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Great-West Capital Management, LLC (GWCM) Research Note

2016 - Prospects for growth among rising interest rates and global volatility

A Q&A with Cathe Tocher

Cathe Tocher is Senior Vice President and Chief Investment Officer at Great-West Financial. As lead portfolio manager she supervises over 20 investment professionals including mortgage and asset back securities analysts, credit and real estate analysts, the trading desk and has oversight and responsibility for the money market team. She has managed over 35 Great-West Life & Annuity Insurance Company custom stable value funds since 1993, oversees 40 mutual funds and other pooled investment products.

What do you expect from the U.S. economy in 2016?
Economic fundamentals generally look good for 2016. For the U.S. we continue to expect modest, and below trend, gross domestic product (GDP) growth of roughly 2% to 2.5%. The job market was a real bright spot in 2015, with broad-based job creation that was significant across most sectors. We expect this positive trend to continue in 2016, despite headwinds from the energy and materials sectors. While not significant to this point, the healthier job market has spurred some wage inflation and we expect this to continue throughout 2016 as modest GDP growth continues to take slack out of the economy. Housing was the other bright spot in 2015, and we continue to expect a solid market in 2016, as well, driven by employment, still-low interest rates and higher wages. As a result, consumer confidence has increased and spending remains positive. If consumer spending picks up as we expect and the rate of household formations continues to accelerate, we think there is upside potential to real growth for 2016. Despite the positive economic outlook, there are potential headwinds. The strong dollar, higher interest rates and slowing global growth can put pressure on corporate profit margins and growth expectations.

Investors experienced the first Federal Reserve (Fed) rate increase in nearly a decade this past December. It is also an election year. How do you anticipate that these two events will impact capital markets?
The capital markets were prepared for the Fed's policy rate hike. The Fed has been relatively transparent in laying out the expected trajectory of additional rate hikes in 2016 and we do not anticipate the hikes to derail growth. The impact of the 0.25% increase in the Federal Funds rate has been marginal; what is critical is how the Fed signals the pace of the tightening cycle and the projected end point. In general, we expect that the slope of the U.S. Treasury yield curve will flatten, with interest rates increasing moderately. We see the Fed activity causing the short end of the curve to shift higher, while the 30-year range will remain relatively anchored based on low inflation and inflation expectations. The forward curve out two years indicates Federal funds at 1.5%, currently 0.25%; the five-year U.S. Treasury rate at 2.45%, currently 1.64%; and the 30-year U.S. Treasury rate at 3.2%, currently 2.97%.

The approach of the presidential election often generates episodes of elevated volatility — interest rates, equity prices and bond spreads/yields. Typically, financial market actions and responses to incumbents' rhetoric are short-term. The outgoing president will take credit for the health of the economy — assuming it's good — and the incumbents will make comments about the Fed and its "irresponsible" decision to embark on rate normalization. Further, campaign speeches and debates will speak to strategies to improve economic activity. According to an analysis by Great-West Capital Management, between 1928 and 2012 the annual returns of U.S. large-cap stocks during an election year have been positive 18 out of 22 years, rallying 11% on average. The theory behind this is that incumbents look to boost the economy with increased government spending or tax cuts in an attempt to gain votes. This economic boost leads to strong profits for companies, which then drives stock prices higher.

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Annual Returns of U.S. Large-cap Stocks

