October 2016

THE ECONOMY

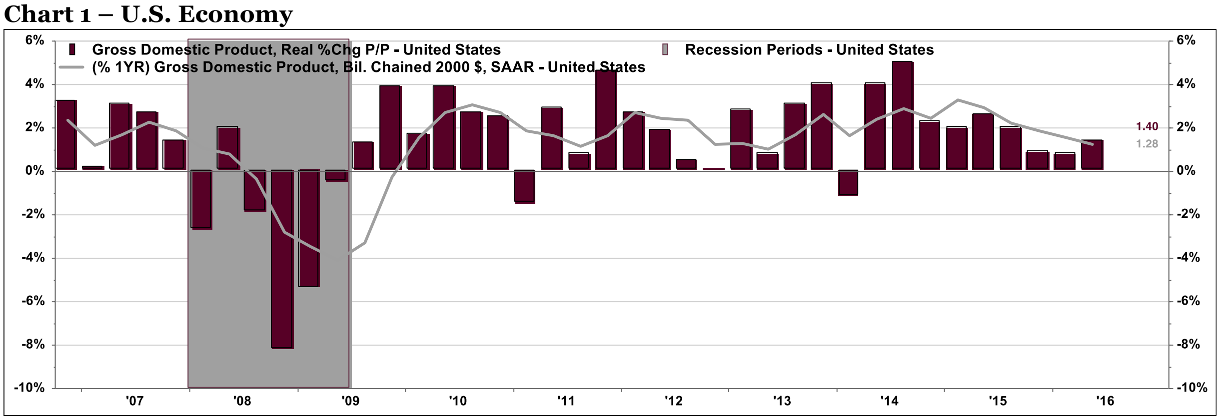
Entering the third quarter, concern surrounded the U.S. labor market and there was economic uncertainty related to Britain's vote to exit the European Union ("Brexit"). The labor market was a key focus due to May's surprisingly weak non-farm payroll gain of just +24,000 jobs versus the expectation for +160,000 jobs. Labor fears quickly faded as non-farm payrolls bounced back in June (up +271,000 jobs), July (up +252,000 jobs) and August (up +167,000 jobs). Brexit fears also faded rather quickly as it became evident the near-term impact on the U.S. economy was likely to be minimal. As these concerns drifted farther away in the rear view mirror, the U.S. economy seemed to gain a little speed while sitting comfortably in the center lane, the Fed remained defensive and cautious in the right lane, where they have been for quite some time, and the equity markets moved over into the fast lane.

Most macroeconomic data released in July and August was positive as consumer confidence, retail sales, home prices, personal income, and employment rose and most indicator surveys continued to suggest near-term economic growth. Data released in September was a different story, and mainly rather weak, including retail sales, ISM Manufacturing & Service Report, housing starts, and new and existing home sales. The outliers in September were employment, consumer confidence—which hit a post-recession high of 104.1, and auto sales—which rose 4.6% from the prior month.

The majority of economic data released in a given month is based upon the prior month's activity. So the weakness in September data was primarily based on August activity. Just as May's weak job report was an anomaly and not a trend, will September's activity bounce back when released in October? So far, this has been the case as September ISM Manufacturing (51.5%) and Service (57.1%) levels, released the week of October 3, rebounded from weak August readings of 49.4% and 51.4% respectively.

The Bureau of Economic Analysis recently released their final estimate for second-quarter 2016 real gross domestic product (GDP), which reflected the U.S. economy grew at a +1.4% annualized pace. The consumer has been the main contributor to recent economic expansion while business investment and government spending have been detractors. Consumer spending is being supported by consistent employment gains, rising confidence and sentiment, higher wages and income, and rising household wealth.

