Economic and Market Overview

Third Quarter 2016

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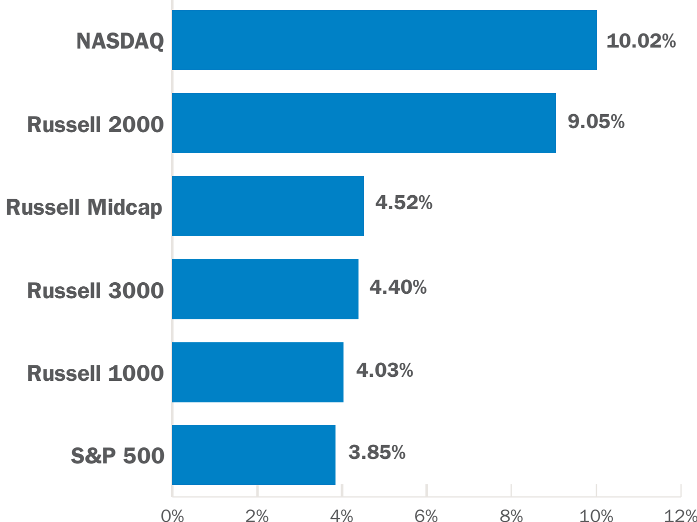
*The following commentary summarizes prior financial market activity, and uses data obtained from public sources. This commentary is intended for **one-on-one use with a client's financial advisor only** as a resource to manage assets and evaluate investment portfolio performance.*

The Economy

Domestically, the economic environment, although still below optimal levels, is beginning to show signs of acceleration. In the US so far, "Brexit"—the UK's decision via referendum to exit the European Union—has had little economic effect. Economic conditions are currently favorable, with, among other things, continued low interest rates; an improving employment situation; surging vehicle sales; and a steadily recovering housing market. The upcoming US presidential election potentially could create unforeseen disturbances to the growth outlook, but so far none are apparent. The Bureau of Economic Analysis reported its third estimate of second quarter 2016 gross domestic product (GDP) of +1.4%, higher than both the prior estimate of +1.1% and the +0.8% reading of the first quarter. The employment situation showed marked improvement, with an average of about 232,000 jobs added each month. The unemployment rate was moderately higher at 4.9%.



Globally, the situation is a bit less rosy. The Brexit result has created a significant amount of uncertainty over what the ultimate impact will be from an economic standpoint. In addition, political effects stemming from Brexit in other European Union countries, such as Germany and Spain, are beginning to percolate. GDP growth in the Eurozone shrank to +0.3% in the second quarter from +0.5% in the first quarter. In China, the economy is slowing due to structural adjustments that will take time to play out. Asian economies generally have slowed as global demand for the region's exports has waned. Other emerging economies, including those in Latin America, are beginning to stabilize, but may remain under some pressure as a result of slackening demand for commodities. Although recent trends have not been favorable, economists believe that global economies will begin to pick up steam later this year and into 2017, partly on the tailwind of acceleration in the US economy.

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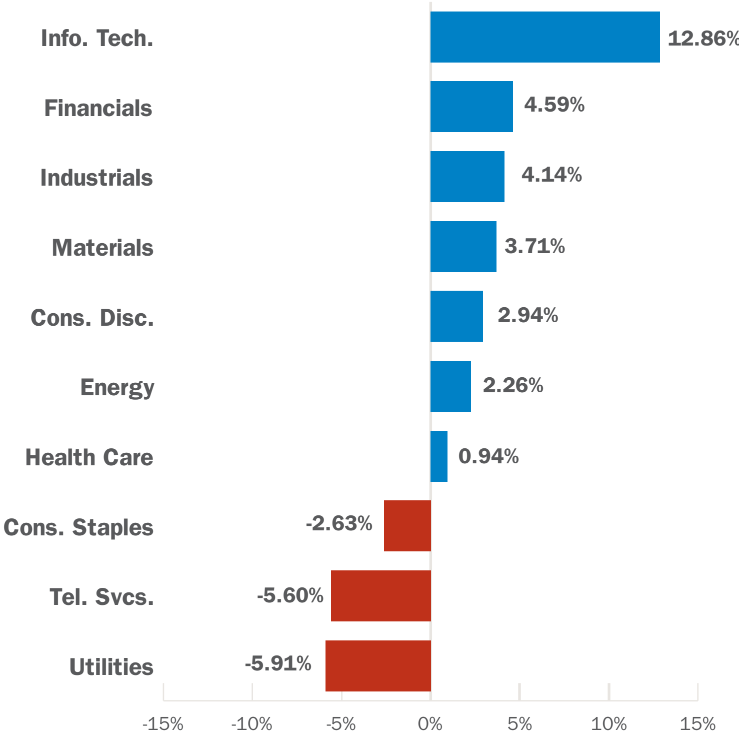
At its most recent meeting in September, the Federal Open Market Committee (FOMC) again stood pat, deciding not to increase the target fed funds rate from the current range of 0.25% to 0.50%. The FOMC stated that risks to the economy are balanced, indicating to many analysts that the committee will decide to raise interest rates by the end of the year.

