HBK Wealth Management
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WEEKLY ECONOMIC COMMENTARY

This Week's Economic Review and Outlook

April 2016

"Making a positive impact on as many lives as I can." Please contact me if you have friends and family who would enjoy receiving this newsletter!

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In This Issue

FOMC FAQs: WHEN DOVES CRY?

KEY TAKEAWAYS

- The Fed holds its third of eight FOMC meetings of 2016 this Tuesday and Wednesday, April 26-27, 2016.
- Without a press conference or a new set of economic and fed funds projections, the Fed must rely on its statement to communicate a complicated message to markets.
- Our view is that by the end of 2016, the fed funds rate will be pushed into the 0.75-1.0% range.

As the third of eight Federal Open Market Committee (FOMC) meetings of 2016 approaches later this week, the market and the Federal Reserve (Fed) again remain deeply divided over the timing and pace of Fed rate hikes. The FOMC's latest forecast of its own actions (March 2016) puts the fed funds rate at 0.875% by the end of 2016. As of April 25, 2016, the market (according to fed funds futures) puts the fed funds rate at around 0.60% by the end of 2016 **[Figure 1]**, essentially pricing in just one more 25 basis point (0.25%) rate hike this year. How that gap closes-between what the market thinks the Fed will do and what the Fed is implying it will do-against the backdrop of what the Fed actually does will continue to be a key source of distraction for markets in 2016. Our view is that by the end of 2016, the fed funds rate will be pushed into the 0.75-1.0% range.

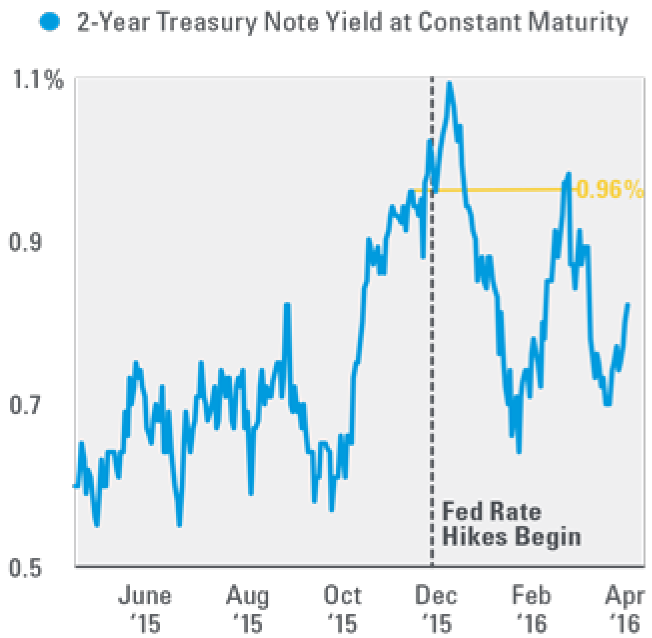
WHAT IS THE SCHEDULE OF EVENTS FOR THE FED THIS WEEK?

This week's meeting will be followed by an FOMC statement at 2:00 p.m. ET on April 27, 2016, but Fed Janet Chair Yellen will not hold a press conference nor will the FOMC release a new set of economic forecasts for gross domestic product (GDP), the unemployment rate, and inflation, or fed funds projections (dot plots). The bad news is that the FOMC statement is the only way the FOMC will communicate its views on the U.S. and global economy and the expected path for the fed funds rate to investors this week. The good news is that financial markets are far less frazzled than they were in late January 2016, the last time the FOMC held a meeting without a press conference or new set of economic forecasts and dot plots.

HAS THE MARKET PRICED IN A RATE HIKE AT THIS WEEK'S MEETING?

In short, no. As of Monday, April 25, 2016, the fed funds futures market has priced in just a 2% chance of a 25 basis point rate hike at this week's meeting. Another good proxy for what the market is pricing in is the yield on the 2-year Treasury note. Although the 2-year note yield has moved higher in the past two weeks (from 0.70% in early April to 0.82% as of April 25), it has moved lower since the last FOMC meeting (March 15-16, 2016), when the yield on the 2-year note stood at 1.0%. In addition, at 0.82%, the 2-year yield is below where it was (1.0%) when the Fed hiked rates in mid-December 2015 [Figure 2].

