CliftonLarsonAllen
WEALTH ADVISORS

MARKET AND ECONOMIC OUTLOOK

April 2017

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Markets Trend Positive as Fed Rates Rise, Confidence and Manufacturing Grow

Investors may be forgiven if they did a double-take when pulling up a market summary on their phone on March 21. The market was down how much? The S&P 500 sank 1.25 percent. Normally, such an outcome to a day's trading is utterly unremarkable. That move, however, snapped a streak of more than 100 trading days without a 1 percent decline in U.S. stocks. Such a long stretch of limited downside volatility is rare. You need to go all the way back to 1995 — when getting stock quotes on your phone meant something else entirely — to find a longer streak of consecutive days without a 1 percent decline (Bespoke Investment Group). Although it may be jarring, the return to a normal volatility environment should be expected and, perhaps, welcomed.

Positives	Negatives
Improving consumer and small business confidence	Future returns (for the next seven to 10 years) from stocks and bonds expected to be lower than long-term historical averages
Employment is strong	Geopolitical concerns, e.g. North Korea, terrorism
Housing market is firm	Political uncertainty in Europe, with significant elections looming
Risk of a U.S. recession appears low in the near-term	Policy uncertainty in the United States, specifically around trade, health care, and tax policy

Broad U.S. stock index stays positive

Despite enduring some downside volatility, the large cap S&P 500 index posted positive returns for the quarter, with the consumer and technology sectors leading the way. U.S. small cap stocks, as measured by the Russell 2000 Index, were flat for the quarter. Growth stocks outperformed value for the quarter.

Stocks in both developed international and emerging markets were also positive for the quarter. The MSCI EAFE International Stock Index was buoyed by its largest constituent, Japan, posting positive returns for the quarter. In developed European countries, March ushered in some encouraging economic signs, including positive jobs growth and the best manufacturing report in nearly six years (IHS Markit, Eurostat.) The largest European stock markets — U.K., Germany, and France — were all in the black for first quarter.

Emerging markets were the star asset class to start the year, up more than 11 percent. Brazil's market, having made a massive 66-plus percent move in 2016, continues to rise and posted a 10 percent gain for the first quarter (MSCI Brazil NR Index). China also surged 13 percent (MSCI China NR Index) but it has also been a source of concern for market participants. Many have feared a "hard landing" for their economy and markets, as perceived excesses in asset prices and debt unwind. For the time-being at least, it appears the Chinese government planners and central bank have avoided worst-case scenarios and their economy appears stable, which can be viewed as hugely positive for both emerging market stocks and the global economy.

In fixed income markets, returns were mostly flat. Bloomberg Barclays U.S. Aggregate Bond Index posted a total return of just less than 1 percent. Looking specifically at the U.S. Treasury Index, the story was pretty much the same, with a return just shy of 1 percent. Municipal bonds, as measured by the Bloomberg Barclays Muni Index, were up 1.3 percent. The key 10-year U.S. Treasury yield closed at 2.42 percent, with its quarterly range at about 2.3 to 2.6 percent (Bloomberg).

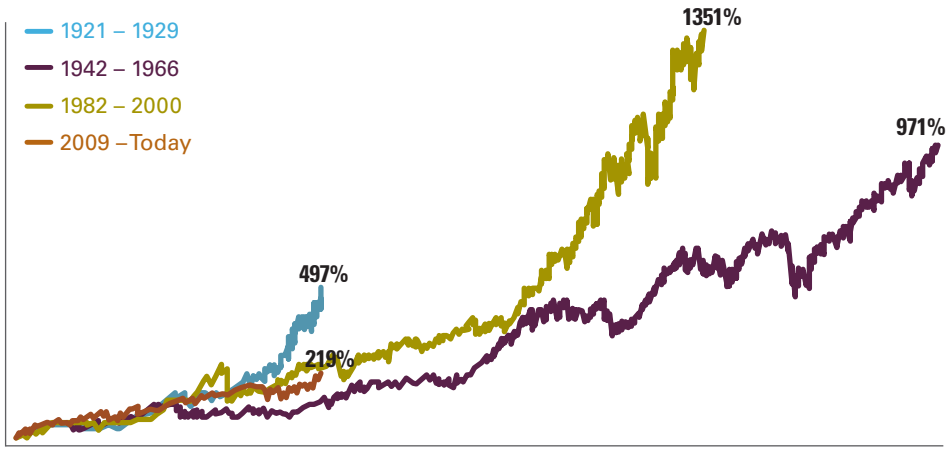
First Quarter 2017 and Last Year Index Returns (%)

Index Name	Capital Market Segment	1Q17	2016
Barclays U.S. Aggregate	U.S. Broad Market Bonds	0.82	2.65
S&P 500	U.S. Large Cap	6.07	11.96
Russell 2000	U.S. Small Cap	2.47	21.31
MCSI EAFE	Non-U.S. Developed Markets	7.25	1.0
MSCI EM	Emerging Market	11.45	11.19
Hypothetical 60/40 Portfolio	Diversified Mix of Indexes	4.18	7.10

The long-range trend for U.S. stocks is positive

We've written previously about the longevity of the current bull market in terms of consecutive months without a 20 percent decline. The magnitude of the advance, though, is much smaller than previous bull markets, implying that the prices could continue to run up. How long will the long-term trend remain positive? No one knows, as the future is unpredictable. For our part at CLA Wealth Advisors, our focus is on client asset allocation and attempting to ensure that investors are prepared when the long-term trend changes.

