market & economic

OUTLOOK 2017

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JASON RITZENTHALER, CFA, CTFA

01 EQUITY MARKET OUTLOOK

What a difference a year makes! In many respects, 2016 was the polar opposite of 2015. Not only were equity returns as a whole much better, but we also saw a large divergence of returns within equities. Investors were rewarded for sticking to their long-term investment plans and maintaining diversified portfolios. 2016 ended a two year period where investors had seen higher returns owning only the S&P 500 versus a basket of equities, both in the US and abroad. Over the long-term, a diversified basket of equities helps to reduce risk and improve returns.

For the year, US small and mid caps led the way with returns of 26.46% and 20.73% respectively. The S&P 500 gained 11.95% while International emerging markets returned 11.27%, after losing some steam in the fourth quarter down 4.31%. International developed markets again trailed with returns of 1.59%. Value stocks reversed their 8% under-performance relative to growth stocks from 2015 and finished up 17.39% while growth stocks gained 6.89%. Financials were the largest contributor with gains of 22.75% this year versus losing 1.56% in 2015. Energy had the largest rebound gaining 27.36% after losing 21.12% in 2015.

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01 JASON RITZENTHALER, CFA, CTFA
EQUITY MARKET OUTLOOK

Although it hasn't been talked about much recently with all the political theater, we also saw an end to the year-over-year corporate earnings recession that lasted nearly two years with Q3 S&P 500 earnings growing 3%. We expect Q4 to continue growth at a rate of 3.2% which would be the first time we have seen back-to-back growth since Q4 2014 and Q1 2015. If corporate profits improve faster than expected then that alone could reduce the price-to-earnings (P/E) multiple on the overall market without a significant price decline. As it stands now, US equities are near the upper band of the normal range but keep in mind that these conditions can last quite a long time. International markets are closer to their median valuation levels.

Our expectation is for US equity market returns to be below long-term averages for 2017 with the S&P 500 returning ~6%. Movement on corporate tax reform and fiscal stimulus could improve market gains, but we will believe it when we see it. We expect international markets to do better given more accommodative monetary conditions from the European Central Bank and Bank of Japan combined with more attractive valuations. Our expectation is for US GDP growth to improve on 2016 coming in between 2.5-3%. We are finally seeing signs of wage growth in the US with year-over-year gains of nearly 3% which was the fastest pace in seven years.

Contrary to perception, volatility was historically low last year and 2017 has started out at the lowest levels since 1962[1]. Reversion to the mean tells us we are likely to see more not less volatility this year. Keep in mind that we average one 10% or more decline each year. We don't know when this may happen again, but we do know the S&P 500 has rallied over 10% since the November 2016 lows. Our investment discipline and commitment to managing risk led us to reduce risk and take profits in accounts after the first of the year. We are still bullish on the markets and economy for the year. Similar to 2016, these tactical changes within accounts will give us the flexibility to be buyers of equity again if we do get some declines. Thank you for your confidence in the MTC investment team, and we look forward to another fantastic year!

[1] *S&P Dow Jones CFA, CTFA Indices*

02 SHELDON REYNOLDS, CFA
GEO-POLITICAL UPDATE

By their very nature, geopolitical risks can be unpredictable. However we should be vigilant in monitoring those things that we believe could have impact on the equity or fixed income markets. While there are many risks, we have highlighted a few that we feel have the probability to be most impactful.

BREXIT

In June of 2016, the citizens of Great Britain voted to leave the European Union. After the vote, Prime Minister David Cameron stepped down, as he was not a supporter of the initiative. Theresa May then took over as the new Prime Minister. Initially, she planned to trigger article 50 of the Lisbon treaty (the mechanism for leaving the EU) at the end of March unless the Supreme Court required parliamentary approval of article 50. However, in a press conference on January, 17th she indicated that she would put the matter before both houses of parliament for a vote. The impetus for the affirmative Brexit vote included a renewed British nationalism, concerns about immigration, and concerns that increasing European debt would have negative impacts on the British economy in the future. Most Scottish voters, did not support the Brexit initiative, leading to renewed concerns that Scotland may be more likely to split from Great Britain in the future. Will Brexit lead to further disintegration of the E.U. in the future?

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02 SHELDON REYNOLDS, CFA
GEO-POLITICAL UPDATE

RUSSIA

2016 saw Russia continue to flex its muscles throughout the world. Russia provided military support for the Assad regime in Syria, ultimately resulting in the destruction of the rebel forces in Aleppo. It appears that the Putin government plans to play a larger role in Middle East affairs. American intelligence agencies have also accused the Russian government of the hacking of key Democrats' email accounts and the dissemination of false news through the RT TV network in an attempt to influence the outcome of the U.S. Presidential election. Russia also continued to deploy additional military forces near Ukraine in 2016 – saber rattling or preparations for something big? What does Russia have planned for this year?

CHINA

China continues to expand territory in the South China Sea by militarizing man made islands in disputed areas and building airstrips long enough to land any type of plane. They are piling sand onto reefs to create new islands located near Philippines, Malaysia and Vietnam in an effort to extend their area of sovereignty. It is also feared by their neighbors that China will exert more control over fishing in the region.

China also stole and briefly detained a U.S. underwater spy drone which was patrolling this area. Could these ongoing disputes evolve into a much larger problem for the affected countries and the U.S.?

