Market OUTLOOK

Economic and Financial Market Outlook — January 2016

U.S. markets look to tread water in 2016

MARKET SUMMARY

- *As we approached press time, consensus is building for an interest rate hike by the Federal Reserve (Fed), the first in nearly a decade.*
- *The U.S. economic recovery has been pedestrian but resilient for six years, supported by improving employment rates, rising home prices, solid auto sales, and steady business investment.*
- *Savings from lower fuel prices are expected to support further gains in consumer spending in the coming months.*
- *We don't see equity prices having much upside in the first half of 2016, and stocks could easily experience a 5% to 10% correction.*
- *Slow global economic growth led to low single-digit returns for the bond market in 2015, and this is expected to be repeated in 2016.*

INTRODUCTION

The fundamentals for continued solid growth in the United States generally remain in place. The recovery's resilience has been on display in recent years, sustained by gains in job growth, housing, manufacturing, and service industry output. Clearly the recovery has not come in lockstep fashion, and this uneven uptrend will likely be in place going forward.

ECONOMIC OUTLOOK

On average, the U.S. economy has been unable to break out of the slow-growth pattern of 2%–2.5% annually that has plagued it since the expansion's inception in 2009, and this trend is expected to continue into 2016 (Chart 1).

Similarly, the global economy is also poised for economic growth that is mostly consistent with its performance over the past few years (near 3.5%). The European countries should do a bit better, while Asia and the commodity-based economies are expected to show slower growth.

The U.S. labor market has been resilient. After remaining relatively subdued during the third quarter, October job additions were well above expectations (Chart 2). The unemployment rate is now down to 5%, though part of the decline is due to the long-term unemployed leaving the workforce. Recent monthly data also show gains in average wages, though at a moderate pace, which should add to consumer optimism. Also, fuel prices have retreated again, and average gasoline prices have moved closer to $2 per gallon. Savings from lower fuel prices are expected to support further gains in consumer spending in the coming months.

Along with the better employment news, we're also seeing stability in housing, where an uptick in building permits recently helped offset a drop in housing starts. Also, progress has been made in improving household and corporate balance sheets. The household sector has enjoyed significant increases in equities and home prices and has reduced its debt relative to income to levels not seen since 2003. In addition, the Leading Economic Index increased 0.6% in October (3.5%

Inside:

CHART 1
REAL GROSS DOMESTIC PRODUCT

Slower global growth has spilled over into slightly weaker U.S. economic growth.

- Year-over-Year (YOY)
- YOY (Estimate)*
- 10-year Trend
- Sustainable Growth Trend

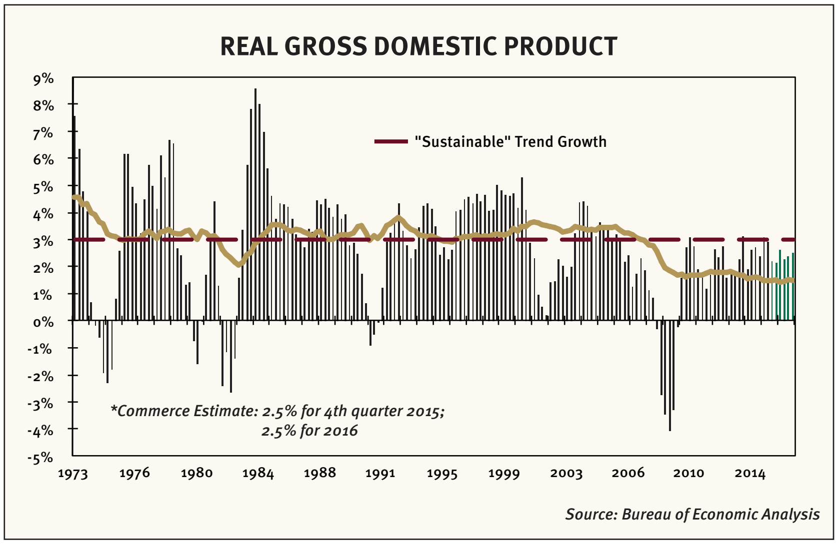
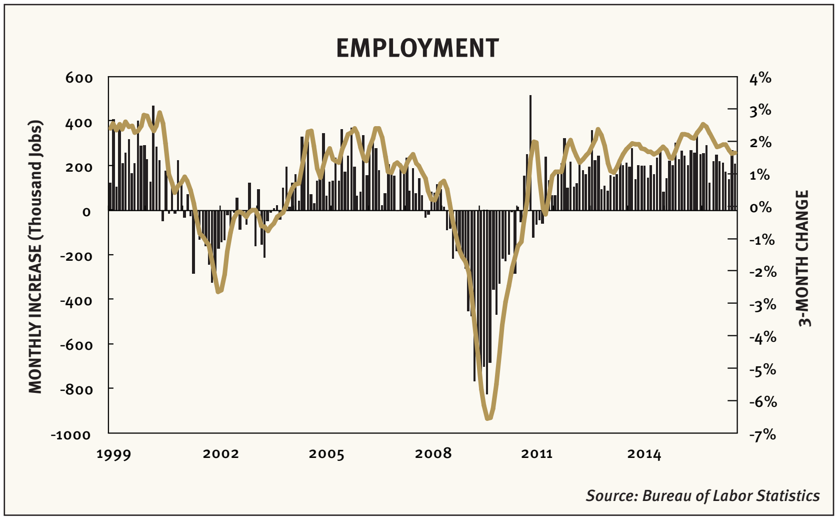


