HBK Wealth Management
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WEEKLY ECONOMIC COMMENTARY

This Week's Economic Review and Outlook

October 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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FOMC FAQs: WILL THEY OR WON'T THEY?

KEY TAKEAWAYS

- The Fed holds its sixth of eight FOMC meetings of 2016 this Tuesday and Wednesday, September 20-21, 2016.
- With a rate hike unlikely, the Fed may begin to prepare the markets for a hike in December.
- Fed Chair Yellen's third post-FOMC meeting press conference of 2016 provides an opportunity for the Fed to add color to its views of the economy, inflation, and financial market volatility, and to dodge questions about politics.

As the sixth 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. In addition, the FOMC itself seems more divided, with many on the committee ready to raise rates now, while others urge patience.

What Is the Schedule of Events for the Fed this Week?

The FOMC meeting this Tuesday and Wednesday, September 20-21, will be followed by an FOMC statement at 2:00 p.m. ET on Wednesday, along with the FOMC's latest economic forecasts for gross domestic product (GDP), the unemployment rate, inflation, and fed funds projections (aka the "dot plots") for year-end 2016, 2017, 2018, and for the first time, 2019, as well as the "long run." At 2:30 p.m. ET, Fed Chair Janet Yellen will hold her third post-FOMC press conference of 2016, which is her first public appearance since her speech at Jackson Hole, Wyoming in late August 2016.

Has the Market Priced in a Rate Hike at this Week's Meeting?

In short, no. As of Monday morning, September 19, the fed funds futures market has priced in just a 20% chance of a 25 basis point (0.25%) 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, the Treasury note most sensitive to the Fed's actions. The 2-year note yield has moved from 0.55% in late July 2016-in the aftermath of the late June Brexit vote and a weak June 2016 employment report (released in early July 2016)-to just under 0.80% here in mid-September 2016. At just 0.80%, the 2-year yield is below where it was (1.0%) when the Fed hiked rates in mid-December 2015 **[Figure 1]**.

1 THE YIELD ON THE FED-SENSITIVE 2-YEAR NOTE IS STILL BELOW MID-DECEMBER 2015 LEVELS

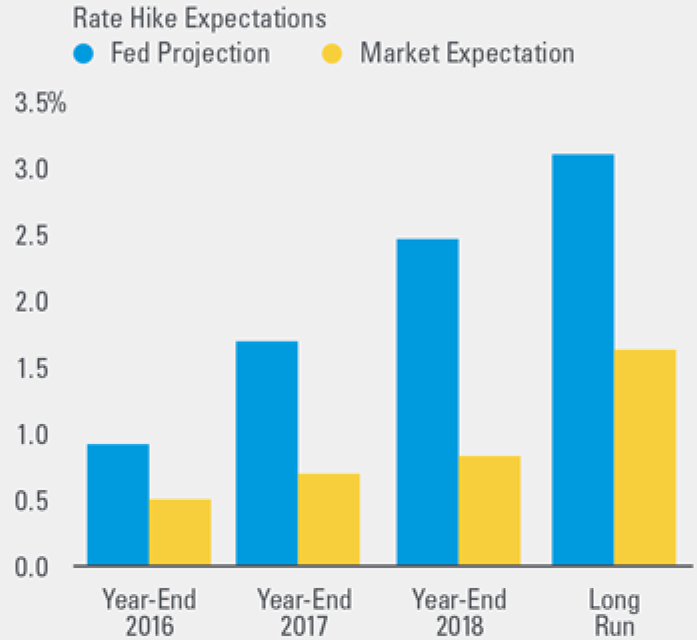
Source: LPL Research, Federal Reserve Board, Haver Analytics 09/16/16

Performance shown is historical and no guarantee of future results.

How Large Is the Disconnect Between the Fed and the Market on Rates?

