BAM Economics Update Following Fourth Quarter 2016

By Ken Martin-Halpine

The economy returned to sub-2% GDP growth in the 4th quarter of 2016 after a good 3rd quarter result. Treasury rates after bottoming in early July continued to move higher through the end of the year. The jobs picture continued to improve with good employment gains and less than a 5% unemployment rate. Because of this good data, the FED decided to raise the Fed Funds rate for the first time since December 2015. In their statement, the FED stated that they anticipate an additional 2-3 more rate hikes in 2017.

The Economy

Real gross domestic product (GDP) increased at an annual rate of 1.9 % in the fourth quarter of 2016, according to the "advance" estimate released by the Bureau of Economic Analysis. In the third quarter, real GDP increased 3.5 %. Positive effects on GDP came from personal consumption expenditures (PCE), private inventory investment, residential fixed investment, nonresidential fixed investment, and state and local government spending and were negatively offset by exports and federal government spending. The Federal Reserve (FED) anticipates GDP growth for 2017 to be slightly above 2% caused by a tight labor market and continued low productivity growth. The current GDP forecasts for the first quarter of 2017 published by the Atlanta FED as of Feb 16 (GDPNow) and the New York FED as of Feb 17 (Nowcast) are 2.4% and 3.1%, respectively.

The fourth quarter of 2016 ended with a December unemployment rate of 4.7% which was 0.1 % increase from the prior month. The unemployment rate for September 2016 was 5.0%. The December 2015 figure was 5.6%. Total nonfarm payroll employment rose by 156,000 in December with increases seen in healthcare and social assistance. The participation rate decreased to 62.7% in December from the September 2016 rate of 62.9%. The unemployment rate in for January 2017 was up 0.1% to 4.8% with nonfarm payroll employment increasing by 227,000. Job gains occurred in retail trade, construction and financial activities.

The National Association of Realtors (NAR) released existing home sales numbers for January 2017. Sales were up 3.3% to a seasonally adjusted annual rate of 5.69 million units from an upwardly revised 5.51 million units in December. January's sales pace is 4.8% higher than a year ago and is the strongest since February 2007. Lawrence Yun, NAR chief economist, says "January's sales gain signals resilience among consumers even in a rising interest rate environment. Much of the country saw robust sales activity last month as strong hiring and improved consumer confidence at the end of last year appear to have sparked considerable interest in buying a home."

A persistent shortage of properties available for sale, which is increasing house prices, remains an obstacle to a robust housing market. The median existing home price for all housing types in January was up 7.1% from a year ago. This was the fastest price increase since last January (8.1%) and marks the 59th consecutive month of year-over-year gains. Also, while the 30 year fixed mortgage rate appears to be stabilizing after rapidly rising following the election, it still remains above 4%. According to Freddie Mac, the average 30-year mortgage rate for December 2016 was 4.20%. The rate experienced a 46 basis points (bps) increase from September 2016. However, the December 2016 rate was only 24 bps higher than the rate of 3.96% at year-end 2015.

The Consumer Confidence Index retreated in January after reaching a 15 year high in December. The index now stands at 111.8, down from 113.3 in December. The Conference Board noted that "The decline in confidence was driven solely by a less optimistic outlook for business conditions, jobs, and especially consumers' income prospects. Consumers' assessment of current conditions, on the other hand, improved in January. Despite the retreat in confidence, consumers remain confident that the economy will continue to expand in the coming months."

After raising the target range (December 2015) for the federal funds rate by 0.25% and then keeping the target range at 0.25 to 0.50% through the first three quarters of 2016, the FED announced in December 2016 that it would again raise the target range for the federal funds rate by 0.25% with a target range at 0.50 to 0.75%. The FED stated that information "indicates that the labor market has continued to strengthen and that economic activity has been expanding at a moderate pace since mid-year. Job gains have been solid in recent months and the unemployment rate has declined. Household spending has been rising moderately but business fixed investment has remained soft" In addition, "Market-based measures of inflation compensation have moved up considerably but still are low". Interestingly, the FED noted that "The stance of monetary policy remains accommodative, thereby supporting some further strengthening in labor market conditions and a return to 2 % inflation."