Current Bull Market Versus Previous Bull Markets



Source: The Irrelevant Investor, *March 8, 2017, www.theirrelevantinvestor.com*

Consumer confidence soars

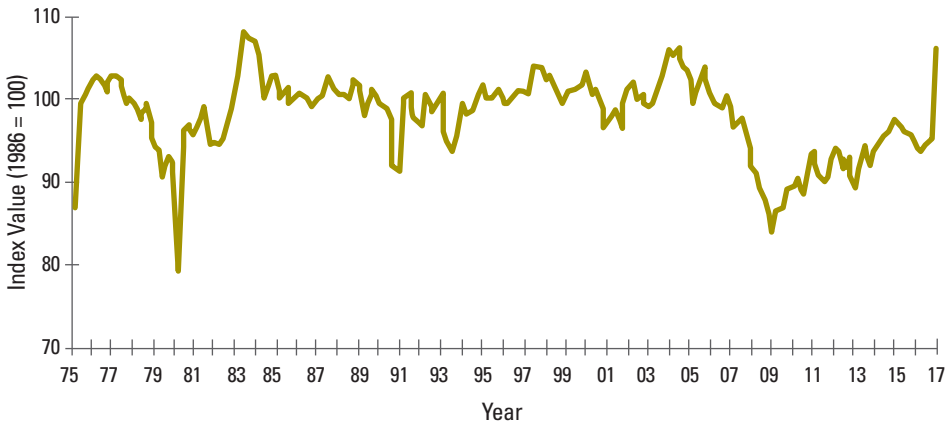
Investors' psychology matters with regard to the economy and capital markets. Renowned British economist John Maynard Keynes famously used the term "animal spirits" to describe risk-taking in the face of uncertainty. A review of the latest readings of sentiment for consumers, business owners, and CEOs can lead to only one conclusion: animal spirits are running high.

The effect of the new presidential administration on these readings is unmistakable. Witness the surge in small business optimism following the election. As we noted in the January 2017 *Market and Economic Outlook*, the new president's emphasis on deregulation would be eagerly embraced by small business owners. Executives at larger companies appear to be growing in

confidence as well. The Business Roundtable CEO Economic Outlook Index took a huge jump in the March 2017 reading and is far higher than its pre-election levels.

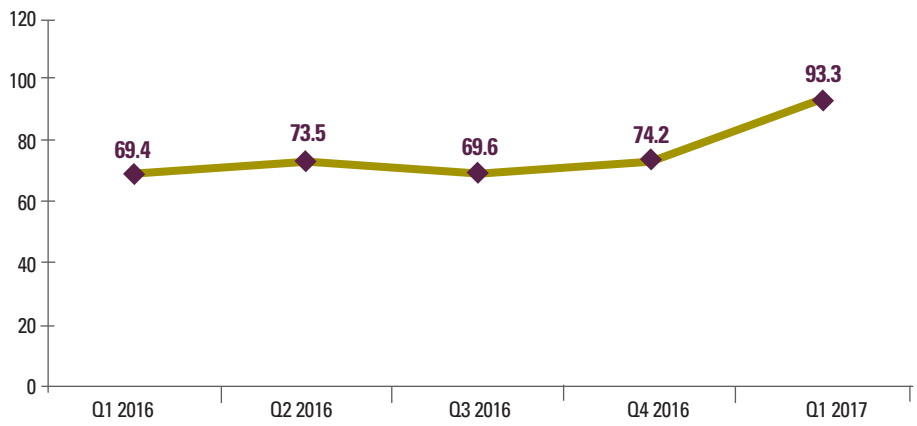
Optimism Index

Based on ten survey indicators (seasonally adjusted 1986 = 100)



Source: NFIB Small Business Trends, *National Federation of Independent Business*