The FOMC's latest forecast (June 2016) puts the fed funds rate at 0.875% by the end of 2016. The Fed will provide a new set of dot plots this week. As of September 19, the market (according to fed funds futures) puts the fed funds rate at around 0.50% by the end of 2016 **[Figure 2]**, not fully pricing in even one 25 basis point (0.25%) rate hike this year. The latest dot plots (released in June 2016) had put the fed funds rate at 1.625% at the end of 2017, while the market says it will be less than half of that, at around 0.70%. The Fed's June 2016 dot plots put the fed funds rate in the long term at 3.0%, down from 3.5%. As noted in **Figure 3**, the FOMC's view of the long run fed funds rate has moved substantially lower over the past four years, as both economic growth and inflation have come in below their forecasts. The debate over the proper level for the "neutral" fed funds rate-among FOMC participants, and between the market and the Fed-is likely to persist well beyond this week's meeting. On balance, we believe the FOMC will continue to lower its "dot plot," forecasts for 2017, 2018, and perhaps even the "long run" to soften the blow of a rate hike later this year, but not by much.

2 THE DISCONNECT BETWEEN THE FED AND THE MARKET OVER RATES SHOWS NO SIGNS OF ENDING



Source: LPL Research, Federal Reserve Board, Bloomberg 09/19/16

Rate hike expectation may not develop as predicted. Long run is defined as five years.

3 THE FED HAS CONSISTENTLY LOWERED ITS VIEW OF THE LONG RUN FED FUNDS RATE IN RECENT YEARS

Forecast Made:	FOMC's Long Run Fed Funds Rate Forecast
December 2012	4.25%
December 2013	4.0%
December 2014	3.75%
December 2015	3.5%
March 2016	3.25%
June 2016	3.0%
September2016	?

Source: LPL Research; Federal Reserve Board 09/19/16

Rate hike expectation may not develop as predicted. Long run is defined as five years.

Figures are historical and no guarantee of future results.

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.

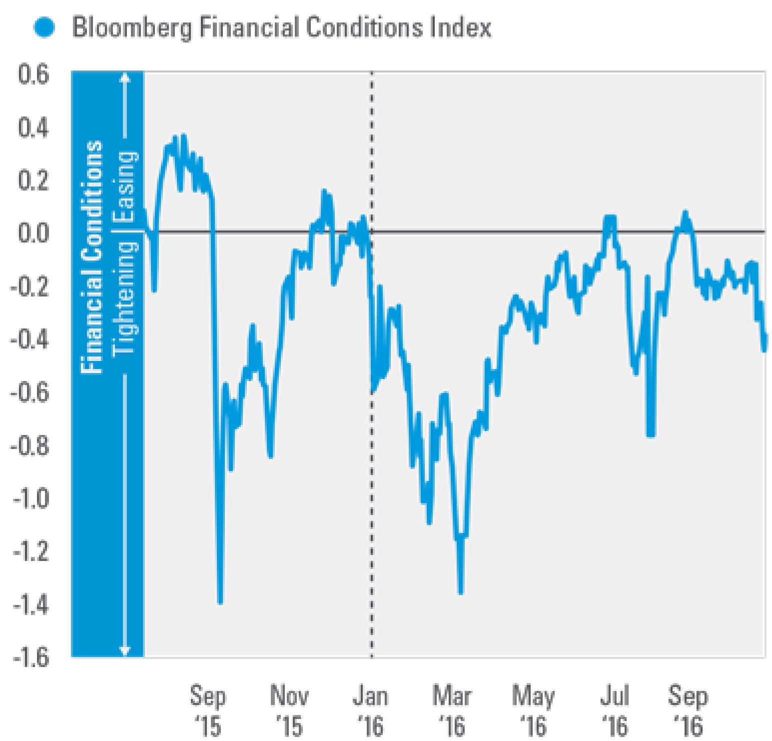
Does the Fed Change Monetary Policy in an Election Year?

It often has and may do it again, despite misconceptions the Fed stands down before major elections. Although 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. We do not expect anything different in 2016, if conditions in the economy and labor force warrant a move. If the data called for a move at this week's meeting, the Fed would likely act. However, the Fed would likely not raise rates at the November 2 FOMC meeting, which is less than a week ahead of Election Day on November 8. The final FOMC meeting of 2016 is on December 13-14, and our view is that the Fed considers that a "live" meeting; the fed funds futures market agrees, currently pricing in about a 55% chance of a hike at the December 2016 FOMC meeting.

