Quarterly Economic Update 1Q 2016

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The quarter in brief. Stocks were down double-digits by mid-February, but better economic numbers and a more cautious Fed spurred a second half rally that erased much of the loss by the end of Q1.

Economic news. The economy showed signs of weakness early in the year and fears of a global recession were growing. Europe's economic difficulties were well documented and recent terrorist attacks and the immigrant crisis weren't helping. The U.S. posted another weak manufacturing number and the first estimate for Q4 GDP growth was a paltry .70 percent. The market was spooked given that only a few weeks prior, the Federal Reserve was removing stimulus (raising rates for the first time in nine years), citing generally stronger economic conditions.

This confluence of negative data was quickly replaced with positive economic news, as the employment picture returned to trend, the industrial economy showed improvement, and three revisions later, GDP ended the quarter at a level twice the initial estimate. Combine this with aggressive monetary policy overseas and we exited Q1 with an economic backdrop very similar to when we entered – mixed.

The U.S. Bureau of Labor Statistics reported that non-farm payroll employment rose by an average of 209,000 jobs per month, showing gradual improvement throughout the quarter. The report highlighted strength in retail, construction, and healthcare, while showing losses in manufacturing and mining. The headline unemployment rate remained unchanged at 5.0 percent and the labor participation rate actually increased to 63.0 percent.

The manufacturing sector expanded for the first time in six months as the ISM Manufacturing Index registered a reading of 51.8, up from 49.5 in February. The non-manufacturing index improved over the course of the quarter to end at a healthy 54.5. Expectations for revenue and earnings growth were reduced, but various CFO surveys indicated cautious optimism overall.

Q4 GDP growth ended at 1.4 percent, according to the third and final estimate, moving higher each month from the initial estimate of 0.7 percent reported in January. Personal consumption (roughly two-thirds of U.S. GDP) and government spending were strong, partly offset by weaker exports. This put full-year GDP growth at 2.4 percent for 2015, the same level as 2014.

Outside of the United States, the European Central Bank and the Bank of Japan each reduced their respective overnight lending rate again (now effectively negative) in an attempt to spur economic growth. China's central bank also announced a cut in the reserve requirement for domestic banks, marking the fifth reduction in the last 12 months.

Early market turbulence clearly unnerved the Federal Reserve as they left rates unchanged (0.25 percent to 0.50 percent) in March and changed their forecast of the number of moves from four to two. Year-end expectations for the Fed Funds rate now stands at .85 percent, far less than the 1.5 percent that was projected as recent as three months ago.

Markets. The benign nature of market returns did little to explain the volatile action during the quarter. Looming recession concerns and a disappointing earnings season pushed stocks sharply lower (S&P 500 -10.5 percent and the Russell 2000 -16.0 percent) through February 11, only to rebound sharply as better economic data, rising oil prices, and "dovish" comments by Federal Reserve chair Janet Yellen shot stocks higher, erasing the year-to-date loss on many U.S. indices. The S&P 500 ended Q1 up 1.35 percent after the v-shaped bounce. Small-cap stocks posted the greatest rebound from the February lows, but it wasn't enough to push returns into positive territory as the Russell 2000 was down 1.52 percent.

Index Performance	Q1 2016	Q4 2015	YTD
Domestic Equity			
S&P 500	1.35%	7.04%	1.35%
Russell Mid Cap	2.24%	3.62%	2.24%
Russell 2000	-1.52%	3.59%	-1.52%
International Equity			
MSCI EAFE	-3.01%	4.71%	-3.01%
MSCI Emerging Markets	5.75%	0.73%	5.75%
Fixed Income			
Barclays Aggregate	3.03%	-0.57%	3.03%

Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.

S&P 500 Sector Performance	Q1 2016	Q4 2015	YTD
Consumer Discretionary	1.60%	5.79%	1.60%
Consumer Staples	5.57%	7.64%	5.57%
Energy	4.02%	0.20%	4.02%
Financials	-5.06%	5.96%	-5.06%
Healthcare	-5.50%	9.22%	-5.50%
Industrials	4.99%	8.00%	4.99%
Information Technology	2.60%	9.17%	2.60%
Materials	3.61%	9.69%	3.61%
Telecommunications	16.61%	7.61%	16.61%
Utilities	15.56%	1.07%	15.56%

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International markets (as measured by the MSCI EAFE) experienced similar volatility, also hitting a bottom by mid-February. Aggressive rate cuts by central banks in Europe, Japan, and China sparked a recovery that continued through quarter-end. While the EAFE index was unable to post a positive return (-3.01 percent), the combination of a sharp rebound in commodity prices and local currency appreciation made Emerging Market equities one of the best performing asset classes (+5.75 percent) for the quarter.