CHART 2
EMPLOYMENT

Jobs data appear consistent with a Fed rate liftoff in December.

- Monthly Increase (Left Axis)
- 3-month Change (Right Axis)



year-over-year). All of this implies that GDP growth, held to just 1.5% in the third quarter by a drawdown in inventories, may approach 2.5% in the fourth quarter, and carry into 2016.

On the weaker side of the economy, U.S. manufacturing companies have been hit by feeble emerging market activity and strength of the dollar, as well as the decline in oil prices. The November ISM – Manufacturing index release confirmed this sluggishness. However, in the face of these headwinds, there are signs manufacturing activity may be slowly bottoming. The inventory overhang has started to unwind, factory output and durable goods orders rose in October, and low energy prices should act as a boost for manufacturing activity into 2016.

At the time of this printing, we sense that the Federal Reserve is poised to raise interest rates, and that will set the tone for the year. We caution, though, that the December jobs report, news on holiday sales, and reports of any economic fallout from potential worldwide terrorist attacks, may have an impact on Fed thinking.

If the Fed is aggressive and quick with the rate-hiking process, typically stock prices are down one year later, on average, about 2% to 4%. But when the Fed has been slow and gentle with its rate-hiking process — and in six of the last 14 rate-hiking cycles it's been gentle — stocks on average in the S&P 500 trended upwards one year later. We expect the Fed will be exceptionally gentle.

Finally, as we survey the global economic landscape, it's worth noting that developments abroad remain unsettled. While centered on China, concerns over global growth have kept commodity prices low, pressuring many emerging economies. That risk has marginally spilled over into slightly weaker U.S. growth. But even though downside risks to growth and inflation exist, our expectation is that these impacts will be manageable and not enough to derail the economy's upward, albeit slow, trajectory.

EQUITY OUTLOOK

Rising equity prices face several headwinds as we begin 2016. The first is weak earnings. We expect earnings for the S&P 500 to decline 5% in 2015 as energy companies' profits collapsed and the rising dollar hurt multinational company earnings. In addition, we don't see the catalysts in place for strong earnings gains in 2016 to help counter the second headwind of high valuation levels of the S&P 500. As we begin the year, the S&P 500 Price/Operating Earnings (P/E) ratio is hovering around 20 times earnings. The long-term norm is 16 times, and we view a P/E over 18 times as an expensive market.

Valuation levels can remain high for years, but if something unexpected happens, the market could be vulnerable, like the 10% decline in three days that occurred last August. Stocks need the economy to show growth in the 3% to 4% range and a stable dollar versus other currencies to get earnings growth back to the 8% to 10% range.

Rising interest rates historically pressured equity prices to the downside while propelling the U.S. dollar higher. In past cycles of rising interest rates, the dollar remains strong for five to six months after the first rate increase. The strong dollar over the past several years has been one reason we have suggested underweighting international equities versus domestic equities, and we are not changing that tilt as we begin 2016. We will be monitoring the dollar and looking for an opportune time to take off the underweight to international equities. Over the past several years, we also have underweighted emerging markets in the international space due to the slowdown in China and the collapse of commodity prices. While emerging markets have dramatically underperformed over the past three years, we think the trend will continue.

At least for the first half of the year, we don't see equity prices having much upside and could easily experience a 5% to 10% correction. We are maintaining our equal weight in equities in portfolios as other investment options don't look much better in the near term.

ALTERNATIVE INVESTMENTS OUTLOOK

Alternative investments include strategies in the main categories of hedge funds, real estate, infrastructure master limited partnerships (MLPs), and commodities. From a portfolio diversification standpoint, alternative investments may be attractive due to lower correlations to traditional asset classes of stocks and bonds.