Highlights and Perspectives

GROSS DOMESTIC PRODUCT (GDP)

The Bureau of Economic Analysis released the third estimate of the second quarter 2016 real GDP, a seasonally adjusted annualized rate of +1.4%. This figure is up from the +0.8% annualized growth of the prior quarter, and is an improvement over the prior estimate of +1.1% growth. The second quarter results confirmed that although the GDP growth rate has improved recently, economic growth remains relatively sluggish. However, economists are generally of the belief that the economy is on the right track, and is poised to accelerate from these levels. Consumer spending was the primary driver of growth, as business investment declined. The environment is favorable to continued support from the consumer, with low interest rates; only modest inflation; low and stable energy prices; a steady recovery in the housing market; and stock prices near record highs. In addition, consumers have increased spending while maintaining a savings rate above 5%. One of the concerns of economists is the decline in business investment, which may adversely affect future productivity growth. Corporate profits fell by -0.6% (not annualized), after rising +3.4% in the prior quarter. Inflation edged up somewhat as energy prices stabilized, with the personal consumption expenditures (PCE) index of prices rising +2.0%, following a +0.3% advance in the prior quarter.



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HOUSING

The housing segment showed signs of moderating after having risen for three years. Existing home sales for August (the latest monthly data available) advanced at an annualized rate of 5.33 million units, down about -1% from the 5.38 million unit rate reached in July, but up +0.8% from August 2015. The inventory of existing homes was about 4.6 months of supply, down slightly from year-ago levels. Existing home prices in August were up moderately from May, and about +5.3% higher from August 2015. In the new home segment, the NAHB Housing Market Index, a measure of homebuilding activity, ended the quarter at a level of 65, the highest reading in 11 months. Homebuilders and analysts remain optimistic about the outlook for housing, as low interest rates and solid employment growth are expected to be supportive into next year.

EMPLOYMENT

The employment situation cooled somewhat in the most-recent monthly report. Employers added 151,000 jobs during August, short of consensus expectations of 180,000 new jobs, and much lower than the gains of the prior two months. The three-month moving average is still a very respectable 232,000, a rate that analysts believe will be able to absorb the growth in the working-age population. The unemployment rate in August was 4.9%, above the 4.7% level in May, but the same level of the prior two months. Average hourly earnings increased +0.1% in August and +2.4% in the past 12 months. Economists have recently lowered job growth forecasts slightly as a result of moderating economic data, but anticipate monthly gains of approximately 180,000 for the next several quarters. Such gains are expected to lower the unemployment rate to about 4.7% over that timeframe. Although the August results were short of the robust gains of the prior two months, the positive trend remains in place. The FOMC will likely consider the magnitude of these recent additions when determining whether to raise interest rates at its December meeting.

