HBK Wealth Management

Haire • Bohmer • Kilcoyne

WEEKLY ECONOMIC COMMENTARY

This Week's Economic Review and Outlook

December 2015

Our roads to success may have twists and turns and ups and downs; together we can navigate a course and enjoy the scenery along the way.

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Weekly Economic Commentary | Week of December 7, 2015

KEY TAKEAWAYS

- Our view is that the U.S. economy--as measured by real GDP--is likely to post growth of 2.5-3.0% in 2016.
- Manufacturing, business capital spending, and net exports may take larger roles in U.S. economic growth, with continued support from consumer spending.
- We believe that economic growth outside the U.S., in both developed and emerging economies, may accelerate modestly in 2016

BACK TO A ROUTINE: 2016 ECONOMIC OUTLOOK

This week's commentary features content from LPL Research's *Outlook 2016: Embrace the Routine*.

Our view is that the U.S. economy--as measured by real gross domestic product (GDP)--is likely to post growth of 2.5-3.0% in 2016. This rate is below its post-World War II average of 3.2%, but above the 2-2.5% average growth rate seen in the first six-and-a-half years of this expansion, based on the factors discussed below. Despite the length of the current expansion (already the fourth longest on record), it has not followed what would be considered a routine path. Supportive monetary policy from the Federal Reserve (Fed) has remained in place throughout the expansion; economic growth, while steady, has been below trend; and inflation, which often picks up near the middle of the cycle, remains near cycle lows. While we believe we are likely in the second half of the economic cycle, 2016 may be the first typical mid-cycle year of the expansion, and investors may need to figure out what it means to get back to that routine.

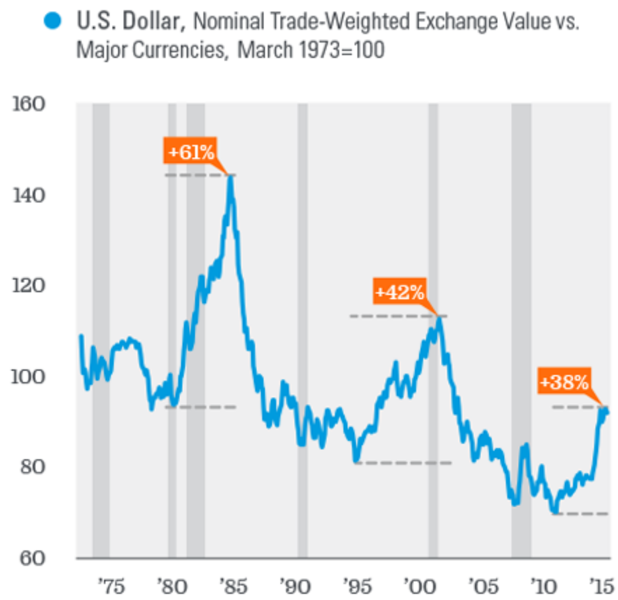
RETURNING TO OUR TYPICAL SOURCES FOR GROWTH

As we plan ahead for 2016, the mix of economic growth may look a bit different than in 2015, with manufacturing, business capital spending, and net exports potentially taking larger roles. The manufacturing economy is stabilizing after a difficult 18-month period (mid-2014 to late 2015) and may accelerate further. The housing sector is expected to contribute to growth for the sixth consecutive year, and the consumer sector may continue adding to growth, benefiting from low energy prices, record levels of household net worth, and still low consumer interest rates. Business capital spending struggled in late 2014 and throughout 2015 amid the collapse in oil prices and stronger U.S. dollar. We believe oil prices may move modestly higher as demand remains strong and, as we've started to see in 2015, supply comes down. Business capital spending may add to growth in 2016 as commodity prices stabilize [Figure 1].

Click here for Figure 1 "Economic Growth Holding Near 2% Despite Headwinds"

The hallmark of this current economic expansion has been underinvesting, especially in research and development, and while we do not expect a boom in 2016, there is potential for some catch-up spending. Net exports, which were a sizable drag on growth in both 2014 and in the first three quarters of 2015, may stabilize as the dollar consolidates after the 20%+ gain between mid-2014 and mid-2015--matching the largest 12-month increase in the value of the dollar versus its major trading partners since the dollar went off the gold standard in the early 1970s [Figure 2]. We expect the dollar will begin to stabilize as central bank policies and the outcomes of those policies become clearer. A stabilizing dollar should help to boost exports and remove a key headwind for manufacturing and profits of U.S. corporations.