2 THE 2-YEAR NOTE YIELD HAS MOVED HIGHER IN RECENT WEEKS, BUT NOT SIGNALING A HIKE AT THIS MEETING



Source: LPL Research, U.S. Treasury, Haver Analytics 04/25/16

DOES THE FED CHANGE MONETARY POLICY IN AN ELECTION YEAR?

The short answer is yes, despite misconceptions the Fed stands down before major elections. While the Fed often pauses in the month or so prior to the November election, the Fed has changed policy (either raised or lowered rates or stopped or started quantitative easing [QE]) in every election year since at least 1968, and we don't expect anything different in 2016.

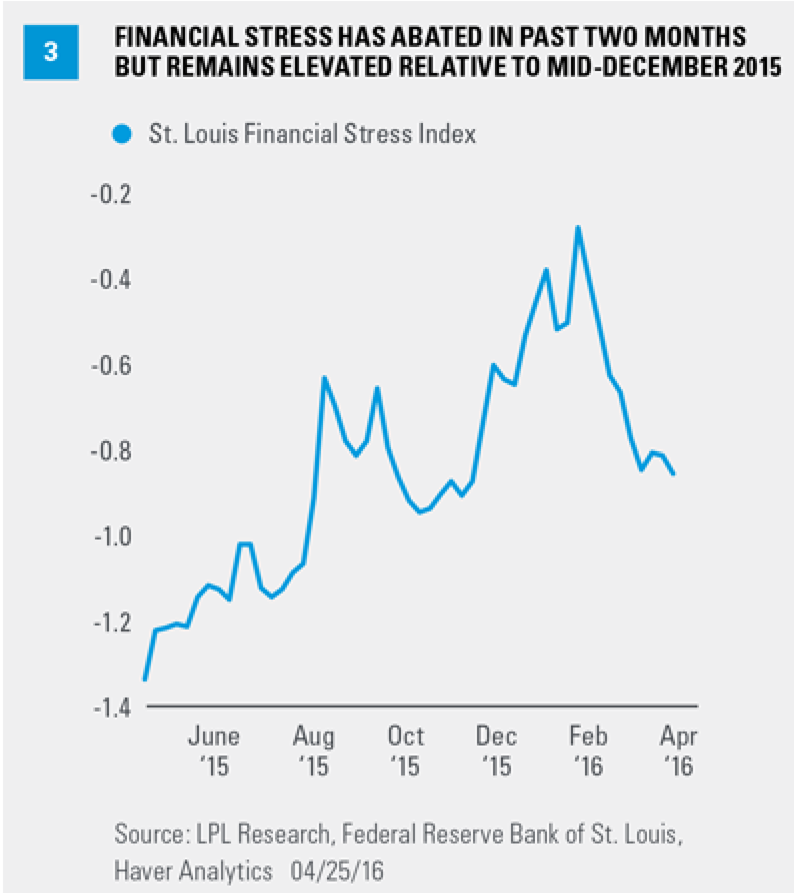
WILL ELEVATED VOLATILITY IN THE MARKETS DETER THE FOMC FROM RAISING RATES?

As we noted in our prior FOMC meeting preview in mid-March 2016, the Fed as an institution and the individual members of the FOMC have a much higher threshold for financial market volatility than financial market participants, investors, and the financial media. There is no question that global financial markets have seen wild swings so far in 2016, with the S&P 500 falling 12% in the first few weeks of 2016, rallying by 7%, and retesting the lows of the year in mid-February 2016, before rallying 15% in the past month. Other markets (commodities, Treasuries, etc.) have seen similar swings.

Although the Fed clearly monitors activity in financial markets, it rarely, if ever, cites financial market weakness as a reason to change (or not change) monetary policy. The FOMC statement released this week is not likely to acknowledge the recent market volatility, but instead say it is continuing to monitor "global economic and financial developments," as it noted in the FOMC statements released in both January and March of this year.

Instead, the Fed typically focuses on financial conditions. We note that Fed Chair Yellen referred to financial market conditions four separate times during her post-FOMC press conference in mid-March 2016, and another three times in a speech she made to the Economic Club of New York on March 29, 2016. The Fed tracks several measures of financial conditions, or financial stress. Figure 3 shows the St. Louis Fed's measure of financial stress, where a reading above zero indicates above average financial stress. It aggregates stress levels in equity, credit, interbank lending, and the securitization markets in the U.S. and abroad. Over time, a rising level of financial stress indicates tightening financial conditions.