Chart 1 – U.S. Economy



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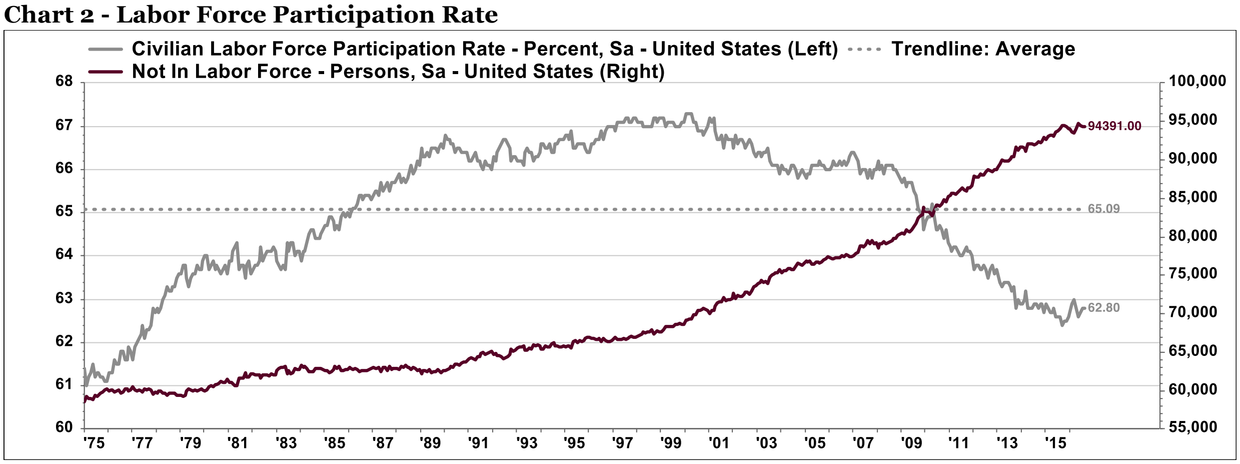
According to FactSet consensus estimates, the U.S. economy is forecasted to grow at a 2.8% annualized pace in third-quarter 2016 and 1.6% for full-year 2016. Since 2010, the U.S. economy has averaged modest annual growth of 2.2%. In December 2015, the Federal Reserve forecasted 2016 U.S. economic growth of 2.4%. In September, the Federal Reserve lowered their 2016 U.S. outlook to 1.8% from 2.0%.

Despite the perceived strengthening in the economy and continued labor market improvement, the Federal Reserve held the fed funds rate steady in September. The decision to hold rates steady was not unanimous, as three FOMC members were in favor of raising the fed funds rate. Fed Chair Janet Yellen cited, “labor market slack being taken up at a somewhat slower pace than in previous years” as one of the reasons to take a more cautious and measured approach.

How is it that with an unemployment rate of 5.0%, 72 months of consecutive monthly job gains and a near record level of job openings (5.8 million), the labor force participation rate (LFPR) is near 40-year lows at 62.9%? In most economic cycles, there are unique attributes; despite the economic expansion, the labor market falls into this distinction.

The LFPR measures the labor force (159.9 million) as a percent of the civilian non-institutional population (254.1 million). While the LFPR has been declining since 2000, the rate of decline accelerated precipitously the past nine years (as shown in Chart 2 below). According to the Bureau of Labor Statistics September 2016 Monthly Labor Review report, all age groups, except for 55 and older, are experiencing declines in the LFPR, especially the 16-24-year-old age group. In 2000, the LFPR for the 16-19 age group was 52.0% and the 20-24 age group was 77.8%. In 2015 the LFPR for the 16-19 age group fell to 34.3% and the 20-24 age group fell to 70.7%.

Chart 2 - Labor Force Participation Rate



What is driving the decline in the LFPR? Is it an aging population and retiring baby boomers? Are younger people staying in school longer and seeking higher education? Is it a lack of training and available skilled labor? Is it the expansion of fiscal policy benefits? Is it the level of discouraged workers? Is it a lack of education? Is it low hourly wages and stagnant median incomes? It is a deteriorating work ethic? It is advances in technology? It is likely a combination of these and other factors.