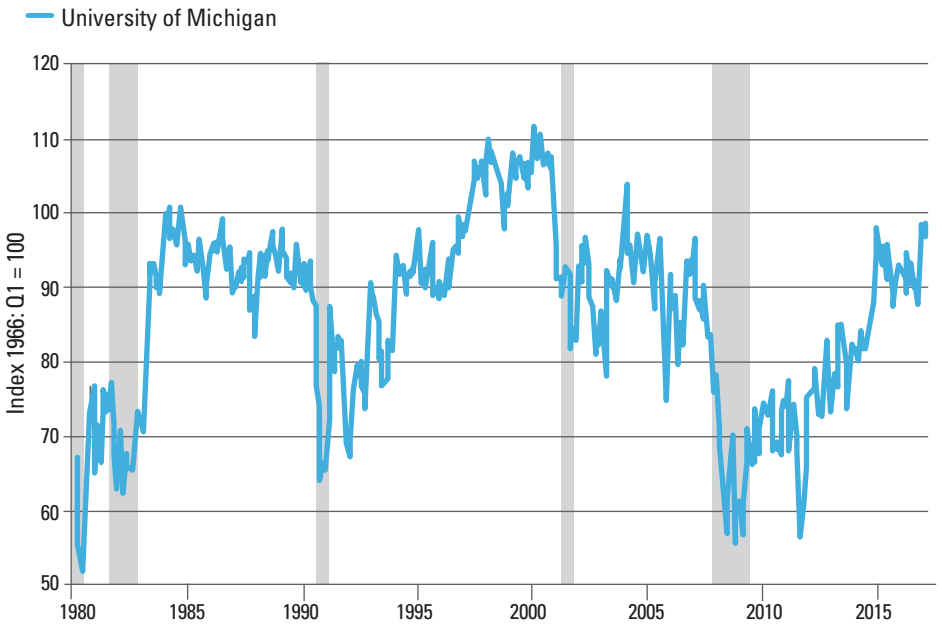
CEO Economic Outlook Index



Source: The Business Roundtable, CEO Economic Outlook Index

Consumer confidence, as measured by the University of Michigan's Index of Consumer Sentiment, also posted an increase in the latest reading, and is up nearly 8 percent from one year ago. The University of Michigan ascribes much of this increase to improved personal finances. This is certainly true, as personal finances, in aggregate, have been improving steadily since the financial crisis. (see the Household Debt Service Ratio and Household Net Worth charts). The rising stock market also has a large effect on this reading, as the movements of the S&P 500 tend to correlate with the consumer confidence reading. It's notable that there is a marked partisan divide in the forward-looking "expectations index" component of the University of Michigan survey. Respondents who self-identify as Republicans registered a reading that implies "robust growth ahead," while the responses of those who self-identify as Democrats would imply a "recession is imminent" signal.

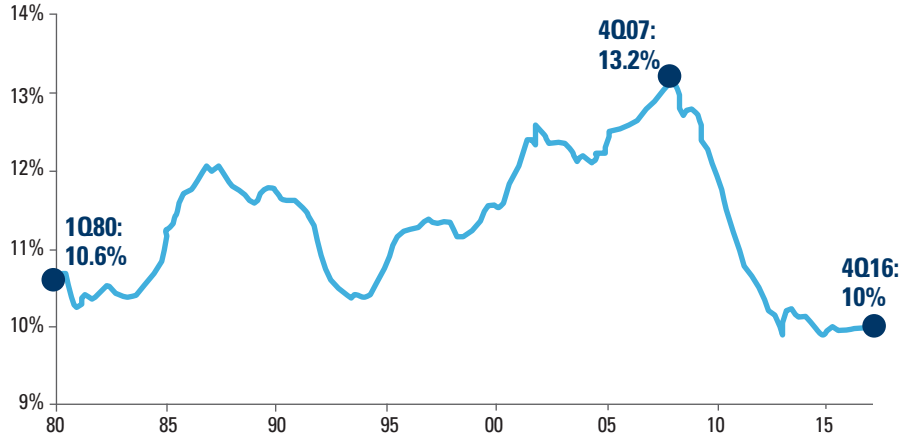
Consumer Sentiment



Sources: University of Michigan, fred.stlouisfed.org

Household Debt Service Ratio

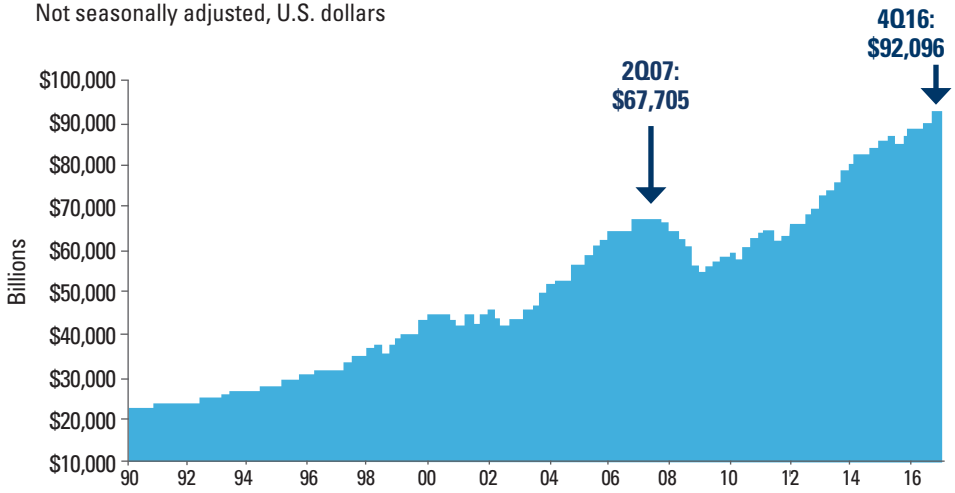
Debt payments as a percentage of disposable personal income, seasonally adjusted



Source: JPMorgan

Household Net Worth

Not seasonally adjusted, U.S. dollars



Source: JPMorgan

Increased confidence is good thing. It means business owners may move forward with capital expenditures and new hires, and consumers may be more inclined to spend their discretionary dollars. These are all things that can lead to a virtuous cycle, economically and for the capital markets.

Fed rates inch higher

The Federal Open Market Committee (the Fed) raised a key short-term rate 0.25 percent on March 15. This was a widely-expected move, essentially already "priced" into the market. As always, the market was keenly interested whether either the Fed's post-meeting statement or Fed Chair Janet Yellen's comments would offer a clue as to what to expect next. The Fed maintained what observers call a "dovish" tone, meaning that it is not inclined to raise rates aggressively.

