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Investment Overview

October 2016

Consumer Spending Growth Lifts Prospects

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Review of 3Q 2016

The S&P 500 rose 3.63 percent in the third quarter, bringing the year-to-date return to 7.84 percent. Near the end of the quarter the S&P 500 hit a new high. This is astonishing, given the anxiety over the vote by Britain to leave the European Union and the possible risks to the markets and the E.U. economy at the end of the second quarter. The U.S. markets have moved higher and have not looked back. The bond market experienced high levels of volatility as second quarter GDP was initially reported at 1.1 percent, when most analysts expected it to come in at 2.2 percent. The shortfall was driven by a drawdown in inventories and a slowdown in corporate spending.

U.S. GDP Estimates

'15 Act.	1Q '16A	2Q '16E	3Q '16E	4Q '16E	'16 Est.	'17 Est.	'18 Est.
1.9%	0.8%	1.4%	2.5%	1.6%	1.6%	1.7%	1.2%

Source: Pinnacle Wealth Advisors

The bright spot for GDP forecasting is that the growth in consumer spending we saw in the second quarter of 2016 is expected to continue to the upside over the next few quarters. This will help the U.S. economy as we move forward. To this end, second quarter GDP was revised up to 1.4 percent, and we estimate that third quarter GDP will come in around 2.5 percent. This is due in part to a build in inventories and continued consumer growth, which has been very uneven over the last two years and began to stabilize during the second quarter of 2016. If the U.S. economy hits these higher growth numbers, this bodes well for stocks in 2016 and 2017.

Even with the volatility in the bond market, the 2- to 10-year treasury spread remains agonizingly low. At the Sept. 21 Federal Open Market Committee meeting, Janet Yellen indicated that the FOMC was prepared to raise the Federal Funds rate in the December 2016 or February 2017 meeting. As you can see from the FOMC Federal Funds future chart below, the current probability for a December hike sits at 61.2 percent, the highest level it has been forecast all year.

2- to 10-Year U.S. Treasury Spread

Source: Bloomberg

U.S. Federal Funds Probabilities by FOMC Meeting

Dates · Meeting · Calculation · Calculated 10/04/2016 · Based on rate 0.25-0.50

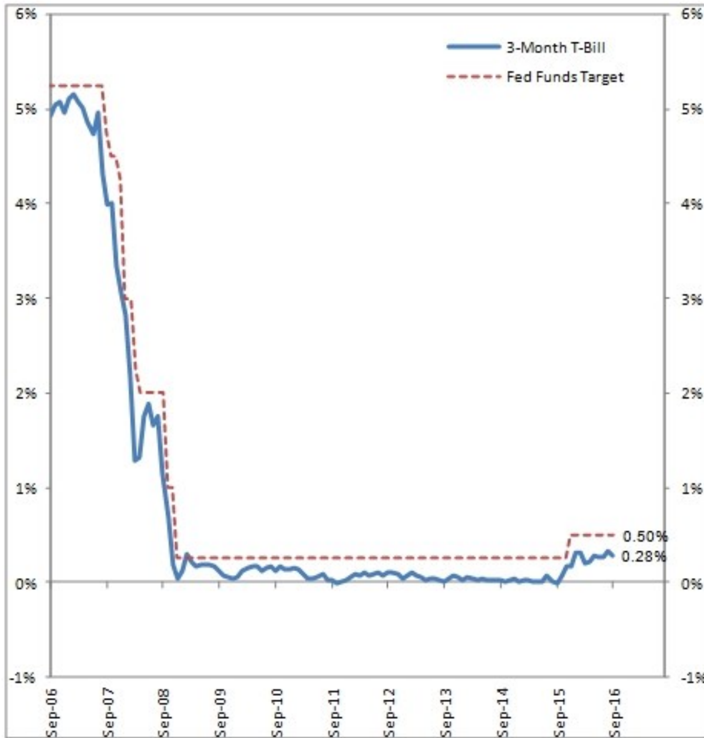
Meeting	Prob Of Hike	Prob of Cut	0-0.25	0.25-0.5	0.5-0.75	0.75-1	1-1.25	1.25-1.5	1.5-1.75
11/02/2016	21.4%	0.0%	0.0%	78.6%	21.4%	0.0%	0.0%	0.0%	0.0%
12/14/2016	61.2%	0.0%	0.0%	38.8%	50.3%	10.8%	0.0%	0.0%	0.0%
02/01/2017	63.6%	0.0%	0.0%	36.4%	49.6%	13.3%	0.7%	0.0%	0.0%
03/15/2017	68.6%	0.0%	0.0%	31.4%	47.8%	18.3%	2.4%	0.1%	0.0%
05/03/2017	70.7%	0.0%	0.0%	29.3%	46.7%	20.3%	3.5%	0.2%	0.0%
06/14/2017	75.8%	0.0%	0.0%	24.2%	43.7%	24.9%	6.4%	0.8%	0.0%
07/26/2017	75.7%	0.0%	0.0%	24.2%	43.6%	24.9%	6.4%	0.8%	0.0%
09/20/2017	78.2%	0.0%	0.0%	21.8%	41.7%	26.7%	8.2%	1.4%	0.1%
11/01/2017	78.6%	0.0%	0.0%	21.3%	41.3%	27.0%	8.6%	1.5%	0.2%
12/13/2017	82.4%	0.0%	0.0%	17.5%	37.7%	29.6%	11.9%	2.8%	0.4%

Source: Bloomberg

With this in mind, we expect the 2- to 10-year spread to rise slowly as the 10-year bond yield moves higher. During the quarter the 10-year bond yield bottomed at 1.36 percent in July and ended the quarter around 1.60 percent. We expect the 10-year yield to end the year in the 1.75-1.85 percent range.