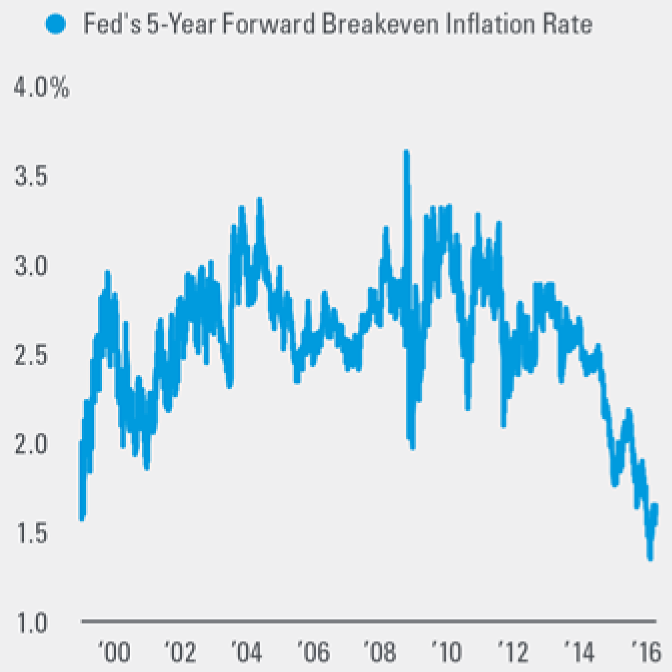
While financial stress has abated somewhat in the past two months after a sharp run higher in the first six weeks of 2016, the stress level remains above where it was just after the Fed raised rates in mid-December 2015. Said another way, the financial markets have done the Fed's job of "tightening policy" and slowing the economy over the past four months or so.



WHAT ABOUT INFLATION EXPECTATIONS?

In her post-FOMC press conference in mid-March 2016, Fed Chair Yellen noted that "inflation expectations remain reasonably well anchored" and that "survey-based measures of longer-run inflation expectations are little changed, on balance, in recent months, although some remain near historically low levels. Market-based measures of inflation compensation also remain low." The Fed tracks inflation expectations using both survey-based and market-based data. The University of Michigan's survey of consumer expectations over the next 5 to 10 years has moved lower in recent months and is at the lower end of the 2.5-3.0% range it has been in for the past 18 years. Low inflation expectations beget low inflation, and the Fed doesn't want to jeopardize this trend. Market-based inflation expectations (the difference between the yield on a 5-year Treasury note and a 5-year inflation-protected Treasury note, or TIP [Figure 4]) stands at 1.62% as of late last week, up from the 1.32% level-an all-time low-in mid-February 2016; but it is still below the 1.72% from mid-December 2015, when the Fed raised rates for the first time since 2006.

4 **MARKET-BASED INFLATION EXPECTATIONS ARE NEAR ALL-TIME LOWS**



Source: LPL Research, Bloomberg 04/25/16

Breakeven inflation rates are implied by difference between nominal U.S. Treasury yields and similar Treasury Inflation-Protected Securities (TIPS) yield. TIPS are adjusted semiannually for inflation based on the Consumer Price Index (CPI).

IMPORTANT DISCLOSURES

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Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

DEFINITIONS

Quantitative easing (QE) refers to the Federal Reserve's (Fed) current and/or past programs whereby the Fed purchases a set amount of Treasury and/or mortgage-backed securities each month from banks. This inserts more money in the economy (known as easing), which is intended to encourage economic growth.

INDEX DESCRIPTIONS

The S&P 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Weekly Market Commentary | Week of April 25, 2016

