{PMFA} Economic perspectives

4th Quarter 2016

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EXECUTIVE SUMMARY

- The final estimate of Q3 GDP indicated that the economy grew at a 3.5% clip, well above preliminary estimates. Although consumption remained a primary driver of growth for the quarter, consumer spending slowed to 3.0%, as other areas of the economy helped to boost growth.
- Inflation measures have been somewhat mixed in recent months, but are edging gradually higher. The Consumer Price Index (CPI) reached 1.7% on a year-over-year basis in November. The core Personal Consumption Expenditures (PCE) Index dipped to 1.6% in November, remaining below the Fed's 2% target.
- Long-term interest rates rose substantially in the latter half of the quarter in anticipation of stronger economic growth in 2017 and a sharp uptick in inflation expectations. The 10-year U.S. Treasury yield ended the quarter at 2.45%, a meaningful rise from 1.60% at the end of Q3.
- The economy added an average of 165,000 new jobs per month from October through December, indicating continued strength in the labor market. The unemployment rate also edged up to 4.7% in December, but remains below the 5.0% threshold.
- For real-time updates on incoming economic data as it's released throughout the quarter, please visit our blog at market-perspectives-blog.pmfa.com.

JIM BAIRD
CPA, CFP®, CIMA®
Partner,
Chief Investment Officer

TRICIA NEWCOMB
CIMA®
Associate,
Senior Strategy Analyst

Economic Dashboard

Gross Domestic Product	Prior Reading	Change	Most Recent
Real GDP QoQ - Q3 (Final)	1.4%	⇧	3.5%
Personal Consumption QoQ - Q3 (Final)	4.3%	⇩	3.0%
Employment Market			
Unemployment Rate - December	4.6%	⇧	4.7%
Nonfarm Payrolls (Change) - December	204K	⇩	156K
Initial Jobless Claims 4-Week Avg - December	262.5K	⇩	256.8K
Continuing Jobless Claims 4-Week Avg - December	2040.8K	⇧	2067K
Inflation			
CPI YoY - November	1.6%	⇧	1.7%
Core CPI YoY - November	2.2%	⇩	2.1%
Core PCE YoY - November	1.8%	⇩	1.6%
Consumer Indicators			
Retail Sales YoY - November	4.2%	⇩	3.8%
Consumer Credit YoY - October	6.1%	⇔	6.1%
Personal Income YoY - November	3.7%	⇩	3.5%
Personal Savings YoY - November	5.7%	⇩	5.5%
Consumer Confidence - December	109.4	⇧	113.7
Business & Production Indicators			
ISM Manufacturing Index - December	53.2	⇧	54.7
ISM Services Index - November	54.8	⇧	57.2
Industrial Production YoY- November	-0.8%	⇧	-0.6%
Small Business Optimism - December	94.9	⇧	98.4
Housing Market			
Existing Home Sales - November	5.57MM	⇧	5.61MM
Housing Starts - November	1340K	⇩	1090K
S&P Case-Shiller Price Index YoY- October	5.0%	⇧	5.1%
Leading Indicators			
ECRI Weekly Leading Index - December	143.9	⇩	143.3
Conference Board Leading Economic Index - November	124.6	⇔	124.6

OVERVIEW

Since the onset of the Great Recession, monetary policy has arguably been at the epicenter of the U.S. financial and investment universe. First, it was the extremes of near-zero policy rates and quantitative easing enacted by the Federal Reserve in an effort to kick start the economy coming out of the recession, followed more recently by the "on again, off again" guessing game of when the first Fed funds rate hike would occur, which finally occurred in December 2015.

Now, one year later, the Fed has concluded to raise rates by a quarter point for the second time – only this time the media buzz and market reaction following the announcement was limited. In part, that's because President-elect Trump's surprising victory in the November presidential election had already shifted attention in a different direction, away from monetary policy and toward the proposed fiscal policies of the incoming administration.