Will Global Economic and Financial Conditions Get a Mention this Week?

Until Fed Chair Yellen's speech in late August 2016 at Jackson Hole, a mention of "global economic and financial conditions" made it into every FOMC statement and was part of every one of her major speeches. However, Yellen left this phrase out of her Jackson Hole speech, leading some market observers to speculate that this was a precursor to a Fed hike as soon as this meeting. While financial stress has ebbed from where it was at the start of 2016 **[Figure 4]**, financial conditions have tightened in the past few weeks and remain tighter than they were prior to the Fed's first rate hike in this cycle in mid-December 2015. We expect the FOMC statement and Yellen's prepared remarks may omit the reference to global economic and financial conditions, but Yellen is likely to be asked about the topic during the press conference.

4 ALTHOUGH THEY HAVE EASED SINCE THE START OF 2016, FINANCIAL CONDITIONS HAVE TIGHTENED IN RECENT WEEKS



Source: LPL Research, Bloomberg 09/19/16

Will the FOMC Hint at a December Rate Hike?

We continue to expect that Yellen and the FOMC will stress that future rate hikes are dependent on the economy, labor market, and inflation tracking toward the FOMC's forecasts. Looking back, in its October 2015 statement the FOMC did acknowledge it was determining "whether it will be appropriate to raise the target rate" at its next meeting. And in fact, the Fed did raise rates at its next meeting in December.

The inclusion of this type of language in this week's statement would signal to the markets that the Fed is leaning toward raising rates at the December meeting. However, in our view, any such move would be heavily dependent on the U.S. data released between now and mid-December, and on global financial market stresses caused by the U.S. dollar, China's bad debt problem, the ongoing negotiations around Brexit, a major terrorist event, or even the U.S. election, remaining relatively muted. We continue to expect that the Fed will raise rates in December 2016.

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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.

The Bloomberg U.S. Financial Conditions Index tracks the overall level of financial stress in the U.S. money, bond, and equity markets to help assess the availability and cost of credit. A positive value indicates accommodative financial conditions, while a negative value indicates tighter financial conditions relative to pre-crisis norms.

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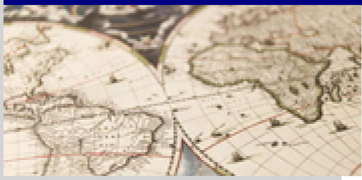


Weekly Market Commentary | Week of September 19, 2016

HIGHLIGHTS

- Earnings growth across emerging market (EM) equities has been positive in contrast to the decline in earnings and earnings expectations in developed international markets.
- Valuations in EM have not increased at the same pace as developed international or U.S. markets, creating a more attractive entry point for the asset class.
- Technical weakness in developed foreign markets is coinciding with reductions in earnings expectations.

