HBK Wealth Management
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WEEKLY MARKET COMMENTARY

A Candid Look into the Current State of the Markets

May 2016

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 May 9, 2016

In our view, the April 2016 employment report underscores a key disconnect between the market and Federal Reserve (Fed).

Weekly Market Commentary | Week of May 9, 2016

KEY TAKEAWAYS

- Markets do not like uncertainty, and Trump undoubtedly brings that to the table.
- Election years are historically good for stocks, though with some volatility until the market gets clarity.
- We may benefit from the typical late election year rally as the macroeconomic and earnings backdrops improve.

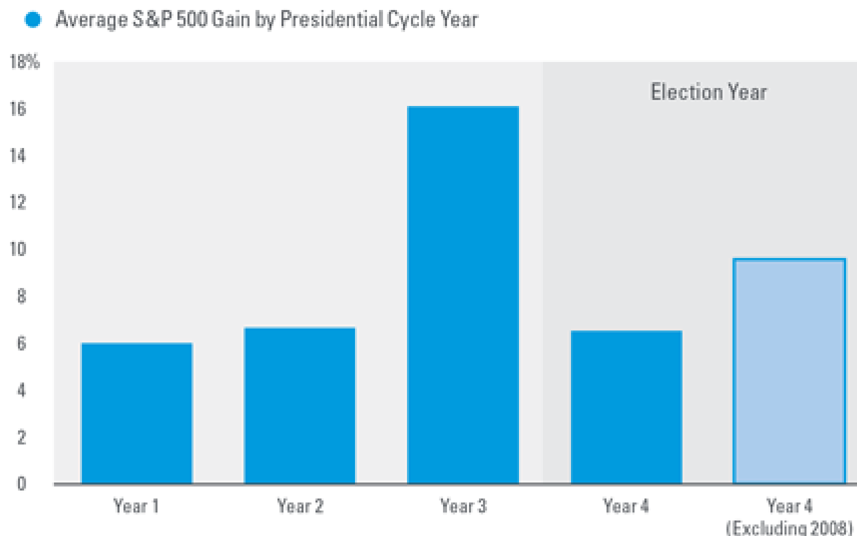
WHAT MIGHT TRUMP THE ELECTION YEAR PATTERN?

This week we look at what the upcoming presidential election may mean for markets in 2016. Following last week's somewhat surprising news that both Ted Cruz and John Kasich had withdrawn from the race, Donald Trump will be the Republican presidential nominee. Given that Trump has no formal policy record or political experience of any kind, this election cycle is, needless to say, unusual. Markets do not like uncertainty, and Trump undoubtedly brings that to the table.

Although stocks may be more volatile between now and November as market participants size up Trump and assess his chances against presumptive Democratic nominee Hillary Clinton, we believe the typical election year stock market pattern, our assessment of the more likely potential outcomes in November, and the macroeconomic backdrop all still suggest modest gains for stocks in 2016.

ELECTION YEAR PATTERN

Election years have historically been good for stocks, though not as good as year three [Figure 1]. Year three (the pre-election year) has been the standout performer since 1950, with only one down year out of 17 (flat in 2011 and -0.7% in 2015) and an average S&P 500 gain of 16%. Election years (year four) have also been good, especially excluding the anomaly in 2008, with gains averaging near 10% (better than we expect stocks to deliver in 2016), and positive returns in a solid 87% of years. Since 1960, the only down election years were 2000 and 2008, when the U.S. economy was either sliding into recession or already in one. Bottom line, election years have generally been good for stocks.



