2016 Economic Outlook

A Long-Range Economic Look at the Year 2016

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Economic Outlook

Economy

POSITIVES

- Consumption has been firm
- Households are healthy financially
- Stable employment

NEGATIVES

- Strong Dollar: exports declining
- Manufacturing slump
- Lack of beneficial government action
- China slowdown
- Consumers remain cautious

The consumer has been holding the economy together. While job openings and wages have improved, new jobs remain focused on those with lower wages. Consumers are cautious, as shown in a record low velocity of money (turnover of a dollar in our economy).

Unfortunately, the strong Dollar and slowdown in China have hurt exports and overseas sales, resulting in a decline in earnings for many companies. Manufacturing has been taking the brunt of this with Industrial Production and Capital Goods orders falling in 2015. The government continues to spend prolifically with undersized benefits for Gross Domestic Product (GDP).

Our economy is vulnerable to outside shocks, especially the world's second largest economy, China. Unless the consumer comes on strong, we are likely to have a year of less than normal growth.

Stocks

POSITIVES

- Share buybacks strong
- Cheaper energy costs aid producers and transporters

NEGATIVES

- Election year volatility
- Equity valuations high
- Margin debt peaked, now falling
- Global debt overhang
- Declining corporate profits

After six years of generally rising prices, the rally in the S&P 500 slowed in 2015. The stock market is likely to begin a correction in 2016 as lame duck years tend to produce the "Gift" of falling stock prices for the next President.

One of the most reliable long term valuation measures, market value of U.S. Equities/U.S. GDP, is close to all-time highs. Margin debt, a gage of the leverage investors are using to buy stocks, had reached an all-time high but has started to decline, historically an early warning.

The market is likely to undergo style rotation. We believe value stocks will outperform growth stocks as profit margins fall. The types of stocks we favor in this environment should benefit from a stronger U.S. Dollar and lower U.S. energy costs. Active management will be important to take advantage of market volatility and lower prices would offer excellent buying opportunities.

Bonds

POSITIVES

- U.S. inflation remains low
- U.S. interest rates attractive globally
- Rapid Federal Reserve (Fed) rate hikes unlikely

NEGATIVES

- Short-term rates hurt by Fed hikes
- China has been selling U.S. Treasuries
- Coupons (income) still low

After seven years of extremely low interest rates, it appears the Federal Reserve is on the verge of raising the overnight lending rate. Many have argued inflation remains low and there is no need for such an increase. However, the Fed has begun to talk about the relationship between low unemployment and how it might spark inflation. What ultimately matters is not the first move, but how many moves and how high rates go. With our sluggish economy, a series of large rate increases does not appear to be in the cards.

While China may be selling a small portion of their U.S. Treasuries, they are generally an outlier. Throughout the world, especially in Europe, yields are lower and sometimes negative. Even with our meager yields, U.S. bonds look attractive compared to most foreign sovereign bonds. In the search for yield, high quality corporate bond yields are above recent historical averages relative to U.S. Treasuries. This may be a buying opportunity. We believe the risks in low quality bonds remain too high.

International

POSITIVES

- Some emerging markets are bargains
- Low tax economies are more attractive
- Pro-business governments should lead to stronger growth
- Many central banks will remain stimulative

NEGATIVES

- Commodity prices have not bottomed
- Anticipation of Fed rate hikes boosts the Dollar
- China's transition to consumer economy slow and painful

While Japan is back in recession, we look for modest growth worldwide. However, China's slowdown and focus on consumer activity will continue to create a serious drag on economies that are highly dependent on exporting basic commodities.

We see some international opportunities in 2016. For example, Chile may bottom in 2016 as they were quick to adjust to falling commodity prices and have substantial reserves. Economies that are commodity importers, such as India, should continue to benefit from low prices. Low tax countries, such as Ireland, may continue to attract foreign business. Pro-business governments, especially in Argentina and the U.K. should help those stock markets move higher in 2016.

Of course, the world remains focused on the rise of international terrorism and rising fears of violence can seriously damage economies. We should expect to see rising defense spending as governments react to public demands for greater security.

Conclusions for 2016

For Business Executives

- Substandard economic growth presents dangers and opportunities
- Household wealth growing meagerly:
  – Sales growth problematic
  – Seek increased customer satisfaction to grow base
- Manufacturing slowdown to continue:
  – World demand sluggish
  – Better prospects domestically
- Commodity prices to remain low:
  – Caution towards producing commodities
  – Favor business segments utilizing commodities
  – Your suppliers' overcapacity may mean bargains

For Investors

- The Year of Unpredictability
- Key: Targeted Opportunities
- Domestic Stocks:
  – Lower expectations: correction possible
  – Indexing will bear brunt of volatility
  – Favor active management
  – Strong Dollar favors: small cap, discount stores
  – Cheap commodities benefit refiners, airlines, grocers and restaurants
  – Undervalued securities should lead
- Bonds:
  – Aggressive Fed rate hikes unlikely
  – Inflation will remain contained
  – Treasuries continue to attract international buyers
  – Avoid low quality bonds
  – Mixed returns across maturities
  – Remain flexible to manage interest rate risk
- Foreign Investments:
  – Beware heavy exporters to China
  – China to remain volatile
  – Opportunities in countries with pro-growth policies (Ireland, U.K., India)
  – Look for oversold emerging markets (Argentina, Chile)

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