FED POLICY

The FOMC ended its recent September meeting standing pat on interest rate policy, maintaining a target range of 0.25% to 0.50% for the fed funds rate. However, resilience in recent economic data, coupled with the committee's perceived desire to continue to normalize rates, leads many analysts to conclude that the FOMC will move to raise rates by the end of the year. The statement accompanying the recent decision noted that the FOMC considers the near-term risks to the economy as "balanced," a signal to economists that the central bank is readying a rate increase. At this meeting there were more dissents from the hawkish segment of the FOMC, who are eager to raise rates. The committee also noted that it would like to see further progress on meeting its dual objectives of full employment and price stability. Although the employment situation continues to improve, the FOMC would likely be interested in seeing some upward pressure on prices so that inflation nears its target of 2%. The futures market is currently assigning a roughly 50% probability to there being at least one increase by the end of this year.

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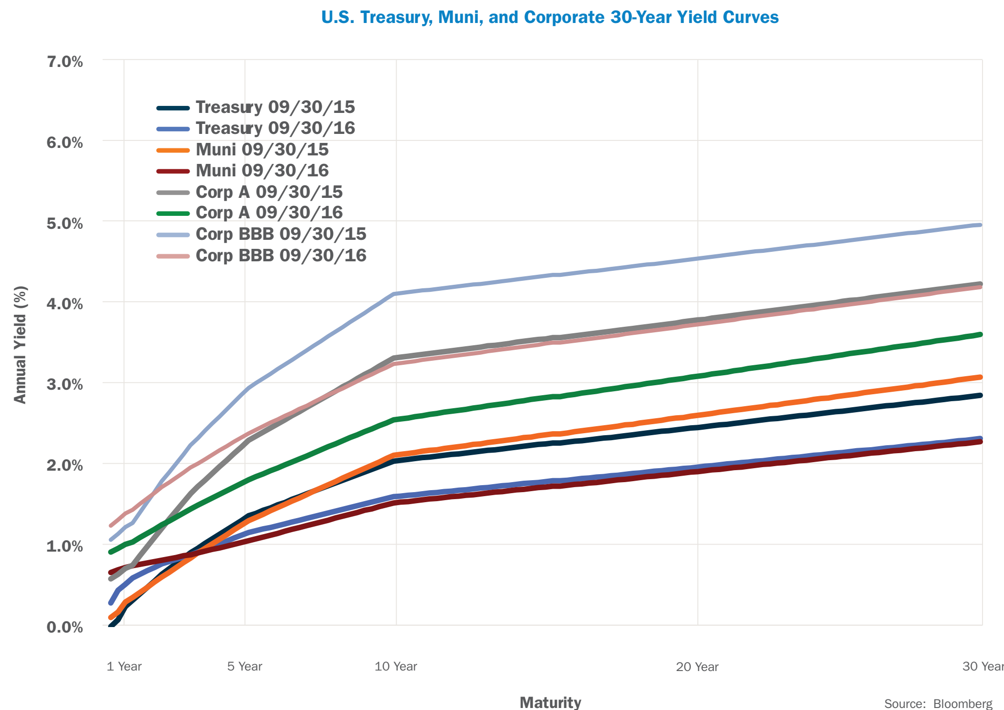
INTEREST RATES

In the third quarter, speculation about whether the FOMC would raise rates in September, coupled with more favorable economic data and the stock market's recovery to near record highs, drove the prices of fixed income securities. As with the lead-up to the FOMC's June meeting, much debate ensued as to whether economic conditions were strong enough to warrant a rate increase at the September meeting. The committee's continued preference is to begin normalizing interest rate policy as soon as practicable, but the FOMC voted not to initiate a second rate increase at the September meeting. Within the context of these various influences, yields generally trended higher into late September, at which time fixed income prices firmed and yields fell.



The yield curve continued to flatten, as has been the prevailing trend for several quarters. Yields on short-term securities rose more than those in the intermediate- to long-term end of the spectrum. By the end of the quarter, the yield on the benchmark 10-year U.S. Treasury note rose to 1.60%, from 1.47% on June 30.