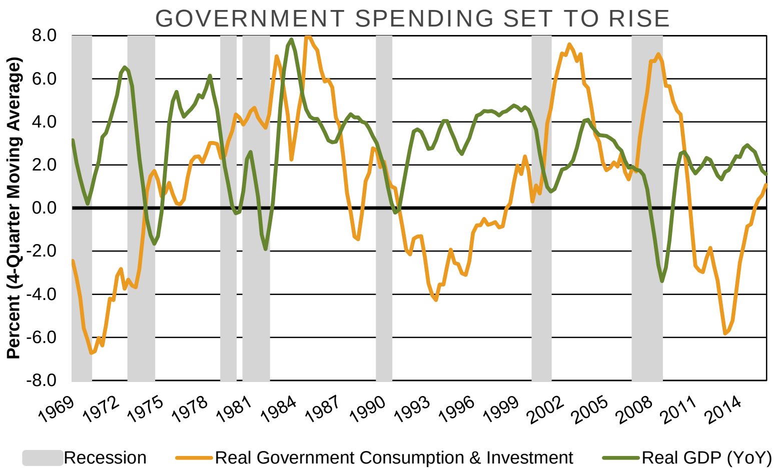
During the course of his campaign, the President-elect put forward a number of proposals aimed at providing fiscal stimulus, primarily focusing on three key areas: tax reform, infrastructure spending, and regulatory reform. For a deeper dive into each of these areas and the potential impact, please refer to our special commentary available on our website, *The Trump Economic Agenda: What It Means For Investors*.

Although there is still much left to be determined, the intended direction of future policy appears clear, with the stated goal of providing a boost to economic growth domestically. Investor expectations and sentiment were quickly recalibrated post-election to incorporate this pro-growth trajectory for fiscal policy.

Incoming data following the election indicates that consumer confidence and small business optimism soared in December. In addition, domestic equities rallied in the final two months of the year, capping off strong double-digit returns for 2016. At the same time, long-term interest rates rose substantially, swiftly erasing the nearly 1% decline that had accumulated throughout the first half of the year.

Even before the election, there were already signs of an improving economic landscape. GDP grew at its strongest pace in five quarters in Q3, at a 3.5% annualized rate, more than double the pace of the prior quarter. Inflation expectations, as measured by the 10-year breakeven rate (the yield difference between a Treasury Note and a Treasury Inflation-Protected Security), had already reversed its downward trend from earlier in the year; the election outcome just accelerated that rebound. Lastly, the labor market continues to produce strong job creation and unemployment has been below 5% for eight consecutive months based on revised data in the December jobs report.

Only time will reveal the specifics of future fiscal policy, and whether or not it will live up to expectations. However, current data suggests that the U.S. economy is staged for continued growth in year ahead.



Source: PMFA, Bureau of Economic Analysis (BEA), National Bureau of Economic Research (NBER)

INSIGHTS

It's no secret that real GDP growth has been muted during the current expansion, hovering around 2%, compared with a historical range of 3-4%. A number of factors have contributed to slower growth over the past six years, one of which has been the decline in government spending, which detracted from growth from 2011 to 2015 after being supportive since the late 90s.

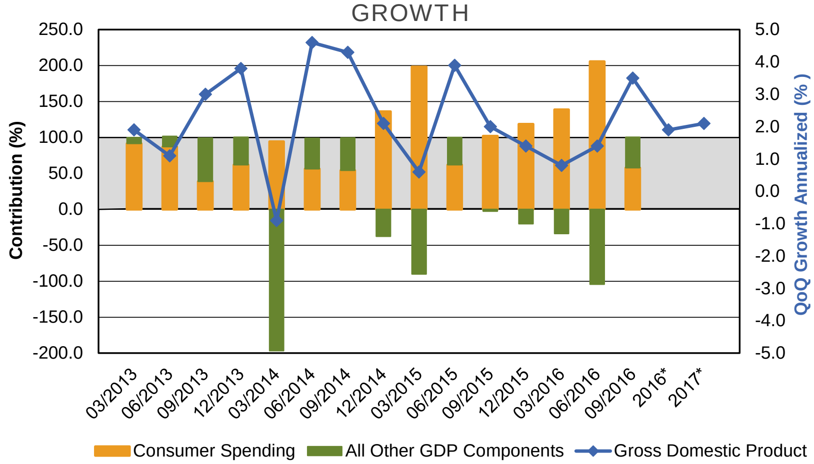
This reversed modestly in 2016, and the bi-partisan support for a multi-year infrastructure spending package appears likely to provide a further boost. While many questions remain about its scope and scale (not to mention how to finance it), the fact that leadership on both sides of the aisle have signaled a willingness to work together on a package improves the likelihood that a deal can be reached. After being a headwind to growth for nearly five years, fiscal spending is now expected to be supportive to growth in the coming years.

