Economics Update 4th Quarter 2016

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After two quarters of lackluster growth, the U.S. economy accelerated in the third quarter, when real gross domestic product increased at an annual rate of 3.2 %, according to the second estimate released by the Bureau of Economic Analysis. In comparison, real GDP increased 1.4% in the second quarter (revised). Because the official estimate of GDP is released with a delay, the Atlanta Fed has developed their own GDP forecasting model called GDP NOW which provides a forecasted estimate of the official estimate prior to its release. The Atlanta FED reported that the "GDP NOW model forecast for real GDP growth (seasonally adjusted annual rate) in the fourth quarter of 2016 is expected to be 2.6 % on December 9."

According to the Bureau of Economic Analysis, "the acceleration in real GDP in the third quarter primarily reflected an upturn in private inventory investment, an acceleration in exports, an upturn in federal spending, and smaller decreases in state and local government spending and residential fixed investment, that were partly offset by a deceleration in personal consumption expenditures, an acceleration in imports, and a deceleration in nonresidential fixed investment."

The third quarter of 2016 ended with a September unemployment rate of 5.0%, which was a 0.2% increase from the rate in June and a 0.1% increase from the rate in August. Total nonfarm payroll employment rose by 156,000 in September with increases seen in professional and business services as well as health care. The participation rate increased to 62.9% in September from the June 2016 rate of 62.7%.

The November unemployment rate was reported to have dropped to 4.6%, with private sector jobs increasing over the last 80 months. U.S. employers added 178,000 jobs in November. This rate is the lowest since August 2007. A broad measure of unemployment and underemployment, which includes those who have stopped looking and those in part-time jobs who want full-time positions, was 9.3% in November, down from 9.5% the prior month and the lowest level since April 2008. The rate averaged 8.3% in the two years before the recession.

"Existing-home sales rose in October for the second straight month, eclipsing June's cyclical sales peak to the highest annualized pace in nearly a decade," the National Association of Realtors® reported. All major regions saw monthly and annual sales increases in October. Total existing-home sales, which are completed transactions including single-family homes, townhomes, condominiums and co-ops, grew 2.0% to a seasonally adjusted annual rate of 5.60 million in October, from an upwardly revised 5.49 million in September. October's sales pace is 5.9 percent above October a year ago (5.29 million) and surpasses June's pace (5.57 million), making it the highest since February 2007 (5.79 million). October's strong sales gain was widespread throughout the country and can be attributed to the release of would-be buyers that were held back over the summer because of tight supply.

According to Freddie Mac, the average 30-year mortgage rate for September was 3.46 %. The rate increased from 3.54% in early November- right before the election- to 4.08% in early December. Mortgage rates between 3.5-4.0% since 2012 were a boon to refinancings and housing. However, with mortgage rates at the highest of the year, borrowers are backing off refinancings. The latest Weekly Applications Survey from the Mortgage Bankers Association shows refinance activity down 16% week over week. Higher-than-expected inflation, along with the near certainty that the Federal Open Market Committee (FOMC) will raise rates in December, has caused this increase in mortgage rates. Higher mortgage rates will drive down homebuyer affordability, which may weaken home sales, may soften house price growth, and may slow the growth in new home construction. It must be remembered that mortgage rates around 5% are more normal.

Not only has the likelihood of a December rate hike increased as the economic results have been better, but expectations for future rate increases have shifted as well. The median expectation amongst FOMC members for the appropriate level of the federal funds rate was significantly higher than the probability implied by futures markets during the last FOMC press conference in September. Freddie Mac expects to see additional interest rate increases in 2017.

The Consumer Confidence Index, which had declined to 100.8 in October, increased significantly in November to 107.1. The November number brings the index to pre-recession levels. According to The Conference Board, “A more favorable assessment of current conditions coupled with a more optimistic short-term outlook helped boost confidence. And while the majority of consumers were surveyed before the presidential election, it appears from the small sample of post-election responses that consumers’ optimism was not impacted by the outcome.”