"The simple message is: the economy's doing well. We have confidence in the robustness of the economy and its resilience to shocks," Yellen stated in her post-meeting comments. As such, the Fed reassured the market that it is staying the course that was previously established, with two more rate hikes penciled in for the remainder of 2017. Some market observers had feared that evidence of rising inflation would strike some fear into the heart of the Fed, thereby having them take a "hawkish" tone and causing them to aggressively raise rates. The less aggressive stance was greeted with relief by the markets, as prices of both stocks and bonds rose after the Fed announcement.

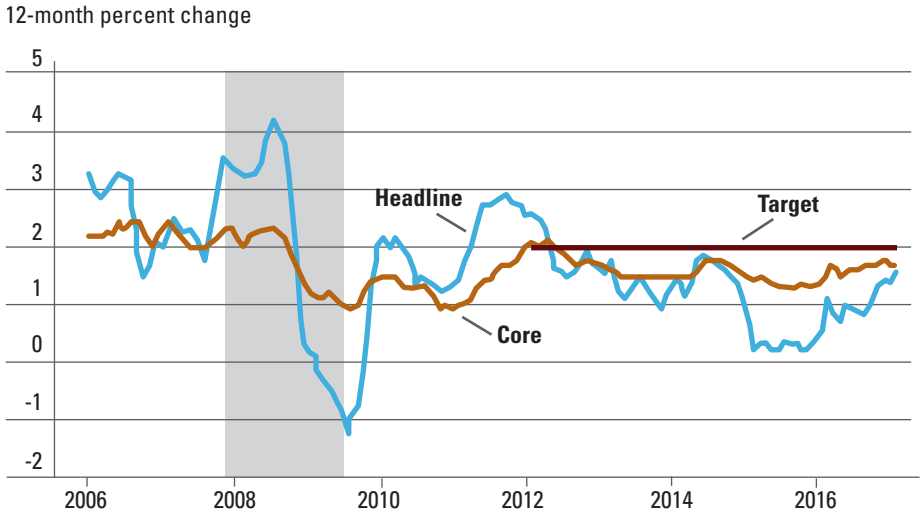
Many in the financial industry are gratified that the Fed is moving toward a more "normal" rate environment. Zero interest rate policy (ZIRP) has been punitive to savers and has perhaps pushed the prices of risk assets beyond what may be supported by fundamentals. Not everyone agrees, though, including some on the Fed itself. One member, Minneapolis Fed President Neel Kashkari, voted against raising rates. He posted a detailed piece called *Why I Voted to Keep Rates Steady* on Medium.com to explain his dissent. It's interesting to review his reasoning. The article provides some good context around the various mandates that the Fed pursues and the many complexities involved with trying to steer monetary policy within the vast and complex U.S. economy.

Inflation concerns and "full" employment

Inflation concerns have been on the radar of investors and the Fed. The Fed's target for inflation is 2 percent (using the personal consumption expenditures (PCE) measure). This inflation measure includes both headline PCE and core PCE,

which excludes energy and food prices. On the 10-year chart below, you'll note how PCE inflation has been benign in the recent past. If anything, economists were concerned more with deflation at times. But prices have been rising lately, trending toward the 2 percent target, which is likely a key input for the Fed deciding to raise rates. Kashkari reasons, however, that although the trend is up, the level of core CPE should not be concerning, as it is still 0.3 percent below the 2 percent target level.

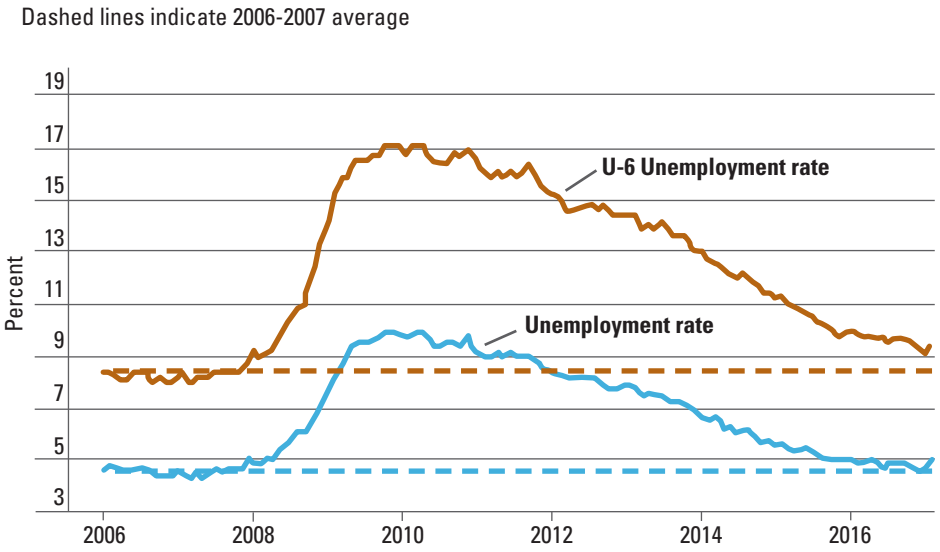
Personal Consumption Expenditures (PCE) Inflation



Source: Bureau of Economic Analysis

Another key mandate of the Fed is full employment. Many would argue that we are at or near full employment, with the unemployment rate hitting a remarkably low 4.8 percent at its latest reading (down from the cyclical peak of 10 percent). This apparent strength in the labor market might indicate that the Fed can green light further rate increases. But the dissenting viewpoint on unemployment looks at what is known as the U6 figure, which includes unemployed workers who have stopped looking for work and part-time workers who would like to be full time. The U6 figure is still above its pre-financial crisis level, which may imply that the labor market still has room to strengthen.