TURKEY

In July an attempted coup against the Turkish government took place. After the coup, Turkish leader Erdogan engaged in a series of purges of military personnel to firm his grip on power. Erdogan is considered a populist Islamic leader, with ambitions of becoming a larger player in the Middle East. The U.S. relationship with Turkey is complicated, as we support Kurdish rebels in Iraq whom the Turks view as terrorists. Erdogan also initially made accusations that the U.S. may have been involved in the attempted coup. Turkey is a NATO member. Turkish relations with Russia seem to be improving, with a 2016 agreement to revive a natural gas pipeline project which would make it easier for Russia to cut off gas to neighboring countries, like Ukraine, without disrupting supplies going to Western Europe. Erdogan's ambitions, whatever they are, could be of increasing importance going forward.

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02 SHELDON REYNOLDS, CFA
GEO-POLITICAL UPDATE

TERRORISM

Terrorism remains a potential risk. Terrorist attacks by Islamic extremists continued in 2016 and include:

- **DECEMBER:** Attack via truck in Germany killed 12 – ISIS claimed responsibility
- **JULY:** At least 84 people killed in Nice France by truck attack – ISIS claimed responsibility
- **JUNE:** 44 killed at Turkey's Ataturk Airport – Islamic State is believed to be behind attack
- **JUNE:** 49 people were killed at an Orlando Florida nightclub by Omar Mateen, who stated that he was inspired by Islamic State
- **MARCH:** Brussels - 32 people dead in 3 coordinated bombings. Two at an airport and one at a subway station. Islamic State claimed responsibility.

None of these acts of terrorism adversely affected the major U.S. stock market indexes but a large-scale act of terrorism has the potential to affect global markets.

We will continue to monitor global events and consider their consequences in our asset allocation and weighting decisions in our portfolios. Let's hope that 2017 is a quiet year and that peace, freedom and prosperity will be the norm throughout the world.

03 KATE BRADDOCK, CFA
FIXED INCOME OUTLOOK

In December, the Federal Reserve Bank raised rates to the 0.5% - 0.75% range after a 12-month pause. This was widely expected by the markets and we saw little reaction. The economy has expanded for the past ten quarters, hiring has stabilized and the unemployment rate has fallen to its lowest level in more than nine years. Federal Reserve Chairwoman Janet Yellen stated that the central bank's decision to raise interest rates was "a vote of confidence in the economy." We had started 2016 looking for four additional rate increases. Instead, due to a weak employment number in May and the Brexit vote in June, we got just one.

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KATE BRADDOCK, CFA

03 FIXED INCOME OUTLOOK

Interest rates are dictated by the strength of the economy and thus the potential for inflation. In 2016, we saw job gains averaging close to +200,000 a month and unemployment at 4.7%. The final employment reading in December added 156,000 jobs, bringing the annual gain to just under 2.2 million. This was the 75th consecutive month of job gains. Wages are starting to show signs of firming. Consumer confidence is at a nine year high and GDP estimates are running in the 2.5%- 3% range. Corporate profits emerged from recession in the third quarter, rising 5% year over year. This was the first positive year over year growth that we have seen since 2014.

Treasuries continue to trade in same range as they have since 2012, but in 2016 we touched a new low. The ten-year treasury traded as low as 1.3% in July following the Brexit vote as investors across the globe flocked to the safety of US bonds causing their yields to compress. Since the US Presidential election in November, rates have increased from 1.8% to 2.4%. Most are calling July 2016 the end of the 30-year bond bull market. Over the same period, we saw big gains in the high yield market as the recovery in the oil fields decreased the expected default rate.

Going forward, as we look to 2017 and what it might bring to the bond market, we expect to see a transition of focus from monetary policy to fiscal stimulus. We are currently expecting three further rate hikes over the course of the year but this will be data dependent and is yet to be determined. As the new administration enters office and begins to implement proposed policy, we will be closely monitoring the economic effects. Inflationary pressures include OPEC production cuts leading to increasing oil prices. The potential for trade restrictions and increased tariffs causing import prices to increase. A more rigorous immigration policy could increase wages, and a repeal of Obamacare will most likely result in higher medical costs for many.

Finally, our economy is currently running at close to full employment and the numbers are beginning to reflect rising wage pressure. Although the yield curve has started to shift upward, we would expect further upward shifts to be constrained due the relative attractiveness of US bonds on the international stage.

04 JOHN LARGENT, CFA, CFP®, CAP, CCE
2017 FORECAST

Regarding the US stock market, 2016 was a much better year than 2015. The S&P 500 gained 11.95% - somewhat above our target but we'll take it. The fixed income markets did okay too. It was mostly a coupon year with interest rates on the ten-year treasury starting out just a bit lower than the close at 2.45%.

2017 is starting out strong but we believe that there will be opportunities to add to the stock market at lower levels sometime during 2017. Members Trust Company's Investment Team Forecast for 2017 is as follows: an increase of 6.43% for the Dow Jones Industrial Average, which is slightly more than 2016's forecast, NASDAQ up 5.80%, developed international markets up 4.53%, and emerging markets at up 5.33%. We forecast fixed income as measured by the 10-year treasury increasing to a 2.94% from the current 2.48%. We're forecasting that the Fed Funds Rate will increase to an average of about 1.23%. Fed Chair Janet Yellen and the rest of the FOMC will again have the market's attention as they watch economic conditions and respond accordingly.

MTC expects the year-over-year growth of the United States economy as measured by Gross Domestic Product (GDP) to be 2.70%. Regarding inflation, many have been concerned about a substantial increase because of the great amount of quantitative easing and now the potential fiscal stimulus. We believe this concern has been and is still overstated for now. MTC expects inflation as measured by CPI of 2.28%, slightly above the FED's target of 2%. Oil prices are a wild card. We see oil stabilizing around $58.90, up just a bit from the current $52.50.

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