EM EARNINGS: BEGINNING TO EMERGE

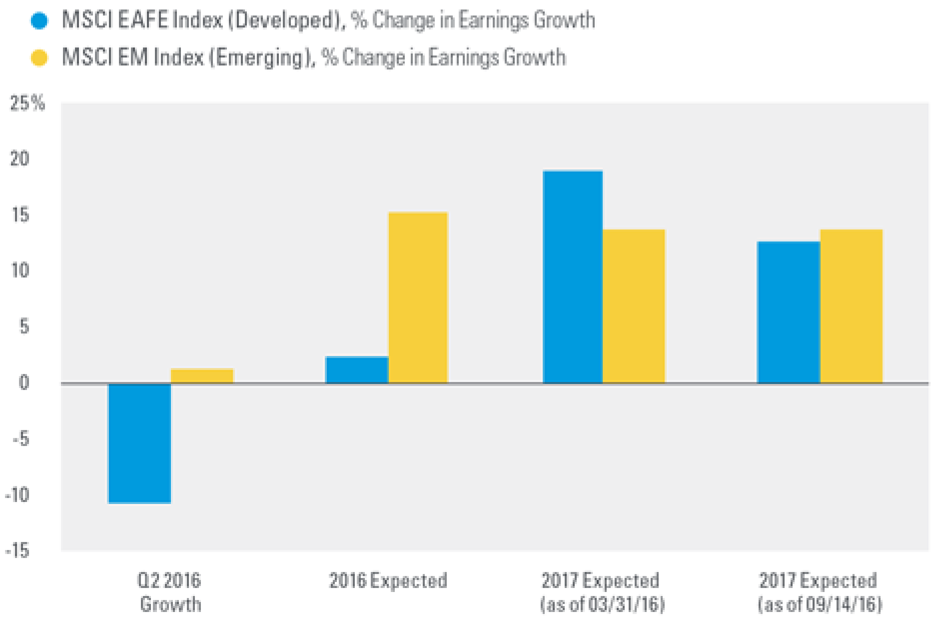
By nature, emerging markets (EM) have greater risks, but they also have attractive attributes relative to developed foreign markets. For most markets, earnings have been stagnant while valuations--what investors are willing to pay for those earnings--have increased. In contrast, emerging markets are beginning to see earnings actually increase, albeit modestly. Initially, EM earnings growth was driven by commodity related sectors, but has broadened out, most importantly to include financial stocks. Furthermore, valuations in EM have not experienced the same expansion as other markets. As the earnings picture is souring for developed foreign markets, represented by the MSCI EAFE Index, overall, these developments increase the relative attractiveness of EM stocks.

International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. These risks are often heightened for investments in emerging markets.

IMPROVEMENT FOR EM EARNINGS

Given that the global financial markets have been in an earnings recession, emerging markets have experienced both earnings growth and improved expectations for future earnings growth. Admittedly, this growth is modest in both respects, but it is in stark contrast to prolonged earnings weakness in Europe [Figure 1]. EM earnings rose 1.3% year over year in the second quarter of 2016, a gain made more significant because at the beginning of the quarter, expectations were for a 6% earnings decline. More importantly, whereas 2017 earnings forecasts for the EAFE Index have declined over the past five months, expectations for EM are essentially unchanged. The fact that EM earnings have grown, and have exceeded expectations, has created greater confidence in forecasts. The poor performance in developed overseas markets has forced the market to lower expectations for the future.

1 EMERGING MARKET GROWTH PULLING AHEAD



Source: LPL Research, FactSet 09/14/16

Earnings growth expectations may not develop as predicted.

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

The source of earnings growth is also telling, and shows the contrasts between developed and emerging economies. Earlier in the year, we saw EM earnings growth largely in commodity-related companies, as prices of not only energy, but also copper, iron ore, gold, and other commodities rallied after the sharp decline in late 2015 and early 2016. However, commodities no longer dominate the EM stock universe. In March 2011, commodity stocks represented nearly 40% of the index; today, energy and materials together only comprise 13.4% of the index. However, commodity-related stocks still "punch above their weight" by affecting stocks in other sectors, and entire national economies for countries like Brazil and Russia are heavily tied to commodity prices.

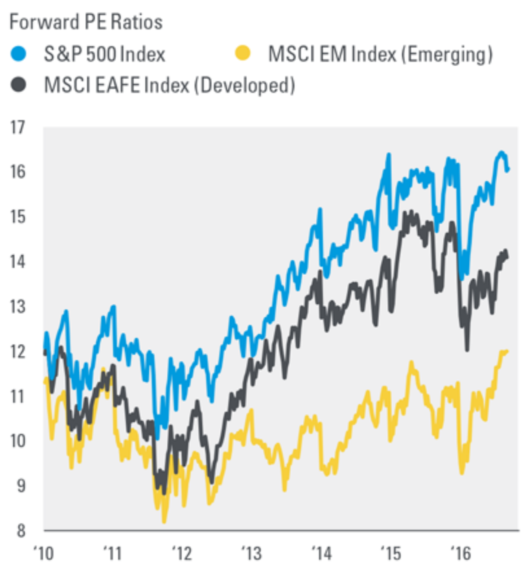
Today, financial stocks are the largest sector in both the MSCI EM and EAFE Indexes, at 26.5% and 19.2%, respectively. As has been well documented, the negative interest rate environment across the developed world has affected earnings and the performance of financial stocks. However, negative rates are a developed market phenomenon only; emerging countries tend to have much higher interest rates. In fact, the farther a country is removed from the global economic mainstream, the higher its interest rates tend to be. For example, export-dependent countries like South Korea and Taiwan have very low, though still positive, rates at 1.25% and 1.375%, respectively; while countries like China and India are at 4.35% and 6.5%. Rates are even higher in less politically stable countries, like Russia, where the central bank just cut rates to 10%, and Brazil, where short-term rates are 14.5%.