Source: LPL Research, FactSet 05/06/16

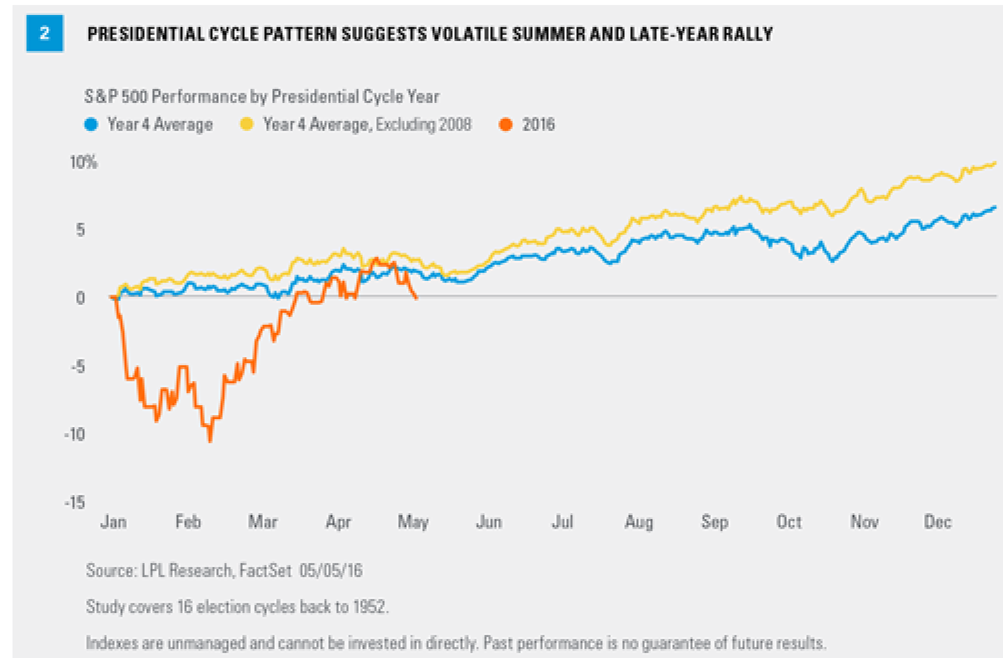
Study covers 16 election cycles back to 1952.

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

Gains during election years are encouraging, but the path to those gains has historically been volatile. The volatility at the start of 2016 was certainly extreme, but the election year pattern for stocks suggests volatility may persist through the summer months until markets have more clarity on the candidates and their platforms [Figure 2]. Once that clarity arrives, often before the election itself, stocks have typically staged a late-year rally, similar to most years (discussed in our "sell in May" commentary last week).

Though it's not official--a third-party run is still technically possible--we assume a Clinton-Trump race at this point (even the odds of a Sanders nomination at this point are not zero). Although the nominees are largely locked in, there is still a lot of uncertainty to clear up in terms of the candidates' platforms, especially Trump's, which could lead to market volatility and potential buying opportunities.

We would not take the market's relatively calm response to Trump's ascension to the top of the Republican Party as a sign of comfort with the idea of him in the White House; rather, we think it's more a function of the amount of time between now and November. Also keep in mind that some of Trump's most controversial proposals during primary season, such as mass deportation of illegal immigrants, will not get through Congress and do not warrant a market reaction. Last, early polling (with an emphasis on early) suggests that Clinton would defeat Trump. Like her or not, Clinton has a long public track record and does not bring the same policy uncertainty.



IS GRIDLOCK GOOD?

The oft-cited market mantra "gridlock is good" suggests that a split Congress, or a President from the opposite party in control of both houses of Congress, would be better for markets. We acknowledge leadership in Washington is only one piece of the story. Historically, the combination of a Democratic President and split Congress has been best for markets, with an average gain of 10.4% for the Dow Jones Industrial Average [Figure 3]. However, that combination has only occurred during the 2010-2014 period (3.5% of all periods), so take those stats with a big grain of salt. Still, this outcome is perhaps the most likely, because--barring a blowout win for Clinton, which could tip the House into Democratic hands--we expect the House to stay Republican and the Senate to follow the White House, where Clinton is currently the favorite. A Republican sweep of the White House and Congress, also a realistic possibility at this point and a fairly common outcome historically (22.6% of periods), has been positive for stocks as well, with an average gain for the Dow of 7%.

3 STOCK MARKET PERFORMANCE UNDER PRESIDENTIAL AND CONGRESSIONAL PARTY COMBINATIONS

	% Gain/Annum	% of Time
Democratic President, Republican Congress	8.6	9.8
Democratic President, Split Congress	10.4	3.5
Democratic President, Democratic Congress	7.2	34.7
Republican President, Republican Congress	7.0	22.6
Republican President, Split Congress	-4.3	10.5
Republican President, Democratic Congress	2.4	19.1

Source: LPL Research, Ned Davis 05/05/16

Dow Jones Industrial Average data back to 1901.

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It's also worth noting that stocks have tended to do better when the incumbent party wins the White House. With Clinton ahead in the polls at this point, one could view that as a positive sign. President Obama's approval ratings have been edging higher recently, which also factors in. But the theory says that the incumbent party wins when the economy is performing well. One could argue, quite rationally, that the economy is disappointing and that Clinton's lead in the early polls is more a function of Trump's higher disapproval ratings than an endorsement of the economy. In other words, we are not sure that a Clinton victory should necessarily be viewed as positive for stocks because of party continuity.

