2016 Economic & Investment Outlook

Mid-year Update: Exploration and Expectations

July 2016

EXECUTIVE SUMMARY

Our outlook toward the future can change in a heartbeat. This axiom certainly applies to the financial markets, where the unexpected can heighten fears and cast uncertainty on what lies ahead. With this in mind, we discuss the immediate and potential long-term impact of the "Brexit" vote, as well as the upcoming U.S. elections and other factors that provide plenty of fuel to stoke investor concerns. Looking ahead to the year's second half, we examine rising wages, falling profits, and adjustments to our U.S. and global GDP forecast. Take a moment to get the full picture in our 2016 Investment and Economic Outlook Mid-year Update, created for the benefit of valued customers like you.

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EXPLORATION AND EXPECTATIONS

The early-20th-century explorer Ernest Shackleton, when he was looking for people to go with him on his exploration to the Antarctic, reportedly placed an ad in a newspaper. It said simply:

Men wanted for hazardous journey. Low wages, bitter cold, long hours of complete darkness. Safe return doubtful. Honour and recognition in event of success.

The advertisement did not sound very appealing, yet Shackleton was successful in both his recruiting and expeditions.

Now let's translate Shackleton's 20th-century advertisement to one focused on investing in today's environment:

- Investors wanted for volatile journey
- Low returns, increased anxiety, long periods of uncertainty
- Return on principal cannot be guaranteed
- Growth of portfolio in event of successful investing

It is the investment professional's job to manage clients' return expectations based on a realistic assessment of current and expected financial market conditions. So Shackleton's investment advertisement does not appear to be too far off the mark based on our outlook for the remainder of 2016.

We expect increased market volatility and higher levels of anxiety as investors focus on a slowdown in global growth (recession fears abound), political uncertainty in the U.S., the unknown ramifications of the U.K. vote to leave the European Union, the actions of the major central banks, and the potential deleterious impact that negative interest rates may have on financial markets. However, we remain optimistic that U.S. equity markets will post mid-to-high single digit returns in 2016 as we continue to climb the wall of worry. U.S. stocks are attractive in light of a low inflation and low interest rate environment. With our outlook that interest rates will remain lower for longer over the next several years, we believe fixed-income investors should realize acceptable total returns in 2016.

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A LOOK IN THE REAR-VIEW MIRROR - RECAP OF 2016'S 1ST HALF

By mid-February, the major U.S. stock indices were down over 10%. After finally raising the Fed Funds rate in December 2015, the 10-year U.S. Treasury yield fell precipitously from 2.27% at the beginning of the year to 1.53% by February 11th. Investors around the globe were searching for safe havens, fearing slowing global growth, low oil prices, and a stronger U.S. dollar.

What followed was a steady climb up the wall of worry. Commodity prices, particularly oil, rebounded significantly from approximately $27 per barrel, at its trough, to slightly above $50 per barrel in July. The S&P 500 hit a low of 1,810 in February before rebounding above 2,100 months later. Oddly enough, the yield on the 10-year Treasury remained range-bound between 1.50% and 2.00%.

THEN CAME THE VOTE: BREXIT – WHO KNEW?

On June 23rd, the U.K. surprised financial markets by voting to leave the European Union. Global equity markets immediately sold off, currencies gyrated, and bond yields plunged. Markets and economies around the globe are likely to continue to be buffeted by the shock waves of the Brexit vote. However, it seems too early to jump to conclusions about the longer-term impact of this vote on the global outlook. It will take time for the U.K. to leave the EU. Once the U.K. notifies the European Council of its decision for withdrawal, as stated in Article 50 of the Lisbon Treaty, the U.K. will have two years to complete negotiations of treaties, trade pacts, and other regulatory matters.

The U.S. economy is relatively resilient. There appear to be few immediate consequences to the U.S. from the Brexit vote. However, this vote suggests that global populism should perhaps be taken more seriously. This movement could serve as a tailwind for Donald Trump as we head toward the U.S. presidential election later this year.

Global economic growth will almost certainly suffer from Brexit. The odds of the U.K. falling into a recession have increased. But keep in mind that the U.K. economy represents just 2% of global GDP growth, whereas the Eurozone represents 16%.