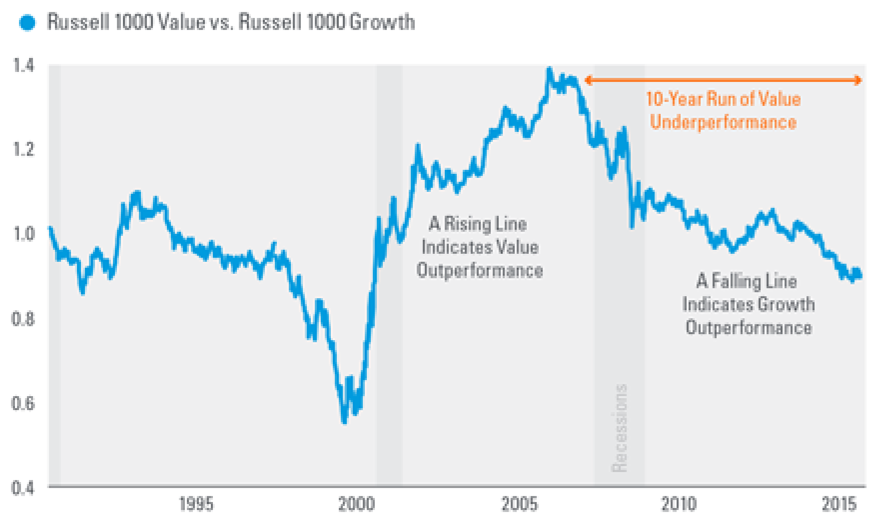
KEY TAKEAWAYS

- After underperforming most of the last decade, value has shown signs of life recently.
- We are a bit skeptical that the recent value resurgence is the beginning of a sustainable reversal in trend.
- A potential pickup in economic and earnings growth, interest rates, and oil prices are key factors to watch to monitor this trend.

VALUE COMEBACK?

Value stocks have staged a comeback versus growth after a long losing streak. Based on the Russell 1000 style indexes, growth has outpaced value for the better part of the last decade. Other than the period between April 2012 and July 2013, it's been all growth all the time since 2006 [Figure 1]. But value has shown signs of life recently, causing some to speculate that we are at the beginning of a sustainable reversal in trend. The Russell 1000 Value Index has outperformed the Russell 1000 Growth Index by 2.6% year to date. Here we discuss whether the value comeback is sustainable.

1 VALUE HAS LAGGED GROWTH FOR THE BETTER PART OF 10 YEARS



Source: LPL Research, Haver Analytics 04/22/16

Indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

THEMES

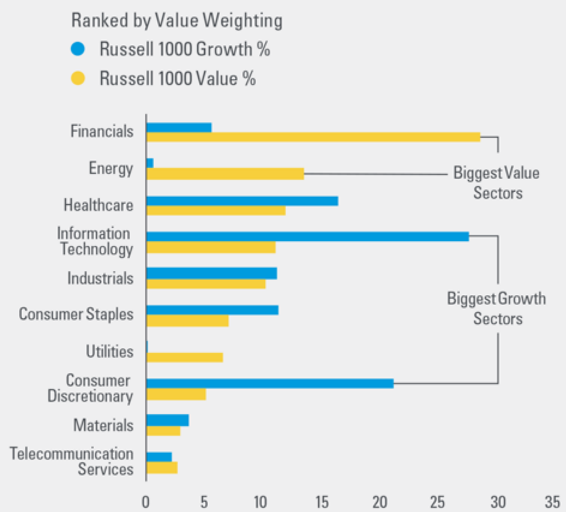
There are many different ways to slice up the equity market beyond the traditional style boxes, which has given rise to the "smart beta" trend. The industry has mostly given us growth and value investments, but when possible, we generally prefer to invest across broader themes (discussed in our *Thought Leadership* piece in October 2015).

EVALUATING VALUE VS. GROWTH: SECTOR MIX

When looking at the growth value question, we like to start by comparing the largest value sector (financials) to the largest growth sector (technology). (We identify growth and value sectors by taking the difference between weights in the growth index and the value index.) Financials is the biggest value sector, carrying 23% more weight in the Russell 1000 Value Index than its growth counterpart (energy is second at 12.9%). On the growth side, technology (16.5%) and consumer discretionary (16%) carry the biggest weight differentials. If you get these sectors right, you stand a very good chance at getting the growth versus value decision right (sector weightings for these indexes shown in Figure 2).

We currently like the technology sector more than financials, which favors growth, in large part due to the financial sector's struggles with low interest rates (more on that later). We are starting to warm up to energy as global oil production has fallen and oil prices have rebounded; and we have cooled some on consumer discretionary as the business cycle matures. Put all that together and the scales tilt slightly toward growth.

2 **FINANCIALS AND TECHNOLOGY KEYS PIECES OF GROWTH-VALUE DEBATE**



Source: LPL Research, FactSet 04/21/16

S&P 500 GICS sectors used for sector classifications.