2 THE DOLLAR HAS SURGED THREE DIFFERENT TIMES OVER THE PAST 45 YEARS, INCLUDING IN 2014–15



Source: LPL Research, Federal Reserve Board, Haver Analytics 11/11/15

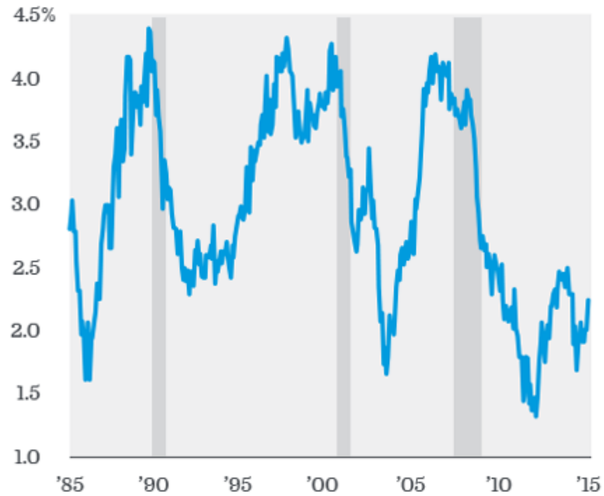
Shaded areas indicate recession.

CONTINUED PROGRESS FOR EMPLOYMENT & WAGES

We expect continued progress in the U.S. labor market in 2016, with the economy generating enough jobs to nudge the unemployment rate ever closer to the elusive "full employment" range, the level at which, in the past, businesses need to raise wages to attract and retain skilled employees. Wage growth has been limited but should continue to accelerate in 2016 [Figure 3]. This acceleration in wages--if not accompanied by better economic growth--may cause headaches for the Fed as it begins to normalize policy in 2016. We expect the Fed to begin raising rates in late 2015 or early 2016, with our focus on the pace of hikes throughout 2016 and beyond.

3 WAGE PRESSURES ARE BEGINNING TO APPEAR FOR THE FIRST TIME IN THIS BUSINESS CYCLE, AND THE FED IS WATCHING

● Average Hourly Earnings
Year-to-Year % Change, Seasonally Adjusted, $/Hour



Source: LPL Research, Bureau of Labor Statistics, Haver Analytics 11/11/15

Average hourly earnings for production & nonsupervisory employees, total private industries

Shaded areas indicate recession.

CHECKING OFF INFLATION

Inflation remains in check, but commodity/goods inflation may be poised to make a comeback, which would help keep the Fed on schedule to begin raising rates. Since the middle of 2009, prices of services in the economy (as measured by the Consumer Price Index [CPI] for services) accelerated from under 1.0% to as high as 2.8% in early 2014, and then settled into a range of 2-2.5%. Prices of services (medical services, rents, etc.) account for over two-thirds of overall CPI, and history suggests that as the business cycle ages, and as the housing and labor markets tighten, service inflation may continue to accelerate. The Fed has to watch this closely.

However, the CPI for goods (prices of oil and other commodities purchased by consumers) sank along with oil prices from mid-2014 through late 2015. This kept the U.S. economy flirting with deflation (a prolonged period of falling wages and prices). Overall CPI posted a 2.1% year-over-year gain in mid-2014, and by the end of October 2015, the overall CPI was just 0.2%. Looking ahead to 2016, if oil prices move up as we expect, the goods portion of CPI may increase by 2-3%; and if the pace of service sector inflation remains between 2% and 2.5%, overall CPI will accelerate quickly and may be well over 2.0% by year-end. By then, the Fed will have already begun raising rates.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services, and is a commonly used measure of inflation.

WATCHING THE FED: DISRUPTION OR DISTRACTION?

The start of a new Fed rate hike cycle may grab investors' attention in 2016, but investors must distinguish where it is more likely to disrupt their accustomed routine (bonds) and where it is more likely to be just a distraction (stocks). In addition, the market and the Fed remain deeply divided over the timing and pace of Fed rate hikes, and how that gap is resolved will determine the extent of the effects on the markets. As a reminder, the start of Fed rate hikes does not signal the end of economic expansions. Indeed, since 1950, the start of Fed rate hikes meant that the economy was still in the first half of the expansion.

