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Capital Markets

The Nationwide Retirement Institute

Charting the markets

Our perspective on the market and economic forces influencing investment planning and retirement.

3rd Quarter 2015

Data as of June 30, 2015

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Introducing *Charting the Markets*

One of those challenges comes in understanding the market forces that affect investment performance and influence investment decisions. With *Charting the Markets*, we present insights and informative commentary about the economy and the financial markets from Nationwide's staff of economists and analysts. You can share *Charting the Markets* with clients to help answer questions about investment performance and inspire greater confidence in the guidance you provide.

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Executive Summary

The global economy is slowly turning the corner, as confidence, spending, and investment are all generally picking up speed. In the U.S., growth has bounced back from another first quarter contraction and appears poised to improve further in the months ahead.

More broadly, this expansion is playing out as they all have — kick-started by monetary policy accommodation and amplified through the labor market. The aggressive policies adopted by the Federal Reserve have helped to foster renewed job growth, which has driven gains in income, spending, and corporate profits. Rising demand and better profitability have in turn fed back into employment, creating a virtuous cycle that remains very much in place today. The quarters ahead should bring continued growth, further declines in unemployment, and healthy performance in financial markets even as interest rates slowly begin to lift.

Financial markets

Highlights

5 The U.S. equity market remained choppy in the second quarter, losing a bit of ground as the crisis in Greece continued to unfold

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36 The dollar pulled back after Federal Reserve officials scaled back expectations for the pace of interest rate hikes. Commodity prices moved higher

The winning streak ends

S&P 500

Index (log scale)

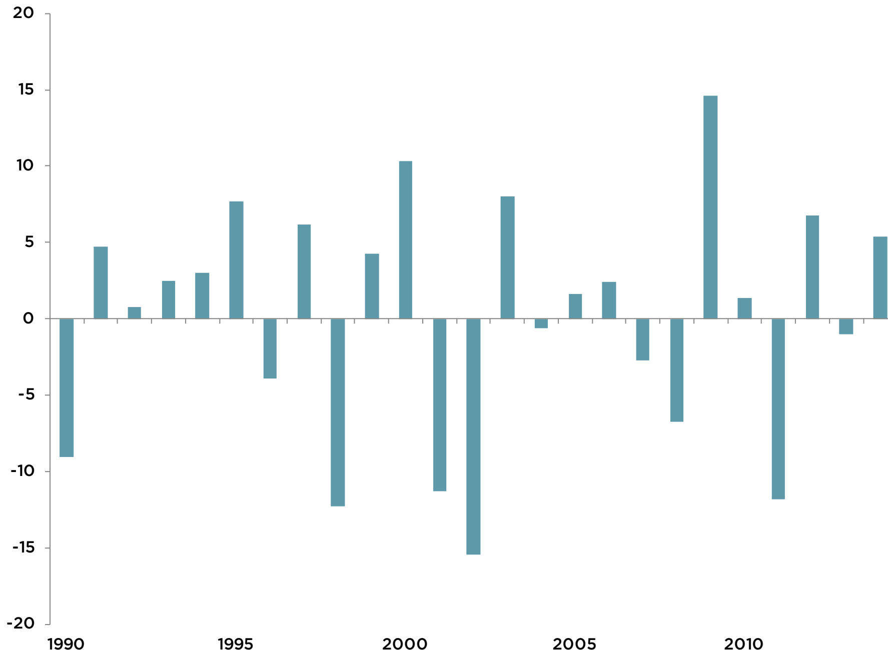
The S&P 500 fell modestly for its first decline in ten quarters in the April-June period, as signs of an improving economy were not enough to offset concerns about the debt crisis in Greece. The unbroken string of consecutive quarterly increases had been the longest for the index since the mid-to-late 1990s.

Source: Standard & Poor's

Sell in May and go away?

Changes in the S&P 500 between Memorial Day and Labor Day

Percent



The summer hasn't always been especially kind to stock market investors, as June and August have been two of only three months in which the S&P 500 has averaged a decline over the past quarter century. Still, the index has more often than not moved higher during the summer months overall and has, at times, recorded very strong gains during these periods.

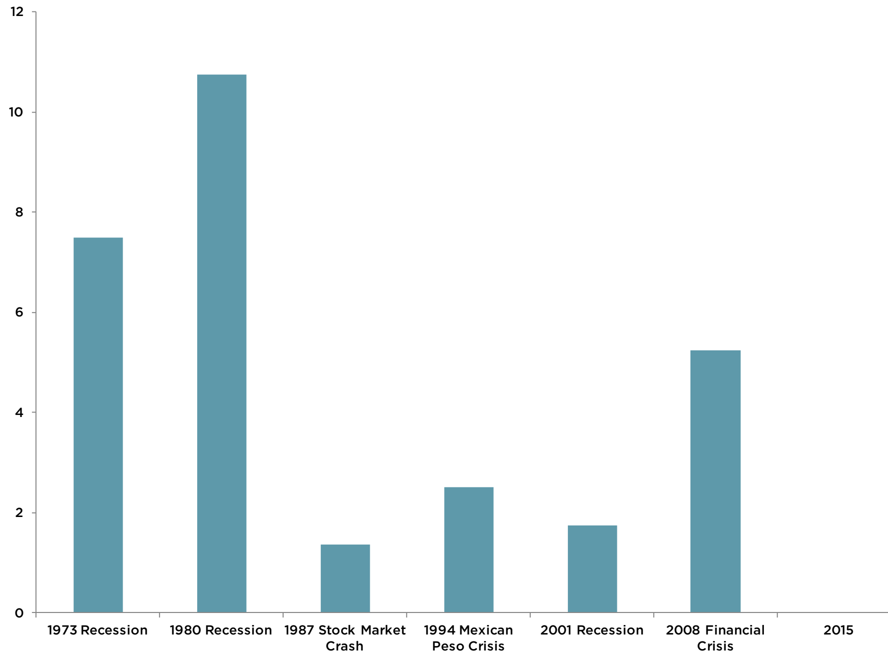
Most importantly, the market's fundamentals remain favorable, unlike those in the summers of 1990, 2000, 2001, 2007, and 2008, for example.

Source: Standard & Poor's

Seven-year cycle driven largely by monetary policy

Changes in the federal funds target prior to seven-year crises

Percentage



From the bear market in 1966 to the financial crisis in 2008, there has remarkably been a significant upheaval every seven years. However, the most important common thread among these events is not the interval between them, but rather the stance of monetary policy preceding them.

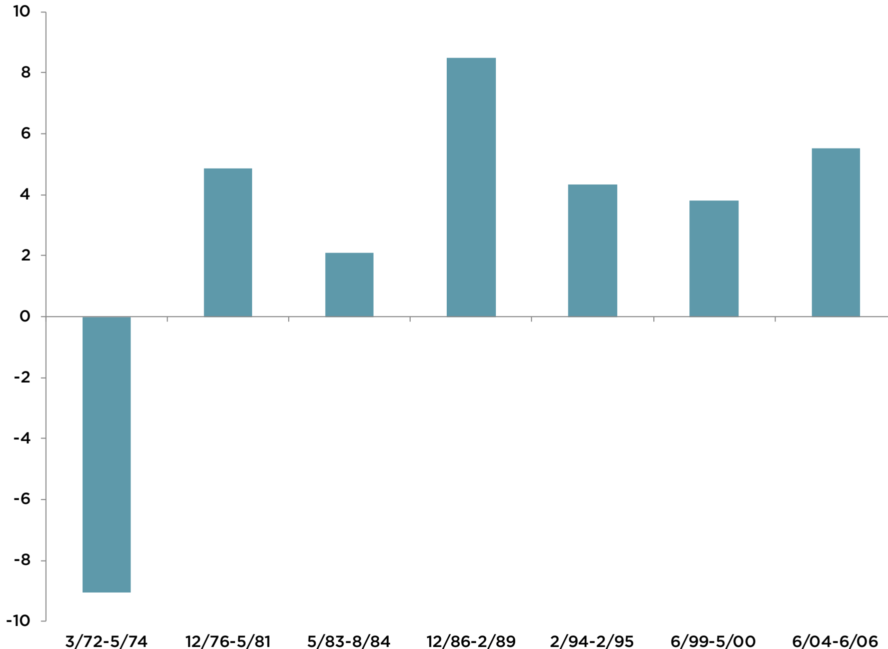
The Fed tightened in front of the stock market crash in 1987, the Mexican peso crisis in 1994, the 2008 financial crisis, and the recessions in 1973, 1980, and 2001. And while the Fed may tighten before this year is out, any rate increases are likely to be modest given the very low rate of inflation and the lingering labor market dislocations from the last recession. The conditions are simply not conducive to the seven-year trend to continue in 2015.

Source: Federal Reserve Board of Governors

Stocks have risen during rate hike cycles

Annualized changes in the S&P 500 during Federal Reserve tightening cycles

Percent



Stocks have moved higher across each of the last six periods in which the Fed was increasing benchmark interest rates, as these periods have coincided with healthy economic growth and rising corporate profits.

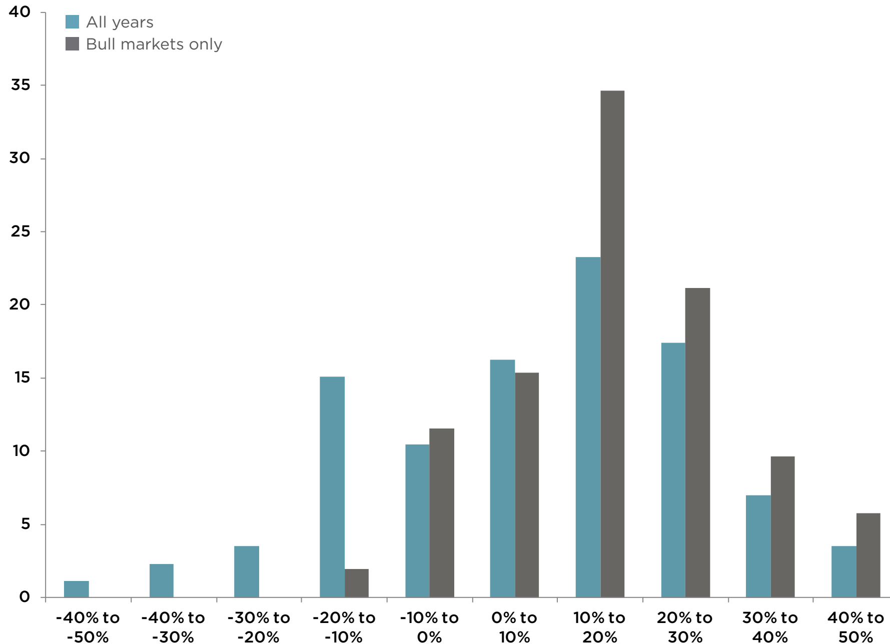
It is typically only after the Fed has finished tightening and the lagged cumulative effects of higher interest rates have pulled the economy down that equity prices have moved lower.

Source: Bloomberg

Double-digit returns occur frequently

Frequency of yearly changes in the S&P 500

Percentage



Although the S&P 500 has averaged a yearly change of 7.5% across its history, single-digit increases have typically occurred only once every six years. Double-digit increases have been more than three times as common as single-digit gains, even before accounting for dividends.