The Markets

The markets repeated the second quarter volatility, but again advanced in the third quarter of 2016. The technology-heavy NASDAQ performed best, and the small-cap Russell 2000 Index was also strong. The S&P 500 continued to outperform the Dow with third-quarter gains of 3.85% and 2.78%, respectively. Year to date, the S&P 500 was up 7.84% (2168.27) while the Dow was up 7.21% (18,308.15). The NASDAQ Composite, after showing losses for the first half of 2016, experienced a gain and was up about 9.37% for the quarter. For the first nine months of 2016, the index was up by 6.08%. Like the disparate performances of the indexes, sector performance varied widely. Of the nine sectors represented in the S&P, seven sectors saw positive performance for the quarter, as measured by the SPDR sector ETF's. The best performing sector was Technology (10.60%), followed by Financials (4.74%), Industrials (4.79%), Energy (4.1%), Materials (3.57%), Consumer Discretionary (2.91%) and Health Care (0.88%). Underperforming sectors included Utilities (-5.94%) and Consumer Staples (-2.89%). In October, stocks fell (the DOW fell the least at -0.8%) as concerns about tighter global monetary policy and uncertainty before the U.S. elections appeared to outweigh some encouraging earnings reports and economic data.

In Fixed Income, the Barclays U.S. Aggregate Bond Index continued to rally, though at a slower rate, through the third quarter, up 0.46% after finishing up 2.21% for the second quarter of 2016. Through the first nine months of 2016, the index was up a total of about 5.70%. In July 2016, Treasury rates reached their lows and then reaccelerated through the fall. While longer-term Treasury rates steepened, the long-end of the yield curve continued to flatten as U.S. Treasury yields increased. The 10 year notes increased by about 20 basis points while the 30-year bond increased by 2 basis points, ending the quarter at 1.60% and 2.32%, respectively. The 10-year note continued to rally through November and now stands about where it was in December 2015. We anticipate that Treasury rates will now pause in the near term as market participants wait to see changes in fiscal and monetary policies. Inflation pressures decreased in the third quarter, reflected in $8.59 losses gold futures prices experienced from the prior quarter, with a September 30 closing price of about $1313.30 per ounce. Oil prices declined slightly through the quarter, decreasing $0.55/bbl and ending the third quarter at about $47.72/bbl. The WSJ Dollar Index remained relatively flat through the third quarter, decreasing by about 0.46 to 86.37.

Conclusion

In early 2016, Bowen Asset Management expected the markets to "finish 2016 in positive territory, but volatility will be dramatic caused by global economic uncertainty." In the second quarter of 2016 our outlook appeared to play out with "Brexit" causing a temporary downdraft in the broader markets which quickly recovered to near record highs. We then expected the highly contested U.S. presidential election to leave investors uncertain regarding how changes in fiscal and regulatory policy would affect future economic activity. Immediately following the election, with many surprised by the results, the market's rally accelerated with some indices hitting new highs, as investors bet that President-elect Donald Trump will push for legislation that includes massive corporate tax cuts, as well as financial and environmental deregulation which supports economic growth. Financial shares have risen 14%, while industrials rose 8.5% in November. We call this market move the "Trump Bump." While the U.S. macroeconomic cycle may get a boost from the proposed fiscal stimulus, corporate tax reform and de-regulation - both the passage and efficacy of these measures - are far from certain at this moment. We think that, fundamentally, risks for equities in 2017 are higher compared to 2016. We are not sure if the "Trump Bump" is a sustainable event. We expect an increased level of geopolitical risk and increased uncertainties related to the new U.S. administration. In addition, we just returned from a major financial conference in New York City and found our concern is spread across the institutional financial community. We are torn between the safety of our larger-than-normal cash positions and missing out on the market rise into 2017. We have tempered our investment return expectations for 2017 as we learn more about Trump's evolving policies and how they are likely to drive market performance.

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