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Yield changes along the maturity spectrum were affected by many of the same factors as in the prior quarter, including a FOMC bias toward raising short-term rates, modestly improving domestic economic data, and investor demand for intermediate- to long-term Treasury securities resulting from negative yields in other safe haven markets, such as Germany and Japan. Except at the very shortest end of the yield curve, yields rose, and those of shorter-term maturities rose more than longer-term maturities. This resulted in a further flattening in the yield curve relative to June 30. The yield on the 3-month Treasury bill settled at 0.28% at the end of the quarter, up slightly from the end of the previous quarter. The yield on the 5-year Treasury note rose modestly, ending the quarter at 1.15%, compared to 1.00% on June 30, and as mentioned above, the yield on the 10-year Treasury note rose to 1.60% from 1.47% over the same period. At the same time, the yield on the 30-year Treasury bond was little changed, ending the period at 2.32%, compared to its beginning level of 2.29%. Inflation expectations crept higher, with the Fed's gauge of five-year forward inflation expectations closing at 1.45% on September 30, up from 1.32% on June 30.

In terms of total returns, fixed income securities on balance generated positive returns across the spectrum, as they have for the prior two quarters. The Barclays Treasury 5-7 Yr. Index fell -0.3%, and the Barclays U.S. Corporate 5-10 Yr. Index gained +1.35% during the three months. High yield securities performed well, advancing +5.6%, as investors' risk tolerance increased and appetite for yield drove prices higher. Municipals were a segment that lost ground, as the Barclays Municipal Bond Index eased by -0.3%. Prices of non-US fixed income securities rose, as the Barclays Global Aggregate ex-U.S. Index posted a +1.0% return. As within the prior quarter, emerging markets bonds delivered solid gains, with the JPM EMBI Global Index adding +3.7%.

EQUITIES

Equity markets quickly shrugged off the Brexit referendum that occurred late in the second quarter. After plunging several percentage points following the announcement that the U.K. would be exiting the European Union, stock prices reversed course at the beginning of July, resuming their previous uptrend and carrying the S&P 500 to a record high. Investors also were heartened by improving news on the employment front, which they believe may presage acceleration in the recovery. The S&P 500 Index finished the quarter with a gain of +3.9%.

More than in recent prior quarters, the ten primary economic sectors exhibited substantial dispersion in performance, making sector allocation and security selection extremely important. The performance disparity between the best- and worst-performing sectors during the quarter was more than 1600 basis points. Information technology, financials, and industrials were the strongest performers, delivering gains of +12.9%, +4.6% and +4.1%, respectively. The telecommunications services, utilities, and consumer staples sectors were the poorest relative performers, posting losses of -5.6%, -5.9% and -2.6%, respectively.

The Russell 1000 Index of large capitalization stocks generated a +4.0% total return. Within the large cap segment, growth stocks significantly outperformed value stocks. Small cap stocks, as represented by the Russell 2000 Index, vastly outperformed large caps, ending with a total return of +9.1%. Small cap growth performed better than small cap value. The Nasdaq Composite, dominated by information technology stocks, finished with a strong gain of +10.0%. The Dow Jones Industrial Average of 30 large industrial companies gained +2.8%.

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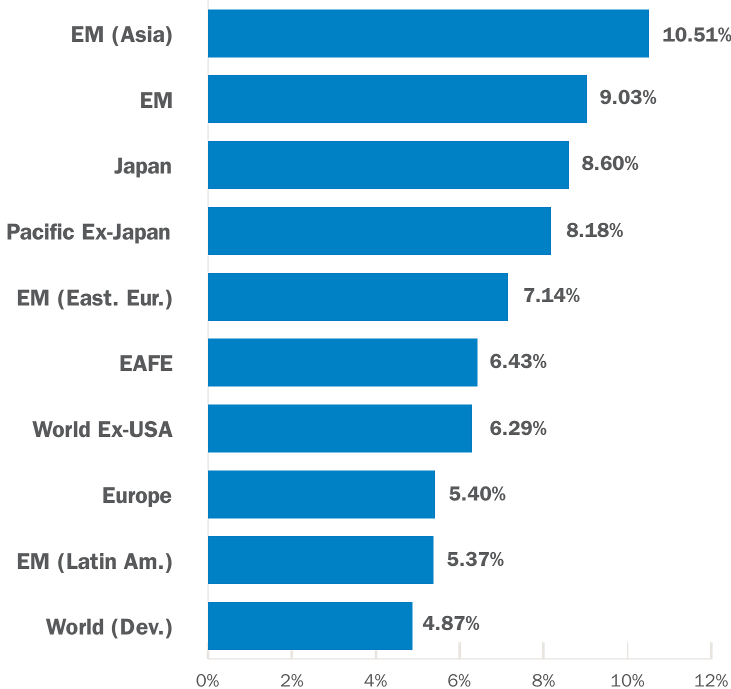
Real Estate Investment Trusts (REITs) were little changed, as interest rates, although still relatively low, trended higher during the quarter. The DJ US Select REIT Index posted a loss of -1.2%. Commodities gave back some of the gains made in recent quarters, with the Bloomberg Commodity Index declining -3.9%.

