HBK Wealth Management
Haire · Bohmer · Kilcoyne

WEEKLY MARKET COMMENTARY

A Candid Look into the Current State of the Markets

October 2016

Making a positive impact on as many lives as I can.

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Weekly Market Commentary | Week of October 10, 2016

HIGHLIGHTS

- We believe the earnings recession may have ended in the third quarter.
- We expect potential upside to third quarter estimates due to supportive economic data, stable oil prices, and U.S. dollar stability.
- We will be watching closely to gauge the confidence of management teams in their ability to produce solid earnings gains in the fourth quarter and first half of 2017.

THIRD QUARTER 2016 EARNINGS PREVIEW: GROWTH RETURNS?

We believe the earnings recession may have ended in the third quarter of 2016. As the drags from sharp energy declines and a strong U.S. dollar continue to abate, backed by a pickup in economic growth, the S&P 500 could potentially produce a small increase in earnings on a year-over-year basis in the just-completed third quarter. This week we preview the third quarter earnings season and discuss the always important outlook for management guidance.

CONSIDER THE SOURCE

Different sources such as FactSet, Bloomberg, Standard & Poor's, and others have different calculations than Thomson Reuters for S&P 500 earnings, based on various methodologies and different interpretations of what constitutes operating earnings.

EARNINGS GROWTH RETURNS?

Third quarter earnings season gets underway this week with Alcoa's results after the bell on Tuesday, October 11, followed by nine other S&P 500 companies over the rest of the week. Thomson-tracked consensus estimates are calling for a 0.7% year-over-year decline in S&P 500 earnings (FactSet and Bloomberg consensus figures are 0.5-1.5% lower). Based on the typical quarterly upside of about 3% that companies have historically delivered, a 2-3% earnings gain is a reasonable expectation, even including an expected 3.4% drag from the energy sector. The average upside above estimates over the past five quarters is actually a bit better at 4.5%.

Should the S&P 500 produce an earnings gain, based on Thomson Reuters data, it would prevent the streak of earnings declines from reaching five (or six based on FactSet and Bloomberg data) and end one of the longest earnings recessions-though far from the deepest-in the history of the index. Revenue growth is expected to return in the third quarter as well, breaking a streak of six straight quarterly year-over-year earnings declines (third quarter consensus is +2.6%). Both metrics may have put in a trough [Figure 1].

1 EARNINGS AND REVENUE GROWTH BOTH APPEAR TO HAVE TROUGHED

Source: LPL Research, Thomson Reuters and FactSet consensus estimates 10/07/16

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

THE GOOD NEWS

We expect at least the typical upside to third quarter estimates and, outside of energy, solid earnings gains for several reasons:

- **Supportive economic data.** The Institute for Supply Management's (ISM) Purchasing Managers' Index, one of our favorite earnings indicators, rebounded more than expected in September 2016 to 51.5. Gross domestic product (GDP) in the third quarter is tracking to near 3% annualized growth, a strong pickup from the sub-2% growth pace in the first half of the year. The U.K.'s planned separation from the European Union (EU) has had a limited impact on the global economy, or even Europe, as of yet.
- **Stable oil prices.** Although the energy sector will likely see another significant earnings decline (though smaller than in the second quarter), oil prices held steady during the third quarter and gained some momentum with an 8% increase in September. That may help energy companies, including energy infrastructure companies in the industrials sector, meet or exceed expectations.
- **U.S. dollar stability.** The currency backdrop for U.S.-based companies operating overseas has generally been favorable over the past three months, although the British pound has weakened significantly versus the U.S. dollar. Still, the broad U.S. dollar index inched lower during the third quarter and fell 0.7% year over year, suggesting the currency may not be much of a profit drag during reporting season.
- **Steady earnings expectations.** The recent stability of analysts' third quarter estimates suggests that the typical quarterly upside of 3-4% could potentially be achievable. Consensus analysts' estimates for the quarter have fallen just 0.5% over the past month.
- **Good start.** The 25 companies that have reported Q3 earnings thus far have delivered solid results. Although this is a small number of companies, 80% have beaten earnings targets and 60% have met revenue forecasts, both about 10% above recent quarterly averages.