We believe a rate hike in December 2015 remains a strong possibility. Our view remains that when the Fed does raise rates--likely in late 2015 or early 2016--that the timing of the first hike matters less than the pace of the hikes; the end point for the fed funds rate in this tightening cycle (the first since 2004) and the gap between the Fed's own view of rates and the market's view remain crucial.

The Federal Open Market Committee's (FOMC) latest forecast of its own actions (September 2015) puts the fed funds rate at 1.375% by the end of 2016. As of November 23, 2015, the market (as defined by the fed funds futures market) puts the fed funds rate 0.50-0.75% lower at around 0.81% by the end of 2016. 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 be a key source of distraction for markets in 2016. Our view is that the Fed will hike rates in late 2015/early 2016, and by the end of 2016, push the fed funds rate into the 0.75-1.0% range.

FISCAL STIMULUS AROUND THE GLOBE

In the wake of the Great Recession (2007-09), governments across the globe, in both developed and emerging markets, increased fiscal stimulus (more government spending, tax cuts, or some combination of the two) to combat the worst global downturn in 75 years. As the global economy emerged from the Great Recession over the past half-decade or so, governments reined in--and in some cases, reversed--the fiscal stimulus put into place during and after the Great Recession, most notably in developed markets. In emerging markets, fiscal stimulus continued, but at a slower pace than during the Great Recession, led by China [Figure 4].

Looking out to 2016, markets don't expect much in the way of fiscal stimulus in either developed or emerging economies. Thus, any stimulus that is enacted would likely be viewed as a positive surprise to markets looking for any boost to global growth.

Focusing on the U.S., outside of the major entitlement programs (Medicare, Medicaid, and Social Security), U.S. fiscal policy at the federal level has been restrictive since the $787 billion fiscal stimulus plan was enacted by Congress in 2009. While there is some historical evidence that fiscal stimulus picks up in an election year, historically, the odds of Congress passing meaningful fiscal stimulus that would impact growth before 2017 is low. However, the election of Paul Ryan (R-WI) as Speaker of the House in October 2015 increases the chances that market-friendly legislation is passed into law in 2016.

Click here for Figure 4 "Fiscal Stimulus Slowing Around The Globe Since The Great Recession"

ADDING GLOBAL GROWTH TO THE AGENDA

We believe that economic growth outside the U.S., in both developed and emerging economies, may accelerate modestly in 2016, albeit from fairly low growth in 2015. A key differentiator is likely to be the role commodities play in a given economy. While economic growth in developed economies (generally commodity consumers) accelerated in 2014 and 2015, emerging market economies have, in aggregate, been decelerating since 2010. Though many factors are at play, China has an outsized role as the marginal consumer of commodities. While the U.S. economy is becoming increasingly sensitive to global matters, on balance, the U.S. economy is still among the least export sensitive of any major economy.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for any individual security. To determine which investments may be appropriate for you, consult your financial advisor prior to investing.

All performance referenced is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

Economic forecasts set forth may not develop as predicted, and there can be no guarantee that strategies promoted will be successful.

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.

Investing in foreign and emerging markets securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

Commodity-linked investments may be more volatile and less liquid than the underlying instruments or measures, and their value may be affected by the performance of the overall commodities baskets as well as weather, disease, and regulatory developments.

Currency risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

DEFINITIONS

The Federal Open Market Committee (FOMC) is the branch of the Federal Reserve Board that determines the direction of monetary policy. The 11-person FOMC is composed of the 7-member board of governors, and the 5 Federal Reserve Bank presidents. The president of the Federal Reserve Bank of New York serves continuously, while the presidents of the other regional Federal Reserve Banks rotate their service in one-year terms.

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Tracking #1-446242 (Exp. 12/16)

KEY TAKEAWAYS

- Although we expect average returns for stocks in 2016, the path to reach them will be anything but routine.
- We expect stocks to produce mid-single-digit returns for the S&P 500, consistent with historical mid-to-late economic cycle performance, driven by mid- to high-single-digit earnings and a largely stable PE.
- This return to a more normal market may mean more volatility, challenging investors' ability to stay focused on their goals.