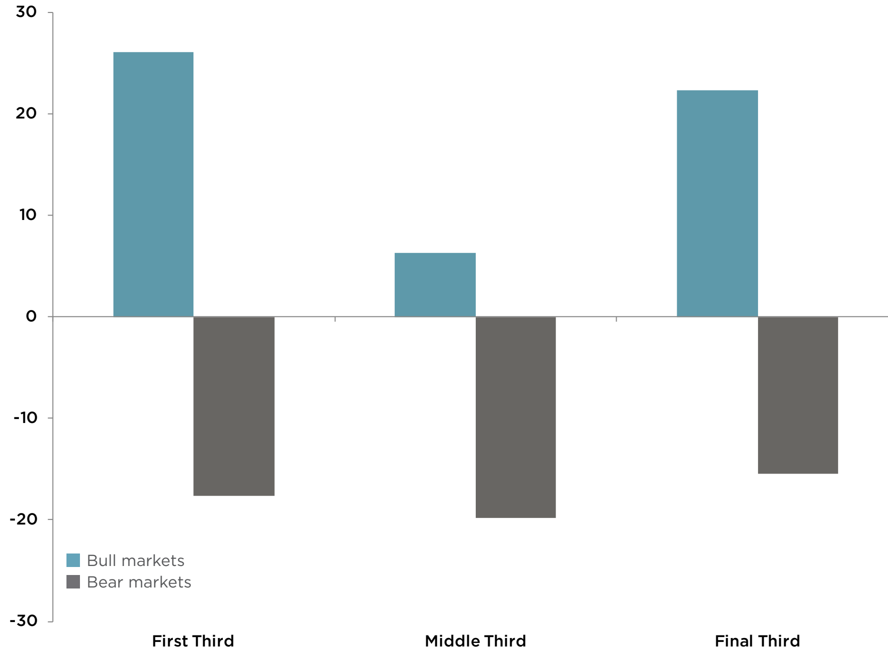
When the market is in an uptrend as it is now, double-digit increases have been more than four times as prevalent as single-digit rises. In fact, there have been just as many annual increases of 30% or more in bull markets as there have been gains of between 0 and 10%.

Source: Standard & Poor's

Stocks tend to soar as bull markets move into latter stages

Average annualized changes in the S&P 500 by stage of market cycle

Percent



Across its history, the S&P 500 has tended to rally strongly in the latter stages of bull markets after hitting a lull in the middle of these cycles. The index has advanced at a double-digit annualized pace in the final third stage in nine out of the last 11 bull markets.

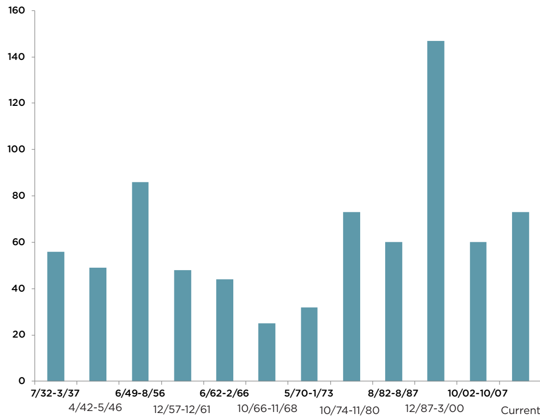
In ten of these cycles, the middle third was the weakest period. This is driven by the fact that stocks tend to spring back in the initial periods coming out of bear markets and then move up robustly again as the economic cycle matures, earnings growth jumps, and sentiment moves to lofty levels.

Source: Standard & Poor's

The bull market still has plenty of room left to run

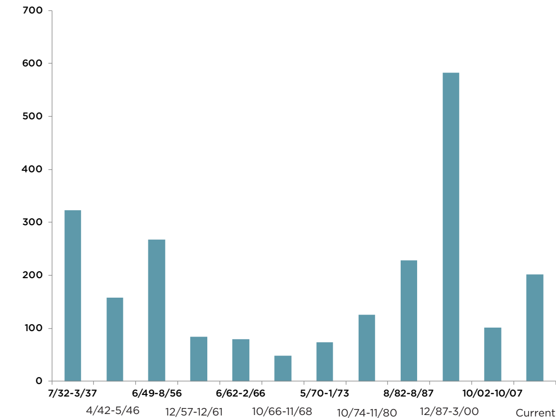
Length of bull markets

Months



Changes in the S&P 500 by bull market

Percent



The bull market is now more than six years old and has already seen a gain exceeding 200% in the S&P 500. While these numbers place the current cycle right in line with the historical averages for both longevity and magnitude, history shows that these periods are far from uniform. The mid-60s cycle ran for just two years and saw an increase in the S&P of less than 50%, while the cycle that ended in early 2000 was more than a dozen years in the making and saw a near-septupling in the index.

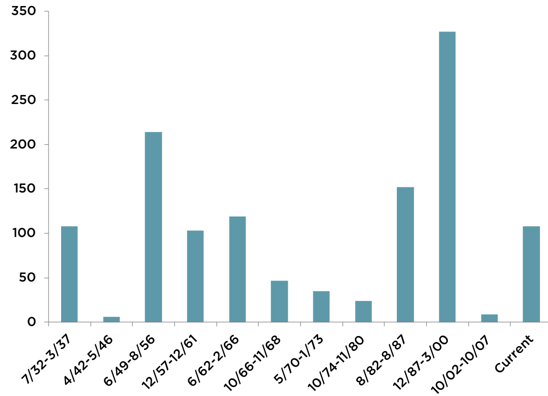
This is simply a reflection of the fact that bull markets die not of old age, but of disease. This one will end as they all do, not after a certain amount of time is reached or a certain return is achieved, but rather only after Fed tightening has been advanced and the economic outlook dims.

Source: Standard & Poor's

This bull market is far from stretched

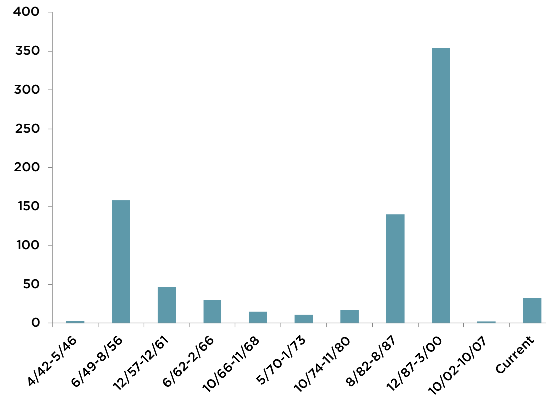
All-time records in the S&P 500 by bull market

Number



Peak to peak changes in the S&P 500 by bull market

Percent



The S&P hit an all-time high for the first time in this cycle in March 2013 and has since gone on to post more than 100 new records, each one bringing with it questions on how much further the rally could extend. In fact, there is no reason why the market shouldn't push ever higher to new peaks as long as the underlying fundamentals remain supportive.

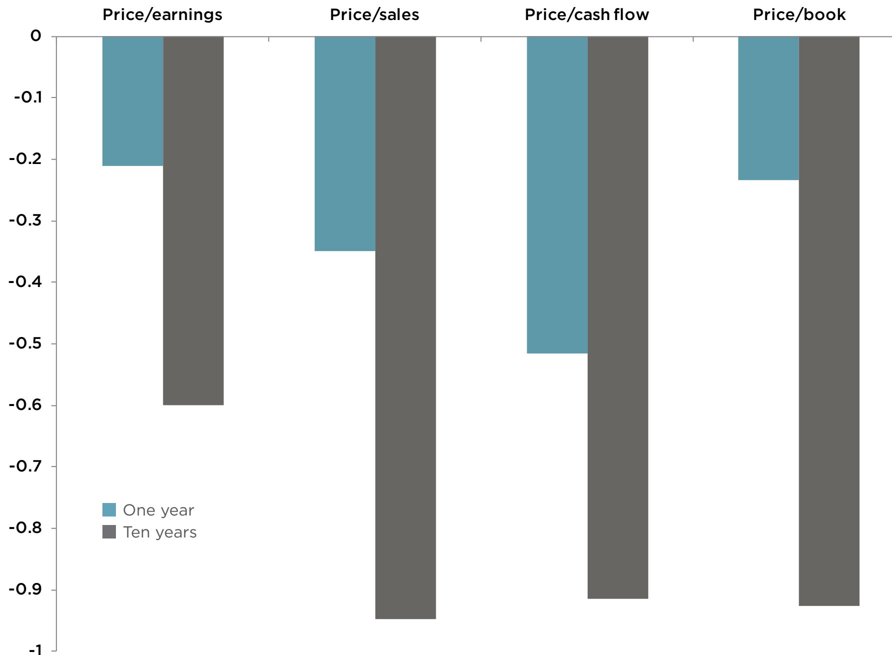
There were over 300 record closes in the long bull run that ended in 2000. And at just over 30% above the previous cycle's high in 2007, the S&P has still added relatively little in this upswing.

Source: Standard & Poor's

Valuations have little influence over short-term returns

Correlations between valuation metrics and S&P 500 returns

Correlation coefficient



Different valuation measures often produce different answers as to whether the stock market is rich, cheap, or fairly priced. What is clear, however, is that none of these metrics is particularly useful in assessing the prospect for market returns over a short-to-intermediate term time frame.

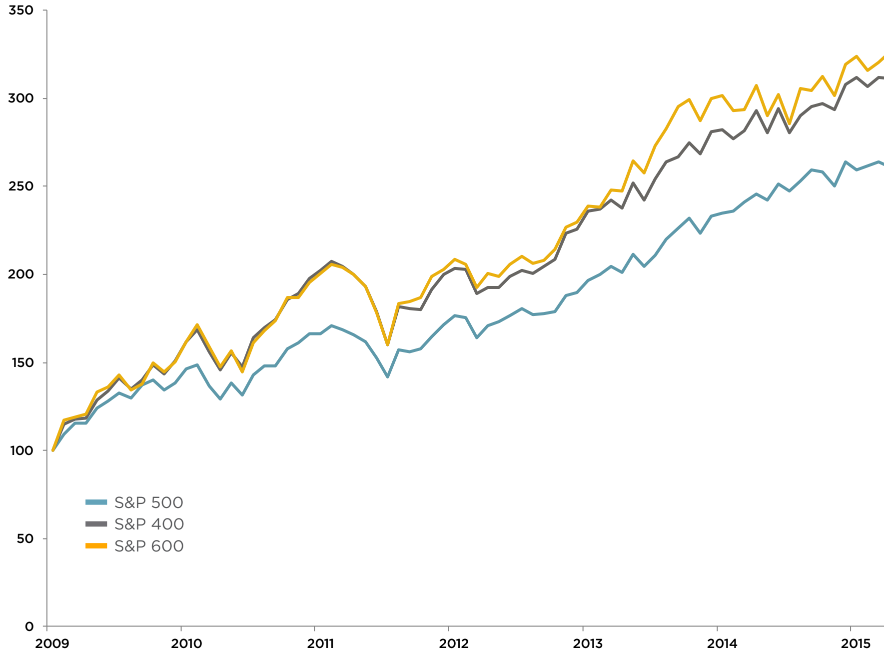
The most popular valuation ratios correlate relatively poorly with subsequent one-year returns, but tend to exhibit very close relationships with longer-term changes in the market. This is a function of the tendency for richly valued markets to fall sharply when the cycle turns from bull market to bear and for cheap markets to take off as recoveries take hold.