We can see the impact of low rates on financial earnings. Second quarter 2016 earnings for the developed world financial sector (defined by the MSCI EAFE Index) declined -11.6%. Equally, if not more important, expectations for earnings for the rest of 2016 and for 2017 have been reduced. At the end of March 2016 (before any first quarter earnings were released), financial sector earnings for the year were expected to be flat. Currently, consensus expectations are for financial sector earnings to decline -9.8% for the year. The outlook for developed market financials has become even gloomier. In contrast, earnings for financial companies in EM actually grew by 2.7% during the second quarter. While not much, it is certainly much better than in developed markets. Furthermore, expectations for financial company earnings for the rest of the year really have not changed from March 31 to today. The market is expecting financial earnings growth of just over 14% for 2016.

VALUATIONS EMERGE AS ATTRACTIVE

Earnings growth is important, but so is what investors are willing to pay for earnings. Low interest rates globally have encouraged investors to buy stocks seeking greater total returns, and increasingly seek income from dividend-paying stocks rather than from bonds. As noted above, EM interest rates have not had the same magnitude of decline; in some markets, rates remain quite high. This is one reason that EM valuations have not expanded as rapidly as the same measures for the U.S. and EAFE [Figure 2]. Globally, we see price-to-earnings ratios (PE) generally follow each other across the regions. This makes sense, despite regional differences; all stock markets operate in a world that became increasingly globalized. However, valuations for both the U.S. and EAFE expanded rapidly, partially because of the cumulative impact of the Fed's third quantitative easing program that began in September 2012 and further interest rate reductions by the European Central Bank (ECB) in May 2013. Equity markets in the U.S. rallied, but with PE expansion as a significant part of that rally. The reverse happened in EM. Stock prices fell and valuations for the asset class contracted. We believe this divergence may represent an opportunity, but only if earnings continue to increase.

2 EMERGING MARKET VALUATIONS RELATIVELY ATTRACTIVE



Source: LPL Research, Bloomberg 09/12/16

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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.

COMBINING FACTORS

LPL Research uses a combination of fundamentals, like earnings growth, valuations, and technical factors in evaluating investment opportunities. While this commentary focused mostly on EM, several previous commentaries have focused on Europe, which is the primary component of the EAFE Index. We can use the activity in the European markets to show how these factors combine. Valuations have increased in Europe, though not to the same extent as for U.S. equities. Earnings in developed overseas markets have declined and expectations continue to fall. The technicals are telling us that the market has real questions about European fundamentals. Overall, Europe continues to lag, as nearly all European country stock markets are down in 2016, with the Financial Times Stock Exchange (FTSE, the primary U.K. stock market gauge) the surprising outperformer. Technically, the EURO STOXX 50 has been in a downtrend for more than 15 years. Focusing on more recent market activity [Figure 3], the EURO STOXX 50 ran into firm resistance from a trend line going back to the April 2015 peak. We can see in this example how the three components of our process can reinforce each other, and in this case reinforce our caution with respect to Europe and developed international equities in general.

3 EUROPEAN STOCKS HITTING RESISTANCE

Source: LPL Research, FactSet 09/16/16

EURO STOXX 50 is an unmanaged index and cannot be invested into directly. Past performance is no guarantee of future results.

