Economics Update-3th Quarter 2016

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Introduction

Economic activity during the second quarter of 2016, while higher than the anemic growth in the first quarter remained below 2%. The equity markets in the second quarter, like the first quarter, experienced considerable volatility but ended higher for the year. Many consumer sectors improved caused by good employment and wage growth. The energy sector experienced the highest gains in the broader stock markets caused by a strong rebound in oil prices.

The US economy remained soft in the second quarter of 2016 as Real Gross Domestic Product increased at an annual rate of 1.1 percent (second estimate) released by the Bureau of Economic Analysis. In the first quarter, real GDP increased 0.8 percent (revised).

The second quarter of 2016 ended with a June unemployment rate of 4.9% which was a 0.2% increase from the prior month and a 0.1% decrease from March 2016. Total nonfarm payroll employment rose by 287,000 in June with increases seen in "leisure and hospitality, health care and social assistance, and financial activities. Employment also increased in information, mostly reflecting the return of workers from a strike." The participation rate decreased to 62.7% in June from the March 2016 rate of 63.0%.

U.S. existing home sales rose in June 2016, up 1.1 % to an annual rate of 5.57 million in June from a downwardly revised 5.51 million in May 2016. Sales were up 3.0% from a year ago. "Sustained job growth" and lower mortgage rates were given for the gains. According to Freddie Mac, the average 30-year mortgage rate for June was 3.57%. The rate experienced a 3bps decrease from March 2016. The June 2016 rate was 0.41% lower than the same time last year.

The Consumer Confidence Index improved in June to 98.0 up from 92.4 in May and 96.2 in March 2016. Despite the Index being much higher than Economists expectations of 93.7, the Conference Board noted that "consumers were still "cautiously optimistic" about economic growth in the short term".

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 quarter, the Federal Reserve (FED) announced in June that they would remain on hold in order to support "further improvement in labor market conditions and a return to 2 percent inflation." The FED noted "that the pace of improvement in the labor market has slowed while growth in economic activity appears to have picked up." In addition, "Since the beginning of the year, the housing sector has continued to improve and the drag from net exports appears to have lessened, but business fixed investment has been soft. Inflation has continued to run below the Committee's 2 percent longer-run objective, partly reflecting earlier declines in energy prices and in prices of non-energy imports. Market-based measures of inflation compensation declined"

The markets repeated the First Quarter volatility, but again ended up for the second quarter of 2016. The temporary swoon late in the second quarter was primarily attributed to the “Brexit” vote in the UK. The S&P 500 outperformed the Dow with gains of 1.9% and 1.4%, respectively. For the first half of the year, the S&P 500 was up 2.7% (2098.86) while the Dow was up a greater 2.9% (17,929.99). The NASDAQ Composite again experienced a loss for the quarter and was down 0.6%. For the first half of 2016 the index was off by 3.3%. Of the 9 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 Energy (11.00%) followed by Utilities (6.71%), Health Care (6.23%), Consumer Staples (4.58%), Materials (3.99%), Financials (2.10%) and Industrials (1.52%). Underperforming sectors included Technology (-1.71%) and Consumer Discretionary (-0.92%).

In Fixed Income, the Barclays U.S. Aggregate Bond Index continued to rally through the second quarter ending up 2.02% after finishing up 3.03 % for the first quarter
of 2016. The long end of the yield curve continued to flatten as U.S. Treasury yields fell with the 10-year note decreasing by about 29 basis points while the 30-year bond fell by 31 basis points, ending the quarter at 1.49% and 2.30%, respectively.

Inflation pressures continued to increase in the second quarter, reflected in gold
futures prices experiencing gains from the prior quarter of about $89.19 with a June 30 closing price of about $1321.89 per ounce. Oil prices accelerated through the quarter, increasing $11.33/bbl to end the second quarter at about $48.27/bbl. The WSJ Dollar Index remained relatively flat through the second quarter increased by about 0.24 to 86.83.

Conclusion

In early 2016, we expected the Markets to “finish 2016 in positive territory, but volatility will be dramatic caused by global economic uncertainty.” Our outlook appears to be playing out with “Brexit” causing a temporary downdraft in the broader markets which quickly recovered to near record highs. The highly contested presidential election will cause investors to remain uncertain regarding future economic activity. In addition, global economic growth remains below expectations and until growth accelerates, revenue and earnings growth will be below trend in the near term. Finally, market participants are anticipating additional increases in the Fed Funds rate in 2016 but remain on the edge of their seats until the FED acts. As a result of these background issues, we expect security selection to continue to drive positive returns in 2016.