BROAD-BASED GAINS

Potential earnings gains are expected to be broad based given the improving macro environment, with potentially nine of 10 sectors (excluding energy) in position to produce earnings growth if industrials and telecom are able to produce sufficient upside [Figure 2]. Among widely held sectors, healthcare could possibly deliver the strongest earnings growth during the quarter at 5.5%, followed by technology at 4.5%. We believe these sectors may be well positioned not only to produce solid growth, but also generate good upside given recent earnings performance. Recall technology was the standout performer in the second quarter while both sectors have seen above-average estimate revisions. The drug price controversy is unlikely to have a material impact on third quarter results for healthcare.

2 POTENTIALLY BROAD-BASED EARNINGS GAINS EXPECTED OUTSIDE OF ENERGY

Source: LPL Research, Thomson Reuters consensus estimates 10/07/16

Indices are unmanaged index and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

All sector returns represent S&P GIC sector indices.

POTENTIAL RISKS TO THE DOWNSIDE

There are some risks to earnings meeting expectations, although we see them as manageable. First, U.S. presidential election uncertainty may have led to some cautious spending and slower capital investment during the quarter. Second, European bank concerns may have spilled over into U.S. financials. Third, although the process of leaving the EU has not begun, companies may have seen some impact from Brexit planning even if only through the financial markets. Fourth, although oil prices have stabilized, companies tied to energy capital investment continue to face a challenging environment. And finally, wage gains have picked up a bit and may limit profit margin improvements.

ALL ABOUT THE GUIDANCE

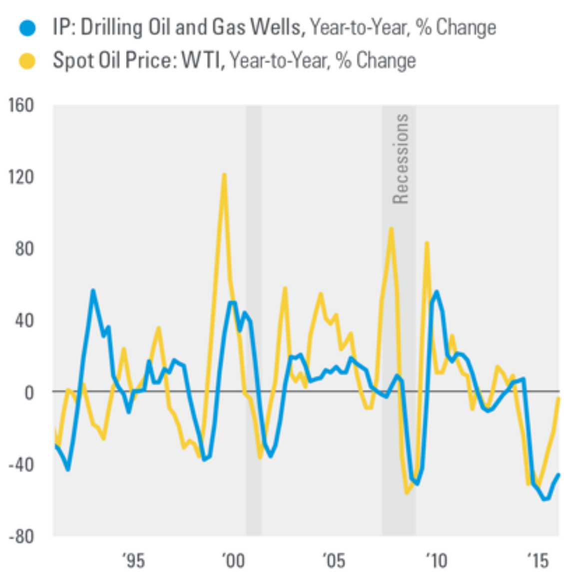
It's always about guidance as stocks trade more on future expectations than past results. Remember that the next 12 months' earnings estimates typically fall 2-3% during earnings season, which means that even a modest decline in estimates during earnings season can be viewed positively.

We expect generally favorable guidance for these reasons:

- **Economic growth is starting to pick up.** We expect the potential pickup in economic growth that occurred in the third quarter to continue through year end and into early 2017, based on our assessment of leading economic indicators. Global growth has been stable, although the U.K. is a risk as it exits the EU, and growth across Europe has been subpar. Bottom line, the macro outlook today is not materially worse than it was three months ago and might be a bit better. Oil prices are on the rise. At a price of $50 (about where West Texas Intermediate crude oil is now), oil prices would be up an average of 19% year over year during the fourth quarter of 2016 and much more in the first quarter of 2017. The relationship between oil prices and energy capital spending is strong [Figure 3].
- **Favorable pre-announcement ratio.** The ratio of companies pre-announcing negative results relative to those pre-announcing positive results, at 2.3, is better than the year-ago (3.1) ratio and the long-term average (2.7). Estimates held up relatively well during second quarter earnings season and may do so again.
- **Future estimates have barely budged.** Estimates for the fourth quarter of 2016 and for 2017 have held up well over the past one and three months, falling just 1.2% and 0.5%, respectively. We do not think the consensus estimates calling for a 14% year-over-year S&P 500 earnings gain in 2017 are realistic (something more like half that is more likely), but we do view the resilience of these estimates as a positive indication that guidance will be supportive.