A blend of alternative investments (30% NAREIT Equity REITs, 10% Bloomberg Commodity Index, 30% Alerian Infrastructure MLPs, 30% HFRI FOF Conservative Hedge Funds) outperformed either the S&P 500 Index or the Barclays Aggregate Bond Index in 17 of the last 19 years. That is why we have an ongoing commitment in this asset class. With interest rates so low, we are recommending a slight overweight to alternative investments at the expense of fixed income (Chart 3).

The bull and bear market cycles for commodities are typically long, lasting as many as 20 years. While we think energy prices have bottomed, they may stay lower for longer. Therefore, we are not allocating to commodities on a tactical basis.

FIXED-INCOME OUTLOOK

The two major themes impacting the bond market in 2015 were an Emerging Market economic slowdown and uncertainty as to when the Federal Reserve was going to raise its benchmark interest rate. China's economic slowdown rippled across the globe, dragging down investment markets. Domestically, most forecasters had predicted at least one Fed rate hike by now and higher interest rates. The modest improvements in job growth and low inflation, however, delayed the much-anticipated normalization of the Fed's monetary policy.

Over the past year, most of the upward movement in Treasury yields was found in the short-end and the long-end maturities. The two-year Treasury rose to 0.93% and the 30-year Treasury rose to 2.97% (as of November 30, 2015). Just four years ago, the difference between these two maturities was more pronounced and resulted in a steep yield curve, indicating the anticipation of an expanding economy. Now the yield curve is moving from a normal upward sloping curve to a flat curve, indicating a low to moderate economic growth environment (Chart 4).

The overall U.S. bond market, as measured by the Barclays Aggregate Bond Index, rose 0.88% year-to-date through November. Returns were hampered by modestly higher interest rates and credit spreads widening. (Credit spreads represent the additional yield above that of a comparable-maturity Treasury for holding a bond with credit risk.)

Returns for most bond sectors struggled to stay in positive territory, with higher-rated credits and intermediate maturities performing better than lower-rated credits and longer maturities. Declining commodity prices contributed to High Yield being a laggard for the period. Commercial mortgage-backed securities and municipal bonds were some of the top-performing sectors. The Barclays Municipal Bond Index was up 2.58% year-to-date through the end of November (Chart 5).

As we enter 2016, the bond market continues to expect U.S. Treasury yields to rise, particularly for the short- and intermediate-maturity bonds. The speed at which the Fed raises rates will be dictated by inflation expectations and the amount of improvement in economic growth.

THE CASE FOR ALTERNATIVES

	Winner		Loser
1996	27.18%	22.96%	3.61%
1997	33.37%	20.89%	9.68%
1998	28.58%	8.67%	-8.15%
1999	21.05%	4.54%	-0.83%
2000	27.26%	11.63%	-9.10%
2001	17.78%	8.42%	-11.88%
2002	10.27%	4.35%	-22.10%
2003	31.31%	28.69%	4.11%
2004	19.29%	10.88%	4.34%
2005	10.37%	4.91%	2.43%
2006	23.55%	15.80%	4.33%
2007	6.96%	5.49%	2.51%
2008	5.24%	-30.85%	-37.00%
2009	39.08%	26.46%	5.93%
2010	21.98%	15.06%	6.54%
2011	7.84%	5.19%	2.11%
2012	16.00%	7.93%	4.21%
2013	32.39%	10.62%	-2.02%
2014	13.69%	10.11%	5.97%

CHART 3
THE CASE FOR ALTERNATIVES

A blend of alternative investments outperformed either stocks or bonds in 17 of the last 19 years.

- STOCKS
- BONDS
- ALTS BLEND

CHART 4
HISTORICAL YIELD CURVE (12/31/2014–11/30/2015)

Most of the upward movement in Treasury yields was found in the short-end and the long-end maturities.