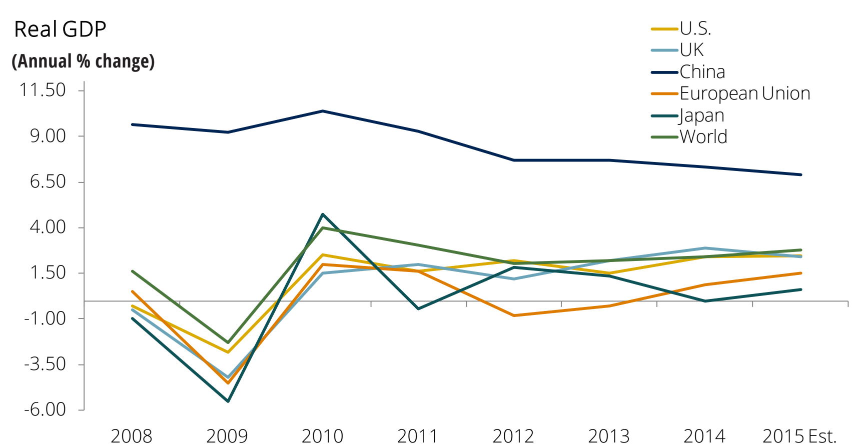
ELECTION YEARS		POST-ELECTION YEARS		MIDTERM YEARS		PRE-ELECTION YEARS	
2012	16%	2013	32%	2014	14%	2015	1%
2008	-37%	2009	26%	2010	15%	2011	2%
2004	11%	2005	5%	2006	16%	2007	5%
2000	-9%	2001	-12%	2002	-22%	2003	29%
1996	23%	1997	33%	1998	29%	1999	21%
1992	8%	1993	10%	1994	1%	1995	38%
1988	17%	1989	32%	1990	-3%	1991	30%
1984	6%	1985	32%	1986	19%	1987	5%
1980	33%	1981	-5%	1982	22%	1983	23%
1976	24%	1977	-7%	1978	7%	1979	19%
1972	19%	1973	-15%	1974	-26%	1975	37%
1968	11%	1969	-9%	1970	4%	1971	14%
1964	16%	1965	12%	1966	-10%	1967	24%
1960	0%	1961	27%	1962	-9%	1963	23%
1956	7%	1957	-11%	1958	43%	1959	12%
1952	18%	1953	-1%	1954	53%	1955	32%
1948	6%	1949	19%	1950	32%	1951	24%
1944	20%	1945	36%	1946	-8%	1947	6%
1940	-10%	1941	-12%	1942	20%	1943	26%
1936	34%	1937	-35%	1938	31%	1939	0%
1932	-8%	1933	54%	1934	-1%	1935	48%
1928	44%	1929	-8%	1930	-25%	1931	-43%
Average Return	11%	Average Return	9%	Average Return	9%	Average Return	17%
# of Down Years	4	# of Down Years	10	# of Down Years	8	# of Down Years	2

Source: Morningstar® Direct℠; GWCM analysis. Returns are shown for the IA SBBI US Large Stock Ext Index. *Past performance is no guarantee of future results.*

Despite steady, modest growth in the U.S., other regions of the world appear to be less certain. The eurozone, in particular, has struggled for growth and experienced significant headwinds. What do you expect from overseas economies in 2016, and how will it impact domestic markets?

Global economies and financial markets have become increasingly integrated over time; however, not all economies in the developed and emerging markets will be on the same growth trajectories, nor will they necessarily have similar growth potential. Therefore, monetary and/or fiscal policies will diverge.

Historical global economic growth



Source: Morningstar® Direct℠; GWCM analysis.

The eurozone, or EU, exemplifies a developed economic region that has struggled economically over the past many years for several reasons. The eurozone is comprised of very strong economies, including Germany, and significantly weaker economies, such as Greece. Most of the member states share a common currency, and the European Central Bank (ECB) sets the monetary policy for the zone. The eurozone is not fiscally integrated, and very different political and socioeconomic realities exist in the various member countries, which have generated headwinds to overall eurozone economic activity since the financial crisis in 2008. Because the growth recovery remains marginal, the ECB implemented aggressive monetary-policy easing, including a significant quantitative easing QE program, and it has stated recently that additional QE will be forthcoming as appropriate. Interest rates are likely to remain very low through 2016 in the EU and volatility is likely to rise.

We expect eurozone economic activity to be modest in 2016. Low oil prices and very accommodative monetary policy have been sources of strong stimulus, but headwinds remain. Political and geopolitical risks, the refugee crisis, and a fading of the oil price stimulus may prove challenging in 2016 for eurozone growth. Other risks to a full recovery of the eurozone are the continued weakening of the euro and U.S. dollar and a lack of structural reform progress across weaker member countries.

Ongoing weakness across other emerging countries will impact the EU and other economies, acting as a drag to growth. Declining growth in China and Brazil remains a considerable drag across the eurozone. The full extent of the aggressive monetary and fiscal policy in China and other emerging market economies should be impactful, but will play out over the long term; consequently, growth is likely to remain slow through 2016.

With higher relative interest rates and significantly larger and more accessible capital markets in the U.S. alongside potentially elevated geopolitical risk in Europe, foreign investment flows into the domestic fixed income and equity markets should remain strong. Though U.S. real GDP growth is expected to be modest, it is likely that the domestic economy will be more robust than other developed and emerging economies, which will also support investment flows. Valuations are likely to rise and interest rates remain lower than suggested by underlying growth fundamentals in the U.S. as a result.

Many investors approaching retirement have questions about how to position their portfolios in a rising rate environment. What types of investment techniques do you consider when facing a rising rate environment?
Today, the U.S. economy is roughly seven years into an expansion, and inflation is very modest. Despite Fed "liftoff," the economy is nowhere near overheating. While interest rates are expected to gradually rise, increases are likely to be modest, particularly for longer maturities (10 to 30 years) and from historically low levels across the U.S. Treasury yield curve. Real returns are projected to be modest given low real interest rates and inflation, as well as below-trend global economic growth. Earnings potential and real final demand are not expected to accelerate significantly over the next few years, which also will limit potential outsized investment returns. Investing for retirement is challenging, but more so when bond yields are low and stocks don't seem to have much upside based on earnings potential.