One potential contagion to global markets is a strengthening U.S. dollar. A significantly stronger U.S. dollar poses problems for China because it almost forces yuan depreciation against the U.S. dollar. A weaker yuan risks rekindling capital outflows from China. In addition, a stronger dollar is a problem for many emerging markets because of the large amount of dollar-denominated debt they have issued.

GLOBAL CENTRAL BANKS – WHO'S YOUR BUDDY, WHO'S YOUR PAL?

Global central banks will do all they can to restore confidence in the financial markets. We expect coordinated provisions of liquidity and currency interventions. Additionally, we believe central banks will not hesitate to ease monetary policy more aggressively if the economic outlook deteriorates dramatically.

For the Federal Reserve, the Brexit vote may have eliminated any chance of an interest rate increase in 2016. Immediately following the vote, the Fed Funds futures market was forecasting a 10.1% probability of a December 2016 rate increase.

THE 2016 PRESIDENTIAL ELECTION

The 2016 presidential election is quickly approaching. Obviously, while it is not possible to predict the results with months to go, it is important for us to examine the several possible outcomes and the potential impact each scenario could have on the economy and financial markets.

As we see it today, assuming it is a race between Donald Trump and Hillary Clinton, we envision three possible outcomes:

- Clinton wins the presidency, the Republican party keeps the House of Representatives and the Senate likely changes hands
- Trump wins the presidency, the Republican party keeps the House and the Senate (GOP sweep)
- Clinton wins the presidency, the Democrats take control of the House and the Senate (Democratic sweep)

Clinton wins the presidency, the Republican party keeps the House of Representatives. This is the base case and would be seen by financial markets as neutral (a good thing – remember, markets like stability) because we would have a divided government. Overall, this would provide some modest near-term fiscal stimulus for the economy and long-term deficit reduction.

Trump wins the presidency, the Republican party keeps the House and the Senate (GOP sweep). This outcome is potentially negative for financial markets overall because of the risk of a trade war and uncertainty over the rest of Trump's agenda. His temperament and lack of policy depth is also a concern. Particularly, his trade agenda could put downward pressure on equity markets and the U.S. dollar.

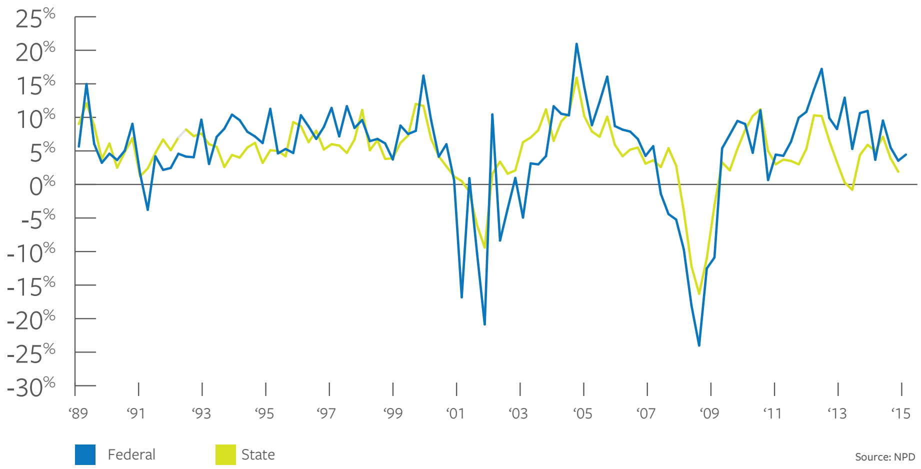
Clinton wins the presidency, the Democrats take control of the House and the Senate (Democratic sweep). The equity market could come under pressure because of Democratic proposals that would specifically target major sectors of the market, including health care, energy, and financials. In addition, we could experience higher deficits concomitant with more debt.

Pharmaceutical companies have a lot at stake in this election, given that the Democrats are pushing for price controls. If Republicans keep the House, it is difficult to see how price controls pass into law. If the Democrats win, Affordable Care Act (ACA)-related companies such as hospitals will benefit. If Republicans win, an ACA repeal effort will likely be mounted but with low probability of success.