Source: Bloomberg

Small- and mid-cap stocks have led the rally

The S&P 500, 400 and 600

Index (March 2009 = 100)



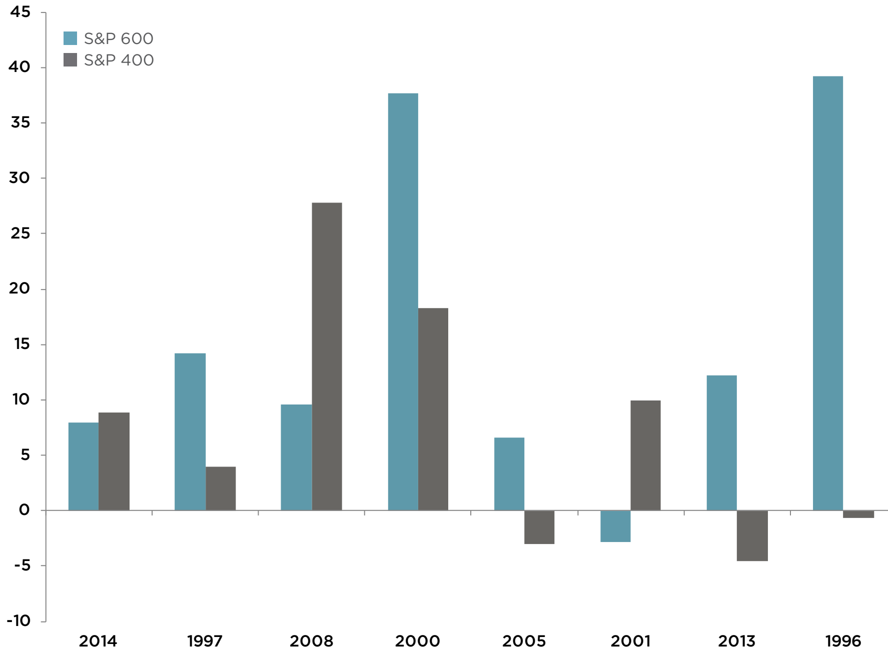
The large-cap S&P 500 outperformed both the mid-cap S&P 400 and small-cap S&P 600 by a wide margin in 2014, but fell behind both again in the first half of 2015.

Source: Standard & Poor's

Smaller companies have less exposure to the rising dollar

Relative changes in S&P 600 and S&P 400 earnings during years with the strongest increases in the trade-weighted dollar

Percentage relative to the S&P 500



Source: Bloomberg

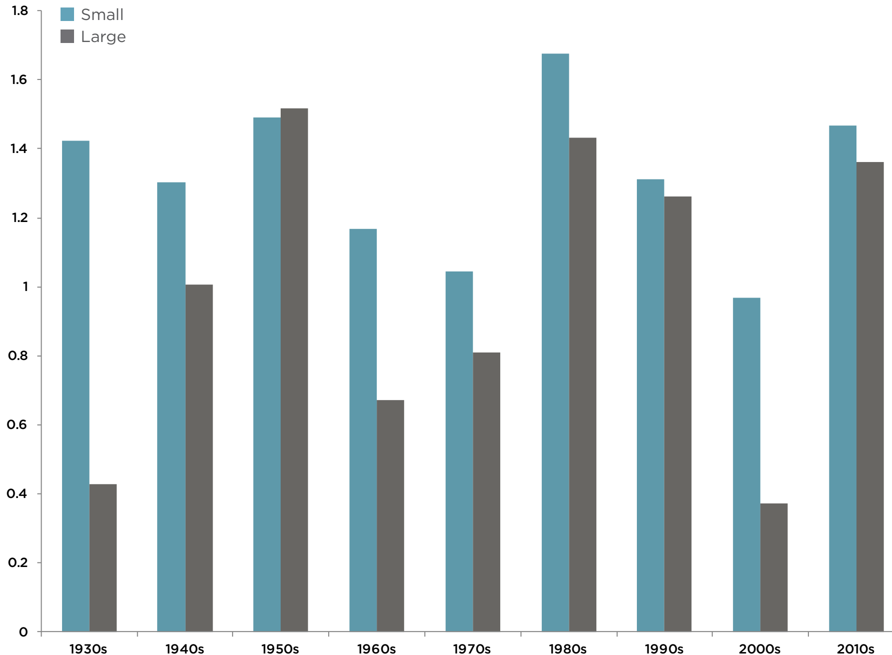
Smaller companies tend to be more domestically focused than larger firms, with foreign sales accounting for less than 40% of S&P 600 revenues vs. close to 50% for the S&P 500. As a result, small-cap earnings tend to be less effected by a rising dollar. In years with the biggest increases in the dollar over the last quarter century, small-cap profits have outpaced large-caps by an average of 15.6%, while mid-caps have outperformed by an average of 7.6%.

Globally focused firms of all sizes will benefit as the world economy continues to stabilize, but the near-term impact of a stronger U.S. currency on corporate profits will be felt less by smaller firms.

Smaller stocks have been stronger over the long run

Average monthly changes in small and large company stocks

Percent



Over long periods of time, small company stocks have consistently outpaced large-caps. The average monthly change in small stocks has exceeded that in large stocks in each of the last eight decades save the 1950s.

Small-caps are also more volatile — the standard deviation of monthly changes in smaller stocks has been higher than that of large-caps in every decade since the 1930s — but have over time compensated investors for the added risk.

Source: Kenneth French, Data as of June 2015

Health care remains at the top of the table

Yearly changes in S&P sectors

Percent

2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015 YTD
Energy 29%	Energy 29%	Telecoms 32%	Energy 32%	Staples -18%	Technology 60%	Discretionary 26%	Utilities 15%	Financials 26%	Discretionary 41%	Utilities 24%	Health Care 9%
Utilities 20%	Utilities 13%	Energy 22%	Materials 20%	Health Care -24%	Materials 45%	Industrials 24%	Staples 11%	Discretionary 22%	Health Care 39%	Health Care 23%	Discretionary 6%
Telecoms 16%	Health Care 5%	Discretionary 17%	Utilities 16%	Utilities -32%	Discretionary 39%	Materials 20%	Health Care 10%	Health Care 15%	Industrials 38%	Technology 18%	Telecoms 1%
Industrials 16%	Financials 4%	Utilities 17%	Technology 16%	Telecoms -34%	S&P 500 23%	Energy 18%	Discretionary 4%	S&P 500 13%	Financials 33%	Financials 13%	S&P 500 0%
Discretionary 12%	S&P 500 3%	Financials 16%	Staples 12%	Discretionary -35%	Industrials 17%	S&P 500 13%	Energy 3%	Technology 13%	S&P 500 30%	Staples 13%	Technology 0%
Materials 11%	Materials 2%	Materials 16%	Industrials 10%	Energy -36%	Health Care 17%	Telecoms 12%	Technology 1%	Telecoms 12%	Technology 26%	S&P 500 11%	Materials -1%
S&P 500 9%	Staples 1%	S&P 500 14%	Telecoms 8%	S&P 500 -38%	Financials 15%	Financials 11%	Telecoms 1%	Industrials 12%	Materials 23%	Discretionary 8%	Financials -1%
Financials 8%	Technology 0%	Staples 12%	Health Care 5%	Industrials -42%	Energy 11%	Staples 11%	S&P 500 0%	Materials 12%	Staples 23%	Industrials 8%	Staples -2%
Staples 6%	Industrials 0%	Industrials 11%	S&P 500 4%	Technology -44%	Staples 11%	Technology 9%	Industrials -3%	Staples 8%	Energy 22%	Materials 5%	Industrials -4%
Technology 2%	Discretionary -7%	Technology 8%	Discretionary -14%	Materials -47%	Utilities 7%	Utilities 1%	Materials -12%	Energy 2%	Utilities 9%	Telecoms -2%	Energy -6%
Health Care 0%	Telecoms -9%	Health Care 6%	Financials -21%	Financials -57%	Telecoms 3%	Health Care 1%	Financials -18%	Utilities -3%	Telecoms 6%	Energy -10%	Utilities -12%

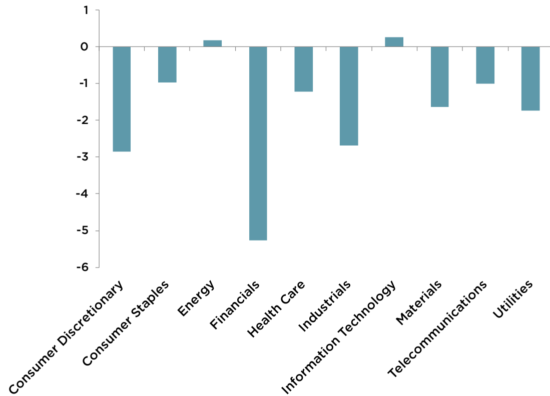
Health care stocks continued to climb in the second quarter while energy shares fell further even as energy prices moved higher. The S&P Health Care Index has recorded only one annual decline in the last 13 years.

Source: Bloomberg

Technology and energy have bucked the dividend trend

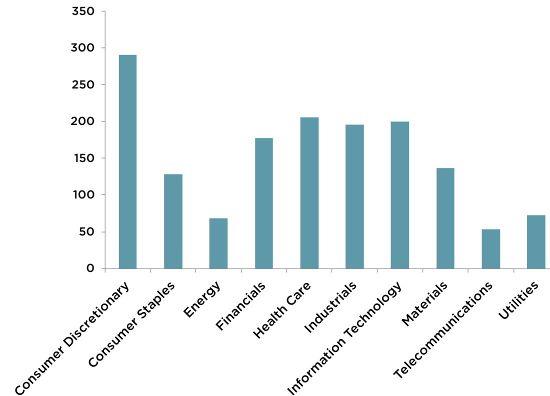
Changes in dividend yield across current bull market

Percent



Changes in S&P 500 sectors across current bull market

Percent



Dividend yields have been in a long-term structural increase since 2000, but have been in a shorter-term cyclical decline since the end of the bear market as payouts haven't quite kept pace with the uptrend in prices. This has been true in every S&P 500 sector except for energy and information technology.

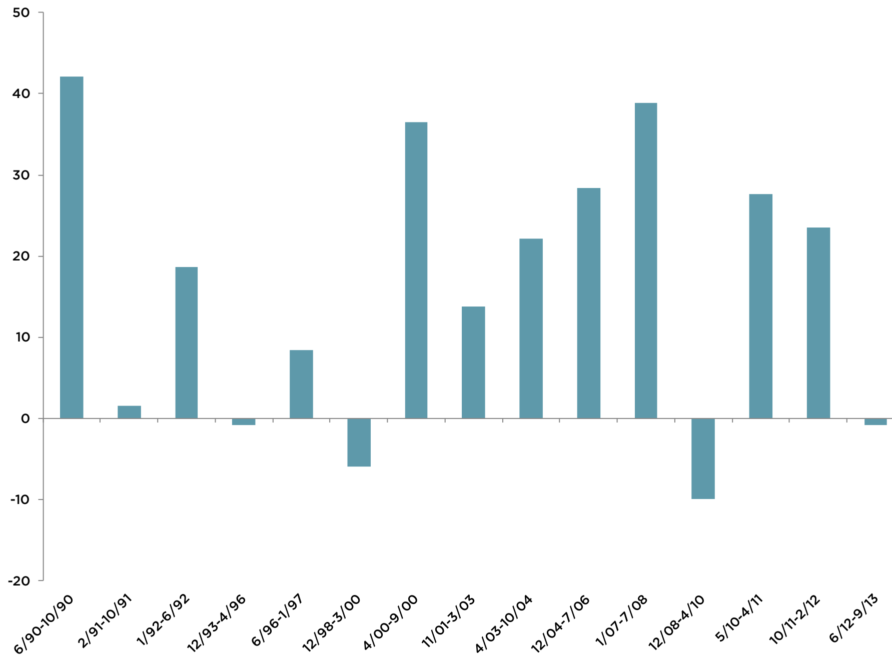
For technology, this is simply a continuation of the trend that began 15 years ago while for energy, the rise in yield owes in part to the fact that the sector has underperformed substantially in recent years. Since the bear market came to an end, only the telecoms have turned in worse performance than energy stocks.