With that as a backdrop, a critical rule of investing well for the long term is diversification. A diversified portfolio is important in any type of economic and interest rate environment — both across and within asset classes and including both fixed income and equity investments. Timing the market without quantifying the potential outcomes to interest rates and prices does not typically generate sustainable performance, but it almost always increases risk.

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Our approach to portfolio management is to develop a top-down macroeconomic outlook integrated with bottom-up fundamental analyses and develop an investment strategy that may be modified depending on risk tolerances and other constraints. Identifying evolving trends and relative value across various asset classes and considering return correlations are part of an ongoing process that drives portfolio modifications.

Tactically, increasing or decreasing sector allocations that normally outperform (e.g., financials/banks, insurance, consumer staples) or underperform (e.g., consumer cyclicals, homebuilders) when rates rise, modifying the portfolio by laddering short-to-intermediate bond maturities, and utilizing floating rate secured bank loans to participate in a rising interest rate environment are some of the investment techniques that have been analyzed and implemented within the framework of our defined investment strategy.

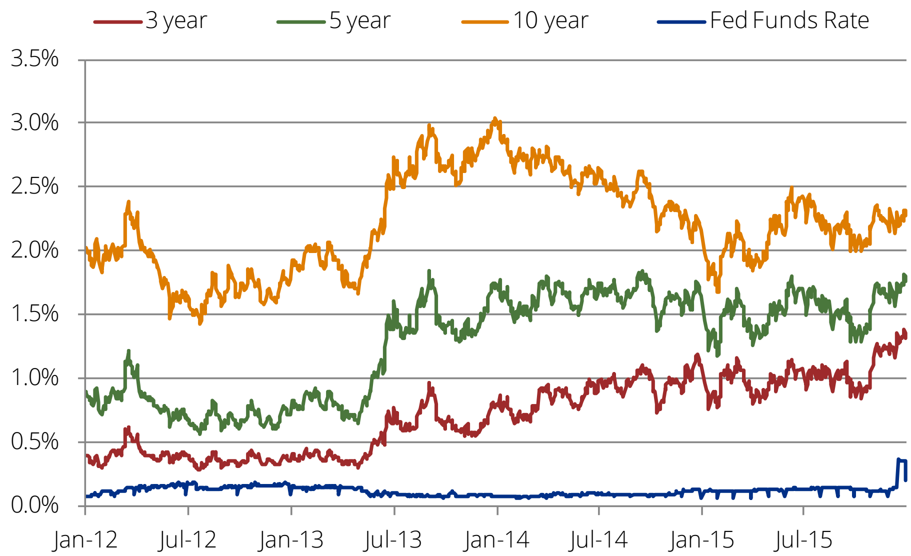
Many economists argue that the economy won't really pick up steam until we start to see real and sustained wage inflation. What are your views on this topic?

Wage inflation is currently underway in the U.S. Wal-Mart, McDonalds, Starbucks and many other large companies already announced higher wages in 2015. This is natural when an economy is at or close to full employment, meaning that further declines in the rate of unemployment, which is currently at 5%, should stoke inflation. Job creation is material and has been over the past few years; broad based and across industries and more recently has included the lower age cohorts. Real and sustained wage inflation that results in increased consumer spending adds significant upside potential to economic growth.

In some regions and sectors of the U.S. economy, such as healthcare, services and technology, labor markets are tight and companies are using different compensation strategies to attract and retain talent. Theoretically, the low unemployment rate means that employers have to work harder to find new workers, which includes offering more competitive compensation packages, and existing workers are able to look elsewhere if they're dissatisfied with their current compensation and/or work environment. As a result, workers are able to demand higher wages.

Many investors have reached for yield in the current market cycle. How important is the role of high quality bonds in an overall investment strategy?

