DMS

Discretionary **M**anagement **S**ervices, LLC

What We Are Telling Clients

By James F. Dykstal, CFA, Portfolio Manager, April 2016

Below is a summary of our views on the economy and markets, which we are sharing with discretionary clients.

Economic Outlook

- GDP will grow modestly over the next 12 months at approximately 2.5%, but the economy will experience periods of unstable growth.
- Headline inflation will remain volatile due to commodity price uncertainty, but the recent readings for the Core inflation rate (without energy) has been steadily above 2.0%. A growing economy will continue to put upward pressure on prices.
- Wage growth will increase slightly with a tighter labor market. Job creation will be stable with the unemployment rate remaining below 5.0%. Labor force participation will increase.
- The U.S. dollar will remain relatively strong, but stable, versus other currencies. The impact of increasing U.S. interest rates has been priced into currencies. The strong U.S. dollar is impacting earnings growth and will limit the upside earnings potential of large cap domestic multinational companies.
- Economic growth in other developed countries will be challenged to grow above 1.0%. Geopolitical events in Europe will put pressure on consumer spending and confidence.

Strategic Market Outlook and Tactical Allocations

Fixed Income: A trend toward higher interest rates is expected as the Federal Reserve raises interest rates in 2016.

- High yield should outperform in a rising rate environment as the incremental coupon will protect against the price pressure from increasing interest rates. Lower oil prices have impacted energy company debt and credit spreads have widened, presenting a buying opportunity.
- We continue to overweight credit versus Treasuries and duration is tilted shorter than benchmarks.
- International bond yields have been pushed lower due to quantitative easing in Europe; therefore, yields do not appear attractive. However, emerging market debt denominated in U.S. dollars provides diversification and yield potential.
- Commercial real estate continues to provide positive returns in a choppy market. Queues can delay additions to positions, and an increase in interest rates could dampen valuation improvements. Value added or opportunistic strategies can be a complement to a core real estate exposure.

Equities: The domestic stock market appears to be fully valued. Earnings have decelerated due to slower economic growth and a relatively strong dollar. Earnings growth should improve in the second half of the year as year-over-year comparisons become easier.

- Small cap stocks are overweighted versus targets in portfolios. Small cap stocks, while more inherently volatile, are impacted less by currency fluctuations than multinational large cap stocks. We will continue to "buy in" and bolster small cap positions during corrections.
- International stocks are overweighted versus the target. The quantitative easing programs in Europe and Japan should provide a tailwind to stocks as the weaker currencies will boost export earnings.
- Within international equities, emerging markets stocks are comparatively attractive due to their low relative P/E multiples and are also overweighted versus targets. Unfavorable economic news has been priced into valuations.
- The dollar has strengthened due to markets pricing in a Fed rate increase and monetary stimulus by foreign central banks. The dollar will remain range-bound given an absence of positive global economic data. This should remove the currency headwind of the stronger dollar on future expected returns.