Unemployment Rate

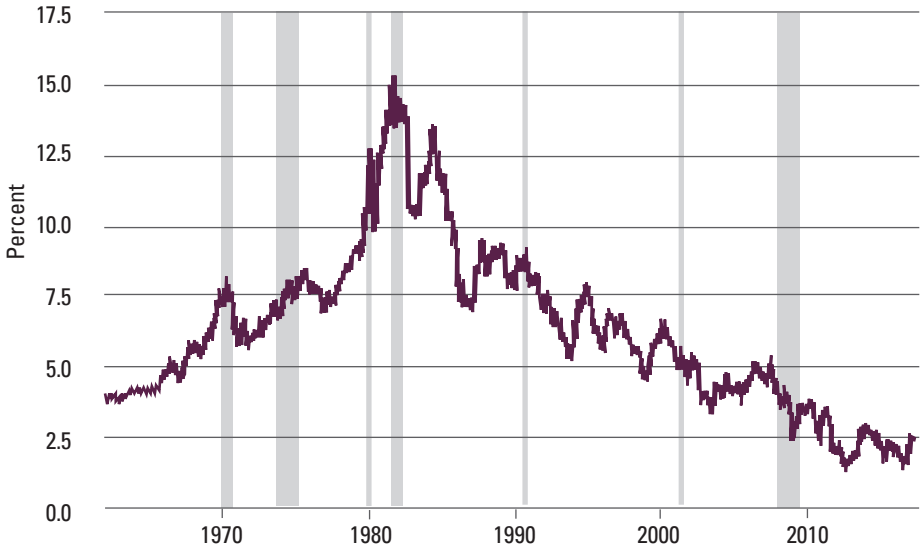


Source: Bureau of Labor Statistics

Bond market math is a bummer

We've written before about the trajectory of interest rates and what that means for bond investors. To review, there is generally an inverse relationship between interest rates and bond prices: when rates rise, bond prices fall; when rates fall, bond prices go up. Bond investors have enjoyed a beneficial environment for well over three decades, with the 10-year Treasury yield falling from the high teens to roughly 2 percent. But no trend lasts forever. We may be at the dawn of a new era of rising interest rates, which will be bad for bond prices and, therefore, bond investors.

10-Year Treasury Constant Maturity Rate

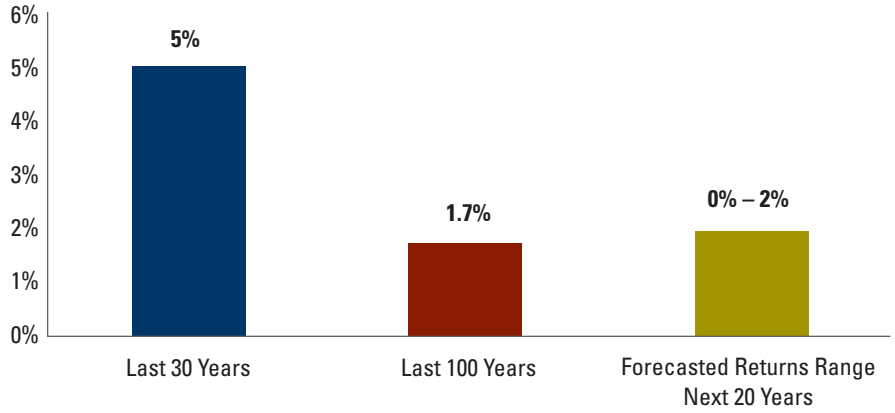


Sources: Board of Governors of the Federal Reserve System, fred.stlouisfed.org

What is the potential reversal in the long-term rate trend likely to mean? There is ample research concluding that forward-looking returns from bonds will be far less than what we experienced in the last 30 years. Here we highlight just one such example, a report from McKinsey & Company which indicates that U.S. bonds will provide real returns (i.e. after inflation) of 0.0 percent to 2 percent, which is much closer to the very long-term, 100-year average.

This means that in a traditional 60/40 portfolio (60 percent stocks and 40 percent bonds) a large portion of the portfolio may produce returns of close to zero over the next decade.

U.S. Bond Real Return Versus Expectations Versus Historical Returns



Source: McKinsey

What is an investor to do? We might suggest as a first step: don't panic. Despite interest rate trends, bonds retain the desirable characteristics that have always made them a core building block of portfolios, namely, low correlation to stocks and much less volatility than stocks. In addition, turning points in interest rates are no easier to predict than those of the stock market. It's not about timing the bond market, in our view, it's about having a thoughtfully diversified portfolio.

Having said that, we are concerned that low prospective bond returns may make it more difficult for our clients to achieve their financial goals. We can mitigate this problem in several ways (where it's feasible and appropriate to do so) including: providing fixed-income portfolios that have less interest rate exposure than the broad bond market, individual bond ladders, and alternative investments that have a much more attractive risk/reward profile than bonds.