GROSS DOMESTIC PRODUCT

	Q1 Final	Q2 Final	Q3 Final
Real GDP QoQ	0.8%	1.4%	3.5%
Personal Consumption QoQ	1.6%	4.3%	3.0%

- The U.S. economy expanded at an impressive 3.5% annualized rate during Q3, up sharply from 1.4% the prior quarter. Personal consumption remained a primary driver of growth for the quarter, rising by 3.0%.
- Q3 was significant not only because of the improvement in top line growth, but because it also marked the first time since Q2 2015 that personal consumption, net exports, government spending and gross private domestic investment all contributed positively to GDP.
- Over the last few years, economic growth in the U.S. has been heavily reliant upon consumer spending, often accounting for most or all of the growth in a given quarter, offsetting declines in other sectors. Fiscal policy under the new administration is expected to fuel government spending, which should continue to bolster overall growth prospects in the coming quarters.

CONSUMERS HAVE BEEN THE PRIMARY DRIVER OF GROWTH



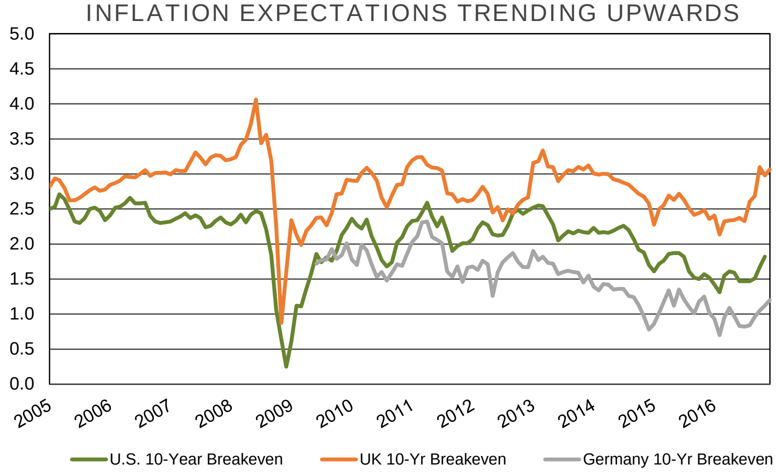
**2016 and 2017 are YoY estimates per the Federal Reserve*
Source: PMFA, BEA, Federal Reserve

INFLATION

	September	October	November
Consumer Price Index YoY	1.5%	1.6%	1.7%
Producer Price Index YoY	0.7%	0.8%	1.3%

- The CPI increased 0.2% for the month of November, while the year-over-year change rose to 1.7%. Core CPI also increased 2.1% over the last 12 months, as the rising costs of car insurance, medical care, and shelter offset the falling costs of airfare, used vehicles, and household items.
- The disinflationary impact of low energy prices has finally waned, as the energy price index rose 1.1% – the largest 12-month increase since July 2014. However, the strong U.S. dollar continues to constrain import prices, somewhat offsetting inflationary pressures domestically.
- Market expectations for future inflation spiked at the end of Q4. Inflationary pressures were already edging moderately higher before the U.S. presidential election, but expectations surged in the aftermath, as investors anticipated the potential impact of new policy initiatives under President-elect Trump.

INFLATION EXPECTATIONS TRENDING UPWARDS



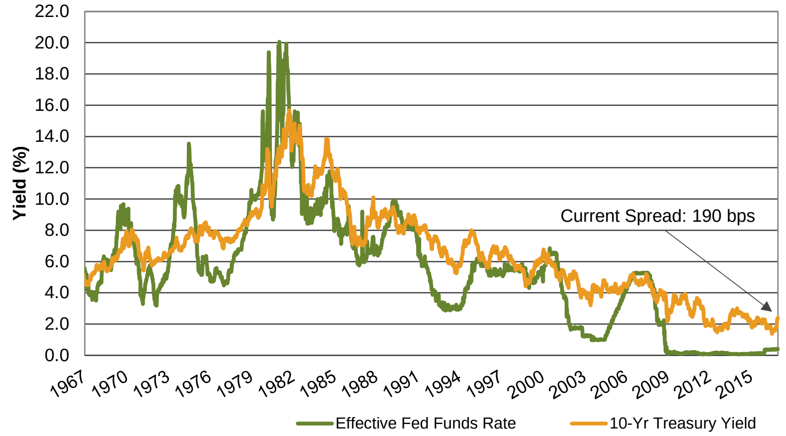
Source: PMFA, Federal Reserve, Bank of England, European Central Bank

INTEREST RATES

Treasury Yields as of	12/31/15	6/30/16	12/31/16
3-month	0.16%	0.26%	0.51%
2-year	1.06%	0.58%	1.20%
10-year	2.27%	1.49%	2.45%