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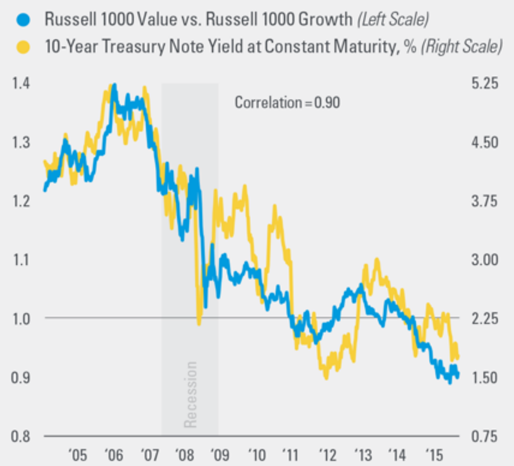
FINANCIALS AND INTEREST RATES ARE KEY

Financials have struggled in recent years for many reasons, but one big reason, at least since the Federal Reserve (Fed) lowered its target federal funds rate to zero and embarked on multiple rounds of quantitative easing (QE), has been low interest rates. Low interest rates impair bank profitability by reducing returns on loans, and hurt other financial firms by reducing returns on cash and bonds (think insurers and brokerage firms). The strain on banks and financial firms is a detriment to the sector overall, and, as a result, contributes to underperformance in value. This connection explains why the drop in interest rates has closely mirrored relative performance of value versus growth [Figure 3].

The next biggest value sector, energy, is also a factor in value continuing to lag behind growth. In fact, the fit between the chart of crude oil and value's relative performance over the past couple of years is just as tight as that of the interest rate chart.

Recently, the tide has started to turn. Oil prices, interest rates, and the financial sector (which are all related) have all moved higher together, fueling better value performance. We see limited near-term upside to all of these, which prevents us from moving aggressively into value at this point.

3 VALUE RELATIVE PERFORMANCE HAS SUFFERED FROM LOWER INTEREST RATES



Source: LPL Research, Haver Analytics 04/21/16

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Correlation ranges between -1 and +1. Perfect positive correlation (a correlation co-efficient of +1) implies that as one security moves, either up or down, the other security will move in lockstep, in the same direction. Alternatively, perfect negative correlation means that if one security moves in either direction the security that is perfectly negatively correlated will move in the opposite direction. If the correlation is 0, the movements of the securities are said to have no correlation; they are completely random.

SLOW GROWTH ENVIRONMENT

One of the main arguments against value (and in favor of growth) in recent years has been the slow global growth environment. When there is not a lot of growth in the economy or corporate profits, then it logically follows that the market would pay a premium for the companies that are generating growth (what we have referred to as motorboats, which can grow without a macro tailwind, as opposed to sailboats, which need economic growth to grow).

The data support this. Over the past 25 years, when economic growth is slow (real gross domestic product [GDP] below 2.5%), growth outperforms value by an average of 4.1%, and beats value two-thirds of the time. The Institute for Supply Management's (ISM) Manufacturing Purchasing Managers' Index (PMI) tells the same story. In years when the ISM Manufacturing Index is below average (under 52), growth outperforms value by an average of 3.3% and beats value 64% of the time. And when S&P 500 profits grow at below-average rates (below 7%), growth outpaces value by an average of 6.4%, and beats value 64% of the time.

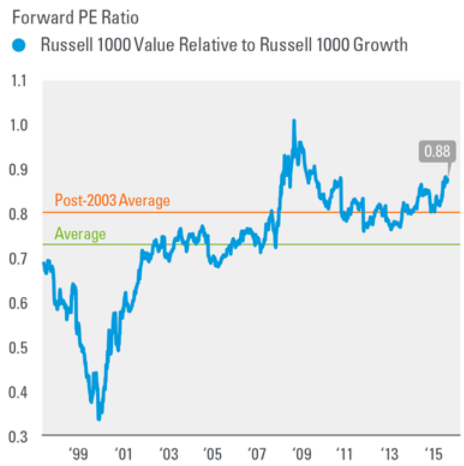
Value prefers stronger economic and profit growth than we are experiencing today, another check in the growth column. We may not have above-average economic growth this year, but we do expect better economic growth this year than last (as noted in our *Outlook 2016* publication); and based on consensus estimates, we believe earnings have a reasonable chance of returning to average growth rates by year-end. This is hardly a strong case for value, but it does suggest keeping allocations fairly well balanced.

IS THERE VALUE IN VALUE?

Valuations are another consideration in the style decision. Naturally, value stocks will be cheaper than growth almost all of the time because valuations are used to classify the securities. Since the late 1990s, only once was the Russell 1000 Value Index more expensive on a forward price-to-earnings (PE) basis than the Growth Index: May 2009. Value earnings were depressed--much more so than growth--immediately following the financial crisis, putting upward pressure on value's PE ratio.