Source: Bloomberg

Energy stocks outperform when oil prices are rising

Spread between annualized changes in the S&P Energy Index and the S&P 500 during oil bull markets

Percent



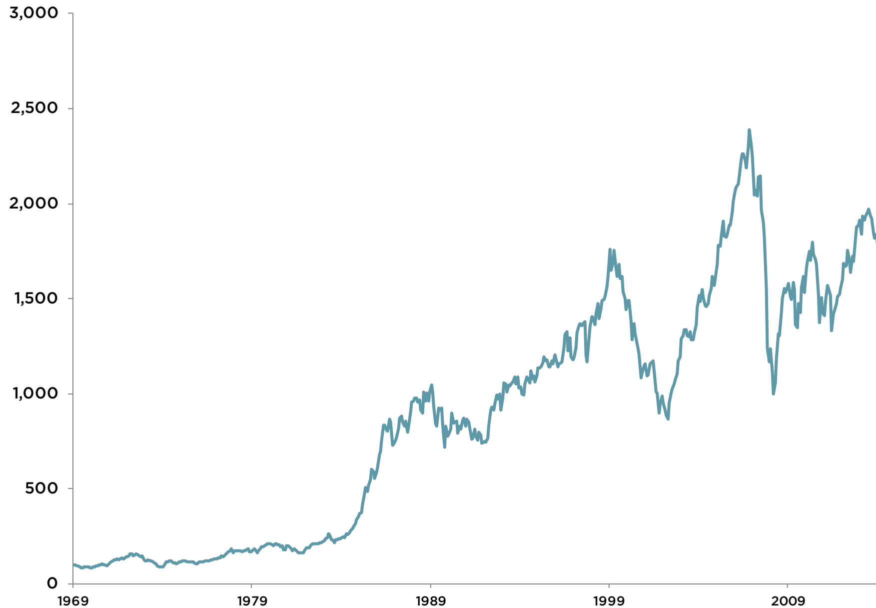
Falling oil prices weighed on energy stocks throughout 2014 and early 2015, as the sector underperformed the S&P 500 in seven out of the last eight quarters.

Oil prices recently moved back into an uptrend, however, and energy stocks have historically tended to outperform during these periods. Across the last 15 bull markets in crude oil prices, the S&P Energy Index has outpaced the broader market by an average of 16.3% on an annualized basis.

Source: Bloomberg

Global stocks move higher again

MSCI EAFE Index



Despite a Greece and China-led pullback in June, international stocks rose for a second straight quarter and hit their highest level in nearly a year. Strength in Asia offset a pullback in Europe while emerging markets underperformed.

Source: Bloomberg

China still up on the year after a bear market

Yearly changes in benchmark equity indices

Percent

2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015 YTD
Brazil 18%	Russia 83%	China 130%	China 97%	UK -31%	Russia 121%	Russia 23%	US 0%	Germany 29%	Japan 57%	China 53%	China 32%
Italy 15%	India 42%	Russia 68%	India 47%	Canada -35%	Brazil 83%	India 17%	UK -6%	India 26%	US 30%	India 30%	Russia 18%
India 13%	Japan 40%	India 47%	Brazil 44%	US -38%	India 81%	Germany 16%	Canada -11%	Japan 23%	Germany 25%	US 11%	Italy 18%
Canada 12%	Brazil 28%	Brazil 33%	Germany 22%	Germany -40%	China 80%	Canada 14%	Germany -15%	France 15%	France 18%	Canada 7%	Japan 16%
US 9%	Germany 27%	Germany 22%	Russia 12%	Brazil -41%	Canada 31%	US 13%	Russia -17%	US 13%	Italy 17%	Japan 7%	France 12%
Japan 8%	France 23%	France 18%	Canada 7%	Japan -42%	Germany 24%	UK 9%	France -17%	Italy 8%	UK 14%	Germany 3%	Germany 12%
UK 8%	Canada 22%	Italy 16%	UK 4%	France -43%	US 23%	Brazil 1%	Japan -17%	Brazil 7%	Canada 10%	Italy 0%	Brazil 6%
France 7%	UK 17%	Canada 15%	US 4%	Italy -50%	France 22%	Japan -3%	Brazil -18%	UK 6%	India 9%	France -1%	India 1%
Germany 7%	Italy 16%	US 14%	France 1%	India -52%	UK 22%	France -3%	China -22%	Russia 5%	Russia 2%	UK -3%	US 0%
Russia 7%	US 3%	UK 11%	Italy -7%	China -65%	Italy 19%	Italy -13%	India -25%	Canada 4%	China -7%	Brazil -3%	Canada -1%
China -15%	China -8%	Japan 7%	Japan -11%	Russia -67%	Japan 19%	China -14%	Italy -25%	China 3%	Brazil -15%	Russia -7%	UK -1%

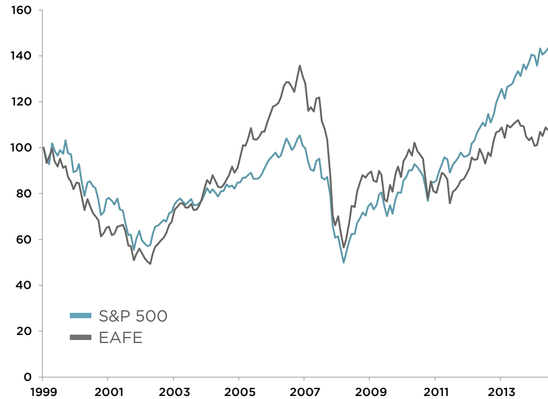
Chinese stocks fell into a bear market in June, but were still up strongly for the first half of the year thanks to a near-doubling through May. The U.S. was a laggard among larger economies.

Source: Bloomberg

Global markets have room to catch up

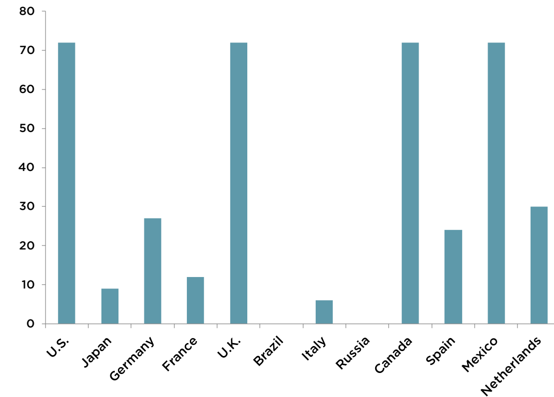
The S&P 500 and MSCI EAFE Index

Index (12/99 = 100)



Time since last recession

Months

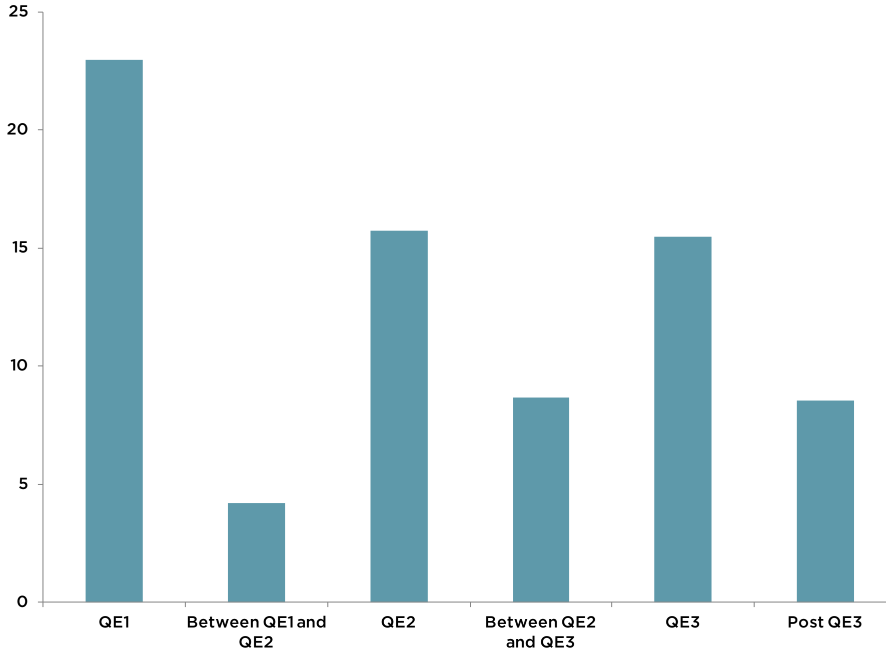


Global developed markets have lagged the U.S. badly in recent years, returning an annualized 8.4% over the last 15 quarters vs. an 18.8% pace for the S&P 500. This owes in large part to the fact that many economies fell into double-dip recessions in the first part of this decade and are now just in the early stages of renewed recoveries. As the nascent expansions in these countries gather steam, market performance should follow in kind.

Source: Bloomberg

Quantitative easing will boost European equities...

Annualized changes in the S&P 500 across the quantitative easing cycle
Percent



Since the Federal Reserve launched its first quantitative easing (QE) program in 2009, the U.S. stock market has fared better during those periods in which the central bank was actively expanding its balance sheet through bond purchases. Similarly, the Nikkei has risen at a near 20% annualized pace since the Bank of Japan began its own QE program in 2013.

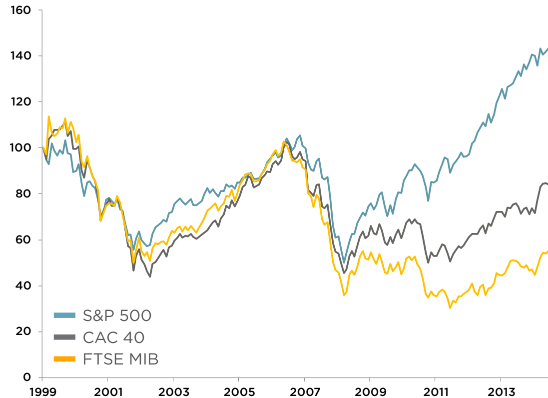
In theory, central bank bond buying should lift inflation expectations and incent investors to take on more risk. The experience in the U.S. and Japan in recent years lends credence to that view and, with the European Central Bank now following a similar path, bodes well for European market performance in the quarters ahead.

