MARKET COMMENTARY

FIRST QUARTER 2016

"In Like a Lion . . . Out Like a Lamb"

This usual descriptor for the winter-to-spring transition that takes place in March succinctly describes the United States equity market during the first quarter of 2016.

While the S&P advanced a rather ho-hum 0.7% price return for the quarter, the path was anything but dull. As a result of the concern about economic growth and fear of the Federal Reserve's tightening, stocks started the year by plunging nearly 13% by midday on Jan. 20 on their way to a closing low on Feb. 11. Pessimism pervaded as recession worries spiked and cataclysmic calls for a reprise of the Great Recession of 2008 intensified. Investors — previously lulled into complacency by a Fed-induced market calm that helped create the second-longest period in the past 65 years without the market showing a -5% year-to-date return — panicked.

Then economic data improved and steadily dragged the markets higher. While the linking of the economy and stock market performance obviously makes sense, this hasn't always been the case in recent years because the Fed has implored investors to ignore the economy — after all, if it were that bad, the Fed would inject more stimulus, right? This strategy led to good and bad economic data alike pushing equity markets higher; in sum, there was a delinking of markets and the economy. Now the Fed is desperately trying to figure out how and when to return to its historical reaction function and avoid having its every action impact the stock market so dramatically.

A Buttress to Longer-Term Economic Prospects

At Northwestern Mutual, we continue to believe that the fundamental U.S. economic backdrop remains positive because the U.S. consumer is benefiting from increased employment and slowly rising inflation. However, against this backdrop, Fed commentary has taken a surprisingly dovish pivot over the past few weeks. This could serve to further complicate its future exit plan if the current sub-par economic growth proves temporary, as we expect it will. This commentary normally elicits a list of "buts," so let's attempt to answer some of the most common objections to our positive economic outlook and resulting fear that current Fed inaction could mean faster rate hikes in the future.

***But* current economic growth is barely positive …** | Accurately measuring the state of the $18-trillion U.S. economy in "real time" can be difficult for investors. While they fixate on every scrap of new economic data, the reality is that almost every one of those numbers is subsequently revised, often more than once.

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As just one recent example, consider the government's three readings for fourth quarter gross domestic product (GDP) in 2015, which went from 0.7% to 1.0% to 1.4%, with most forecasters missing the mark each time. Then we combine a large majority of these "imperfect" estimates to tally the number that many use as a measure of overall economic well-being, U.S. GDP. This measure has gained special scrutiny over the past year, largely because it hasn't squared with another important economic variable: job growth. Without delving too deeply into economics, in 2015 we learned that the seasonal adjustments used to put the quarters of GDP on equal footing weren't seasonally adjusting very well. More importantly, a recent study by CNBC revealed that even after the government's third revision to GDP, the number still exhibited a large and persistent error rate of, on average, 1.3%.

This complicated calculus may figure into one of the most puzzling realities of the past few quarters, namely, why do companies continue hiring and posting record job openings if economic growth is really so anemic? Some answer that these conditions can coincide with the answer being that the output (GDP) each worker can produce (productivity) has all but stagnated, so more workers are required. However, we counter that productivity is the result of economic growth divided by employees. Certainly there's also an error rate in the employment report estimates, but ultimately, counting employees is simpler than adding up the many and disparate parts of the overall economy. Perhaps we'll find out further down the road that the government's current estimate of economic growth (numerator) was short of reality, and therefore, the estimates of productivity were also off the mark.

But the labor market isn't really improving … | The jobs market remains robust, and amidst all of the noise and bluster over the past two quarter's weak GDP growth, the labor market appears to point to not only more robust current growth but also the prospect for better potential future growth. Long-term potential economic output is simply how many people work and how productive they are. We have already opined on productivity, so now let's focus on the size of the workforce.

One recovery theme has been that many individuals have dropped out of the labor force and were no longer willing to, or looking for, work. If the past six months are any indication, however, that trend may be changing per the Bureau of Labor Statistics (indeed, the household unemployment rate for March rose from 4.9% to 5.0% because more people were looking for work; and at the same time, the labor force participation rate reached its highest level in two years). During this six months, more than 2.4 million people have come off the sidelines to look for jobs, and in most cases, they're finding employment. In fact, this is the highest six-month percentage change since the late 1990s (and before that since the late 1970s/early 1980s, when women were moving into the labor force in large numbers). If this trend continues, it's a longer-term economic positive and a buttress to future potential growth prospects.

But the Fed is making a mistake … | Okay, you may have us here, but we think of the risk of the Fed's timing when raising its benchmark rate differently than most. The Fed's chairwoman, Janet Yellen, and her band of policymakers keep finding new reasons to defer rate hikes. The Fed's dual mandate of employment and stable prices (defined as 2% inflation) has recently expanded to include global developments, amongst other concerns. It appears that market movements have convinced policymakers to abandon their plan of acting earlier so future hikes may well be more gradual (in December of last year, for instance, when the Fed raised its rate for the first time since 2006, it indicated it planned to make four quarter-point hikes in 2016; now it may make two). The Fed appears to have decided that its best option is to risk waiting longer and possibly having to slam on the brakes more quickly in the future. In her speech at the Economic Club of New York in late March, Yellen admitted that since rates were near 0%, ability to employ traditional policy (should the Fed's economic calculus prove wrong) was limited. However, she also noted that if the economy runs hotter, that would be okay since the Fed has the tools (that is, rate hikes) to quickly cool it off. We worry this could mean more frequent and larger future rate hikes, which could prove to be very disruptive to U.S. markets further down the road.

The Bottom Line

There are many risks and "buts" to our outlook, and we continue to monitor the environment for signs that we need to adapt our thinking and adjust our course. That's why, as always, a diversified portfolio remains a necessity in this period of uncertainty and elevated market volatility.

At the same time, we continue to focus on the fundamental U.S underpinnings. We believe the U.S. job market is likely a better indicator of current conditions than economic growth or productivity measures. And given this outlook coupled with U.S. equity market valuations, we continue to expect positive, albeit modest-to-moderate, U.S. equity returns in the near term. While our longer-term U.S. economic and market outlooks remain positive, we worry the path will be increasingly volatile since current Fed inaction may require them to play a more disruptive game of rate hike "catch-up" later.