Wealth Advisory Group, Inc.
A Registered Investment Advisory Firm

Wealth Advisory Group – Review and Outlook – Q2 2017

Economic and Market Review

Economy – The economy continues to grow in one of the longest, albeit slowest expansions on record. While the 2.1% annualized growth rate is well below historic norms, it means there is still significant upside potential for the US economy. During a period of significant global economic weakness, the Federal Reserve (Fed) has managed to sustain the US economy with very low interest rates and an unprecedented expansion of the Fed's balance sheet. The "Goldilocks" recovery never showed signs of overheating and the Fed managed to sidestep any potential weakness with additional stimulus, and as one would expect there are pockets of strength and weakness within the economy. Employment numbers have been solid but mixed with a wide range between skilled and unskilled workers in participation, unemployment and wage rates. Household net worth has recovered and debt service is near all-time lows. Accordingly, housing starts have recovered but remain well below the peaks of 2006, and while auto sales may have passed cycle peak, they remain above the long-term average. Inventories are slightly elevated and capital goods orders have been soft but showing signs of recovery. Importantly global economic activity has picked up as the Eurozone and emerging markets are showing signs of sustainable growth.

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Markets – The second quarter was marked by solid gains across the board for equities. Large cap US growth did particularly well, as did developed and emerging markets with many of these markets now up double digits for the year. While earnings results and expectation continue to be quite strong, market valuations are well above average and signal muted expectations for returns going forward. Fixed income returns were mixed with high yield and international leading the way while TIPS and municipals lagged.

Commodities – Crude oil fell below $50 and remained in the mid-$40 range for most of the quarter. Continued strong US production and loose compliance with OPEC production cuts has kept supply ample, while moderate growth and ever greater efficiency has tempered demand. We expect Crude oil to remain range bound as economic realities in oil producing countries will keep oil flowing and any price increases will be met with more production from higher cost fracking. Gold traded in a tight range during the quarter as did most commodities. Raw material prices have lifted over the past year signaling better global economic activity and bode well for resource dependent emerging markets.

Outlook

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Unfortunately, that does not mean it is clear sailing for investors as high valuations and rising interest rates will force selectivity in choosing investment options. Investors should be wary of threats to principal from rising interest rates and overvaluation as losses are more difficult to recover than gains are to accumulate. So, while investors should temper their return expectations, we firmly believe in the long-term return potential of capital markets and believe diversified portfolios will perform well and help investors meet their goals.

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While the political arena continues to offer a never-ending source of consternation and/or amusement, serious economic issues are being delayed by the partisan infighting. A health care fix, tax reform and infrastructure spending are all bogged down in Congress. Simmering geo-political issues, including North Korea, could also rear up at any time and negatively impacting the positive market sentiment and the level of economic activity.

Interest rates – Interest rates finished the quarter very close to where they started after drifting lower during the period. In mid-June, the Fed raised short term rates for the second time this year and outlined a plan to reduce the balance sheet by allowing bond holdings to roll off. Clearly the Fed is serious about normalizing monetary policy, which implies continued interest rates increases for the foreseeable future. The Fed's mission is now complicated by improving global economic activity, which means it will not be acting in as much of a vacuum when setting monetary policy.

Markets – The second quarter was marked by solid gains across the board for equities. Large cap US growth did particularly well, as did developed and emerging markets with many of these markets now up double digits for the year. While earnings results and expectation continue to be quite strong, market valuations are well above average and signal muted expectations for returns going forward. Fixed income returns were mixed with high yield and international leading the way while TIPS and municipals lagged.

Commodities – Crude oil fell below $50 and remained in the mid-$40 range for most of the quarter. Continued strong US production and loose compliance with OPEC production cuts has kept supply ample, while moderate growth and ever greater efficiency has tempered demand. We expect Crude oil to remain range bound as economic realities in oil producing countries will keep oil flowing and any price increases will be met with more production from higher cost fracking. Gold traded in a tight range during the quarter as did most commodities. Raw material prices have lifted over the past year signaling better global economic activity and bode well for resource dependent emerging markets.

Outlook

Economy – Most economic indicators currently point towards continued economic growth which is often the case even as recessions begin. However, despite the headwinds from a single-minded Fed to normalize monetary policy, we believe there is greater likelihood for increased economic growth as a synchronized global recovery takes hold. After years of stagnation across many of the world major economic engines (Europe, China, Japan and Emerging markets), forward looking indicators show signs of strength across the board. Therefore, we see a greater probability of stronger economic growth rather than potential for a recession.

Unfortunately, that does not mean it is clear sailing for investors as high valuations and rising interest rates will force selectivity in choosing investment options. Investors should be wary of threats to principal from rising interest rates and overvaluation as losses are more difficult to recover than gains are to accumulate. So, while investors should temper their return expectations, we firmly believe in the long-term return potential of capital markets and believe diversified portfolios will perform well and help investors meet their goals.

Equity Markets – Despite robust earnings growth, US equity markets remain modestly overvalued, which limits long-term potential returns. The market is also overdue for a correction as the last 10% drawdown was 16 months ago and long since forgotten by investors. The high profile Large-cap Growth names have had a tremendous run over the past 12 months, while high quality, dividend oriented names have underperformed and may offer good downside protection. International and emerging markets have done well recently and still have plenty of upside due to years of underperformance.

Fixed Income – At the risk of stating the obvious, interest rates will have an important impact on the returns for fixed income investors. We believe the higher yields of longer duration bonds will not adequately compensate investors for potential principal losses in a rising rate environment. We suggest shepherding principal in shorter term instruments to reinvest at higher yields in the not too distant future. Foreign bonds also offer attractive yields and diversification.

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Wealth Advisory Group – Review and Outlook – Q2 2017

Economic and Market Review

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