CONCLUSION

Emerging markets have seen earnings increase and future expectations remain stable. This improvement has occurred across many sectors, including the important financial sector. Combined with relatively attractive valuations, we believe opportunities exist in EM for suitable investors, though strength in these markets will likely depend on continued earnings growth. We can see how disappointing earnings can impact performance, and therefore the stock charts and technicals, by looking at recent technical weakness in European stocks.

Thank you to Ryan Detrick for his contributions to this report.

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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 MSCI EAFE Index is recognized as the pre-eminent benchmark in the United States to measure international equity performance. It comprises the MSCI country indexes that represent developed markets outside of North America: Europe, Australasia, and the Far East.The MSCI Emerging Markets Index captures large and mid cap representation across 23 emerging markets (EM) countries. With 822 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The EURO STOXX 50 Index is a blue-chip index for the Eurozone, which covers 50 stocks from 12 Eurozone countries: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain.

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Market Watch | September 2016

Dear Valued Investor:

After a very quiet stretch for stocks in the second half of the summer, market volatility has returned in September. Much like shifting to busier fall schedules once September and the new school year begin, this pickup in volatility we've seen is normal from a historical perspective, but does require some adjustment after a quiet summer. Here are some of the key items to watch as we make our way through one of the most historically volatile months of the year.

What's been driving the recent increase in market volatility? Not surprisingly, the Federal Reserve (Fed) has been playing an important role. When central bank policy is helping to support the economy (sometimes called "loose monetary policy"), it tends to lower volatility. Market participants see central bank support as a backstop. Over the last month, there have been a number of Fed officials, including Chair Janet Yellen, who have signaled that an additional interest rate hike (the first since December 2015) may be warranted given improving economic data, including job growth in June and July that was well above expectations. Our view remains that these comments are likely aimed at acclimating markets to a December 2016 rate hike, considering the weaker August jobs report, but a September hike remains a possibility.

Although the Fed's gradual moves toward a more neutral role in the economy may increase market volatility, historically, at these early stages of rate increases, it has had little impact on stock returns. That's held true for this last year or so too. As of the end of August, the S&P 500 Index had a total return of a little over 6% since the Fed's first rate hike in almost 10 years, which occurred back on December 16, 2015. What may be more important for stocks is a pickup in earnings growth. Thomson Reuters estimates put third quarter earnings growth for the S&P 500 at near flat, followed by meaningful acceleration in the fourth quarter of 2016 and into 2017.

One other shift we've seen recently is the rise in the 10-year Treasury yield. Although this increase was jarring for some investors, it does not seem to be indicating the start of a major bond sell-off; instead, it is more likely that the market is already preparing for potentially reduced central bank stimulus overseas and an upcoming Fed rate hike. A market on guard for a rate hike is much less likely to be shocked by one, and thus potentially less likely to produce a significant sell-off.

We continue to see little evidence signaling we may be on the verge of a recession, despite increased financial market volatility. The chance of a recession in the next year is at about 20%, based on economic indicators that have historically led the economy. Economic data on the whole have improved over the last several months, although reports received in August and early September were not quite as strong. Absent a recession, an earnings rebound over the next several quarters, if it materializes, should help support financial markets.

U.S. elections will also continue to grab headlines over the next almost two months. America will go to the polls on Tuesday, November 8, with presidential debates scheduled for September 26, October 9, and October 19. Early voting starts as early as Friday, September 16, when battleground state North Carolina becomes the first state to mail out absentee ballots. Markets historically have not signaled any real preference for one party or the other, but markets do dislike uncertainty and volatility could pick up pre-election if polls continue to be close; however, both candidates have the capacity to settle markets once the election is behind us.

While uncertainty around the election and the Fed bears watching closely, we continue to believe that the most important factors in reaching financial goals are not short-term market drivers but sound advice, a good plan, and patience. The school year often begins with a new assignment book for students to help them learn to stay on track (although, as with so many things, these days there's an app for that). Although we do want to check in on our progress from year to year or as circumstances require, the "assignment book" in financial planning typically covers decades and requires slow, steady progress. Staying focused on those long-term goals can help maintain perspective as we enter a potentially more volatile fall.

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

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