Should Republicans gain control of the government in 2017, we would expect a relaxation on the rules that regulate carbon emissions. This should benefit the coal and related industries and electric utilities. This shift is contrary to the current administration's stance, which has focused on moving away from fossil fuels.

Should Trump win, we would expect to see a large boost in defense, cyber, and homeland security spending as Trump focuses on fighting ISIS, enforcing the border, and increasing intelligence work. Drones, prisons, and communications networks all stand to benefit. Regardless of who wins, infrastructure companies should benefit as both candidates are focusing on fiscal policy to help boost

Figure 1: Federal & State Tax Revenue Growth Y/Y Pct Chg



economic growth.

THE PENDULUM HAS SWUNG FOR FEDERAL AND STATE BUDGET DEFICITS

April is the largest month for tax collections at the federal and state levels. In recent years, equity markets helped produce very strong April tax collections from capital gains and bonus income accruals. But this April, tax revenues declined, falling 6.7% compared to 2015. Tax collections, year to date in fiscal 2016, are now running $50B below the Congressional Budget Office's expectations. Leading this decline is non-withheld personal income taxes (i.e., capital gains and bonuses) down $19B (7%) and corporate income taxes down $9B (20%) due to lower corporate profits. Notably, 2016 will be the first year the federal deficit will increase since 2009.

Given the correlation between federal and state tax collections, we expect states dependent on capital gains tax revenue to guide their FY16 revenues lower.

State budgets have been in relatively good shape since late 2010 as they slashed spending and prudently underestimated revenues. The pendulum is now swinging in the other direction. Pent up demand for new spending and slower tax revenue growth indicates that states are going to struggle in the coming years. Ironically, state and local spending is ramping up just as tax revenue is slowing. (Figure 1)

Federal spending on defense and infrastructure should increase regardless of who wins the presidential election. This will contribute positively to GDP growth. However, state and local spending looks to detract from GDP growth. This is quite a reversal from the past several years.

RISING WAGES AND FALLING PROFITS?

Rising wages are typically offset by increased productivity. Thus, corporate profit margins are maintained. However, productivity gains are not keeping pace with wage increases. Over the past 12 months, average hourly earnings are increasing at a 2.5% annual rate while productivity gains are a mere 0.7%.

When wage compensation outruns productivity, the result is an acceleration in labor costs per unit of output. In the first quarter, unit labor cost increased 3% from a year earlier. If companies are unable to boost productivity, then either profit margins come under pressure or prices are raised in order to maintain their profit margins. Corporate profit margins may be squeezed unless the U.S. economy realizes sizable productivity gains in the second half of 2016. The concern is that absent productivity gains, U.S. companies will slow hiring and further reduce capital expenditures.

There is no clear explanation for the productivity slowdown, as it has coincided with a period of impressive technological enhancements, including, among others, cloud computing and robotics. However, since the Great Recession ended, capital expenditures, or business investments, has been subpar. Many workers were forced to take lower-paying jobs. The U.S. economy still faces a mismatch between the skills of the workforce and the needs of industry as employers continue to complain of labor shortages in higher-skilled positions. These factors could be prime contributors to the lack of productivity gains.

Throughout the seven-year U.S. expansion, the unemployment rate tumbled from a peak of 10% in 2009 to a current low of approximately 4.9%. However, policymakers have been focused on the slack in the labor market. While that may seem counterintuitive, Federal Reserve Chairwoman Janet Yellen has been among those emphasizing that the low unemployment rate is not an accurate reflection of available labor supply. That is because a large number of Americans have stopped looking for work, which means they are no longer counted as part of the labor force. The labor-force participation rate slipped to 62.6% in May, just shy of a four-decade low.

Recent payroll reports are weakening, showing the U.S. economy is creating fewer jobs. However, this is not unusual for an economy in the second half of an expansion. Yet, as we mentioned earlier, the unemployment rate is low and wages have begun to rise. Many believe we are at an inflection point and wages will continue to rise. Not so fast. We may be at an inflection point, but wage increases could just as easily slow from these levels due to a deterioration in business confidence, overseas weakness, and trends in temporary employment.