Although valuations do not have a lot of predictive value month to month, we would suggest that for intermediate- to longer-term investors, value looks expensive. The Russell 1000 Value Index is trading at a 12% discount to its growth counterpart, compared to its 18-year average discount of 27%. Even if the tech boom is removed--a period when growth was dramatically overpriced--and we just look at the last two economic cycles (2003 and the present), value is still currently 8% more expensive than its average [Figure 4].

4 VALUE STARTING TO LOOK A BIT EXPENSIVE



Source: LPL Research, FactSet 04/21/16

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The PE ration (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with a lower PE ratio.

Forward price-to-earnings is a measure of the price-to-earnings ratio (PE) using forecasted earnings for the PE calculation. While the earnings used are just an estimate and are not as reliable as current earnings data, there is still benefit in estimated PE analysis. The forecasted earnings used in the formula can either be for the next 12 months or for the next full-year fiscal period.

TECHNICAL TAKE

From the perspective of technical analysis, the Russell 1000 Value Index's relative strength trend compared with the style-neutral Russell 1000 Index has been moving higher since January 2016, while the Russell 1000 Growth Index's relative strength trend is moving lower. This means that the Russell 1000 Value is outperforming the Large Cap Index, whereas the Russell 1000 Growth is underperforming. The latest leg of the value rebound has been driven by technology sector weakness after disappointing earnings last week (April 18-22, 2016), coupled with financials' recent strength.

The daily relative trend line for the Growth Index initially reversed in January 2016, and since then has made a lower high, confirming a downtrend. Correspondingly, a higher low for the Russell 1000 Value Index relative strength line confirms an uptrend [Figure 5].

The longer trends may have reversed, but they are near major areas of support and resistance, indicated by the blue lines in Figure 5. Should the blue lines give way, this would be further confirmation that value's relative strength is suggesting a major longer-term change in trend. Should the trends cross resistance/support, it would suggest another leg higher for value's relative performance.

CONCLUSION

After growth outpaced value for the better part of the last decade, value is starting to show signs of life. We are a bit skeptical that the recent value resurgence is the beginning of a sustainable trend reversal, but we acknowledge that the scales have started to tilt a bit more toward value and its run may not be over. A potential pickup in economic and earnings growth, rising interest rates, and higher oil prices are key factors we will be watching to monitor this trend, in addition to valuations and technical analysis.

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Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

Value investments can perform differently from the market as a whole. They can remain undervalued by the market for long periods of time.Because of its narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

All investing involves risk including loss of principal.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Institute for Supply Management (ISM) Index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

Purchasing Managers' Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries, and the employment environment.

The Russell 1000 Index measures the performance of the large cap segment of the U.S. equity universe. It is a subset of the Russell 3000 Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 represents approximately 92% of the U.S. market.

The Russell 1000 Value Index measures the performance of the large cap value segment of the U.S. equity universe.

The Russell 1000 Growth Index measures the performance of the large cap growth segment of the U.S. equity universe.

Blood Money: Managing Business Loans Between Relatives

If both parties focus on the rational, business aspects of the deal, there is a greater chance that the personal -- and financial -- relationships involved will emerge intact.

Sometimes a family member is the most obvious source of start-up capital for a new business venture. And despite the potential strain such a transaction could put on family ties, it needn't be a negative experience. If both parties focus on the rational, business aspects of the deal, there is a greater chance that the personal -- and financial -- relationships involved will emerge intact. Here are some tips for both borrowers and lenders to consider.

- **Borrower**: Don't pressure the lender to say "yes."
- **Lender**: If you don't want to lend money, say so directly and then stand your ground.
- **Lender**: Put everything in writing in the form of a legal contract. That way, the borrower will be reminded that the money is a loan -- not a gift.
- **Lender**: Let the contract be your guide when it comes to handling late payments (and assessing late fees).
- **Borrower**: Volunteer full disclosure, including a business plan, financial statements, etc. A family member may feel uncomfortable asking for these documents.
- **Lender**: Apply the same scrutiny to this information as you would to any other financial transaction.
- **Both parties**: Recognize the potential consequences to the family relationship if something goes wrong and the loan goes unpaid.
- **Both parties**: The loan may or may not give the lender a voice in the running of the business. Come to an agreement on that point up front and respect the decision.

To learn more about extending loans or lines of credit to a family member, contact your business banker or a trusted financial advisor.

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