INITIAL POLICY THOUGHTS

A policy discussion at this stage requires a big disclaimer. It is very early. We have little information about Trump's policies. Any policy discussion at this point is speculation. That said, ironically, Trump's and Clinton's stances on several key issues are surprisingly similar:

- Budget deficit and entitlement reforms. Neither candidate seems to have expressed much concern about the federal budget, including entitlement reforms such as raising the age for social security and Medicare. By not aligning with the conservative movement on this issue and avoiding the controversial topic, Trump may fare better in the general election. And Trump's business record certainly suggests he is comfortable with debt.
- Drug pricing. Both candidates have expressed support for the government to negotiate drug prices directly with drug companies for the Medicare and Medicaid programs to help control healthcare costs. The issue of high drug prices has been a political hot button, but prices are likely to remain largely in the manufacturers' hands regardless of who wins the White House in November.
- Foreign trade. Trade policy has been a major issue in both parties' selection process. Trump has made his distaste for current trade policy well known, calling for higher tariffs and other restrictions, particularly with respect to Mexico and China, to get "better deals" for the U.S. Clinton has officially denounced the Trans-Pacific Partnership and as a member of the U.S. Senate, voted against the Central American Free Trade Agreement (CAFTA), which effectively extends the NAFTA agreement to Central American nations.
- Infrastructure spending. Both candidates have supported, at least conceptually, the idea of spending money on public works projects such as fixing roads and bridges to help stimulate the economy and increase employment. In what has in recent years been more of a Democratic position than Republican, the tailwind behind infrastructure spending may get a bit stronger next year.
- Tax reform. At times, both candidates have supported higher tax rates. There does appear to be genuine, and relative bipartisan agreement, on many aspects of the tax code, especially on lowering the corporate tax rate, limiting deductions, and eliminating loopholes. Trump and Clinton are both in favor of eliminating carried interest, an exemption that allows hedge fund and private equity managers to pay low long-term capital gains rates on the majority of their compensation. We expect that regardless of who wins, some changes to the tax code will occur.

We are not saying these candidates are the same, even on these issues. Both candidates will refine their policy proposals as the election nears; both have also shown some flexibility on issues due to political considerations, while the rise of populism will likely have more influence. And certainly Congress will have a lot to say about legislation. It's going to be a very interesting six months.

CONCLUSION

Markets do not like uncertainty, and Trump is certainly unpredictable. But election years are historically good for stocks. Although more volatility may lie ahead, we could potentially benefit from a late-year rally as the

macroeconomic and earnings backdrops improve. So even if the headlines from the campaign trail lead to pullbacks or corrections between now and November, more likely than not, we would view them as buying opportunities.

Thank you to Ryan Detrick and Matthew Peterson for their contributions to this report.

Note: Liberals, conservatives, Democrats, Republicans, and even a libertarian contributed to this bipartisan report.

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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 Dow Jones Industrial Average Index is comprised of U.S.-listed stocks of companies that produce other (non-transportation and non-utility) goods and services. The Dow Jones industrial averages are maintained by editors of The Wall Street Journal. While the stock selection process is somewhat subjective, a stock typically is added only if the company has an excellent reputation, demonstrates sustained growth, is of interest to a large number of investors, and accurately represents the market sectors covered by the average. The Dow Jones averages are unique in that they are price weighted; therefore, their component weightings are affected only by changes in the stocks' prices.
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YET ANOTHER DISCONNECT

KEY TAKEAWAYS

• The BLS recently released the Employment Situation for March, which showed mixed results.

• In our view, the April 2016 employment report underscores a key disconnect between the market and Fed.