Q1 was a strong quarter for fixed income markets with the Barclays U.S. Aggregate Index posting a gain of 3.03 percent. Long-term Treasury yields closed at their lowest level since the end of 2012 with the ten-year Treasury yield dropping .50 percent to 1.77 percent. The two-year Treasury yield fell to 0.72 percent, leaving the spread between the ten-year and two-year (1.05 percent) at the lowest level in nearly eight years.

Falling rates and a volatile market helped both traditionally-defensive and high-yielding sectors outperform. Telecom and Utilities were by far the best performing sectors in Q1. The Consumer Staples sector finished up 5.57 percent, and stabilizing oil prices helped the Energy and Materials sectors recover nicely.

On the flip side, the probability that interest rates would remain lower for longer, and the subsequent flattening of the yield curve, hurt financials (-5.06 percent), especially banks. The worst performing sector in Q1, however, was a group that traditionally is one of the most defensive – Healthcare. Heightened political risk crushed the group (-5.50 percent for the S&P 500 Healthcare and -17.00 percent for Small Cap Healthcare), as both political parties are threatening increased regulation on drug pricing. Though legislatively remote, the market has punished the group, reducing many price-to-earnings multiples down to single digits.

Outlook. The consensus view is that economic growth in the U.S. will continue its sub-par trajectory as we move through the year. Current estimates have now fallen to a range of 1.50 percent to 2.00 percent for 2016. While this may prove too low, it does reflect a certain level of pessimism.

Consumer spending is expected to remain strong, supported by a healthy employment environment, better wage growth, and the eventual benefits of lower energy costs. This should continue to compensate for weakness in the industrial sector. While lower energy costs are eventually a net positive to consumers, many have underestimated the negative impact lower oil would have on the economy in the form of evaporating capital expenditures.

Fourth quarter earnings for the S&P 500 Index declined 14 percent year-over-year, hurt by a poor Energy sector, declining productivity, and a strong U.S. dollar. This was far short of the 8.0 percent rate of growth expected at the beginning of earnings season. Excluding the Energy sector drag, S&P 500 earnings-per-share growth would have been only 2.0 percent in Q4. With profit margins near peak levels and productivity waning, an earnings recession seems like a bigger risk than an economic recession.

While market swings may not be as extreme as Q1, the mature nature of this recovery (more than seven years in the making) will undoubtedly keep market volatility high. A more dovish Fed, a stable U.S. dollar, and steady energy prices make the outlook more encouraging. However, we need corporate earnings to recover before stocks can move meaningfully higher.

The Russell 2000 Index measures the 2000 smallest companies in the Russell 3000 Index, which represents approximately 10% of the total market capitalization of the Russell 3000 Index. The Russell Midcap Index measures the performance of those Russell Midcap companies with higher price-to-book ratios and higher forecasted growth values. The stocks of the Russell Midcap Index are also members of the Russell 1000 Growth Index. The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general. The MSCI EAFE index is an unmanaged aggregate of 21 developed country indices that collectively represent many of the major markets of the world. MSCI Emerg Mkts is a capitalization-weighted index of stocks from 26 emerging markets that only includes issues that may be traded by foreign investors. The Barclays US Aggregate Index covers the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS, ABS, and CMBS. It is not possible to invest directly in an index. The statements and opinions expressed in this article are those of the author as of the date of the article. These views should not be construed as investment advice. Content and/or statistical data may be obtained from public sources and/or third party arrangements and is believed to be reliable; however we make no representation as to its completeness or accuracy. The underlying assumptions and the views are subject to change. All economic and performance data is historical and not indicative of future results. Investors have the opportunity for losses as well as profits. The market indices discussed are unmanaged and can't be invested into directly. Investors should consult their financial advisor for guidance concerning their particular situation.