US Treasury Yields



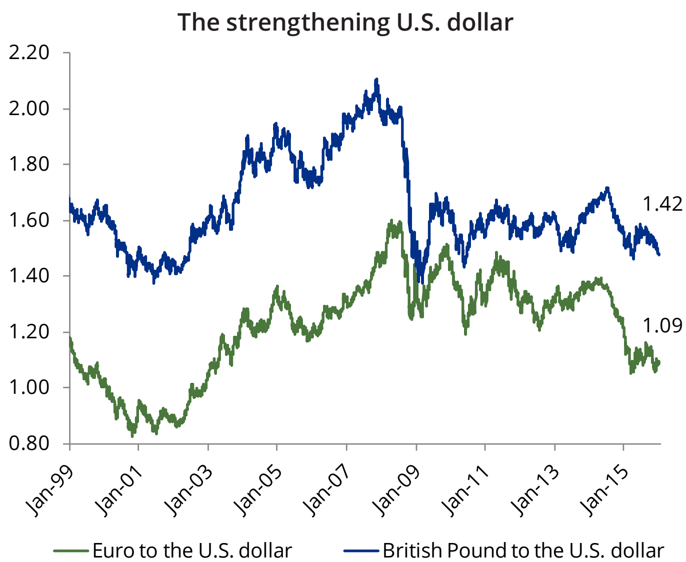
Source: U.S. Department of the Treasury

U.S. interest rates have been in a secular downtrend for many years. Because rates have traded in a narrow range and at historically low levels since the Great Recession, "reaching for yield" has been a popular investment theme. Understanding and quantifying the risks associated with a more aggressive strategy, including those related to credit and/or duration when building and managing a portfolio of investments, is critical — and diversifying those risks is crucial. As economic cycles unfold, credit fundamentals may improve or deteriorate, interest rates are likely to change direction, and earnings potential and, therefore, valuations will likely be impacted.

High quality, or investment-grade, bonds (AAA to BBB) typically earn lower yields compared to high yield bonds (BB to CC) with the same maturity. The higher yield associated with junk bonds in general is typically a function of the higher risk of default. It represents the premium or compensation demanded by investors to own the increased risk. Investment-grade bonds have a lower risk of default and typically lower spread/price volatility than similar-duration high yield bonds.

Much ink has been spilled on the risks associated with rising rates on the fixed income portion of an investment portfolio, especially target date funds. It is important for investors to understand that the most significant risk in a portfolio typically comes from the equity side of the portfolio. A bear market in stocks is often far more painful than a bear market in bonds.

The U.S. dollar has strengthened in recent years. How do you see the Fed's monetary policy impacting its value in 2016?



Source: Morningstar® Direct℠; GWCM analysis.

The U.S. dollar is likely to be impacted more today by sluggish/slowing global economies and commodities prices than by the Fed's recently implemented change in monetary policy. Increases in policy rates are expected to be gradual and data-dependent and will consider primarily domestic economic conditions.

In the short term, rising U.S. interest rates typically lead to U.S. dollar appreciation because rising rates signal confidence in the strength and sustainability of domestic economic growth. Additional strength of the U.S. dollar today is due to the EU, Japan and other developed and emerging economies that expect to continue aggressively easing monetary conditions in 2016. A strong/appreciating U.S. dollar, a relatively strong economy and rising interest rates make investing in the U.S. markets attractive to foreign investors. Higher relative rates across the curve have been attracting foreign capital for several years, reinforcing the theme of ongoing strength in the domestic currency.

At some point, global economies will recover, energy prices will stabilize as supply and demand reach equilibrium, and central banks around the world will terminate QE programs and begin to raise rates. Foreign exchange rates will be revalued. Capital will flow to where the best/highest risk-adjusted return can be earned.

How do you see China's slowdown affecting the U.S. economy and the Fed's monetary policy in 2016?

China's slowdown has been significant as the economy transitions from industrial-driven to a more consumption-driven model; further slowing is expected despite massive monetary and fiscal stimulus. Policymakers seem to be focused on growth and stability, and the People's Bank of China is apparently poised to ease further as financial conditions remain tight. The government's policy response, though, is unpredictable. Keep in mind the stock market intervention in mid-2015, surprise devaluation of the yuan in third quarter 2015, and reliability/accuracy/overstatement of economic data. Global equity markets dropped sharply in response to both the stock market intervention and the currency devaluation and have not yet fully recovered. Industrial metals prices also declined sharply as markets reacted to much weaker growth data than anticipated out of China.

The slowdown in China and policymaker responses have impacted many developed and emerging economies and financial markets. The global industrial sector will remain weak as demand for capital goods, commodities and other industrial goods continues to shrink in emerging markets/China. Global companies, including U.S. multinationals, in the basic materials, industrial and energy sectors have experienced/are experiencing declining profitability. In the U.S., though, we continue to expect positive economic growth, with particular strength in consumer spending, housing and the labor market.

The Fed has specifically highlighted global economic uncertainty in its past policy statements, which mainly refers to China. While we still believe the Fed will be cognizant of China's impact on the economy and markets when making further monetary decisions, it will continue to be U.S. data dependent in achieving its dual mandate of full employment and 2% inflation.

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