■ 12/31/2014
■ 11/30/2015

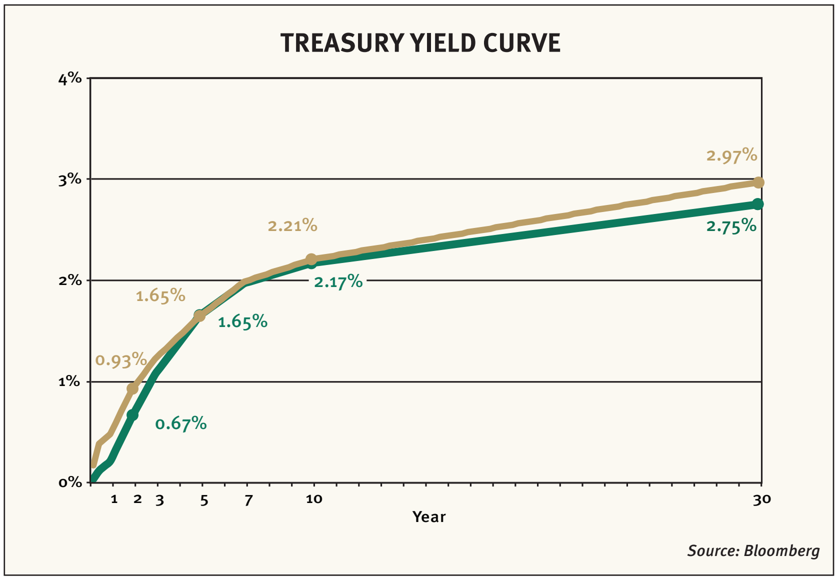
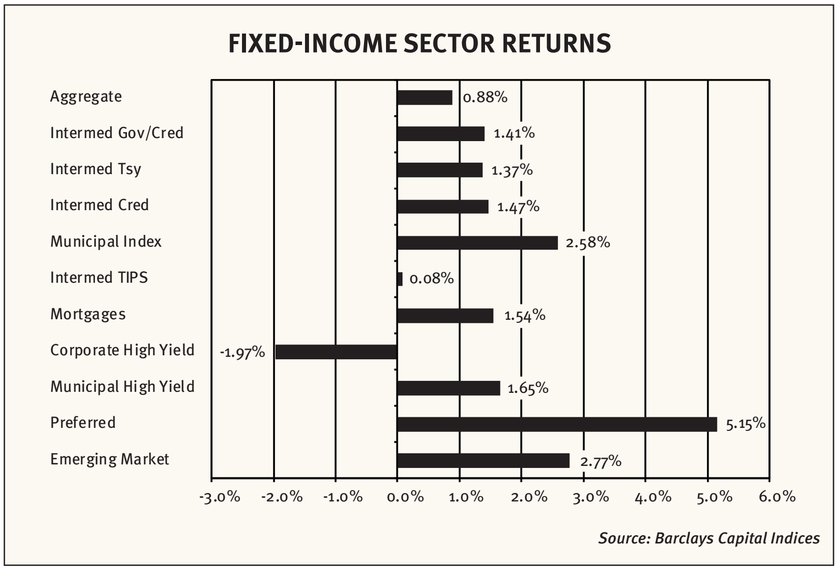


CHART 5
FIXED-INCOME SECTOR RETURNS YEAR-TO-DATE (AS OF 11/30/2015)

Most sectors struggled to stay in positive territory for year-to-date returns.



Most bond sectors are once again expected to produce low single digit returns in a rising-rate environment. Both High Yield and municipal bonds may be able to ride out the impact of the Fed rate hikes and perform better than the other sectors. High Yield bonds are attractive at above historic averages and near their widest credit spread levels since mid-2012. So any sign of steady-to-improving credit conditions would help offset some of the negative impact of rising rates.

For municipal bonds, higher interest rates could lead to lower supply, while demand could pick up if investors become more risk-averse due to geo-political concerns or a deteriorating equity market. The combination of reduced supply and greater demand could boost municipal bond prices and lower yields.

CONCLUSION

Will the Fed keep raising rates once it starts? The Fed currently believes it will eventually get short-term rates into the 3% to 3.5% range several years out. To the extent that inflation remains at about its 2% target, we think it is very unlikely the Fed will push cash yields much past that 2% without dramatically slowing the economy. We doubt that rates will rise as high as they have historically once the Fed initiates a rate-hike cycle.

2016 may be the year of U.S. markets treading water as we don't see much upside in stock prices given high valuations and the initial impact of the assumed rate hike on bond prices. In the meantime, consumers may continue to enjoy an unprecedented break in gasoline prices for some time yet, wages may accelerate their trend upward for the first time in many years, and inflation is expected to remain near historic lows.

INVESTMENT POLICY COMMITTEE
DECEMBER 14, 2015

COMMERCE TRUST INVESTMENT CONTACTS

Christie Cody, CFA
(816) 234-2415

Mike Cody, CFA
(314) 746-8551

Scott Colbert, CFA
(314) 746-8557

Cynthia Rapponotti, CFA, CAIA
(314) 746-8794

Joe Williams, CFA
(816) 234-2564

commercetrustcompany.com