International stocks delivered better performance than US equities overall, led by a surge in Asian issues. Even though economic data in many regions remains listless, foreign central banks, including the European Central Bank, continue to implement aggressive monetary policies. At the same time, lawmakers around the world have been urged by the heads of the central banks to enact fiscal policy reforms to spur demand. Against this backdrop, international stock indices were almost uniformly higher. The MSCI ACWI ex-USA Index, which measures performance of world markets outside the US, gained +6.9%. The MSCI EAFE Index of developed markets stocks advanced by +6.4%. Regional performance was positive across the board, with Asia in particular enjoying solid gains. China and Japan were the strongest performers on a relative basis, with the MSCI China and MSCI Japan indices posting returns of +13.9% and +8.6%, respectively. Europe and Latin America were the poorest relative performers, with gains of +5.4% and +5.4%, respectively. Emerging markets performance was strongly positive, as the MSCI Emerging Markets Index gained +9.0%.



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Outlook

On balance, there are many reasons to be optimistic about the domestic economy, including improving job growth, a sustained recovery in housing, very strong vehicle sales, and high levels of consumer confidence. In addition, households have taken advantage of years of low interest rates to lock in low mortgage payments and still maintain an adequate level of savings. Many economists believe that employers will continue to add about 180,000-200,000 jobs per month into 2017, and that the unemployment rate will trend back down to 4.7%. And while the FOMC is likely to resume raising interest rates again by the end of the year, the prospect of the hike has been clearly signaled, and seems to have been digested by the markets. The impact of the US presidential election on the markets is a wild card, but markets are an excellent discounting mechanism, meaning any dislocation occurring as a result of the outcome may be short-lived, much like Brexit's impact. There are certainly other ongoing risks, such as the threat of terrorist activity and unforeseen setbacks in either the domestic or global recoveries, but the consensus among economists is that an end to the economic recovery is not yet on the horizon.