Manufacturing output is up workforce challenges persist

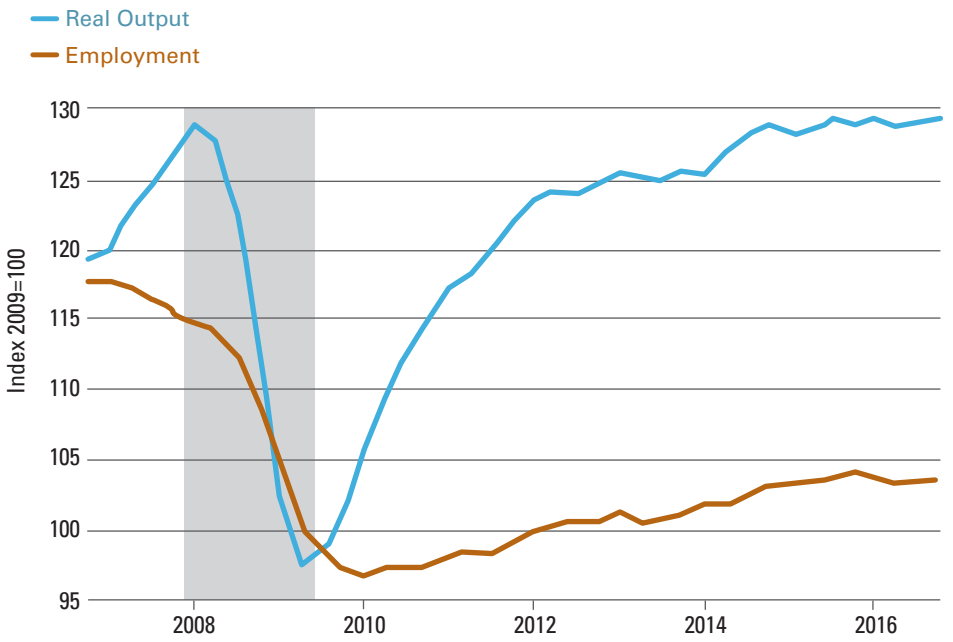
One of the keys contributors to economic growth in this country has been the manufacturing sector. Recent data are very encouraging, with manufacturing output rising for six consecutive months as of February 2017. The numbers are especially strong this year, with the January and February month-over-month factory output growth rates the highest back-to-back performance in three

years. More appropriate levels of inventories, a recovery in global markets, and increased spending on equipment have put manufacturers on firmer footing.

Besides contributing to economic growth and producing goods for both U.S. and international consumers, the manufacturing sector employs a huge number of people — 12.3 million workers, or about 9 percent of the American workforce (Bureau of Labor Statistics). Many of the jobs pay well, too. The average manufacturing worker earned $25.58 per hour versus the average U.S. worker's wage of $21.32 per hour (as of February 2016 according to Industry Week, *15 Facts About 15 Manufacturing*).

Increased production, though, has not led to similar increases in levels of employment. As you can see in this graph with data from the U.S. Bureau of Labor Statistics, increased production has been accomplished with fewer and fewer employees, due primarily to innovation and automation.

Manufacturing Sector: Real Output and Employment



Sources: U.S. Bureau of Labor Statistics, fred.stlouisfed.org

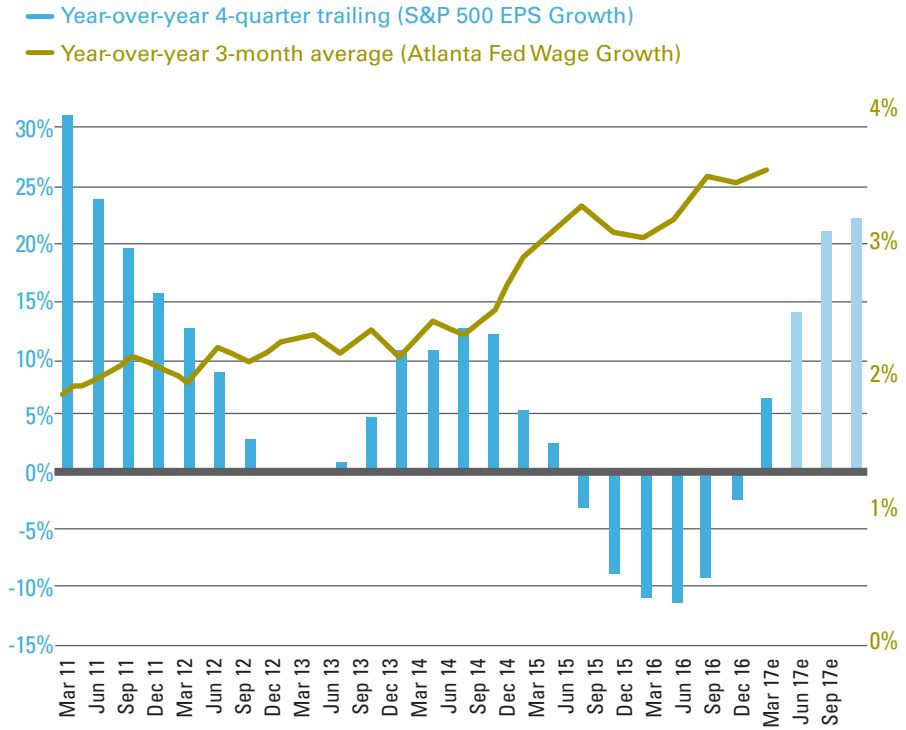
There is a mosaic of factors that affect the prospects for the manufacturing sector. To examine some of them, we turn to CLA's Sixth Annual *Manufacturing and Distribution Outlook* report. The survey of manufacturing and distribution leaders, conducted late in 2016, includes a large cross section of small to mid-size companies across the country.