These factors suggest that mid-single-digit earnings gains in the fourth quarter of 2016 may be achievable (consistent with consensus estimates), which could help support near-term stock market gains.*

3 HIGHER OIL PRICES BODE WELL FOR A POTENTIAL ENERGY SECTOR PROFIT TURNAROUND



Source: LPL Research, FRB, EIA/CME/Haver Analytics 10/10/16

IP = Industrial Production

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.

CONCLUSION

The earnings recession may be coming to an end with third quarter results. There are reasons to suggest that earnings may potentially produce solid upside relative to expectations including mostly favorable economic data, oil price and currency stability, and steady estimates in recent weeks. But it's always about guidance, so we will be watching closely to gauge the confidence of management teams in their ability to produce solid earnings gains in the fourth quarter of 2016 and first half of 2017.

**As noted in our Midyear Outlook 2016 publication, we believe the conditions are in place for a solid earnings rebound during the second half of 2016, due to the easing drags from the U.S. dollar and oil, coupled with minimal wage pressures. A slight increase in price-to-earnings ratios (PE) above 16.6 is possible as market participants gain greater clarity on the U.S. election and the U.K.'s relationship with Europe, and begin to price in earnings growth in 2017.*

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

The economic forecasts set forth in the presentation 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.

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.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

All investing involves risk including loss of principal.

DEFINITIONS

Purchasing Managers Indexes are economic indicators derived from monthly surveys of private sector companies, and are intended to show the economic health of the manufacturing sector. A PMI of more than 50 indicates expansion in the manufacturing sector, a reading below 50 indicates contraction, and a reading of 50 indicates no change. The two principal producers of PMIs are Markit Group, which conducts PMIs for over 30 countries worldwide, and the Institute for Supply Management (ISM), which conducts PMIs for the US.

A Leading Indicator is an economic indicator that changes before the economy has changed. Examples of leading indicators include production workweek, building permits, unemployment insurance claims, money supply, inventory changes, and stock prices. The Fed watches many of these indicators as it decides what to do about interest rates.

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 USD Index measures the performance of the U.S. dollar against a basket of foreign currencies: EUR, JPY, GBP, CAD, CHF and SEK. The U.S. Dollar Index goes up when the dollar gains "strength" compared to other currencies.

This research material has been prepared by LPL Financial LLC.

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Weekly Economic Commentary | Week of October 10, 2016

HOUSING CHECK-IN

KEY TAKEAWAYS

- We continue to expect housing may add to GDP growth in 2017 and for the next several years, as the market normalizes following the severe housing bust of 2005-2010.
- Housing affordability, housing supply, home mortgages supply, and home prices may largely determine the pace at which housing adds to GDP growth in the years ahead.
- At only around 4% of GDP, housing is not large enough to carry the economy by itself.

Economic data released in the next two weeks will shed light on the state of the housing market as the third quarter of 2016 ended and the fourth quarter began, including reports on homebuilder sentiment for October 2016 (due October 18, 2016), housing starts and building permits for September 2016 (October 19, 2016), and existing home sales for September 2016 (October 20, 2016).

In addition, on October 28, 2016, the data on gross domestic product (GDP) for the third quarter of 2016 will be released, providing the first look at what impact housing had on the overall economy in the third quarter and in 2016 so far. Housing-as measured by residential fixed investment-added 0.3 percentage points to GDP growth in the first quarter of 2016 but gave that all back in the second quarter **[Figure 1]**.

Despite the mixed performance so far in 2016, housing boosted GDP growth in 18 of the 21 quarters since early 2011. Prior to that, between late 2005 and late 2010, housing had been a drag on the overall economy in 17 of the 20 quarters (or five years), as the economy endured the housing-induced Great Recession and its aftermath. We continue to expect (per our long-held view) housing may add to GDP growth in 2016, 2017, and for the next several years, as the market normalizes following the severe housing bust of 2005-10, but we acknowledge, that at under 4% of GDP, housing alone cannot carry the U.S. economy.