- Long-term interest rates rose sharply during Q4, with the majority of the increase occurring in the post-election period. The 10-year Treasury yield ended the year at 2.45%, up from 1.60% at the start of the quarter.
- The Federal Open Market Committee (FOMC) voted to increase the federal funds rate by 0.25% in December, marking the first rate increase since one year prior and only the second in the last decade. Currently, median expectations from the Fed's projections are calling for three additional rate increases in 2017.
- Long-term interest rates tend to be highly correlated with the fed funds rate, with an average historical spread of about 1.1% over the past half century, or 1.6% over the last 30 years. While long-term yields going forward are likely to be somewhat anchored by historically low short-term rates, rates may continue to trend upward if supported by solid economic growth and more Fed tightening in the coming year.

LONG-TERM YIELDS ANCHORED BY FED POLICY RATES



	Average	Maximum	Minimum
Spread Differential (Post-1966)	110 bps	410 bps	-780 bps
Spread Differential (Post-1986)	160 bps	410 bps	-150 bps

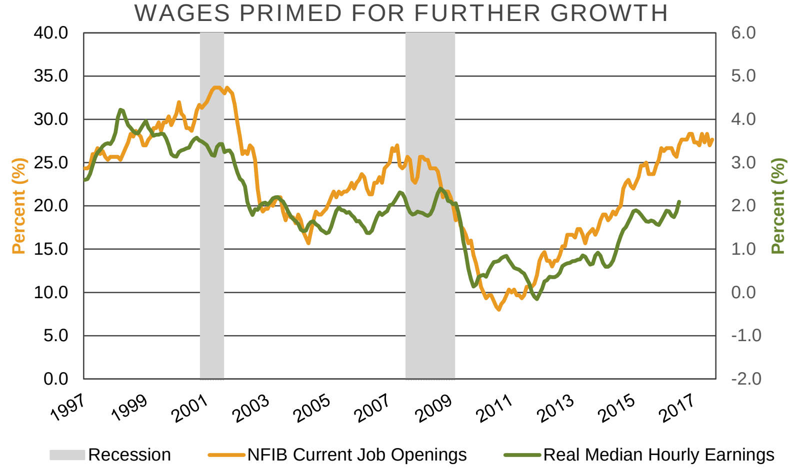
Spread Differential represents the difference between the 10-Yr Treasury Yield and the Effective Fed Funds Rate
Source: PMFA, Federal Reserve

EMPLOYMENT

	October	November	December
Unemployment Rate	4.8%	4.6%	4.7%
Nonfarm Payrolls (Change)	135K	204K	156K

- Growth in nonfarm payrolls was solid in Q4, as the economy added an average of 165,000 jobs over the past three months, marking a slowdown relative to the corresponding period a year ago, but still strong overall.
- The unemployment rate rose modestly to 4.7% in December, but remains near its nine-year low point, providing further proof of a generally strong labor market.
- As the labor market has tightened, wage growth has picked up, recently exceeding 2% real growth for the first time since 2009, as illustrated in the chart to the right. Historically, wage growth has been highly correlated with the number of available jobs, after adjusting for the lagged impact as employers subsequently increase pay to attract skilled workers. With job openings at their highest level in over a decade, it stands to reason that wages should continue to move higher from here.

WAGES PRIMED FOR FURTHER GROWTH



Source: PMFA, NFIB, Atlanta Fed
NFIB Current Job Openings is advanced 16 months and percentages represent 3-month moving averages

Past performance does not guarantee future results. All investments include risk and have the potential for loss as well as gain.

Data sources for peer group comparisons, returns, and standard statistical data are provided by the sources referenced and are based on data obtained from recognized statistical services or other sources believed to be reliable. However, some or all information has not been verified prior to the analysis, and we do not make any representations as to its accuracy or completeness. Any analysis nonfactual in nature constitutes only current opinions, which are subject to change. Benchmarks or indices are included for information purposes only to reflect the current market environment; no index is a directly tradable investment. There may be instances when consultant opinions regarding any fundamental or quantitative analysis may not agree.

Sources for the Economic Dashboard include PMFA, Bureau of Economic Analysis (BEA), Bureau of Labor Statistics (BLS), U.S. Department of Labor, U.S. Census Bureau, Federal Reserve, The Conference Board, Institute for Supply Management (ISM), National Federation of Independent Business (NFIB), U.S. Department of Housing and Urban Development, National Association of Realtors, Standard & Poor's (S&P), and the Economic Cycle Research Institute (ECRI).

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