MARKET COMMENTARY

BY BRENT SCHUTTE, CHIEF INVESTMENT STRATEGIST, NORTHWESTERN MUTUAL WEALTH MANAGEMENT COMPANY

FIRST QUARTER 2017

It's More Than a Feeling ...

Intentionally or sub-consciously, many people, including yours truly, have referred to the economy over the past eight years as being in a state of recovery.

Indeed, the scars of the "Great Recession" were so deep, that the past eight years have been spent rebuilding the economic framework and fragile psyche of the United States consumer and business owner. As a result, consumers have fortified their balance sheets by paying down and eschewing debt, while business owners have forgone expansion and capital investment. At the same time, tougher government rules and regulations, coupled with annual balance sheet stress tests administered by the Federal Reserve, have forced large U.S. commercial banks to lend a little less, and instead, buy Treasuries and rebuild their balance sheets. Even the federal government has adopted the "austerity" mindset by spending and investing less. One could reasonably draw the conclusion that the sum total of these actions has been the root cause of the relatively weak economic growth in the recent past. However, our reading of the economic data over the recent months, especially during the first quarter of 2017, leads us to conclude that the U.S. economy has entered a new phase and finally shifted into expansion mode. In other words, the long-awaited arrival of animal spirits has finally arrived.

How so? Well, the first quarter of 2017 witnessed a rapid increase in consumer confidence, by some measures – back to early 2000 levels. No longer are we "filling in holes or recovering old highs" left in the data charts after the economic plunge in 2008. And it's not just consumers expressing heighted optimism in their financial situation and outlook – the sentiment of business owners has spiked from doldrum levels, and chief executive officers are now becoming more confident in their outlook and prospects.

Interestingly, the chorus of skeptics continues to believe that consumer confidence reports are "soft data" based solely upon feelings and not actions. These naysayers believe that if, or when, President Donald Trump's tax promises and regulatory reforms fall by the wayside, the economy will once again falter. Allow us to disagree. Above all other arguments, we note that soft data is often included in and referred to as "leading economic indicators" because they have historically led the "hard economic data." Simply put, before you buy, hire or expand, you must first feel comfortable and confident enough to do so.

What are the leading indicators telling us?

During the first quarter of this year, the Conference Board's U.S. Leading Economic Index (LEI) composite finally set a new high and filled in its hole left from the 2008 to 2009 economic recession.After hitting an all-time high of 125.9 in March 2006, this data set fell all the way to 90.6 in March 2009. These dates are important because the National Bureau of Economic Research has determined that the Great Recession began in December 2007 and ended in June 2009. In other words, the LEI does tend to lead recessions and recoveries.

61-1185

This finding brings us to three important points:

1. While many continue to lament that this "recovery" is long in the tooth by historical standards, we want to point out that, on average, the next recession doesn't begin until years after the LEI has worked its way back above its old highs. That event just occurred in February, suggesting that the economy still has time to expand.

2. The Conference Board states that a recession warning is generated after three straight negative months with an annualized rate of change over a six-month period of 4.5% and the diffusion index being below 50%. Currently, the LEI is expanding at an increasing pace reflecting improved prospects for U.S. economic growth.

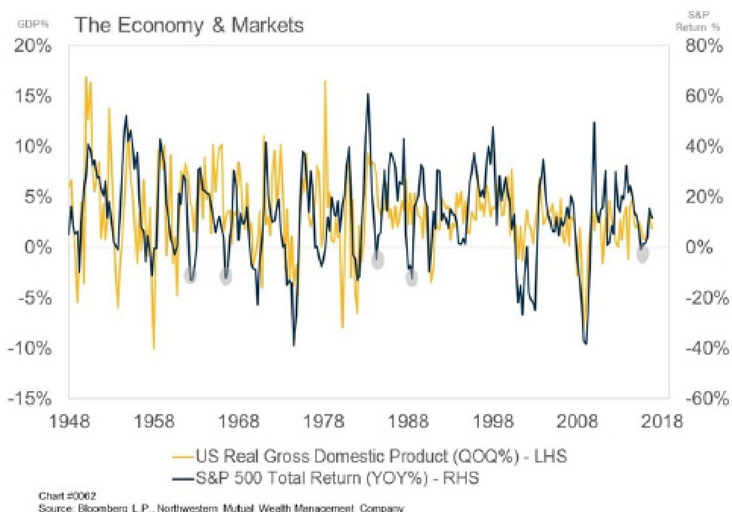
3. Indeed, for those who suggest that the spike is being exclusively driven by confidence data, we would like to note that there are 10 indicators that comprise the Conference Board's LEI. While some of them are soft data, many are hard data, such as job claims, the length of the average work week and building permits. Currently, the LEI advance is broad based. And a review of the LEI six-month diffusion index (or the number of indicators higher versus lower), shows that all 10 indicators are moving higher. In the past 695 months – that's 57 years and 11 months – there have only been 40 such readings.