If you compare the CLA survey with the employment data presented earlier, you find that one explanation for why manufacturing employment may not be increasing as much as it could is that manufacturers have struggled in recent years to find enough skilled workers. Companies have tried to deal with this through in-house training to teach desired skills to "competent, trainable" employees.

The effects of the low unemployment rate is now making the situation even more desperate for employers, as some report that the shortage of skilled workers has developed to a shortage of workers, period. In fact, respondents report that recruiting activity has slowed as a means of addressing workforce issues.

"We get the sense that when it comes to workforce challenges and costs, company leaders know they have to be more flexible, try different things, and be creative," says Samantha Metcalf, CLA's managing principal of industry for manufacturing and distribution. "They are getting pretty scrappy in their pursuit of solutions." More than half of respondents say they are turning to technology to address limited cost reduction options and workforce constraints. This includes smarter automated equipment that doesn't require highly skilled operators, along with data management and enterprise resource management software to streamline operations.

Corporate Earnings Versus Wage Growth

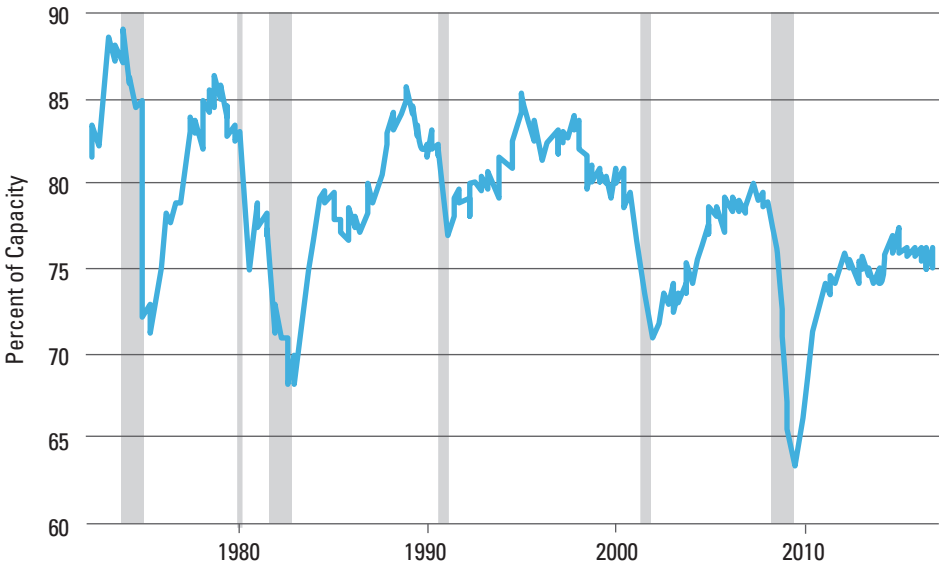


December 2016 earnings captures 407 out of 500 companies. e = estimate.

Sources: Standard & Poor's, Federal Reserve Bank of Atlanta, Fidelity Investments (AART), as of Feb. 16, 2017.

Capacity is always an important manufacturing metric, and last year, many survey respondents expressed a desire to add capacity — an audacious step for a manufacturer. While a healthy 41 percent of respondents say they are utilizing 80+ percent capacity, the number operating at or below 50 percent utilization grew to nearly one-quarter of the companies participating. The nationwide measure of capacity utilization from the Federal Reserve, while still below the pre-financial crisis peak, is currently above 75 percent.