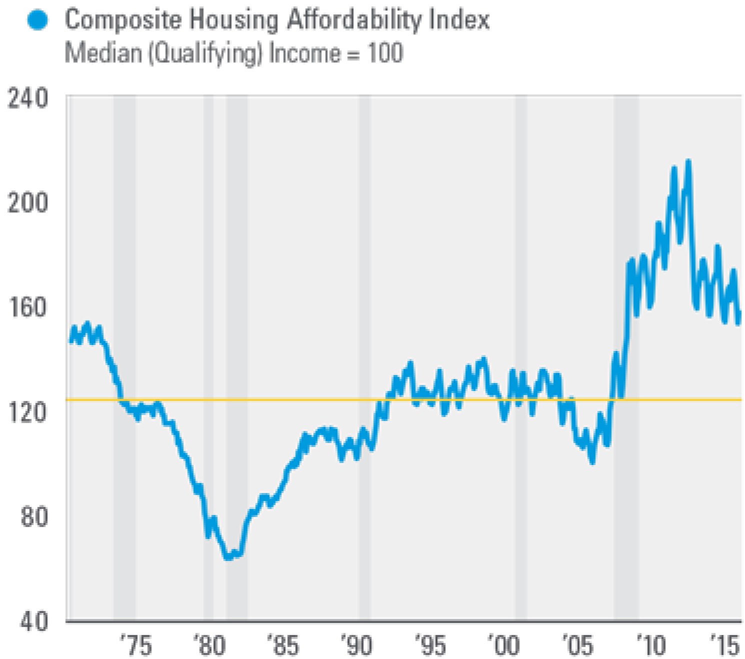
KEY DRIVERS OF HOUSING IN 2016 AND BEYOND

Several factors will likely determine the pace at which housing adds to GDP growth in the coming years. Among them are:

- **Housing affordability.** The ability of a household with the median income to afford the payments on a median-priced house at prevailing mortgage rates hit an all-time high in early 2013, before the big run-up in mortgage rates that began in mid-May 2013, as a result of what is now known as the "taper tantrum." Since then-despite another sharp drop in mortgage rates since late 2013-a combination of rising home prices and sluggish income growth have driven affordability some 25% lower. Although mortgage rates have moved about 100 basis points (1.00%) lower since the end of the taper tantrum, they remain 25 basis points higher than the 2013 lows that preceded it.

  Despite the drop, affordability is well above its long-term average **[Figure 2]** and also well above levels during the mid-2000s housing boom. The three components of affordability-incomes, home prices, and mortgage rates-may all continue to move higher, potentially driving affordability lower back toward its long-term average, but not much below.