We believe the U.S. economy is accelerating and, absent some exogenous shock such as a natural disaster or an unexpected political event, hard U.S. data and overall U.S. gross domestic product will show continued, and likely accelerated, improvement. For those worried about my shock caveat, hopefully this puts your mind at ease. As we've said on numerous occasions, recessions have often occurred when American consumers and/or banks are harmed. The big recessions, such as the one that began at the end of 2007, occur when "something" has been done to both groups. And our assessment shows the U.S. consumer and banks are in as good shape financially as they've been in decades. In other words, if an unforeseen shock did occur, it would likely only cause a very mild and brief economic "hiccup."

The Economy and the Equity Market

Many investors and pundits continue to fret about the relative valuations of U.S. equities. We don't disagree that the valuations of equities look lofty on an absolute basis. However, when compared to incredibly, and perhaps artificially, low bond yields, equities still look like a decent deal. After all, for buy-and-hold investors, much of the bond market still offers yields and returns that are below the rate of inflation. We also note that while equity valuations are an important variable when it comes to the magnitude of long-term returns, they have little predictive power in the shorter- to intermediate-term.

One variable that we believe does matter to nearer-term equity market prospects is, not surprisingly, the U.S. economy. Reviewing U.S. Large Cap performance from 1948 to today, we note that there are roughly 16 clusters of negative year-over-year returns. Our analysis reveals that 11 of the downturns contained at least one negative quarter-over-quarter of economic growth, with two of the remaining five registering as barely positive; and the others were event driven – think the Cuban Missile Crisis, the Vietnam War, Black Monday in 1987 and Federal Reserve rate hikes.



Yes, history can be an imperfect guide, but it does provide the data to help build a probability-weighted mosaic for predicting the future. Given our expectations of a rising U.S. economy, and a U.S. investor who is anything but over exuberant, we continue to believe that, over the coming year, the stock market will be pulled northwards by the revived economy.

The Recovery Goes Global

Over the past few quarters, we've expressed our evolving belief that better relative valuations, and, therefore better long-term return opportunities, reside in overseas markets. While we may have arrived early to the party, the appetizers are now finally being served. Indeed, the first quarter of this year saw International Developed and Emerging Markets outperforming the major U.S. indexes.

We expect international's relatively strong performance to continue alongside economic recovery. Eurozone economic data accelerated in the first quarter, and while election risks remain, we believe these worries are adequately reflected in current sentiment, not to mention the fact that for the most important election, in France, polls shows the euro-friendly candidate ahead.

Even in Japan, the economic data is improving, with Japanese corporations showing signs that they will no longer hoard cash and choke the flow of money. With their jobless rate at the lowest level since 1994, wages are rising. Their corporations are also investing in new equipment, while paying out higher dividends.

The Fed is Pricing in Too Much Uncertainty

That said, there are some trends that we're keeping a weather eye on. For example, bond yields around the globe remain exceedingly low. Trillions of dollars of debt globally have negative yields, and much of the debt in the U.S. still yields less than the current level of inflation. Against a backdrop of improving economic growth, the Fed – an entity that spent and expanded its balance sheet by buying Treasuries over the past few years – is now set to enter its period of frugalness. At some point, the Fed may be forced to sell some of the longer-term Treasuries it has accumulated. Indeed, the Fed still owns approximately 33% of the total Treasuries that have a maturity date greater than the next 10 years.

While consumers and business owners have expressed confidence and therefore less uncertainty about the future, Fed policymakers continue to make the term "uncertainty" the most overused economic descriptor in their press conferences and media appearances. At her most recent press conference, Chairwoman Janet Yellen noted her belief that caution, restraint and risk aversion among consumers and businesses over the past few years are some of the reasons why she believes the current real neutral federal funds rate has been low. Put more simply, this thinking shapes the Fed's reasoning as to why short-term interest rates only reside at 1%. She further stated that as this aversion erodes, the real neutral rate will move higher. If our assessment is correct and this change is already underway, then we believe the odds are that the Fed will be forced to increase the pace of its rate hikes.

