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573.629.3826
816.279.5900
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OUTLOOKS

February 2017

ECONOMIC OUTLOOK

Summary

It's early February and a good time to take stock of the U.S. economy through the lens of last year's GDP. As The Washington Post's headline put it, "the U.S. had its worst year of economic growth in 2016 since 2011." The hopeful spike in Q3 GDP, clocking in at 3.5%, gave way to a lackluster Q4 GDP print of 1.9%. For all of 2016, our economy grew at a 1.9% annual rate, about in line with the 2% growth experienced over the last four years.

Taking a look at some of the sub-sectors within the GDP report reveals a household sector whose consumption picked up in each of the past three quarters. The acceleration was modest, but consumer spending is going in the right direction. The fourth quarter rise in year over year business investment was the first in a year. The biggest improvement was mining, which includes oil and gas rigs, and which rose 24% after seven consecutive quarterly declines. Trade in imports and exports recovered in 2016 with imports outpacing exports considering the relative strength of the U.S. economy compared to other parts of the world.

The outlook for 2017 in economic terms is promising with many economists projecting about 2.5% growth, which sounds about right to us. Markets and corporate executives are in the early stages of adjusting to President Trump's abrupt and unpredictable management style. Some of his policy proposals are akin to putting one foot on the gas and another on the brake, at the same time. Consumer and business confidence has soared since the election, but as a rule, a pickup in expectations translates into faster spending only when expectations become reality. We will have to wait and see.

Positives

Unemployment rate at 4.8% continues to reflect a strong labor market

Labor force participation rate increased to 62.9% from a 62.4% low in September 2015

Monthly personal income and spending data are steady but have room for improvement

Negatives

Average hourly earnings tick down to 2.5% year over year, from 2.8% recently

Wholesale inventories rise 1.0% as the inventory to sales ratio remains elevated

Construction spending month over month was down and trending near the flat line

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OUTLOOKS

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EQUITY OUTLOOK

Summary

The post election rally in equities remained on a roll in January, as U.S. indices churned to record levels in the month.

The S&P 500 was one such index, closing the month over 2,278, up 1.9%, after setting a record close on January 25. Other U.S. indices, including the DJ Industrials and the Nasdaq followed suit.

Topping the best performing economic sector list were materials, up 4.6% in the month and up a whopping 36.5% since January 2015. Both the technology and health care sectors recorded better than 4% returns as well. Bringing up the rear were telecom and energy, off 2.5% and 3.6% respectively. In a reversal of nearly all of 2016, S&P 500 growth stocks (up 3%) outpaced S&P 500 value stocks (up 0.7%).

The belief persists that the new administration will successfully reduce impediments to corporate profitability, such as financial regulation and tax rates. This would improve earnings and we do subscribe to the notion that stock prices follow earnings.

Little in the way of substance has been forthcoming on these issues, and, until details are available, it's difficult to assess actual real world impacts of any legislation. In deference to any information to the contrary, we are maintaining our overweight to domestic equities but are beginning to move at the margins.

For example, we carried an overweight exposure to mid-cap stocks for much of last year, and given the subsequent strong performance of this sector, have taken some profits here. Where then to invest the proceeds?

Of particular interest to us has been the nearly stealth rebound of foreign markets, both developed (think Europe) and emerging (China, South Korea, etc.) in January but particularly the emerging markets over the past 12 months (up 22.5%). We are gradually increasing exposure to the emerging market sector, where valuations are attractive vis-à-vis the U.S., but catalysts have been lacking.

Equity markets are components of forward looking models (leading indicators) expressly because prices discount future earnings, and prices around the globe seem to be pointing toward a cyclical bump in activity and profitability.

Positives

Cyclical upturn in global outlook continues

Economic proposals positive for earnings

Negatives

Uncertainty surrounding administrative delivery

Unknown

Response to proposed renegotiated trade agreements

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OUTLOOKS

February 2017

FIXED INCOME OUTLOOK

Summary

Since the big spike in interest rates following the presidential election in November, the volatility in yields has moderated as the markets have taken a “wait and see” approach to the new policies being put forward by the Trump administration. The 10-year Treasury note traded in a 19 basis point (bp) range during January which is toward the lower end of the 13 to 61 bp monthly range that has been seen over the past two years. For the month in whole, the entire yield curve from 2 years to 30 years ended almost exactly where it started the year with the 2-year note at 1.20%, the 5-year at 1.91%, the 10-year at 2.45% and the 30-year at 3.06%.

The stars continue to shine brightly on corporate credit as investors not only seek the relatively safe incremental yield, but anticipate policy changes that should favor the supply/ demand fundamentals of the sector. Two changes being discussed by the new administration, a reduced tax on the repatriation of overseas profits and the elimination of interest deductibility, would likely reduce the need or desire for new borrowings by larger corporations. With demand constant or increasing, the appetite for existing bonds could drive credit spreads even lower than they are today. Last month intermediate investment-grade corporate bonds delivered almost twice the return of intermediate Treasury bonds at +0.39% versus +0.20% even though aggregate spread levels narrowed by only 3 bps.

We still believe that the market’s current yield levels make sense given the push for tax cuts, an infrastructure spending program and a border-adjustment tax. But change will not be easy as even within the Republican Party, the deficit hawks are beginning to squawk a bit louder about the impact these changes would have on the federal budget. On the surface, most of the new initiatives being discussed would lead to higher interest rates and higher inflation, both obviously bad for bond investors. Because of this, we are maintaining a slightly defensive duration policy where we have the flexibility to do so. While defensive, we also believe that the likelihood of numerous policies being enacted that would cause inflation to move significantly beyond the Fed’s target level is also relatively slim. In our opinion, their forecast of three additional rate increases in each of the next three years has about a zero chance of occurring. As in the past, we still favor corporate credit but are less optimistic than before.

Positives

- Productivity challenges continue to restrict economic growth with little change on the horizon
- Demographic headwinds of aging populations continue in most developed countries
- U.S. bonds still offer significantly higher yields than other developed nations
- Higher yields and lower prices should cause rebalancing in favor of bonds

Negatives

- The Fed has been signaling that three rate hikes are possible for 2017, 2018 and 2019
- Increasing budget deficits require greater issuance of Treasury bonds
- Saber rattling could cause foreign debt buyers to curtail purchases of U.S. debt
- Inflationary expectations have risen with the threat of tariffs

Unknowns

- Populist and nationalist movements continue in Europe with a “Frexit” now being discussed
- Terrorism and potential impacts on travel and global economic growth
- Bad debt and capital inadequacies in the European banking system, particularly in Italy

Expanding Possibilities

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