GODSEY & GIBB
WEALTH MANAGEMENT

INVESTMENT WATCH

October 2016

Global risk increasing, but U.S. fundamentals remain solid.

As we enter into the final quarter of 2016, the U.S. economy continues to grow at a moderate but somewhat uneven pace driven by a healthy consumer. Interest rates remain near historically low levels due to an extremely cautious Federal Reserve and the global search for yield. Outside of the U.S., economic growth is positive but mixed, with some strength in the Asia-Pacific countries (excluding Japan, which is experiencing weakness) and low growth in Europe. We still face headwinds from volatile currencies, rising geo-political risks, ongoing worries about the future of the European Union and the U.K economies after Brexit, and in the U.S. the uncertainty brought about by a highly contentious Presidential election. While the headwinds have created plenty of volatility, the economic fundamentals remain steady.

The economy has continued to gain some momentum as the year has progressed. Economic activity was slower at the beginning of the year, but picked up in the latter part of the spring and continued to improve over the summer. The U.S. economy grew at a 1.4% pace in the second quarter and is expected to have grown around 2.5% for the third quarter. The consumer remains the main driver of economic growth, accounting for nearly 70% of activity. We are also seeing a small but positive contribution from the housing sector as well as from the government sector. Business investment remains somewhat uneven from quarter to quarter as companies remain hesitant to spend, particularly given the uncertainty of the election and the potential for very different policy outcomes. Regardless of who wins the election, it is likely that we will see some increase in fiscal spending at the federal level next year. However, some of that may be offset by reduced spending at the state and local levels as tax receipts have begun to decline.

Despite the seemingly endless negative headlines, consumer confidence remains strong and reached a nine-year high in September. While the pace of job gains is beginning to slow, we are still seeing steady growth in employment, and through September, 1.6 million new jobs have been created. In addition, and perhaps more importantly, we are starting to see a moderate expansion in the labor force participation rate, as previously discouraged workers reenter the workforce. With more people employed, it is becoming more difficult for employers to fill open positions, and that is helping to push wages higher. Higher wages along with still-low energy costs have increased disposable income which in turn leads to increased spending. While more traditional retail spending has been weaker, we are still seeing gains in larger ticket items such as autos and appliances.

Equity markets ended the third quarter higher on the improved economic activity. The S&P 500 rose 3.8% in the third quarter driven by a strong rally in technology and financial stocks. Unlike the first half of this year, the more defensive sectors underperformed those more closely tied to economic growth. Through the first three quarters of the year, the S&P 500 is up 7.7% with defensive sectors such as Utilities and Telecom leading the way.

In response to better economic growth, interest rates have begun to move off of historic lows. After reaching a record low of 1.3% in July, the 10-year U.S. Treasury bond is now yielding 1.7%. Shorter-term interest rates have also moved higher in anticipation of a potential move by the Federal Reserve. Given the current economic conditions, the bias should be towards higher interest rates; however, given the very cautious Fed and the low to negative interest rates globally, significantly higher rates may be slow to materialize.

The Federal Reserve continues to vex the market and has contributed to investor anxiety. After raising rates a quarter

RICHMOND, VA
6806 Paragon Place, Suite 230
Richmond, Virginia 23230
(804) 285-7333

VIRGINIA BEACH, VA
4445 Corporation Lane, Suite 218
Virginia Beach, Virginia 23462
(757) 213-6862

GREENVILLE, SC
40 West Broad Street, Suite 350
Greenville, South Carolina 29601
(864) 312-5130

COLUMBIA, SC
1501 Main Street, Suite 400
Columbia, South Carolina 29201
(803) 254-9241

of a point in December 2015, market expectations were for the Fed to hike rates several times this year. However, to date we have seen no action from the Fed and more often than not we seem to get mixed signals from the various Federal Reserve Bank Presidents as well as from Chairperson Janet Yellen. Our expectations were that the Fed would begin the process of normalizing interest rates, moving away from the near zero rates that have been in place since the financial crisis. While the unemployment rate has been hovering around 5%, inflation has remained below the Fed's 2% target. Declining energy prices over the past two years have been a large contributor to the decline in inflation, while prices in other areas of the economy have moved marginally higher. In this environment it is getting harder for the Fed to justify "crisis era" monetary policy. There are two more Fed meetings this year, one in November and one in December. It has long been a preference of the Fed to not make changes to policy just prior to a Presidential election. Given that and the recent data, it appears that they will vote to raise the funds rate by 0.25% at the December meeting, but as has been the case for most of this year, new data and potential global events could cause them to push a second rate hike into 2017.

While we wait to see when the Federal Reserve might take another step towards normalizing interest rates, foreign central banks are moving towards easing monetary policy in order to stimulate growth. The European Central Bank recently extended its bond-buying program to include purchases of corporate bonds. As a result, we recently saw several high-quality German corporations issue new debt at negative yields. Across Europe there are negative yields on government debt out to about a 7-year maturity and corporate debt out to a 5-year maturity. Negative yields are also in place in Japan, where the central bank recently announced a policy targeting a zero yield on 10-year government debt. Since the vote to leave the European Union, the British Pound has fallen to decades-old lows. However, the stock market in the U.K. has been one of the best performers this year. The true economic impact from this decision will play out over the longer term.

Since reaching a low in mid-February, oil prices have been slowly moving higher and have recently closed above $50 a barrel. Price increases have been driven by an improving supply/demand outlook. While it took longer than expected to materialize, U.S. production of oil has started to decline, removing some excess supply from the market. Global inventories have been coming down as global demand for oil continues to rise. More recently, we have begun to see some suggestion from OPEC and non-OPEC foreign producers that they will reduce output. While these countries benefit from a lower cost of production for oil, they depend on oil revenues to fund government spending, including large welfare programs. Two years of very low prices have strained government budgets and have led these countries to consider production cuts to stabilize prices. Time will tell whether cuts in production are actually implemented, but the outlook is improving. The combination of improved pricing and lower cost of production in the U.S. has improved the outlook for U.S. oil companies. Despite the better outlook, it would likely take higher prices for a longer time before these companies would look to add new production. In the meantime, the current price range is supportive of improving profitability for oil producers, while still being low enough to benefit consumers and business users of energy.

We expect the economy to continue to grow at a moderate pace for the foreseeable future, supported by a healthy and confident consumer. Within our growth portfolios, we remain focused on companies that have the ability to generate strong earnings growth despite the more moderate global growth. In our income portfolios we are focused on good stable companies with strong cash flow generation that can support and grow dividends. Within the fixed income allocation we remain focused on generating incremental yield in a risk-managed framework. We recognize that global headwinds remain, including the U.S. election. However, we believe that while these headwinds can impact the short-term performance of the market, we remain focused on the long-term outlook. We continue to closely monitor the economy and the financial markets and remain poised to act if we see any change in the long-term fundamentals.