NO PAIN, NO GAIN: 2016 MAY REQUIRE TOLERANCE FOR VOLATILITY

This week's commentary features content from LPL Research's *Outlook 2016: Embrace the Routine*.

Gains in 2016 may require tolerance for volatility. Stocks historically have offered a tradeoff of higher return for higher risk, the gain of more upside than high-quality bonds versus the pain of market volatility and losses. For the last few years, U.S. stock markets provided below-average pain, while still providing strong returns. Between October 2011 and July 2015, the S&P 500 Index went nearly four years without a "correction" of more than 10%, while climbing an average of 20% a year.

Although we expect average returns for stocks in 2016, the path to reach them will be anything but routine. LPL Research expects stocks to produce mid-single-digit returns for the S&P 500, consistent with historical mid-to-late economic cycle performance, driven by mid- to high-single-digit earnings and a largely stable price-to-earnings ratio (PE). This return to a more normal market may mean more volatility, challenging investors' ability to stay focused on their goals.

HOW IS 2016 SHAPING UP?

In 2016, we expect the macroeconomic environment to be molded by a mid-to-late cycle U.S. economy, modest inflation, and the start of a Federal Reserve (Fed) rate hike campaign. If the U.S. does not enter recession in a given year, the probability of an S&P 500 gain is 82%, based on historical data from 1950 to present. Heading into 2016, there have been scant signs of excesses in the U.S. economy that may signal vulnerability to recession. We are always on watch for economic deterioration, but would be surprised if the U.S. economy begins to contract in 2016. In short, this low recession risk points to a potentially positive year for stock markets.

Given our view on the economy, we have high confidence that the range of likely potential market outcomes in 2016 will fall into those highlighted in Figure 1, characterized as mid-cycle years. We believe the worst returns during these years are unlikely. These years included shocks such as severe Fed rate hikes (1994), an inflationary oil shock (1977), and a European debt crisis (2011). We believe the high end is also unlikely, since it also includes several years with unusual circumstances such as a bounce back from an accounting scandal (2003), several years inflated by a stock bubble (1995, 1996, 1998), or recovery from the fiscal cliff crisis (2013).

That leaves -5% to +25% as a reasonable range of outcomes, with +5% to +15% the most likely based on these observations alone. The historical likelihood of a positive year coupled with our low-return expectations for the bond market support our positive stock market view for 2016.

Click here for Figure 1 "Historical Mid-Cycle Returns Suggest Modest Gains For Stocks In 2016"

EARNINGS RAMP UP

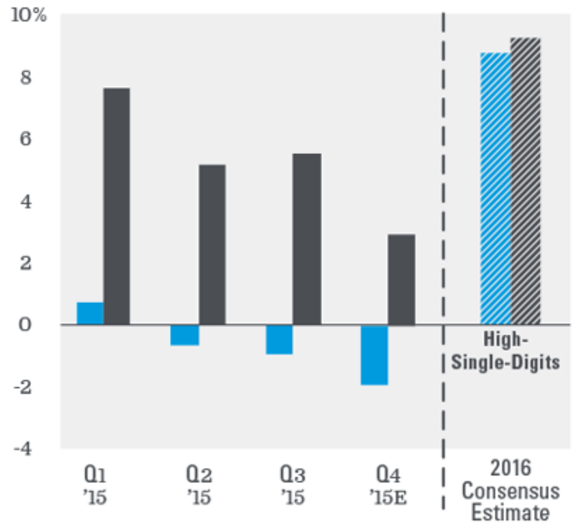
Getting the most out of a routine usually requires a little variety. Corporate profits felt stagnant in 2015, largely due to the drag from a strengthening U.S. dollar and the impact of the drop in oil prices on energy sector profits. Because we expect 2016 U.S. GDP growth near its long-term trend, corporate America should get back to delivering solid profits with mid- to high-single-digit earnings growth (in-line with Thomson Reuters consensus estimates), helping to push the stock market higher. Earnings growth in 2016 is expected to be similar with and without energy included, as shown in Figure 2.

Steady GDP growth in 2016 would set the tone for corporate revenue growth, which historically has correlated well with the growth of the overall economy. Adding in improving growth overseas and a more stable dollar should provide a solid macroeconomic backdrop for revenue, which, through operating leverage, may help support profit margins. Profit margins remain near multi-decade highs and we expect corporate America to maintain strong margins through a combination of: 1) limited wage pressure, 2) cost efficiency, 3) widespread use of automation/technology, 4) low input cost inflation, 5) low borrowing costs due to low interest rates, and 6) falling tax rates as more profits are earned overseas in lower tax countries.