Source: Bloomberg

...as will long overdue reforms

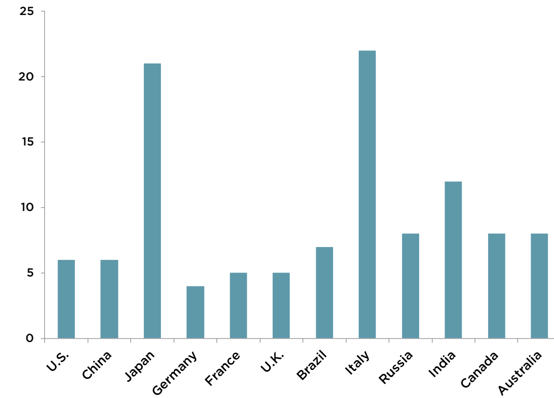
The S&P 500, CAC 40 and FTSE MIB

Index (12/99 = 100)



Heads of state, 1980-present

Number



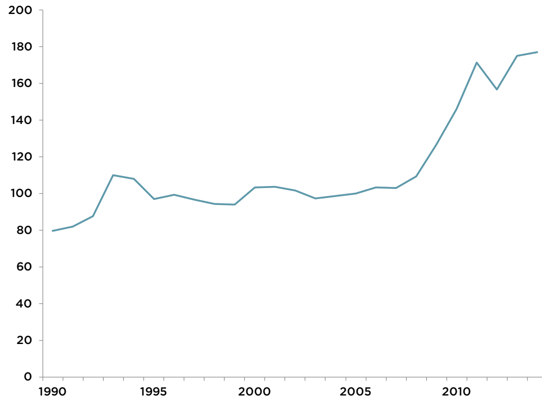
Some of the larger European markets have turned in especially poor relative performance not just in recent years, but over the course of more than a decade. Italy's MIB has trailed the S&P 500 for eight consecutive years while France's CAC has outperformed the U.S. benchmark only once in that time frame.

The future looks brighter for these markets, though, thanks to the European Central Bank's large-scale quantitative easing program as well as to renewed drive for reform. Taxes have been cut and some industries have been deregulated in France, while in Italy, a recently passed electoral reform should mean more stable governments and hence better governance moving forward. Italy has had 22 different governments since 1980, making for an especially ineffective public sector.

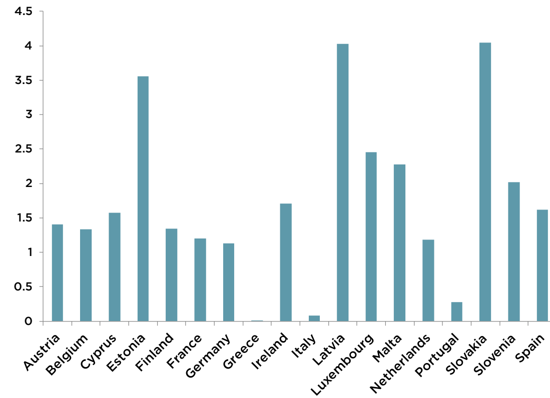
Source: Bloomberg

Greece on the brink, again

Greek sovereign debt as a percentage of GDP
Percent



Annualized real GDP growth, 2000-present
Percent



Greece's status within the eurozone is once again in jeopardy after the country defaulted on a loan repayment to the International Monetary Fund on June 30 and instituted capital controls to prevent a run on its banks. This is the latest in a long-running crisis that has seen the country's debt burden rise to among the highest in the world despite two bailouts and the biggest sovereign restructuring in history in 2012.

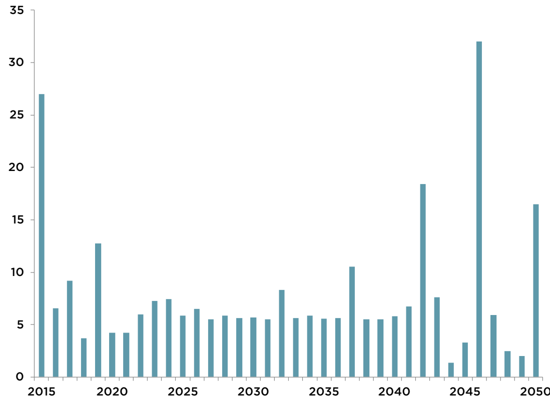
In fact, the roots of the crisis likely date back to Greece's adoption of the euro in 2001; plagued by poor productivity growth and weak institutions, it has consistently produced the slowest growth rates in the currency zone and hence has been burdened with interest and exchange rates that have been too restrictive relative to its fundamentals.

Source: Eurostat

Greek crisis unlikely to derail global recovery

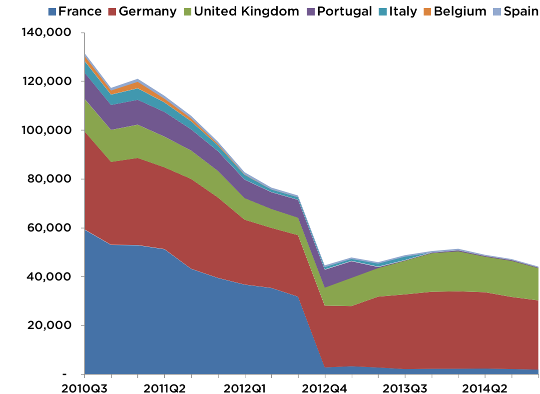
Greek debt payments due

Billion euros



Bank exposure to Greek sovereign debt

$ Millions



While this latest chapter in the Greek debt crisis has pushed the country closer to an exit from the eurozone, such an outcome is still far from assured. Greece's obligations are heavily front-end loaded, suggesting that its debt burden could be sustainable for a time if it can make it past 2015.

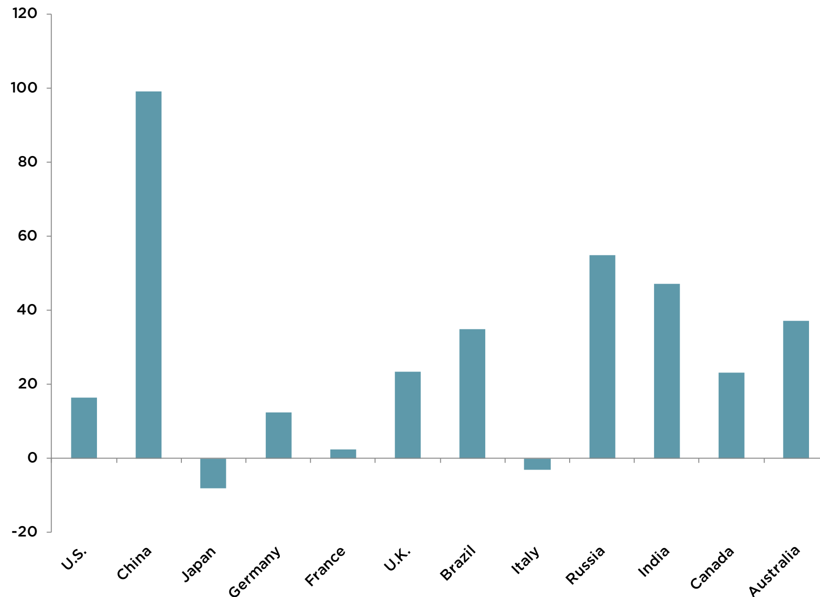
The European authorities have the wherewithal to bail Greece out again and still have a vested interest in keeping the country in the fold given its existing obligations as well as its geopolitical importance. Should an exit actually take place, the risk of contagion is likely to be limited given the relatively modest exposure to Greek debt in the European banking system.

Source: Bloomberg, Bank for International Settlements

Chinese crosscurrents mask an ongoing growth story

Changes in per capita GDP, current decade

Percent



Source: Global Insight

Chinese equities have been extremely volatile this year, as the benchmark index doubled in just over five months before rapidly falling into a bear market over a two-week time span in mid-June. The manic swings owe in no small part to the opacity of the Chinese economic data and the often incongruous longer-term trends.

Beneath the surface, however, China is still emerging in the truest sense — per capita GDP nearly doubled in the first five years of this decade, a growth rate bested only by Turkmenistan and Mongolia (two countries that, not coincidentally, are closely tied to China economically) and one that comes on the heels of a 340% increase in the prior decade. China faces numerous challenges, but its long-term structural tailwinds that are now manifesting themselves lend credence to what was very recently world-beating market performance.

Yields were back on the rise in Q2

Ten and two-year U.S. Treasury yields

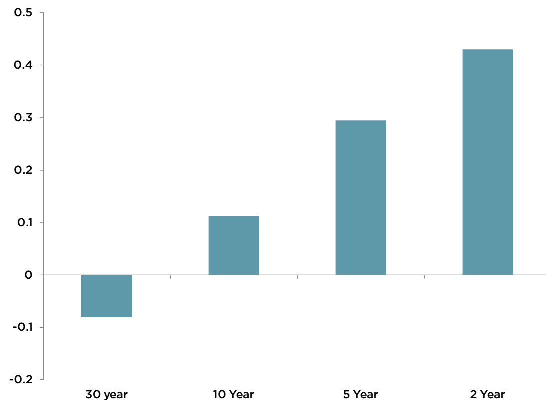
Percent

Better economic data and expectations that the Federal Reserve might begin tightening policy later this year sent both short and long rates higher in the second quarter.

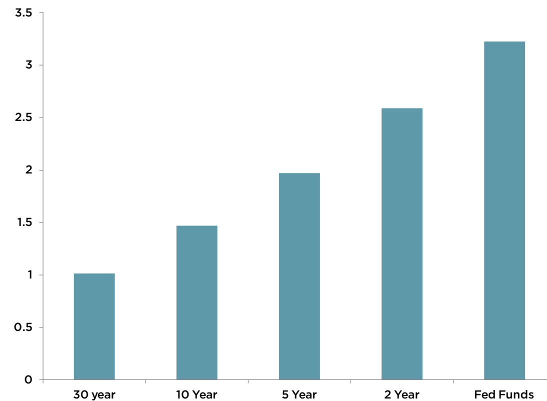
Source: Bloomberg

Rates should begin to lift as monetary tightening draws near

Average changes in yield between Fed easing and tightening cycles
Percent



Average changes in yield during Fed tightening cycles
Percent

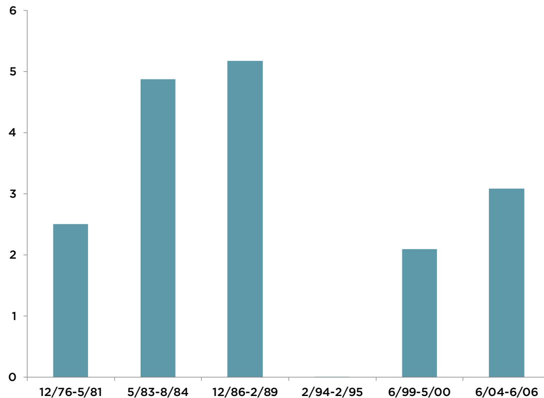


Rates across the yield curve are largely a function of monetary policy. Yields generally begin rising after the Fed ends an easing cycle and typically continue to move higher as benchmark rates begin climbing. The curve flattens during these periods as well, with Fed policy exerting a bigger pull on short-term rates than on long-term rates. On average, ten-year yields rise at half the pace of the federal funds target during monetary tightening cycles.

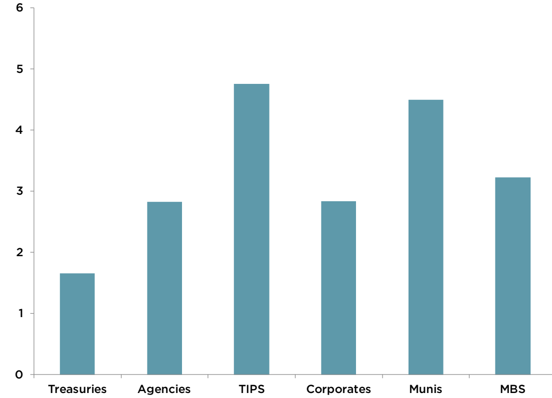
Source: Bloomberg

Fixed income returns have remained positive during rate hike cycles

Annualized returns in the Barclays Aggregate Fixed Income Index during Federal Reserve tightening cycles
Percent



Annualized fixed income returns during the 2004–06 tightening cycle
Percent



While fixed income investments tend to underperform when the Fed is raising rates, the carry they earn — the income portion of fixed income — has meant that they generally haven't lost money during these periods. Low yields will pressure returns in the forthcoming Fed cycle, but even modest carry should help a diversified basket of fixed income investments avoid substantial losses.