Stock Market

The broader equity markets repeated the second and third quarter volatility, but again ended higher for the fourth quarter of 2016. The broader markets weakened through the quarter and bottomed in early November before rallying after the November 8th Presidential election. For the quarter, the S&P 500 underperformed the Dow with gains of 3.3% and 7.9%, respectively. For 2016, the S&P 500 was up 9.5 % (2238.83) while the Dow was up a greater 13.4 % (19762.60). The NASDAQ Composite, after showing losses for the first half of 2016 experienced gains in the third quarter (9.37%) and was up 1.34% for the fourth quarter. For the full year of 2016 the index was up by 7.50 %. Of the 10 sectors represented in the S&P, 7 sectors saw positive performance for the quarter, as measured by the SPDR sector ETFs. The best performing sector was Financials (21.00%) followed by Industrials (7.18%) and Energy (7.17%). Other gainers for the quarter were Materials (4.72%), Consumer Discretionary (2.27%), Technology (1.54%) and Utilities (0.10%). Underperforming sectors included Consumer Staples (-2.09%), Health Care (-4.00%) and Real Estate (-4.43%). For 2016, the top performing sectors were Energy (28.01%), Financials (22.69%) and Industrials (19.95%). Only Healthcare underperformed for the full year with a return of -2.83%.

In Fixed Income, the Barclays U.S. Aggregate Bond Index continued to rally, but at a slower rate, through the third quarter ending down about 3.0 % (1976.37) after finishing up 0.46% for the third quarter of 2016. Through the full year of 2016, the index was up a total of about 2.6%. After bottoming in July 2016, the 10-year note began to rally through the third quarter and strongly rallied through the fourth quarter to end 2016 at 2.45%. While longer term Treasury rates steepened sharply, the long end of the yield curve continued to flatten as U.S. Treasury yields increased with the 10-year note increasing by about 85 basis points while the 30-year bond increased by 74 basis points, ending the quarter at 2.45% and 3.06%, respectively. Interestingly, rates for the 10-year and 30-year Treasuries at the end of December 2015 were 2.27% and 3.01% respectively. Inflation pressures decreased in the fourth quarter, reflected in gold futures prices experiencing losses from the prior quarter of about $8.59 with a September 30 closing price of about $1313.30 per ounce. Oil prices strengthened through the quarter, increasing about $6.03/bbl to end the third quarter at about $53.75/bbl. For the year, oil rallied about $16.62/bbl from a year-end 2015 price of $37.13/bbl. The WSJ Dollar Index accelerated through the fourth quarter, increasing by about 6.57 to 92.94.

Conclusion

All through 2016 Bowen Asset management was cautiously optimistic with an overhang of considerable uncertainty going into the November election. Since then, we have seen the market clearly adopt expectations that Trump’s election platform will drive above average economic growth. A number of things however remain to be seen: Will Trump be able to pass a simplified corporate tax package and reduce the corporate tax rate significantly below the effective corporate tax rate for most companies? Will a repatriation of offshore earnings drive an increase in plant investment when the industrial capacity utilization rate is at a recession level low, why invest in a new plant when there is so much unused industrial capacity? If not, repatriated funds could flow into mergers and acquisitions which would buoy the current stock market levels but may not necessarily help with job expansion. Now that the Republicans control the House, Senate and the White House, Republicans should be able to push Trump’s aggressive vision through congress but it’s all about how the plan gets implemented. We remain quite optimistic long term assuming that the majority of his policies will eventually pass however we think that it will take longer than investors realize and expect to see a market correction before the fall of 2017. The easy Trump money was made during Trump’s first month in office. Now Trump has to deliver, on his election promises. At Bowen Asset, we are looking for buying opportunities which take advantage of anticipated market corrections.

Disclaimer:

While this article may concern an area of investing or investment strategy in which we supply advice to clients, this document is not intended to constitute a complete description of our investment services and is for informational purposes only. It is in no way a solicitation or an offer to sell securities or investment advisory services. Any statements regarding market or other financial information is obtained from sources which we and/or our suppliers believe to be reliable, but we do not warrant or guarantee the timeliness or accuracy of this information.

Past performance should not be taken as an indicator or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. As with any investment strategy or portion thereof, there is potential for profit as well as the possibility of loss. The price, value of and income from investments mentioned in this report (if any) can fall as well as rise. To the extent that any financial projections are contained herein, such projections are dependent on the occurrence of future events, which cannot be predicted or assumed; therefore, the actual results achieved during the projection period, if applicable, may vary materially from the projections.