Manufacturing Capacity Utilization

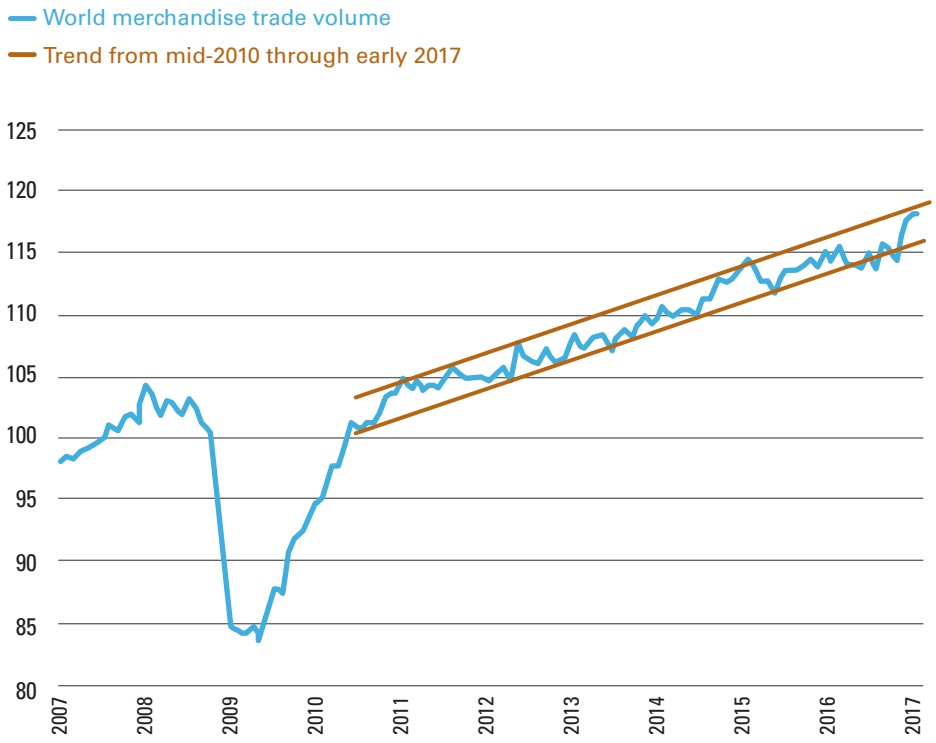


Sources: Board of Governors of the Federal Reserve System, fred.stlouisfed.org

"Not fully utilizing capacity is one of the biggest drains on profitability, but manufacturers are often tentative about filling their existing capacity," Metcalf says. "We try to help our clients see that the upshot of keeping more of their equipment humming and people working all year long is more revenue and better profitability."

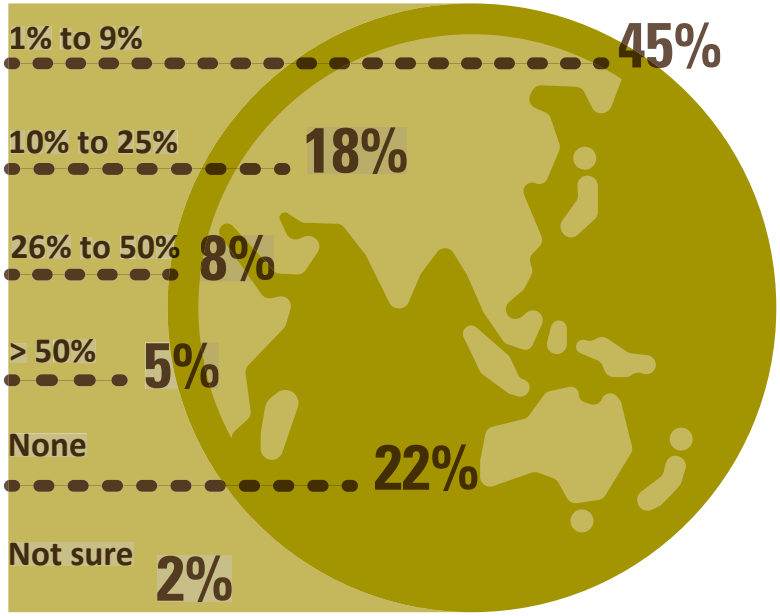
The flow of goods and services across borders continues to be an important consideration for manufacturers and, indeed, nearly all industries. That fact is clear when you note that the source of revenues for S&P 500 companies is 56 percent domestic and 44 percent international (JPMorgan, as of 3/31/2017). But it's not just the large companies that are impacted by global trade. Two-thirds of the small and mid-size companies represented in the CLA manufacturing and distribution survey reported that they are "participating in the global economy." However, their participation represents a much smaller percentage of total revenue from international sources.

World Trade Steadily Rising



Source: Charles Schwab, Bloomberg data as of 4/2/2017

Percentage of Total Revenue From Sales Outside of the United States (Directly or Indirectly)



Source: Sixth Annual Manufacturing and Distribution Outlook Report*, CliftonLarsonAllen*

Increasing global trade has been, in aggregate, beneficial, contributing to economic growth and prosperity in the United States and around the world. But there are always matters of controversy and political contention. As such, trade policies have a large impact on the global economy and the capital markets. Investors are closely watching President Trump's stance on global trade. He has signaled a desire to renegotiate or scuttle international trade deals, such as the North American Free Trade Agreement (NAFTA) and the Trans Pacific Partnership (TPP). He also signed two executive orders in March related to trade, including one that calls for the Department of Commerce to launch a 90-day study to review country-by-country trade for signs of "unfair practices." Some construe this as a precursor to the administration effecting policies that could restrict global trade.

Worldwide, there are other forces that could limit global trade. Brexit negotiations (U.K.'s withdrawal from the European Union) are advancing, and candidates that favor a more protectionist trade stance could win forthcoming elections around Europe this year. How trade policies will evolve is uncertain and provides some risk to the global economy and capital markets.

On balance, investors are justified in feeling confident as we enter the second quarter of 2017. Stock prices continue to be in a long-term upward trend, with recent advances accompanied by very little volatility. Unemployment is low, consumer balance sheets continue to improve, and there are few signs of an imminent recession. However, there are myriad risks lurking that could change the investment and economic landscape quickly. Uncertainty around the Fed and the direction of interest rates, the new administration's trade policies, and global political unrest are just a few examples. We are constructive in our investment outlook, while remaining vigilant to risks.

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