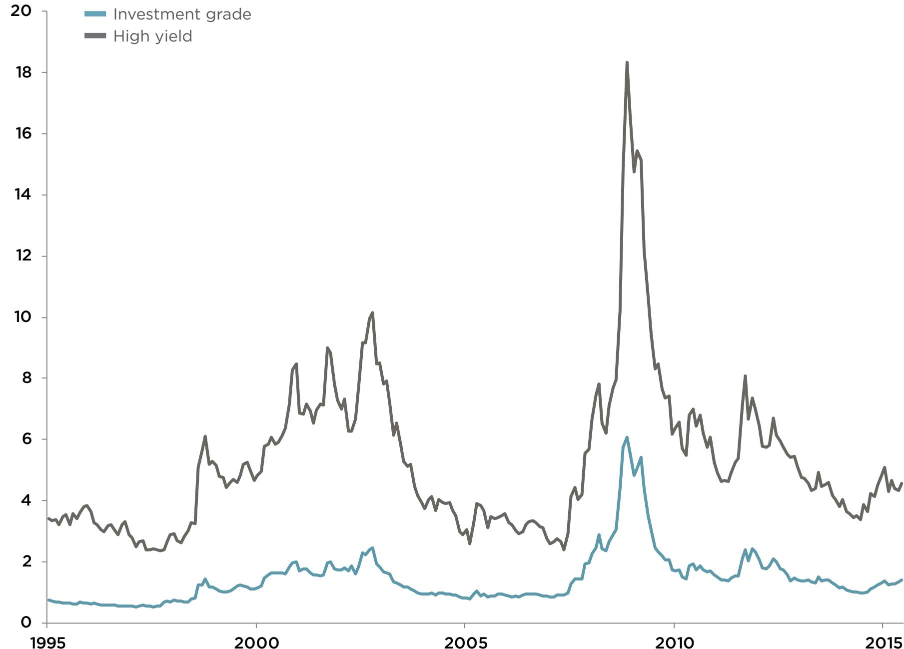
Yields were also relatively low at the outset of the 2004–06 tightening cycle — the fed funds target started that period at 1.0% — and all major fixed income asset classes still gained marginal ground across the cycle.

Source: Barclays

Spreads still have room to tighten

Investment grade and high yield option adjusted spreads

Percent



Credit spreads hit two-year highs in the second quarter and remain somewhat wide for this stage of the business cycle. Investment grade corporate spreads, which ended the first half of the year at 1.4%, were below 1% for the better part of four years in the last cycle and for nearly seven years in the 1990s cycle.

High yield spreads have followed a similar pattern. Most importantly, spreads do not begin rising in earnest until the economic cycle turns.

Source: Barclays

Most fixed income asset classes little changed in 2015

Yearly changes by asset class

Percent

2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015 YTD
Municipals 3.5%	High Yield 11.8%	Barclays TIPS 11.8%	Treasuries 20.1%	High Yield 58.2%	High Yield 15.1%	Treasuries 17.2%	High Yield 15.8%	High Yield 7.4%	Treasuries 10.7%	High Yield 2.5%
High Yield 2.7%	MBS 5.2%	Treasuries 9.7%	Agencies 9.3%	Corporates 18.7%	Corporates 9.0%	Barclays TIPS 14.0%	Corporates 9.8%	Agencies -1.4%	Municipals 9.1%	Agencies 0.6%
Barclays TIPS 2.7%	Municipals 4.8%	Agencies 7.9%	MBS 8.3%	Municipals 12.9%	Treasuries 8.0%	Municipals 10.7%	Barclays TIPS 7.3%	MBS -1.4%	Corporates 7.5%	MBS 0.2%
MBS 2.6%	Agencies 4.4%	Barclays Agg 7.0%	Barclays Agg 5.2%	Barclays TIPS 10.5%	Barclays Agg 6.5%	Corporates 8.1%	Municipals 6.8%	Corporates -1.5%	MBS 6.1%	Municipals 0.1%
Barclays Agg 2.4%	Barclays Agg 4.3%	MBS 6.9%	Barclays TIPS -1.7%	Barclays Agg 5.9%	Barclays TIPS 6.3%	Barclays Agg 7.8%	Barclays Agg 4.2%	Barclays Agg -2.0%	Barclays Agg 6.0%	Barclays TIPS 0.1%
Agencies 2.3%	Corporates 4.3%	Corporates 4.6%	Municipals -2.5%	MBS 5.9%	MBS 5.4%	MBS 6.2%	Treasuries 4.1%	Municipals -2.6%	Barclays TIPS 4.4%	Barclays Agg -0.1%
Treasuries 2.1%	Treasuries 1.3%	Municipals 3.4%	Corporates -4.9%	Agencies 1.5%	Agencies 4.4%	High Yield 5.0%	MBS 2.6%	Treasuries -7.8%	Agencies 3.6%	Treasuries -0.5%
Corporates 1.7%	Barclays TIPS 0.5%	High Yield 1.9%	High Yield -26.2%	Treasuries -9.8%	Municipals 2.4%	Agencies 4.8%	Agencies 2.2%	Barclays TIPS -9.3%	High Yield 2.5%	Corporates -1.0%

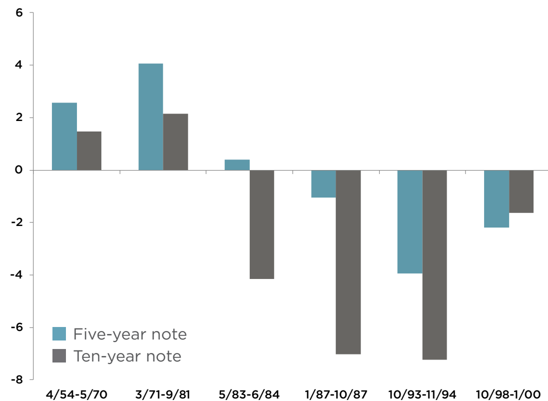
Returns for spread products mostly languished in the first six months of the year. High yield rebounded a bit after falling into the end of 2014.

Source: Barclays

Treasury losses tend to be limited in rising rate environments

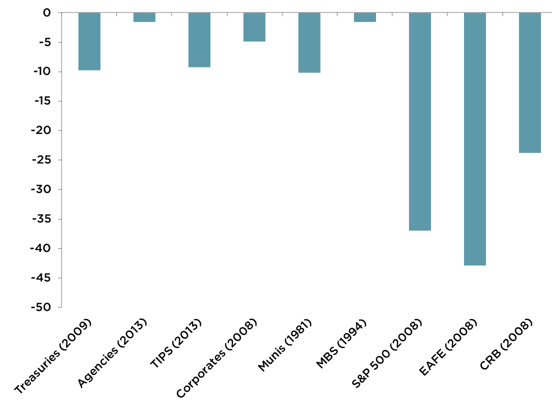
Treasury market returns during fixed income bear markets

Percent



Worst annual return performance, 1980-present

Percent



While Treasuries have generally sold off in recent decades when long-term rates have been rising, these losses have generally been limited, even when the rate increases have been substantial. From 1971 to 1981, for example, the 10-year yield jumped from less than 6% to more than 15% and yet intermediate and long Treasuries still delivered modest but positive returns, thanks to their income components.

Shorter bear markets with fewer coupons to clip saw losses, but these were far from catastrophic. Again, it is the income component of fixed income that constrains the potential losses relative to other asset classes. Over the last three and a half decades, the declines in even the worst years for most fixed income asset classes have been limited to the single-digits.

Source: Bloomberg

Commodity prices stabilized in the second quarter

The CRB Commodity Index

Index

Commodities rose for the first time in a year in the second quarter, as energy prices bounced back. Still, the longer-term downtrend looks to remain intact as commodity demand continues to catch up to the lift in supply that dates back to the last cycle.

Source: Commodity Research Bureau

Commodity prices remain broadly on the decline for the year

Yearly changes in commodity index prices

Percent

2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015 YTD
Industrials 36%	Industrials 61%	Energy 42%	Precious Metals 0%	Industrials 82%	Precious Metals 34%	Precious Metals 7%	Agriculture 6%	Energy 5%	Livestock 14%	Energy 1%
Energy 31%	Precious Metals 24%	Agriculture 28%	Livestock -27%	Precious Metals 25%	Agriculture 34%	Energy 5%	Precious Metals 6%	Livestock -4%	Precious Metals -4%	Precious Metals -1%
Precious Metals 19%	Agriculture 13%	Precious Metals 28%	Agriculture -29%	Energy 11%	Industrials 17%	Livestock -1%	Industrials 1%	Industrials -13%	Industrials -7%	Agriculture -6%
Livestock 3%	Livestock -7%	Industrials -6%	Industrials -49%	Agriculture 4%	Livestock 10%	Agriculture -16%	Energy -1%	Agriculture -18%	Agriculture -11%	Livestock -9%
Agriculture 2%	Energy -27%	Livestock -9%	Energy -52%	Livestock -14%	Energy 2%	Industrials -22%	Livestock -4%	Precious Metals -30%	Energy -44%	Industrials -10%

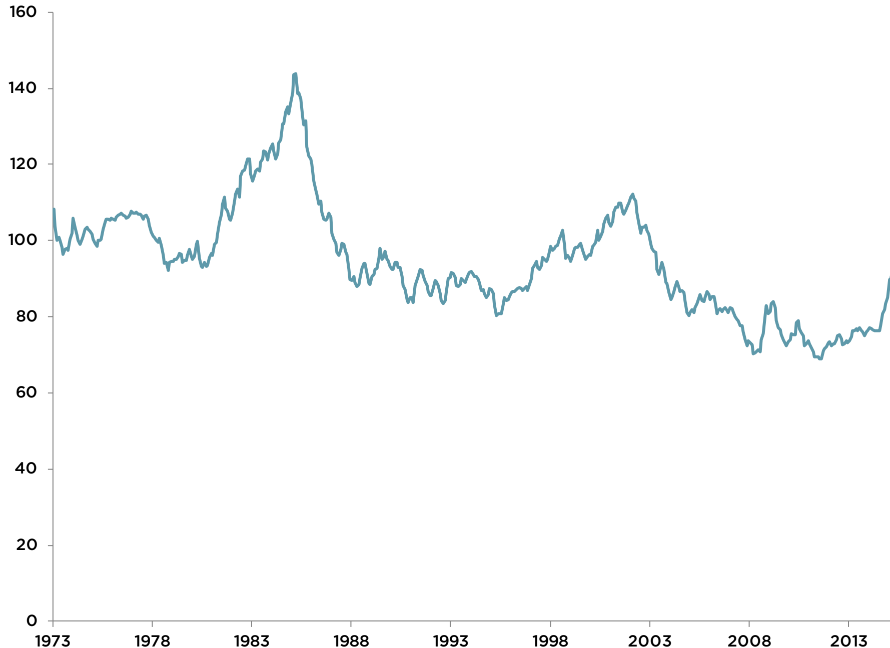
While energy prices are now positive on a year-to-date basis, every other commodity sector remains in negative territory.