If the LFPR were to trend 2.2 percentage points higher, back to its historical average of 65, it would equate to roughly 5.6 million more people in the labor force and could help to further drive economic expansion. The sources for the LFPR decline have been and will continue to be debated, but a low LFPR likely is negatively impacting economic growth. Expansion in many industries is being tempered by a shortage of available labor. The housing industry is one example. In the September 25 edition of the *Traverse City Record-Eagle*, an article highlighted the plight of local contractors who have had to turn down new housing projects because of a lack of skilled and unskilled labor. Also, for many months now, the National Association of Home Builders has cited how a shortage of labor has hindered housing starts and completions.

Capital Markets

After the aforementioned Brexit and labor market concerns abated, the risk trade was on early in the third quarter as stock markets rallied—supported by a strengthening economy, accommodative global central bank policy, higher oil prices and better than expected corporate earnings. As shown in Table 1, riskier asset classes were the best performers last quarter, led by the technology heavy NASDAQ index. Small-caps Russell 2000, MSCI Developed and Emerging market, and mid-cap S&P 400 all outperformed large-cap S&P 500 and Dow Jones Industrial stock indexes.

Table 1- Stock Index Total Returns as of September 30, 2016

Equity	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
MSCI Emerging	1.29	9.03	16.02	16.78	-0.56	3.03	3.95
S&P 400	-0.64	4.14	12.40	15.33	9.35	16.50	9.11
Russell 2000	1.11	9.05	11.46	15.47	6.71	15.82	7.07
S&P 500	0.02	3.85	7.84	15.43	11.16	16.37	7.24
Dow Jones Industrial	-0.41	2.78	7.21	15.46	9.23	13.77	7.39
NASDAQ	1.96	10.02	7.09	16.42	13.45	18.54	10.08
MSCI Developed	1.23	6.43	1.73	6.52	0.48	7.39	1.82

While Fed monetary policy will continue to garner much focus in the near-term, the next rate hike is highly anticipated, and should likely be anti-climactic from a market perspective. The U.S. economy can handle a rate hike or two. The primary risk to the equity market over the next several quarters will likely be corporate earnings growth. Year-over-year quarterly earnings in the S&P 500 have declined five consecutive quarters and third quarter 2016 is estimated to be the sixth (-2.2%). The good news is earnings are expected to rebound in the fourth-quarter (+6.0%) and for full-year 2017.

FactSet 2017 consensus is that estimated earnings growth for the S&P 500 currently stands at 13.4%. Earnings growth is welcome news with the S&P 500 trading (16.8x) above its 5-yr (14.7x), and 10-yr (14.1x) price to earning averages. If the economy continues to improve, it should bode well for revenue and earnings growth and support market valuations. Given market valuations, expect volatility to increase if earning expectations do not materialize as forecasted.

Bond returns were mixed for the quarter, with investment grade and non-investment credits outperforming Treasuries and municipal bonds. Bond yields rose slightly as the 10-year Treasury rose 13 basis points to close the quarter at 1.60%. Credit spreads tightened in the quarter, especially high-yield spreads (+628 bps to +508 bps), resulting in the corporate bonds outperforming in the quarter.

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Table 2 – Fixed Income Total Returns – As of September 30, 2016

Fixed Income	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Barclays High Yield	0.67	5.55	15.11	12.73	5.28	8.34	7.71
Barclays Aggregate	-0.06	0.46	5.80	5.19	4.03	3.08	4.79
Barclays Municipal	-0.50	-0.30	4.01	5.58	5.54	4.48	4.75
Barclays Michigan Muni	-0.38	-0.23	3.81	5.50	5.97	4.80	
Barclays Inter Gov't/Credit	0.13	0.16	4.24	3.52	2.80	2.45	4.17
Barclays Municipal 5-Year	-0.39	-0.02	2.30	2.98	2.93	2.63	4.08

Prepared by Perry Adams, Senior Vice President/Director of Investments

Sources: FactSet, Federal Reserve, Bureau of Economic Analysis, Bureau of Labor Statistics, Federal Reserve Bank – St Louis, Traverse City Record Eagle, Institute for Supply Management, National Association of Home Builders