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573.629.3826
816.279.5900
www.hnbbanks.com

OUTLOOKS

May 2016

ECONOMIC OUTLOOK

Summary

One segment of the U.S. economy we have not examined recently is the residential home market. Home, sweet home. My how things have changed! The real estate bubble in the early to mid-2000's burst around 2007, crushing bank balance sheets and consumer net worth. Since then, banks have charged off and have been fined tens of billions of dollars and credit standards have been raised significantly. The aftermath has created a much healthier industry, but one where the composition and context of the "American Dream" has changed dramatically.

Residential fixed investment as a percentage of gross domestic (GDP) product peaked in 2005 at about 6.20%, then plunged to 2.50% by 2010. The current percentage is approximately 3.30% and is 40% below the 1999 level. Another housing-market measure is existing home sales, which has recovered to about 5.3 million annually, from near the 7-million rate in 2004 and 2005. Home ownership rates have fallen from a peak of 69% in 2004 to around 64% today, a 30-year low. Not surprisingly, multi-family construction has picked up the slack and surpassed all-time highs in units produced, while single-family home starts limp along at around half of the level in 2000.

This is good news. Housing sales are one of the most important components in our economy and have a strong "multiplier" effect. Furniture sales, home remodeling and other household purchases provide a real boost to GDP. It would seem that housing will be a steady and reliable contributor to economic growth in the years ahead as the sector gradually regains its historical share of the domestic economic pie.

Positives

Existing home sales increase 5.1% month over month

S&P/Case-Shiller home price index increases 5.3% year over year

Personal income increased 0.4% month over month

Negatives

Housing starts drop 8.8% month over month

Preliminary first-quarter 2016 GDP reading at a disappointing 0.5% annualized

Personal spending increased 0.1% month over month

Expanding Possibilities

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EQUITY OUTLOOK

Summary

The reversion rally in commodity sectors began in earnest mid-February and has continued through April. Why is a commentary devoted to equities leading off with a reference to commodities? Simply, the run in raw-material prices spilled over to stock prices as well.

The energy sector jumped 8.6% last month, while materials added 4.9%. So far this year, these sectors have surged 12% and 8%, respectively.

Both sectors are widely represented in value-oriented strategies, as are telecom (up 11.5% year to date) and utilities (up 11.7% in 2016). As such, the race between value and growth has been skewed to the value camp, while valuations of growth stocks (e.g., Google and Netflix) have compressed.

Regardless of whether the price action this year has been due to speculators, who made significant returns shorting those sectors last year, then switched positions to jump back in this year, or a (doubtful) harbinger of better global growth to come, the move appears to be overdone in the near term.

Corporate earnings reports for the first quarter, as well as outlooks for the second, are rolling in. One measure of the direction of earnings for the year, analysts' net aggregate estimate revisions, has turned positive recently for the first time in years. Granted, corporate guidance has been anything but rosy for the past two quarters, so expectations have ratcheted down dramatically.

Still, our contention that earnings growth is absolutely necessary for equity returns to be positive in 2016, and that it will be a second-half story, remains intact.

Positives

Global monetary policies not constrictive

Housing/autos/consumer remain positive tailwinds for the economy

Negatives

The presidential election battle is set

Dollar needs to remain range bound, and not trend higher

Unknown

Consequences of “negative” interest rates

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FIXED INCOME OUTLOOK

Summary

Interest rates ended April slightly higher across the curve. The 2-year Treasury note yield increased 6 basis points (bps) to end the month at 0.78%. After declining the greatest amount during the first quarter of the year, the 5-year increased the most for April, ending the month at 1.30%, up 9 bps. The 10-year and 30-year note each increased by about 7 bps to end at 1.83% and 2.68%, respectively. The modest increases again masked intra-month swings that have become all too common. During the month, the high-to-low range in the 10-year was 25 bps — about average for the monthly range over the past few years.

Corporate credit continued to ratchet tighter for investment-grade bonds across the curve. After widening about 55 bps through the first six weeks of the year, the rally in corporate bonds brought spreads back to even in early April and now they are about 20 bps tighter than where they ended 2015. For the past year, credit spreads have been highly correlated to commodity prices and the onset of this tightening coincided with the mid-February bottom. Overall, the blended government and corporate bond indexes have returned more in the past three months than most forecasters expected for the entire year.

Even though the labor market was robust during the first quarter, the economy expanded only modestly, with the first estimate of GDP growth coming in at 0.5%. While still early, current estimates for this quarter's growth rate are about 1.5%. The outlook for growth for the U.S. and the world in general are being lowered by most of the world's central banks and global financing entities. Declining demographics, the existing debt burden, and global turmoil are expected to continue to constrain innovations, capital investments and true animal spirits from fostering faster growth. In this environment, inflationary pressure will remain muted and the Fed is unlikely to achieve the target overnight rates that they forecast as neutral for two or three years out from now. Rates are likely to remain volatile, but trade within the range that they've seen this year. We still see little reason to actively shorten duration given current levels.

Positives

Falling global growth forecasts by the IMF, World Bank and others

The U.S. still has the highest yield of any large developed safe-haven nation

Money flows have been increasing for U.S. fixed income

Negatives

Commodity and industrial input prices appear to have bottomed

Inflation expectations have increased for further years out

Another increase in the fed funds rate is likely this year

Unknowns

U.S. presidential race (folly) now set between Trump and Clinton

Terrorism and the threats to major world cities

Ability of other central banks to combat deflation

The effects of negative interest rates over the long term

Expanding Possibilities