The weak foreign backdrop and U.S. political uncertainty are both big contributors to the declining trend in business confidence. And, if business confidence declines further, growth will not accelerate much as employment and capital expenditures will weaken.

The National Federation of Independent Businesses (NFIB) optimism index remains well below its 2014 high. Political uncertainty, volatile financial markets, headwinds from the ACA, and weakness in exports appear to be taking their toll on small businesses. With the optimism index trending lower, hiring at small companies could falter with wage gains following suit. It is important to remember that 78% of jobs are at small-to-medium-sized businesses. In other words, small- and medium-sized business employment is 3.5 times bigger than large business employment.

Overseas weakness is a headwind on large business employment. Earnings of large U.S. multinationals may come under pressure due to fallout from the Brexit and slowing global growth, particularly from China and the emerging markets. Unfortunately, U.S. large business employment remains 0.8% below its prior peak, perhaps reflecting weakness overseas.

Temporary help services employment growth is one of the 19 indicators in the Federal Reserve's Labor Market Condition Index (LMCI). According to Cornerstone Macro, it has an 86% correlation with overall payroll growth, leading by five months. Recently, temporary employment grew at just 0.6% y/y, its slowest pace since January 2010, which suggests that payroll growth may slow further.

Important to our outlook is that global growth picks up, average hourly earnings continue to increase at a steady pace, small business confidence improves, and productivity gains accelerate. All expectations seem reasonable with the exception of a pickup in global growth. We will monitor the events in Europe closely.

WILL THE U.S. STOCK MARKET PREDICT THE NEXT PRESIDENT OF THE UNITED STATES?

The S&P 500 has correctly predicted 19 of the past 22 presidential elections going back to 1928 and every election since 1984. (Figure 2) If stocks are higher in the three-month period prior to the election, the incumbent party wins and vice versa. Intuitively, this makes sense. A lower stock market reflects a down trending economy, which is not good for the incumbent party (1992, 2000, and 2008). Moreover, the uncertainty associated with a new president could weigh on financial markets in the shortrun.

It appears as though we should pay particularly close attention to the performance of the S&P 500 from August through October this year to predict our next president.

EVALUATING OUR 2016 FORECAST AT THE HALFWAY POINT

As a result of the recent developments within the European Union and the potential slowdown in Chinese and emerging market growth, we have reduced our U.S. and global GDP growth forecasts for 2016. In our 2016 Economic & Investment Outlook, we noted that inflation would hold steady between 1.50% - 2.00%. We see no reason to alter our inflation forecast. The unemployment rate has fallen and is now within our forecasted range of 4.7% - 5.0%. We now expect no Fed Funds interest rate increases in 2016. So it appears as though the Fed Funds rate will finish the year at the lower end of our forecast range. We expected the 10-year Treasury yield to rise to 2.50% - 3.0%. This appears to be too high. With all the global economic and financial market uncertainty that exists and the flight to safety as investors seek risk-off assets, we need to reduce our yield forecast for the 10-year Treasury note. Since we maintain our lower for longer interest rate premise, we now expect a range of 1.25% - 1.75% for the remainder of the year. And, finally, we expected a positive total return for the S&P 500 in the range of 5% - 10%. This still seems achievable.

Figure 2: Predicting the Election Results? S&P 500 Performance 3 Months Prior to Presidential Election

Year	1928	1932	1936	1940	1944	1948	1952	1956	1960	1964	1968
S&P 500 Price Return	14.91	-2.56	7.92	8.56	2.29	5.36	-3.26	-2.58	-0.74	2.63	6.45
Incumbent Party	Won	Lost	Won	Won	Won	Won	Lost	Won	Lost	Won	Lost
	☑	☑	☑	☑	☑	☑	☑	☒	☑	☑	☒

Year	1972	1976	1980	1984	1988	1992	1996	2000	2004	2008	2012
S&P 500 Price Return	6.91	-0.09	6.73	4.80	1.91	-1.22	8.17	-3.21	2.16	-19.48	2.45
Incumbent Party	Won	Lost	Lost	Won	Won	Lost	Won	Lost	Won	Lost	Won
	☑	☑	☒	☑	☑	☑	☑	☑	☑	☑	☑

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