2 EARNINGS POISED TO ACCELERATE IN 2016 AS ENERGY DRAG ABATES

Earnings, Year-over-Year % Change

● Change ● Change Ex-Energy



Source: LPL Research, FactSet 11/06/15

Based on the consensus of analysts' estimates collected by FactSet.

This is for illustrative purposes only and is not representative of the performance of any index or investment product. The economic forecast may not develop as predicted.

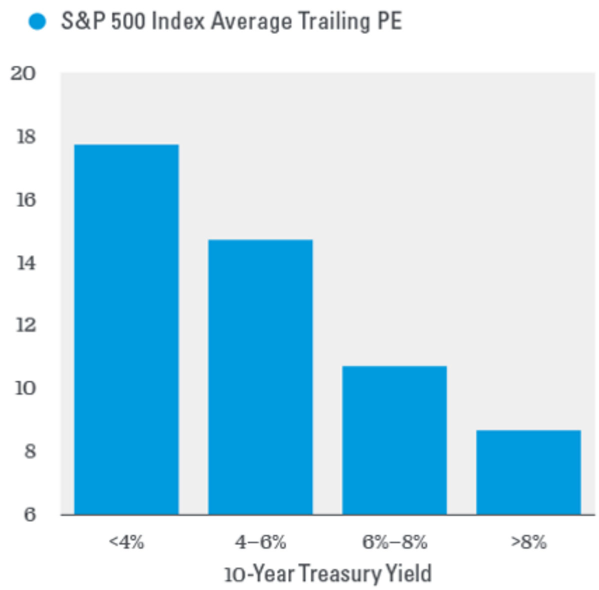
STRETCHING OUT THE BULL MARKET

We expect the generally favorable macroeconomic backdrop to lead to potential stock gains in 2016 and possibly bring the current bull market, one of the most powerful in the S&P 500's history, to its seventh birthday. The age of the bull market and above-average valuations have led some to question whether stocks may be too expensive to continue to rise. Valuations have not historically been good predictors of stock market performance over the coming 12 months; but, like a regular warm-up, monitoring valuations can help investors' long-term health.

At 17.6 as of November 23, 2015, stocks are above their long-term average trailing PE of 15.3 (based on S&P 500 data back to 1950), though they are only slightly above the average since 1980 of 16.4.

However, these valuations look more reasonable when put in context of low interest rates [Figure 3]. Since 1962, the average trailing PE ratio when interest rates are low (below 4% on the 10-year Treasury) is 17.7 versus 8.6 when they are high (above 8%), suggesting stocks are fairly valued. The relationship is similar when inflation is low.

3 STOCK VALUATIONS HISTORICALLY HIGHER AT LOW INTEREST RATE LEVELS



Source: LPL Research, FactSet 11/06/15

Indexes are unmanaged and cannot be invested into directly.

STICK WITH YOUR HABITS EVEN THROUGH VOLATILITY

One characteristic of the stock market that is customary, but certainly does not feel that way, is volatility. The S&P 500's peak-to-trough decline of 12% (May 21 to August 25, 2015) did not feel typical. But this type of pullback is actually quite normal, even in positive returning years. In fact, since 1950, the average peak-to-trough decline for the S&P 500 is 14%; even in positive returning years, the average is 11%, and the index suffered at least a 10% correction in 41% of those positive years [Figure 4]. Another way to show that the volatility experienced in 2015 is closer to the norm is by looking at the VIX, a measure of implied stock market volatility. The year-to-date average for the VIX in 2015 is 16.6, above the average of the prior two years between 14 and 15, but below the 20-year average (20.9) and the average during the current bull market (19.6).

Click here for Figure 4 "Stock Market Corrections Are Normal Even In Positive Years"

We expect volatility to be with us again in 2016 as the business cycle ages, making sticking to your long-term investment habits even more important to avoid locking in losses and missing out on opportunities. A number of factors beyond the aging business cycle could lead to increased market volatility in 2016. The Fed is about to embark on its first rate hike campaign since 2004-06. A further pronounced drop in oil prices--though not our expectation--could negatively impact the global economy and markets. And recent terrorist attacks in Paris and the associated military response highlight the heightened geopolitical risk in the Middle East and throughout the world.

