Review & Outlook

Fourth Quarter 2017

January 9, 2018

Executive Summary

John Augustine, CFA, Chief Investment Officer

There was a change in view for business, the economy and corporate earnings during the fourth quarter. Several areas contributed to this:

1. The global economy seemed to continue to pickup pace. The U.S. had two consecutive quarters of +3% real GDP growth, and economies from Europe to China are seeing positive economic indicators.
2. Business sentiment remained very high and that confidence was affirmed by a robust corporate tax bill that addressed repatriation, accelerated capital spending write-downs for tax purposes and a noticeably lower corporate tax rate.
3. Earnings estimates for large U.S. companies, via the S&P 500, are rising for 2018, and continue to do so. At the end of September, the sell-side estimate for 2018 earnings per share growth was an increase of 12.17% from 2017. That number is now up to 14.84% and likely to go higher as companies announce how the tax cuts will affect them with quarterly earnings releases in January.

The stock market took note of these factors in the fourth quarter, with the Dow Jones Industrial Average rising an impressive 10.33%. The returns in the fourth quarter cap a very good year for stock investors around the world.

Interestingly, the bond market stayed fairly calm during the quarter, with the 10-year treasury yield rising slightly from 2.33% on 10/1/17 to 2.41% by year’s end. This helped further propel stocks.

We start 2018 with an optimistic tone for business and markets. How central banks will react to this and how companies will deliver on the optimism is an area of focus for all market participants in the first quarter of the New Year. Stocks are due for a pullback, but the fundamentals are improving. A solid state of affairs for diversified investors.

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

The U.S. economy continued strong overall growth in the fourth quarter with most major sectors providing contributions to growth. Consumers increased retail sales in November over last year by 5.8% for the strongest 12-month increase since March 2012. For the 3 months ending November, businesses placed 8.9% more new orders for Nondefense Capital Goods Excluding Aircraft than in the same period last year, effectively returning investment to levels last experienced in the third quarter of 2014. Exports continued steady annual growth of 5.6% in October, setting the stage for the first year of export growth in the U.S. economy since 2014. According to the ISM report, Manufacturing had its strongest growth in the fourth quarter since the first quarter of 2011. Although not quite as spectacular as Manufacturing, the Services sector also grew solidly in the fourth quarter on broad-based strength. The economy added 611,000 jobs in Q4, bringing the official unemployment rate down to 4.1% -- the lowest unemployment rate since 2000. Recovery from the severe hurricane season was a temporary growth factor this fall, but economic performance in the fourth quarter was clearly above average for recent years even after accounting for these tragic events.

The outlook for 2018 remains positive with 2.5% annual real GDP growth projected for the year. "The Tax Cut and Jobs Act of 2017" is expected to provide stimulus to economic growth via increased incentives for business investment and higher overall disposable incomes in 2018 and beyond, even as many of the personal income tax cuts expire after 2025. Inflation is expected in the 2.5% range in 2018, but increasing producer price pressures in the near-term will likely create upward pressures on the Fed Funds rate target and long-term interest rates. We expect at least 3 more quarter point Fed Funds rate target hikes and a 3.0% Treasury yield by year-end. An improving international economy will likely add to economic growth, but will also put upward pressures on world interest rates and inflation. Labor markets in the U.S. are expected to tighten with rising real wages and increasing labor force participation.

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

Last quarter, The Treasury 10-year note yield was range-bound until a late December selloff as markets began to fully price-in the tax reform's boost to growth. Yields briefly touched 2.5% before settling down to close the year at 2.41% which is about where 2017 began at 2.44%.

U.S. government agency debt continued its relative outperformance, beating its Treasury counterpart by 24 basis points (+0.24%). Callable agency notes added another eleven 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 +98 basis points (+0.98%) of excess return compared to Treasury securities. Over the past year, the advantage expands to +377 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

Fixed Income Markets - continued

credit spreads are at 10-year low levels. Sector performance strongly favored Basic Industry, Energy, and Retail. Lagging sectors included Consumer Goods, Capital Goods and Technology. 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 -0.20%% in the quarter. For the year, this measure indicates bond investors have gained +2.14%.

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. Thus, we expect the 10-year Treasury yield to gravitate towards 3% over the course of 2018. 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, currently 2.65%. Producer prices have already begun rising sharply. In terms of our sector allocation for investment grade corporate bonds, we remain cautiously optimistic. The trends identified above are expected to continue at least through the first half of 2018. We can now add repatriation of overseas profits to the list of positive factors impacting corporate issues. Added funding should reduce balance sheet pressures in the months ahead. However, after nine years of narrowing credit spreads, we find credit spreads near the narrowest levels of the cycle and will remain highly 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.

Equity Markets

Randall Hare, Senior Vice President, Director of Equity Research

U.S. stocks, as measured by the S&P 500, finished the year with a strong performance, climbing 6.2% for the quarter ending December 31, 2017, and up 21.8 for the year ending the same date. All sectors in the S&P 500 had positive performance for the quarter except Utilities. The markets were led higher by the Consumer Discretionary sector and the Technology sector, with returns of 9.7% and 8.9%, respectively. During the third quarter, U.S. stocks, as measured by the S&P 500, had their 9th consecutive quarter of positive gains.

Looking ahead to the first quarter of 2018 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 are on pace to have increased double digits for the 2017 calendar year. Earnings expectations for 2018 continue to move higher. As noted above, estimates have moved higher to 14.8% for 2018.

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Equity Markets – continued

- Synchronized global growth is continuing to be a tailwind to corporate earnings as well as global stock markets.
- 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. At Huntington, we are focusing 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 a continuing acceleration in S&P 500 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.