls for 2.3% real GDP growth next year, some pick-up in inflation and three more Fed Funds rate target hikes by year-end 2018. However, the economic course for 2018 will likely depend on developments in fiscal and tax policies in the coming weeks and months. In the event of no major changes, the Fed Funds rate target and the 10-year Treasury yields are expected to move only modestly above the September 30th rates of 1.13% and 2.33%, respectively. On the other hand, depending on the scope of new tax and fiscal policies, economic growth and inflation could be significantly higher than the continuation of modest

current trends. Hence, our view is that the forecast uncertainties for the Fed Funds rate target and overall market interest rates are unusually high, and 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***

In the third quarter, bond markets gyrated on shifting government policies and geopolitical uncertainty. August witnessed a particularly unsettling period of policy uncertainty that pushed yields lower and credit risk spreads wider. The highest risk parts of the market suffered major underperformance, which should serve as a warning to investors that relative calm can change without notice. However, by the end of September, all was well and the entire move was reversed. Treasury yields moved higher and credit spreads snapped back to cycle low levels. In the final analysis, the period was slightly more volatile than recent quarters, but provided an overall positive return environment for fixed income investors. Corporate bond investors in particular were rewarded with another quarter of positive excess returns. This brings the cumulative count to eight consecutive quarters of better returns than Treasury markets have produced.

Here are the key highlights for the third quarter:

- While the Treasury 10-year note yield dipped briefly below the well-defined long-term range of 2.12% to 2.42%, it ending the period about where it began at 2.33%.
- U.S. government agency debt continued its relative outperformance, beating its Treasury counterpart by 33 basis points. Callable agency notes added another three 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 +95 basis points (0.95%) of excess return compared to Treasury securities. Over the past year, the advantage expands to +427 basis points.
- Corporate bond supply has been strong, but buying demand has been robust. As a result, credit spreads are at cycle low levels and BBB-rated credit spreads are at 10-year low levels!
- Sector performance strongly favored Basic Industry and Energy, with Real Estate and Telecommunications coming in a distant third and fourth.
- Lagging sectors included Leisure, Capital Goods and Retail. While these were the last place groups, they still managed to beat Treasury securities for the quarter.
- Bloomberg Barclays Intermediate Gov't/Credit index produced a total return of +0.60% in the quarter. For the year, this measure indicates bond investors have gained 2.34%.

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. Looking ahead, our economic outlook suggests the balance of evidence to weigh towards higher yields as the year progresses. As a result, we expect the 10-year Treasury yield to gravitate higher by year-end. Given our view that interest rate volatility is likely to increase, the bond market may have seen its lows for the year, absent a systemic shock. Inflation trends will be top of mind for bond investors in the coming months. If expectations start to increase for 2% or higher inflation, yields will likely push above the upper range of 10-year Treasury notes (2.42%) and may test the 2017 high water mark of 2.62%.

In terms of our sector allocation for investment grade corporate bonds, we remain cautiously optimistic. The combination of reduced issuance, strong earnings growth, declining corporate defaults and steady outperformance has once again 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. August was a warning that corporate bond valuations are no longer clearly attractive, and disruptions to the positive operating environment will be met with selling pressure. Consequently, after eight years of narrowing credit spreads, we are becoming more selective. We favor higher-quality credit issuers with strong or improving metrics, while shying away from the lower-rated credits. Upgrading portfolio quality requires little yield sacrifice, and produces a more stable portfolio. Investors may need to become satisfied with simply collecting the incremental income afforded by corporate bonds, should credit spreads remain near present levels. As for sector preferences, we find attractive risk/reward opportunities in Health Care, Banking and Insurance.

## Equity Markets

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

During the third quarter, U.S. stocks, as measured by the S&P 500, returned 4% for the eighth consecutive quarter of positive stock returns. Over these two years, the index is up 37%.

- Technology stocks led all other sectors, returning 8.4% in the third quarter, followed by Energy stocks with a total return of 6.9%. Consumer Staples were the only stocks with negative performance (-1.2%) for Q3. Energy scored a rare negative earnings surprise median figure, as more firms missed than beat their earnings estimates.
- For Q3, Growth stocks beat Value stocks, despite a September surge in Value stocks. Banks and some beaten-up Energy firms carried the water for the S&P 500 in September, while Technology paused.
- The biggest story of Q2 earnings (reported in Q3) was the upward revision to earnings estimates. We started the quarter with expectations of 6.5% for the S&P 500, and ended at 10.1%.

Looking ahead to the fourth 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 be modest, around the consensus of 2.3% for 2018. We forecast an acceleration in inflation, with a continual rise in the Fed Funds rate.
- S&P 500 EPS increased 11% in Q2-2017 from the year-ago period. For Q3-2017, estimates are for a more moderate growth rate of 3.5%. For calendar year 2017, EPS growth estimates remain at 11% growth from the previous year. Calendar year 2018 looks to continue with double-digit earnings growth. The earnings outlook 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 outcome of these efforts, we could see the U.S. viewed as a more favorable 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 to accelerating earnings growth where valuation presents attractive opportunities. Staying invested is likely to provide investors with the best opportunity to achieve their portfolio objectives.

Weighing the headwinds and tailwinds, we see a continuation of double-digit earnings growth, 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.