CONCLUSION

Stocks, we believe, will not collapse, as many think, or soar, as many hope, but may offer near historical routine returns as earnings start to normalize and oil markets find their equilibrium. But we are still in the second half of the economic cycle, and investors need to be vigilant about monitoring pockets of volatility and potential signs of an economic downturn.

IMPORTANT DISCLOSURES

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All investing involves risk including loss of principal.

Commodity-linked investments may be more volatile and less liquid than the underlying instruments or measures, and their value may be affected by the performance of the overall commodities baskets, as well as weather, geopolitical events, and regulatory developments.

Currency risk arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Because of its narrow focus, investing in a single sector, such as energy or manufacturing, will be subject to greater volatility than investing more broadly across many sectors and companies.

Trailing PE is the sum of a company's price-to-earnings, calculated by taking the current stock price and dividing it by the trailing earnings per share for the past 12 months. This measure differs from forward PE, which uses earnings estimates for the next four quarters.

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.

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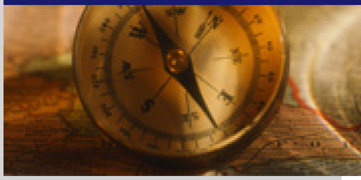

Outlook 2016 Client Letter | Week of November 30, 2015

Dear Valued Investor:

A key to success, in life and investing, is juggling the familiarity and wisdom of old routines with the adjustments demanded by an ever-evolving world. As we look forward to 2016, the LPL Research team expects a return to routine for some key areas of the economy and market, but by a path that may catch some investors unprepared. Investors will need a solid plan to navigate the changing landscape as they adjust to changes like the start of Federal Reserve (Fed) rate hikes, a maturing economic cycle, and the 2016 elections. As a guide to revitalizing routines for 2016, we are excited to introduce the *LPL Research Outlook 2016: Embrace the Routine*, with financial market forecasts, economic insights, and investment guidance for the year ahead. Some of the expectations for 2016 include:

- **U.S. economic growth of 2.5-3%.*** The mix of that growth may look different than in 2015, with manufacturing, business capital spending, and net exports taking larger roles. Labor markets are almost back to long-term expectations, and inflation may be poised to accelerate. An extraordinary extended period of loose monetary policy in the United States should start to normalize.
- **Mid-single-digit returns for the S&P 500.**** Stocks, we believe, will not collapse, as many think, or soar, as many hope, but may offer near historical routine returns. Earnings may start to normalize, and oil markets should find their equilibrium. International markets may re-emerge as a more viable investing opportunity. But we are still in the second half of the economic cycle, and investors need to be vigilant about monitoring pockets of volatility and potential signs of an economic downturn.
- **Limited returns for bonds.** The year as a whole may look similar to 2015, with bond prices facing the challenges of high valuations, steady economic growth, and the prospect of interest rate hikes. Still, bonds play a vital role in investors' portfolios to help with risk mitigation and diversification.

We believe *LPL Research's Outlook 2016* will help investors refresh, renew, and embrace their routines in the face of unexpected developments and a changing environment. By embracing new routines, investors will be able to focus on what matters most to markets, block out short-term distractions that will quickly fade, and seek to make progress toward long-term financial goals.

As always, if you have questions, I encourage you to contact me.

Click here to view the publication *LPL Research Outlook 2016: Embrace the Routine*

**Our forecast for GDP growth of between 2.5-3% is based on the historical mid-cycle growth rate of the last 50 years. Economic growth is affected by changes to inputs such as: business and consumer spending, housing, net exports, capital investments, and government spending.*

***Historically since WWII, the average annual gain on stocks has been 7-9%. Thus, our forecast is in-line with average stock market growth. We forecast a mid-single-digit gain, including dividends, for U.S. stocks in 2016 as measured by the S&P 500. This gain is derived from earnings per share (EPS) for S&P 500 companies assuming mid- to high-single-digit earnings gains, and a largely stable price-to-earnings ratio (PE). Earnings gains are supported by our expectation of improved global economic growth and stable profit margins in 2016.*

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Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.

Investing in foreign and emerging markets securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond and bond mutual fund values and yields will decline as interest rates rise and bonds are subject to availability and change in price.

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