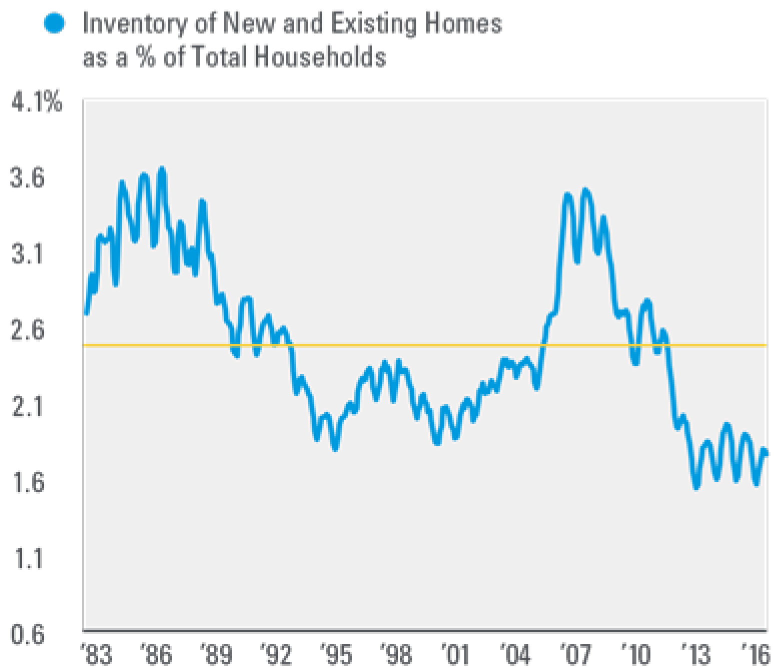
2 RISING HOME PRICES HAVE MORE THAN OFFSET RISING INCOMES AND FALLING RATES



Source: LPL Research, National Association of Realtors, Haver Analytics 10/10/16

- **Housing supply.** At 235,000 units, the number of new single-family homes for sale at the end of August 2016 was well below the peak of nearly 600,000 units for sale in 2006, but above recent lows (140,000-150,000 units). The number of existing single-family homes for sale (1.8 million in August 2016) is 1.6 million units below the peak of 3.4 million set in mid-2007. Combined, the level of new and existing homes for sale remains well below average **[Figure 3]** relative to the number of households in the economy-and the low level of inventory is likely to be a big factor in driving housing construction in the coming years. We'll receive an update on both new and existing home inventories (through September 2016) in the last two weeks of October.

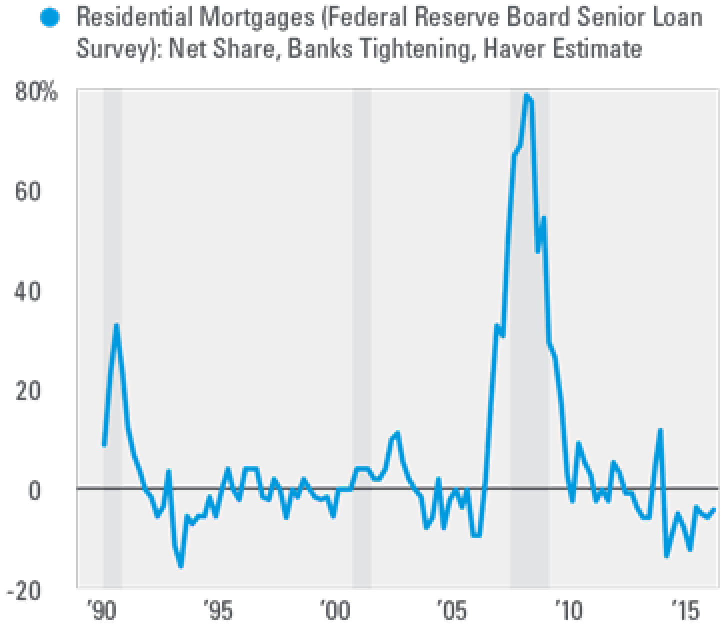
3 THE INVENTORY OF NEW AND EXISTING HOMES FOR SALE REMAINS WELL BELOW AVERAGE



Source: LPL Research, U.S. Department of Commerce, National Association of Realtors 10/10/16

- **Home mortgages supply.** From the mid-1990s through late 2006, bank lending standards (required down payments, credit scores, work history, etc.) for residential mortgages were relatively easy. Coupled with low rates and rapid innovation in financial products backing residential mortgages, this easy credit helped to fuel the housing boom. The banking industry began tightening lending standards in late 2006 and continued to tighten standards for more than two years. Lending standards eased in 2009 and 2010, but remained more restrictive than they were in the peak boom years from 2004-06. The latest survey (third quarter 2016) revealed that although bank lending standards for home mortgages tightened a bit between the second and third quarters of 2016, over the past two years, they have been the easiest in 20 years **[Figure 4]**. The improvement in this indicator in recent quarters is a good sign and may help to offset the recent rise in the rates banks are charging for mortgages. The market will get an update on this metric for Q4 2016, via the Federal Reserve's Senior Loan Officer Survey, in early November 2016.