The Bottom Line

As the world returns to economic normalcy over the coming years, we believe the wildcard may be any adverse reaction in interest rates. While our base case is that any such rise will be gradual and contained, we worry that any unforeseen spike may filter through to the equity markets. As bond traders like to remind us, interest rates are the dog that wags the equity tail. Until then, however, we maintain a positive economic and market outlook.

Northwestern Mutual is the marketing name for The Northwestern Mutual Life Insurance Company, Milwaukee, WI (NM) (life and disability insurance, annuities and life insurance with long-term care benefits) and its subsidiaries. Northwestern Mutual Wealth Management Company®, Milwaukee, WI (investment management, trust services, and fee-based financial planning), subsidiary of NM, limited purpose federal savings bank. **Northwestern Mutual Investment Services, LLC (securities)**, subsidiary of NM, broker-dealer, registered investment adviser, member FINRA and SIPC.

Brent Schutte, CFA®, is chief investment strategist of Northwestern Mutual Wealth Management Company. The opinions expressed are those of Brent Schutte as of the date stated on this report and are subject to change. There is no guarantee that the forecasts made will come to pass. This material does not constitute investment advice and is not intended as an endorsement of any specific investment or security. Information and opinions are derived from proprietary and non-proprietary sources. Sources may include Bloomberg, Morningstar, FactSet and Standard & Poors.

Please remember that all investments carry some level of risk, including the potential loss of principal invested. Indexes and/or benchmarks are unmanaged and cannot be invested in directly. Returns represent past performance, are not a guarantee of future performance and are not indicative of any specific investment. Diversification and strategic asset allocation do not assure profit or protect against loss. Although stocks have historically outperformed bonds, they also have historically been more volatile. Investors should carefully consider their ability to invest during volatile periods in the market. The securities of small capitalization companies are subject to higher volatility than larger, more established companies and may be less liquid. With fixed income securities, such as bonds, interest rates and bond prices tend to move in opposite directions.

When interest rates fall, bond prices typically rise; and conversely, when interest rates rise, bond prices typically fall. This also holds true for bond mutual funds. When interest rates are at low levels, there is risk that a sustained rise in interest rates may cause losses to the price of bonds or market value of bond funds that you own. At maturity, however, the issuer of the bond is obligated to return the principal to the investor. The longer the maturity of a bond or of bonds held in a bond fund, the greater the degree of a price or market value change resulting from a change in interest rates (also known as duration risk). Bond funds continuously replace the bonds they hold as they mature and thus do not usually have maturity dates and are not obligated to return the investor's principal. Additionally, high-yield bonds and bond funds that invest in high-yield bonds present greater credit risk than investment-grade bonds. Bond and bond fund investors should carefully consider risks such as interest rate risk, credit risk, liquidity risk and inflation risk before investing in a particular bond or bond fund.

Standard and Poor's 500 Index® (S&P 500®) is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Conference Board is a global, independent business membership and research association working in the public interest. The Conference Board is a non-advocacy, not-for-profit entity holding 501 (c) (3) tax-exempt status in the United States.

The Conference Board Consumer Confidence Index® (CCI) is a barometer of the health of the U.S. economy from the perspective of the consumer. The index is based on approximately 3,000 completed questionnaires reflecting consumers' perceptions of current business and employment conditions, as well as their expectations for six months hence regarding business conditions, employment, and income.

The Conference Board Leading Economic Index is intended to forecast future economic activity and is calculated by The Conference Board, a non-governmental organization, which determines the value of the index from the values of 10 key variables. These variables have historically turned downward before a recession and upward before an expansion.

The National Bureau of Economic Research (NBER) is a private, nonprofit, nonpartisan research organization dedicated to promoting a greater understanding of how the economy works. The NBER is well known for providing start and end dates for recessions in the U.S.

The eurozone, officially called the euro area, is a monetary union of 19 of the 28 European Union (EU) member states which have adopted the euro as their common currency and sole legal tender. The other nine members of the EU continue to use their own national currencies.

The gross domestic product (GDP) is the amount of goods and services produced in a year, in a country.

61-1185 Not Available for field order.