For the 10-year bond to reach the forecasted year-end target, the short end of the yield curve will also need to rise to around 0.75 percent. At quarter end, the 90-day T-bill was yielding 0.28 percent, with the Federal Funds rate at 0.50 percent (and expectations of a near-term FOMC rate hike). As you can see from the chart below, there is a 97 percent correlation between the 90-day T-bill rate and the Federal Funds rates. We believe that if the economic news is positive between now and year end, we will see a rate hike in December.

U.S. Federal Funds Rate Vs. 3-Month T-Bill



Source: Laffer Associates

U.S. Housing Starts

'14 Act.	'15 Act.	1Q '16A	2Q '16E	3Q '16E	4Q '16E	'16 Est.	'17 Est.
1,001	1,102	1,113	1,195	1,150	1,020	1,095	1,013

In thousands seasonally adjusted

Source: Pinnacle Wealth Advisors

Home prices across the country continue to rise, and in most areas are above pre-recession levels. We continue to see a slowdown in durable goods sales. With a FOMC rate hike on the horizon, I expect home prices to level off with the economy in 2018-2019, as higher mortgage rates slow down buyer appetite and erode purchasing power.

Unemployment Rate

'14A	'15A	1Q '16A	2Q '16E	3Q '16E	4Q '16E	'16E	'17E
5.7%	5.1%	4.9%	4.9%	4.7%	4.7%	4.8%	4.6%

Source: Pinnacle Wealth Advisors

Economic Outlook

As we look to year end, we expect volatility to increase as the FOMC raises rates at least once--and possibly twice--over the next 12 months. The British exit from the EU presents uncertainties, but the recent election of Angela May as the new British Prime Minister should shed light on exit plans as we move toward the end of the year. The U.S. stock market has responded favorably to higher consumer spending and higher GDP forecast, providing an expectation for the U.S. markets to close out the year strong. Over the last three quarters there has been a corporate earnings recession, driven in part by falling oil prices and weak consumer spending. These trends seem to be reversing. OPEC's recent announcement to cut 750,000/bbl/day has seen oil prices stabilize in the $50-55/bbl range. With this in mind we have raised our CPI forecast and believe that higher oil prices could provide an incentive for the FOMC to raise rates more quickly in 2017 and 2018.

Below is a chart showing S&P 500 price/earnings ratios by sector. If the earnings recession is over, and we see price/earnings ratios decline by yearend 2017, which sectors could lead the way? We believe that earnings will rise the most in energy and consumer discretionary sectors.

Price Earnings by Sector

Index	Current P/E	P/E 6/30/15
S&P 500	20.34	19.77
S&P Energy	72.23	68.82
S&P Cons Staples	21.95	23.10
S&P Info Tech	21.90	19.39
S&P Health-care	20.56	20.56
S&P Cons Discretionary	19.55	19.02
S&P Materials	18.99	18.69
S&P Industrials	17.95	17.52
S&P Utilities	17.59	19.47

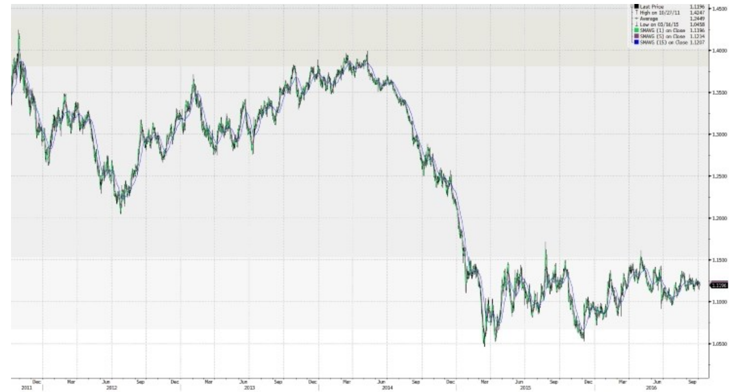
Source: Bloomberg

Energy stocks are currently trading at 72x current earnings, and with oil prices rising with the OPEC cut, it is easy to see how price/earnings ratios could decline along with higher oil prices. The next sector where we think price/earnings ratios can decline is consumer discretionary. This sector is currently trading at 23x earnings, and with higher consumer spending, it is reasonable to believe that we get some P/E contraction over the next six months or so.

The S&P 500 is currently trading at 20.34x earnings. As third quarter earnings are reported, we expect the price/earnings to decline to 18x by year end 2017, which should provide room for an optimistic 2017 S&P 500 earnings target. With this in mind, our 2016 year end S&P target is now 2190, or up 10 percent. We also expect higher S&P 500 earnings to help GDP growth, which has been slowing over the last year. Our estimate is for GDP to pick up in 2017.

With U.S. stocks trading in the high teens, we are focusing on areas of the world where stock valuations are much less expensive, such as Europe. The Bloomberg European 500 Index is forecast to trade at 8x earnings in 2017 versus 18x for the U.S. markets. Europe is not without risks, but we believe that investors will take a second look as valuations are attractive.

U.S. Dollar/Euro 5-Year View



Source: Bloomberg

Consumer Price Index Estimates

‘14A	‘15A	1Q ‘16A	2Q ‘16E	3Q ‘16E	4Q ‘16E	‘16E	‘17E
1.6%	0.0%	0.9%	1.0%	1.3%	1.3%	1.2%	1.0%

Source: Pinnacle Wealth Advisors

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