Source: Goldman Sachs

The dollar takes a breather

The trade-weighted major currencies U.S. dollar index

Index



The dollar fell for the first time in a year in the second quarter and by the most in any quarter since 2012. With the Fed still likely to tighten policy before other major central banks, however, the uptrend could well resume before long.

Source: Federal Reserve Board of Governors

The euro is slouching toward parity

Annual currency changes

Percent

2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015 YTD
Dollar Index 12.8%	British Pound 12.0%	Canadian Dollar 14.4%	Japanese Yen 18.9%	Canadian Dollar 13.6%	Japanese Yen 12.8%	Japanese Yen 5.2%	British Pound 4.4%	Euro 4.0%	Dollar Index 12.8%	Dollar Index 5.8%
Canadian Dollar 3.3%	Euro 10.2%	Euro 9.5%	Dollar Index 6.0%	British Pound 9.7%	Canadian Dollar 5.2%	Dollar Index 1.5%	Canadian Dollar 2.9%	British Pound 1.9%	British Pound -6.3%	British Pound 0.9%
British Pound -11.3%	Canadian Dollar -0.3%	Japanese Yen 6.1%	Euro -4.4%	Euro 2.5%	Dollar Index 1.5%	British Pound -0.5%	Euro 1.7%	Dollar Index 0.3%	Canadian Dollar -9.4%	Japanese Yen -2.2%
Euro -14.4%	Japanese Yen -1.1%	British Pound 1.3%	Canadian Dollar -22.1%	Japanese Yen -2.6%	British Pound -3.6%	Canadian Dollar -2.3%	Dollar Index -0.5%	Canadian Dollar -7.1%	Euro -13.6%	Canadian Dollar -7.5%
Japanese Yen -14.7%	Dollar Index -8.2%	Dollar Index -8.3%	British Pound -35.9%	Dollar Index -4.2%	Euro -7.1%	Euro -3.3%	Japanese Yen -12.8%	Japanese Yen -21.4%	Japanese Yen -13.7%	Euro -8.6%

The euro recovered slightly in the second quarter, but remains on track for another annual decline. The pound has been bolstered by better-than-expected economic growth in the U.K.

Source: Bloomberg

U.S. economy

Highlights

39 Real GDP growth was healthy in the second quarter, led by solid consumer spending growth and a jump in residual investment

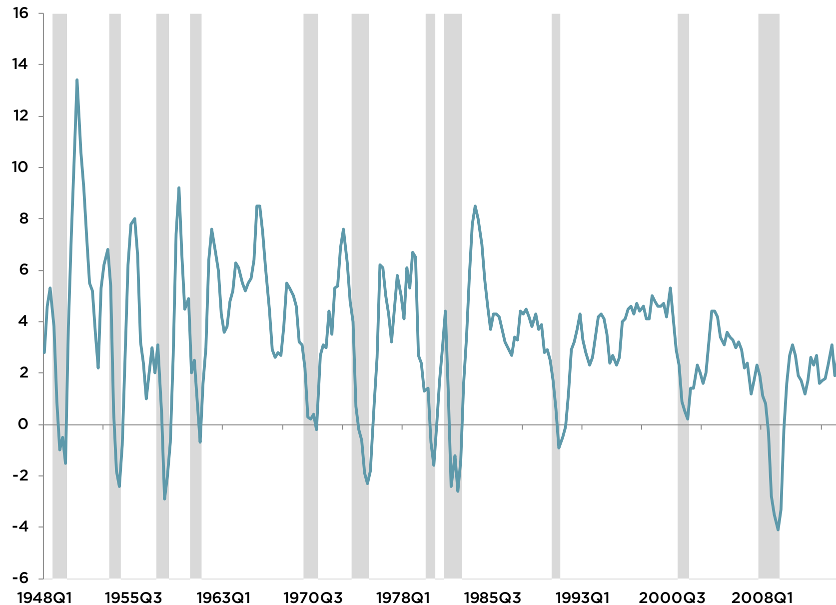
43 The onset of the next recession will still be distant even after the Federal Reserve begins to tighten monetary policy

47 Core inflation pressures continued to build slowly

The expansion is slowly gaining traction

Yearly changes in real gross domestic product (GDP)

Percent



Growth has been mediocre throughout this recovery, with real GDP averaging an annual increase of just 2.2% since the recession ended in 2009. The pace of expansion is beginning to lift, however, as GDP has advanced at an annualized pace of at least 3.5% in four out of the last seven quarters.

For the second straight year, real GDP growth quickly bounced back after a first quarter contraction.

Source: Bureau of Economic Analysis; Note: Shaded areas depict recessionary periods.

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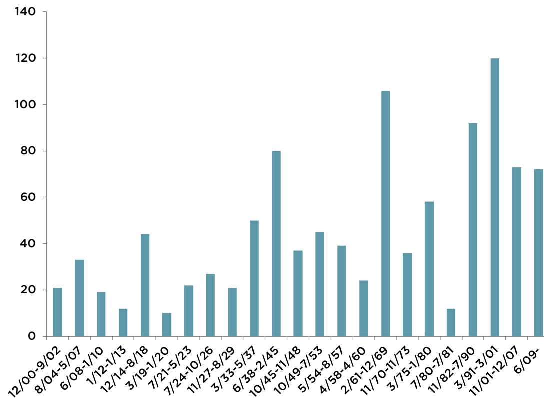
Recovery has a long way to run

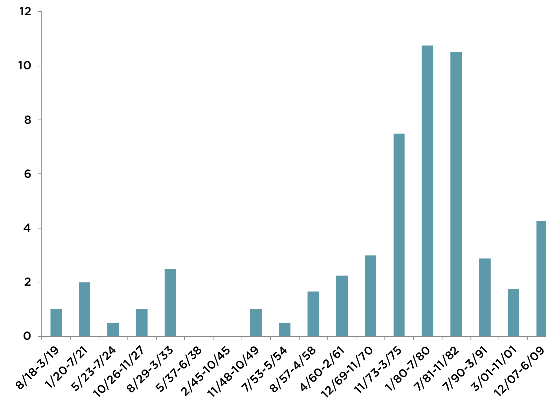
Length of economic expansions

Months



Changes in benchmark Fed interest rates ahead of recessions

Percent



The expansion has reached its sixth anniversary, but remains relatively young by recent standards. Each of the last three expansions lasted longer than six years and together averaged almost eight years in length. More to the point, these cycles ended as all modern cycles did — via tighter monetary policy from the Federal Reserve. With Fed officials hinting strongly that policy tightening will proceed slowly in the years ahead, the next recession continues to appear distant.

Source: National Bureau of Economic Research, Bloomberg

Investment spending/exports turned in strongest post-recession rebounds

Yearly changes in the real GDP components

Percent

2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015 YTD
Exports 6.5%	Exports 10.2%	Exports 9.9%	Government 3.3%	Government 2.3%	Imports 12.0%	Investment 9.6%	Exports 2.4%	Investment 8.7%	Imports 5.6%	Imports 7.1%
Imports 5.7%	Imports 4.5%	Government 1.8%	Consumption -2.0%	Exports 0.8%	Investment 11.1%	Exports 4.2%	Investment 2.1%	Exports 5.1%	Investment 5.4%	Investment 2.4%
Investment 5.7%	Consumption 3.3%	Consumption 1.4%	Exports -2.8%	Consumption -0.2%	Exports 10.1%	Imports 3.5%	Consumption 2.0%	Consumption 2.8%	Consumption 2.9%	Consumption 2.1%
Consumption 3.0%	Government 2.1%	Imports 0.8%	Imports -6.0%	Imports -6.2%	Consumption 3.1%	Consumption 1.5%	Imports 0.4%	Imports 2.5%	Exports 2.4%	Government -0.6%
Government 0.8%	Investment -2.7%	Investment -2.2%	Investment -15.9%	Investment -11.0%	Government -1.1%	Government -3.0%	Government -1.7%	Government -1.9%	Government 0.8%	Exports -5.8%

Both investment and exports were battered in the first quarter of this year, but both have otherwise been quite healthy throughout the recovery. Consumer spending has yet to hit its stride in this cycle, but should be bolstered by the improving labor market in the quarters ahead.

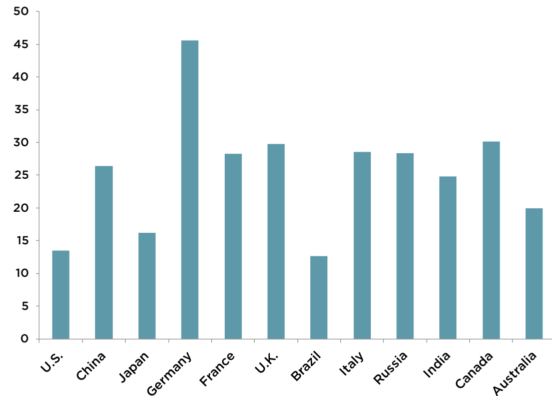
Source: Bureau of Economic Analysis

Nationwide Retirement Institute

Stronger dollar only a modest headwind to growth

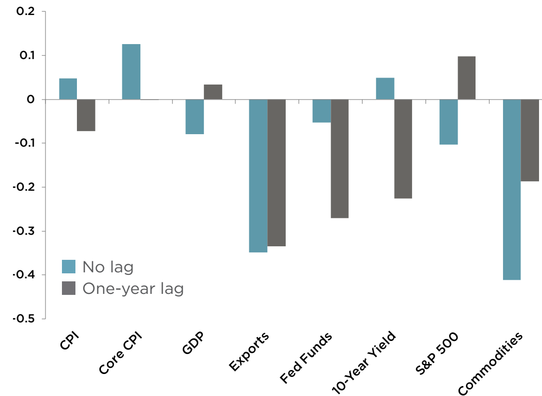
Exports as a percentage of GDP

Percent



Correlations with yearly changes in the trade-weighted dollar

Correlation



While far from insular, the U.S. is less dependent on exports than virtually every other large economy in the world. As a result, changes in the value of the dollar have historically had little impact on economic growth even as they have exhibited a statistically significant relationship with exports.

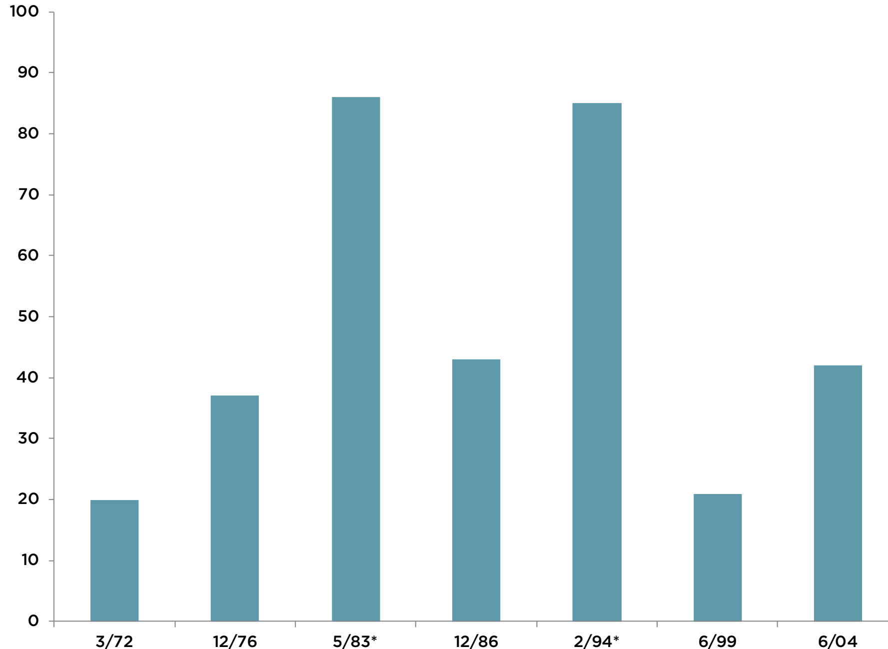
Where a stronger dollar has had an impact over time has been in weighing on dollar-denominated commodity prices and keeping somewhat of a lid on interest rates.