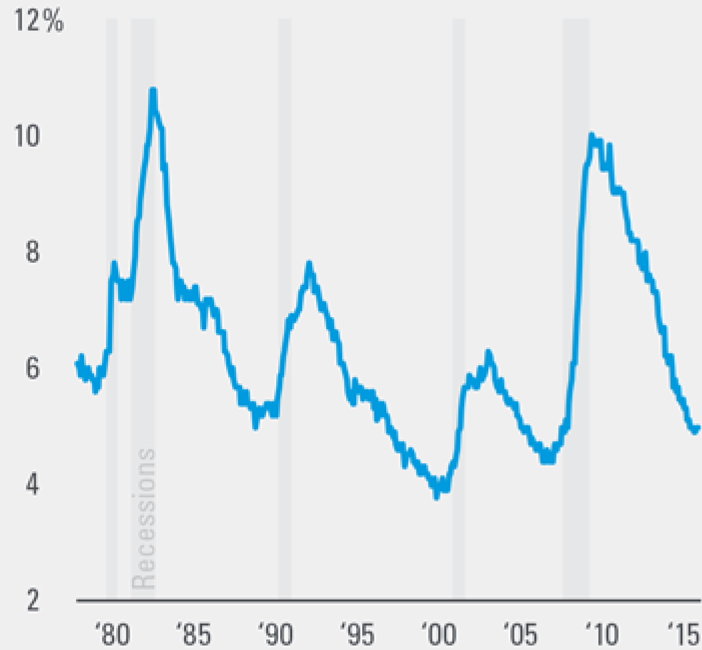
• We believe by the end of 2016, job growth will more routinely be in the 120,000 to 150,000 per month range, a clear deceleration from the average pace over the past six years.

In our view, the April 2016 employment report underscores a key disconnect between the market and Federal Reserve (Fed). What pace of labor market growth is necessary to tighten the labor market, push up wages, and ultimately spark inflation?

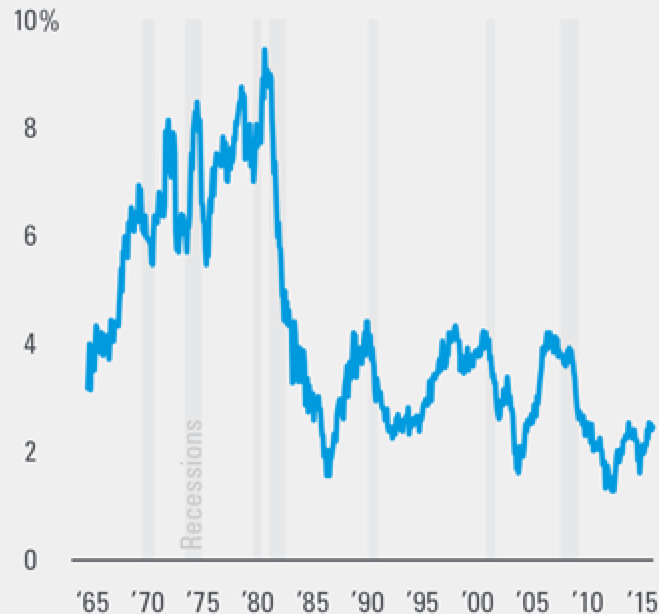
This past Friday, May 6, 2016, the Bureau of Labor Statistics (BLS) of the U.S. Department of Labor released its Employment Situation report for April 2016. Each month, the report generates plenty of attention from market participants, the financial media, and of course policymakers at the Fed, and for good reason. The report provides a timely look at the health of the labor market and one side of the Fed's dual mandate to promote full employment and low and stable inflation; it is also a key driver of consumer spending. The employment report can also help market participants and the Fed make judgments about the amount of slack in the labor market, which, in turn, can provide a window into wage and inflation pressures in the economy, the other half of the Fed's dual mandate.

MIXED APRIL 2016 EMPLOYMENT REPORT

Relative to market expectations and to recent labor market data, the April 2016 employment report was mixed, at best. The economy added 160,000 jobs in April 2016, well below the consensus estimate of 200,000 jobs, and also well below the 200,000+ jobs per month created, on average, over the past six years (since early 2010), which is when the economy began regularly creating jobs again after the end of the Great Recession **[Figure 1]**. The monthly job count is culled from a survey of nearly 150,000 businesses. At 5.0% in April 2016, the unemployment rate (the number of unemployed as a percentage of the labor force, data culled from a survey of 60,000 households) matched the March reading, but was higher than expected (4.9%) by a consensus of economists as polled by Bloomberg News. Aside from the 4.9% readings in January and February of this year, the unemployment rate is the lowest level since April 2008, but remains above the low prior to the Great Recession, 4.4%, hit several times in 2006 and 2007 **[Figure 2]**.



