DMS

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

What We Are Telling Clients

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

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

Economic Outlook

- GDP growth will be modest at approximately 2.5%, but the economy will experience periods of unstable growth. Consumer confidence will improve as the job market will continue to slowly add jobs. Wage growth will increase slightly with a tighter labor market.
- Job creation will be stable with the unemployment rate remaining in the 5.0% range. Eventually, the labor market will tighten enough to provide a boost to wages, which will bring some people back into the labor force, leading to increased labor force participation.
- 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.
- The Federal Reserve will be monitoring the pace of global growth, factoring it into the decision to raise interest rates. Headline inflation has been tame due to falling commodity prices.
- Economic growth in China is slowing as the Chinese reorient their economy from one fueled by exports to one that is based on internal growth. Investors will fear that slowing Chinese economic growth will cause other economies to falter, contributing to market volatility.

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. The Fed increased the Fed Funds Rate for the first time in nine years in December. Longer term interest rates remained steady as inflation remains muted and as the market had priced in rate increases.

- High yield should outperform in a rising rate environment in 2016. 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.
- 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.
- 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.
- Hedge funds with a non-directional or absolute return focus are viewed as an attractive option uncorrelated to bonds.

Equities: The domestic stock market appears to be fully valued. Slower earnings due to a relatively strong dollar impact domestic firms with global earnings. The European Central Bank's and Bank of Japan's quantitative easing programs have weakened their currencies and have boosted the earnings of companies that export.

- Small cap stocks are over weighted 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 over weighted 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, comparatively attractive due to their low relative P/E multiples, are also over weighted versus targets. Unfavorable economic news has been priced into valuations.
- The dollar has strengthened due to the market's pricing in a Fed rate increase and due to 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.