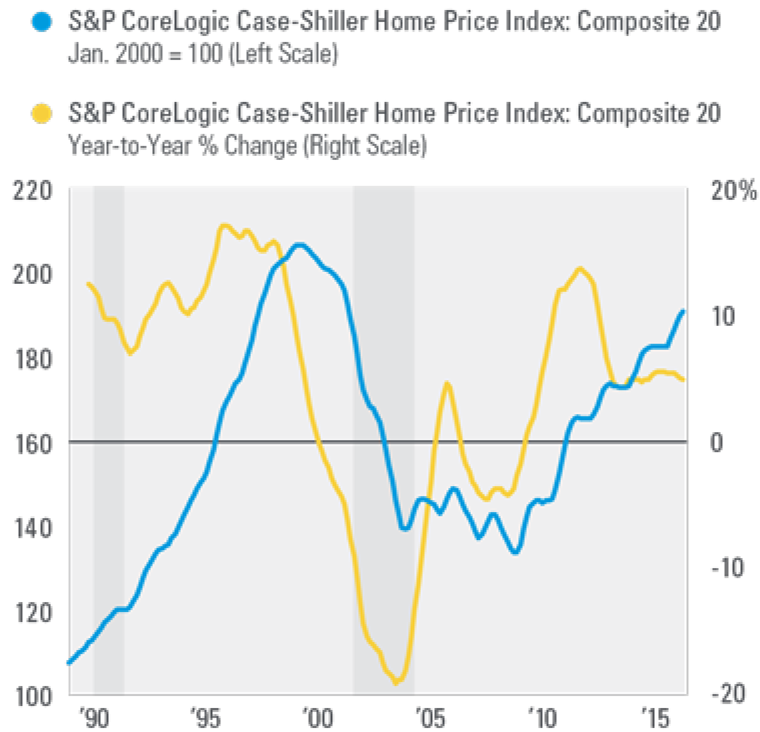
4 IN RECENT YEARS, BANKS' LENDING STANDARDS FOR MORTGAGES HAVE BEEN THE EASIEST SINCE THE MID 1990s



Source: LPL Research, Federal Reserve Board, Haver Analytics 10/10/16

- **Home prices.** The market will have to wait until the final two weeks of October 2016 for an update on home prices via the new and existing home sales reports for September 2016 and the S&P/CoreLogic Home Price Index for August 2016. There are various measures and sources for home price data, which are a component of housing affordability. In general, home prices rose rapidly (much faster than inflation or income growth) in the early 2000s, peaked in 2004-06, fell between 25 and 30% through 2009-10, and have been in recovery mode since then. The S&P/CoreLogic Index **[Figure 5]** is a good proxy for home prices nationwide. It shows the big run-up in prices in 2000-06, the big drop in prices from 2006-09, the sideways move in house prices in 2009-12, and more solid gains in 2013-16. On a year-over-year basis, the Core Logic Home Price, has been moderating over the past two years, after peaking at an unsustainable 14% year-over-year increase in late 2013, to a more sustainable 4-5% pace over the past year. We would view price increases in that range, which would be in line with recent personal income growth and consistent with the average housing price gain in the past 35 years, as a sign that the housing market is stable and poised to be a consistent contributor to GDP growth in the quarters and years ahead, without the boom bust cycle of the 1990s and 2000s.

5 HOME PRICE APPRECIATION IN RECENT YEARS IS TRENDING BACK TO THE LONG-TERM AVERAGE NEAR 4% PER YEAR



Source: LPL Research, Standard & Poor's, Haver Analytics 10/10/16

CONCLUSION

We continue to expect that housing may add to economic growth in the years ahead. Although interest rates are likely to move higher in the coming years, we expect the increases to be modest and in general, we expect the trends that have helped the housing market recover from the housing bust to remain in place. Still, like other segments of the economy that have struggled to recover from the Great Recession, the housing recovery remains choppy and uneven.

IMPORTANT DISCLOSURES

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The S&P/Case-Shiller U.S. National Home Price Index measures the change in value of the U.S. residential housing market. This index tracks the growth in value of real estate by following the purchase price and resale value of homes that have undergone a minimum of two arm's-length transactions. The index is named for its creators, Karl Case and Robert Shiller.

The Composite Housing Affordability Index is published monthly by the National Associate of Realtors and measures median household income relative to the income needed to purchase a median-priced house.

The National Association of Home Builders Housing Market Index is based on a monthly survey of NAHB members designed to take the pulse of the single-family housing market. The survey asks respondents to rate market conditions for the sale of new homes at the present time and in the next six months as well as the traffic of prospective buyers of new homes.

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