Brandon Thomas, *Chief Investment Officer,* Envestnet | PMC

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INDEX OVERVIEW

The **Dow or DJIA** (Dow Jones Industrial Average) is an unmanaged index of 30 common stocks comprised of 30 actively traded blue chip stocks, primarily industrials and assumes reinvestment of dividends. The **Nasdaq Composite** is a stock market index of the common stocks and similar securities listed on the NASDAQ stock market. The **S&P 500 Index** is an unmanaged index comprised of 500 widely held securities considered to be representative of the stock market in general. The **DJ U.S. Select REIT Index** is a subset of the Dow Jones Americas Select RESI and includes only REITs and REIT-like securities (The Dow Jones U.S. Select Real Estate Securities Index (RESI) represents equity real estate investment trusts (REITs) and real estate operating companies (REOCs) traded in the U.S.). The **Bloomberg Commodity Index** is a broadly diversified commodity price index that tracks prices of futures contracts on physical commodities on the commodity market and is designed to minimize concentration in any one commodity or sector. The **MSCI EAFE Index** is recognized as the pre-eminent benchmark in the United States to measure international equity performance. It comprises the MSCI country indices that represent developed markets outside of North America: Europe, Australasia and the Far East. The **MSCI Emerging Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. The **MSCI ACWI Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 46 country indexes comprising 23 developed and 23 emerging market country indexes. The **MSCI Emerging Markets (EM) Eastern Europe Index** captures large- and mid-cap representation across 4 Emerging Markets (the Czech Republic, Hungary, Poland and Russia) countries in Eastern Europe. With 52 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. The **MSCI EM (Emerging Markets) Latin America Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of emerging markets in Latin America. The **MSCI ACWI Ex-U.S. Index** is a market-capitalization-weighted index maintained and designed to provide a broad measure of stock performance throughout the world, with the exception of U.S.-based companies. The **MSCI China Index** captures large and mid-cap representation across China H shares, B shares, Red chips and P chips covering about 85% of this China equity universe. The **Barclays Municipal Bond Index** is an unmanaged index comprised of investment-grade, fixed-rate municipal securities representative of the tax-exempt bond market in general. The **Barclays Global Aggregate ex-U.S. Index** is a market capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type. Most U.S. traded investment grade bonds are represented. Municipal bonds, and Treasury Inflation-Protected Securities are excluded, due to tax treatment issues. The index includes Treasury securities, Government agency bonds, Mortgage-backed bonds, Corporate bonds, and a small amount of foreign bonds traded in U.S. The **Barclays U.S. 5-10 Year Corporate Bond Index** measures the investment return of U.S. dollar denominated, investment-grade, fixed rate, taxable securities issued by industrial, utility, and financial companies with maturities between 5 and 10 years. Treasury securities, mortgage-backed securities (MBS) foreign bonds, government agency bonds and corporate bonds are some of the categories included in the index. The **Barclays Capital US 5-7 Year Treasury Bond Index** is a market capitalization weighted index and includes treasury bonds issued by the US with a time to maturity of at least 5 years, but no more than 7 years. The **Russell 1000 Index** is a market capitalization-weighted benchmark index made up of the 1000 largest U.S. companies in the Russell 3000 Index (which comprises the 3000 largest U.S. companies). The **Russell 2000 Index** is an unmanaged index considered representative of small-cap stocks. The **Russell 3000 Index** is an unmanaged index considered representative of the US stock market and measures the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market. The **Russell Midcap Index** is a subset of the Russell 1000 Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. The **Housing Market Index** (HMI) is based on a monthly survey of **NAHB** members designed to take the pulse of the single-family housing market. The survey asks respondents to rate market conditions for the sale of new homes at the present time and in the next six months as well as the traffic of prospective buyers of new homes. The **JPMorgan Emerging Market Bond Index** (EMBI Global) tracks total returns for traded external debt instruments in the emerging markets, and is an expanded version of the JPMorgan EMBI+. As with the EMBI+, the EMBI Global includes U.S. dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least $500 million.

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DEFINITIONS

The **Federal Open Market Committee** (FOMC) is the monetary policymaking body of the Federal Reserve System. **Fed Funds Rate**, the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. The **European Central Bank** (ECB) is the central bank for Europe's single currency, the euro. The ECB's main task is to maintain the euro's purchasing power and thus price stability in the euro area. The euro area comprises the 19 European Union countries that have introduced the euro since 1999. The **Gross Domestic Product** (GDP) rate is a measurement of the output of goods and services produced by labor and property located in the United States. The **Bureau of Labor Statistics** (BLS) is a unit of the United States Department of Labor. It is the principal fact-finding agency for the U.S. government in the broad field of labor economics and statistics and serves as a principal agency of the U.S. Federal Statistical System. The **Bureau of Economic Analysis** (BEA) is an agency in the US Department of Commerce that provides important economic statistics including the gross domestic product of the US; a governmental statistical agency that collects, processes, analyzes, and disseminates essential statistical data to the American public, the U.S. Congress, other Federal agencies, State and local governments, business, and labor representatives. The **PCE (Personal Consumption Expenditure) Index of Prices** is a US-wide indicator of the average increase in prices for all domestic personal consumption. Using a variety of data including U.S. Consumer Price Index and Producer Price Index prices, it is derived from personal consumption expenditures; essentially a measure of goods and services targeted towards individuals and consumed by individuals.

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