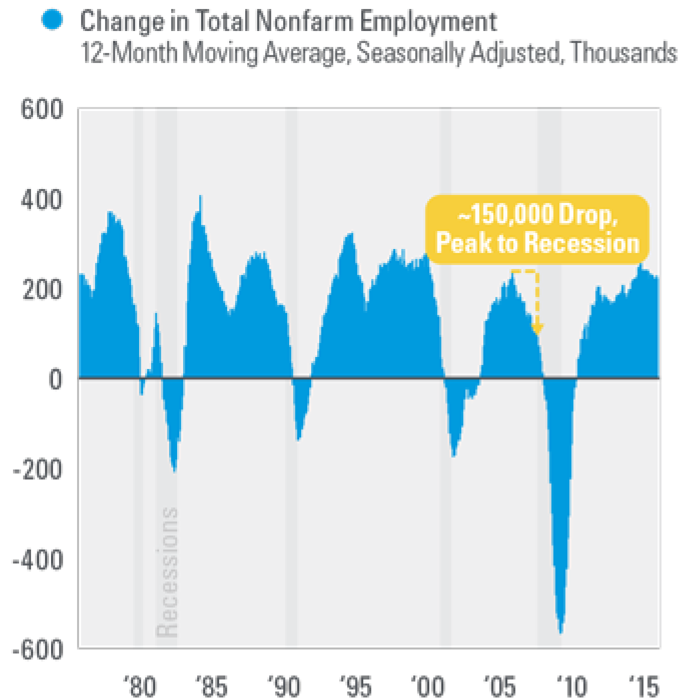
The strongest component of the report-relative to both consensus expectations and recent readings-was the acceleration in wages measured by average hourly earnings, which accelerated to +2.5% year over year in April 2016 from +2.3% in March. The consensus was looking for a more modest acceleration in wages to 2.4% in April. At 2.5%, the pace of wage inflation is the fastest since early 2010, when it was rapidly decelerating from the prerecession high of 4-4.25% hit in 2006 and 2007, down to the low of 1.3% hit in late 2012 **[Figure 3]**. The deceleration in wages years after the end of the Great Recession is typically what happens after the end of a recession.



One final data point worth noting in the April employment report is the reading on temporary help jobs, which showed just 9,000 new jobs added in April, after a similar gain in March and losses totaling 50,000 in the first two months of 2016. This category of jobs-a key leading indicator of future job growth-has shed 27,000 jobs in the first four months of 2016, the worst performance since mid-2009 when the economy was emerging from the Great Recession. If sustained, the slowdown in temporary help jobs suggests a slowdown in overall jobs creation later this year.

DISCONNECT IN PERSPECTIVE

The economy has created an average of 200,000 jobs per month in the past 12 months-despite the tepid reading (+160,000) in April 2016-and there is even a case to be made that the weaker than expected April 2016 reading was "payback" for warmer/drier weather than usual in the first quarter of 2016, which may have artificially boosted job counts in that quarter. In our view, if sustained over the next several months, market participants would likely view this downshift as a sign that the economy is slowing, and may even begin preparing for the next recession and next set of rate cuts from the Fed. Keep in mind that employment is a lagging indicator of the overall economy. In the past 35 years and 5 recessions (1980, 1981-82, 1990-01, 2001, 2007-2009), the average monthly job gain over 12 months typically decelerates by 150,000 to 200,000 jobs before signaling a recession **[Figure 4]**. Applying that rubric to today suggests that the 12-month average on job creation would have to slow from the current 200,000 to around 25,000 to 50,000 per month to indicate that a recession is underway.



But here's where the market and the Fed may be at odds. In a series of public appearances over the past few years, Fed officials noted that monthly job gains as low as 120,000 would still be enough to tighten the labor market, take up slack in the economy, and push up wages and ultimately inflation. Whereas the market would likely view a downshift to job creation of 120,000 jobs per month-or even 160,000 per month-as a sign of a slowing economy, and begin to worry about global growth and the onset of recession.

Based on where we are in the business cycle and the recent downshift in temporary help jobs, we believe by the end of 2016, job growth will more routinely be in the 120,000 to 150,000 per month range, a clear deceleration from the 200,000 per month pace seen, on average, over the past six years. At that point, some market participants may be expecting the Fed to ease; but the Fed, all else equal, will likely be tightening. Yet another disconnect between the Fed and the market to worry about.

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The monthly jobs report (known as the employment situation report) is a set of labor market indicators based on two separate surveys distributed in one monthly report by the U.S. Bureau of Labor Statistics (BLS). The report includes the unemployment rate, non-farm payroll employment, the average number of hours per week worked in the non-farm sector, and the average basic hourly rate for major industries.

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