Source: World Bank, Bloomberg

Rate hikes only start the process by which the cycle will end

Time between the start of Federal Reserve tightening cycles and the beginning of recessions

Months



It takes years on average between the start of a Fed rate hike cycle and the onset of recession. After the beginning of the last seven monetary tightening cycles, it took an average of nearly four years before the economy slipped into contraction.

Even excluding the two episodes in which the Fed was able to raise rates without igniting a recession, the average was still nearly three years. It takes time for rate hikes to work their way through the economy and become truly restrictive. That point in this cycle is still well into the future even if the Fed begins the process at some time in 2015.

Source: Federal Reserve Board of Governors; Note: Asterisks represent soft landings.

Feedback loops are strengthening

Average monthly changes in nonfarm payroll employment

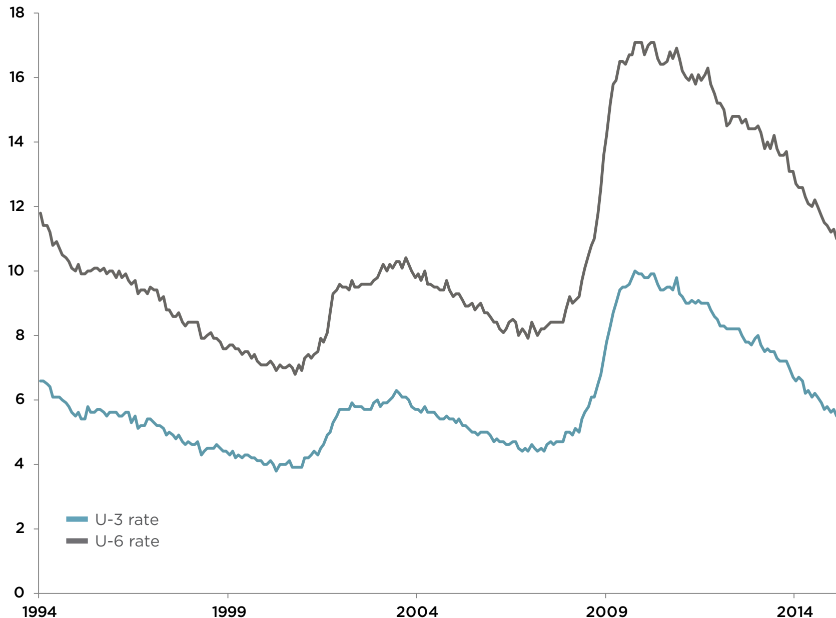
Thousands

The labor market continues to heal. Last year was the fifth in a row of accelerating job growth and marked the biggest increase in payrolls since 1999. This year is already off to another strong start.

The pickup is further evidence of a strengthening feedback loop whereby employment gains lead to income, spending, and corporate profits, which in turn drive further job growth. This virtuous cycle bodes well for both the sustainability and strengthening of the recovery.

Source: Bureau of Labor Statistics

The labor market is tightening by any measure



While the Labor Department's official unemployment rate, also known as the U-3 rate, has fallen to well below 6%, other measures of joblessness remain elevated relative to the long-term trend. The broadest measure that the government produces, the U-6 rate, which includes discouraged workers and those working part-time for economic reasons, still sits in the double-digits, for example.

This figure, though, has also come down substantially in recent years as the economic and labor market recoveries have continued apace. In fact, while full-time employment has soared by 10 million in the last five years, the number working part-time for economic reasons has retreated by more than two million. The rising tide of growth is lifting most boats.

Source: Bureau of Labor Statistics

All major industries are adding workers

Yearly changes in employment growth by major groups

Percent

2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015 YTD
Construction 5.8%	Hospitality 3.0%	Education 2.9%	Education 2.7%	Education 1.8%	Transportation 3.5%	Services 3.4%	Services 3.3%	Construction 3.7%	Construction 5.7%	Construction 1.8%
Services 4.0%	Services 3.0%	Hospitality 1.9%	Government 0.8%	Government -0.3%	Services 3.3%	Hospitality 2.9%	Hospitality 3.2%	Hospitality 3.5%	Services 3.8%	Education 1.3%
Education 2.6%	Transportation 2.8%	Services 1.6%	Hospitality -2.2%	Hospitality -2.4%	Education 1.7%	Construction 2.7%	Transportation 3.0%	Services 3.1%	Transportation 3.6%	Services 1.2%
Transportation 2.4%	Education 2.7%	Government 1.3%	Financial -2.6%	Retail -3.7%	Hospitality 1.6%	Transportation 2.2%	Education 2.4%	Retail 2.5%	Hospitality 3.3%	Hospitality 1.1%
Hospitality 2.2%	Construction 2.0%	Retail 1.1%	Transportation -3.4%	Financial -4.1%	Manufacturing 1.0%	Retail 1.9%	Construction 2.0%	Information 1.9%	Education 2.3%	Retail 0.9%
Financial 1.9%	Financial 1.3%	Transportation 0.4%	Information -3.8%	Services -4.3%	Retail 1.0%	Education 1.8%	Manufacturing 1.4%	Transportation 1.9%	Manufacturing 1.8%	Financial 0.8%
Retail 1.5%	Government 1.0%	Information -0.3%	Retail -4.5%	Information -5.7%	Financial -0.8%	Manufacturing 1.8%	Financial 1.2%	Education 1.5%	Financial 1.7%	Information 0.6%
Government 0.9%	Retail 0.3%	Financial -1.3%	Services -4.6%	Transportation -6.3%	Government -1.0%	Financial 0.6%	Retail 1.1%	Financial 1.1%	Information 1.6%	Transportation 0.5%
Manufacturing -0.7%	Information -0.7%	Manufacturing -1.9%	Manufacturing -6.5%	Manufacturing -10.7%	Information -2.3%	Information 0.0%	Government -0.3%	Manufacturing 1.0%	Retail 1.5%	Manufacturing 0.3%
Information -0.8%	Manufacturing -1.3%	Construction -2.5%	Construction -10.5%	Construction -15.6%	Construction -3.3%	Government -1.4%	Information -0.3%	Government -0.3%	Government 0.3%	Government 0.2%

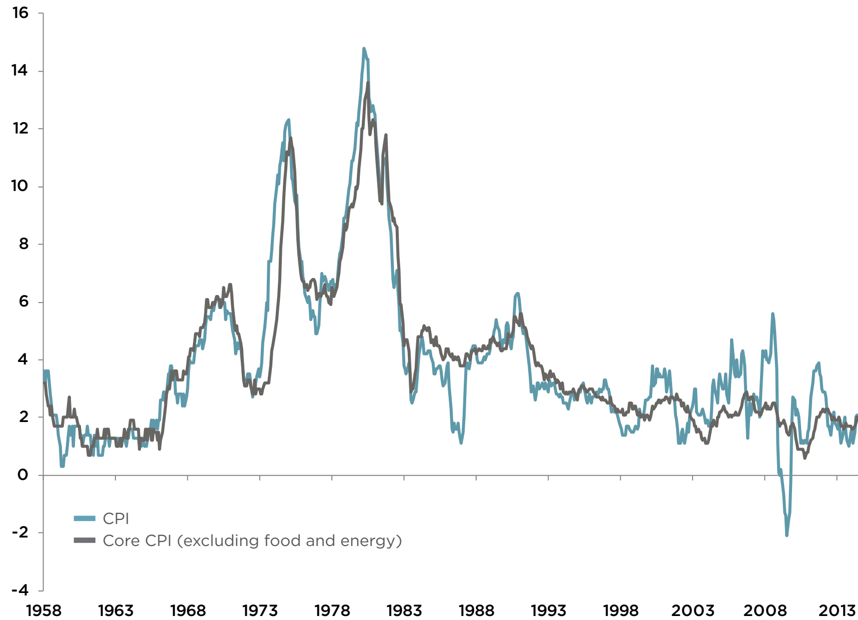
Jobs continue to be added across every major sector of the economy. The widespread nature of payroll gains is another reason to expect that the healing process in the labor market will continue.

Source: Bureau of Labor Statistics

Inflation remains subdued

Yearly changes in the consumer price index (CPI)

Percent



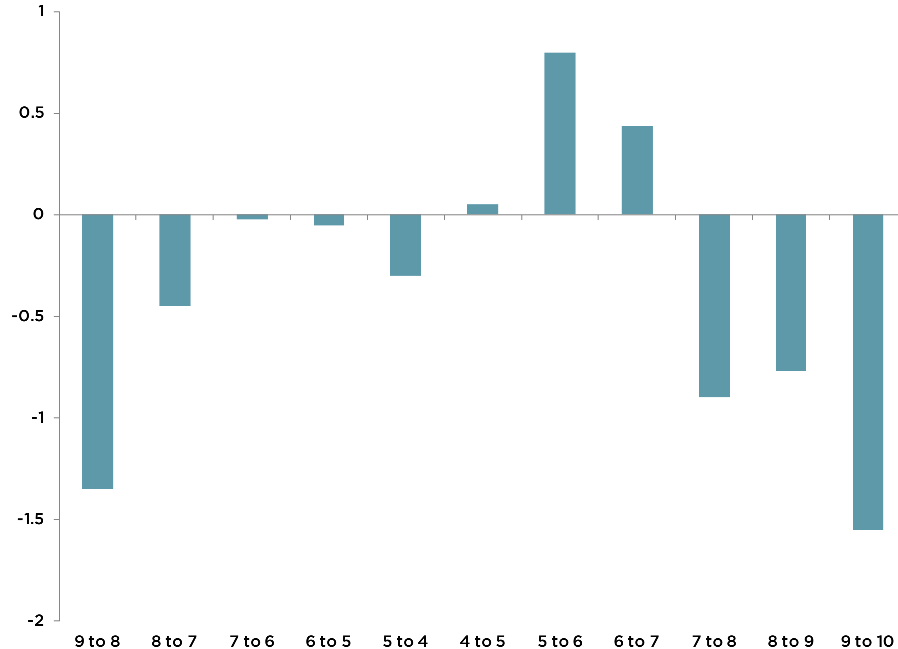
The Consumer Price Index (CPI) inflation rate has spent the bulk of 2015 below zero thanks to falling energy prices while core inflation pressures have continued to build only slowly.

Source: Bureau of Labor Statistics

Inflation is a lagging indicator

Change in the core Consumer Price Index inflation rate by change in the unemployment rate

Percent



Inflation is a function of economic growth, but it is also a lagging indicator. In fact, it has historically only started to pick up on average after the cycle has turned and the unemployment rate has started to climb.

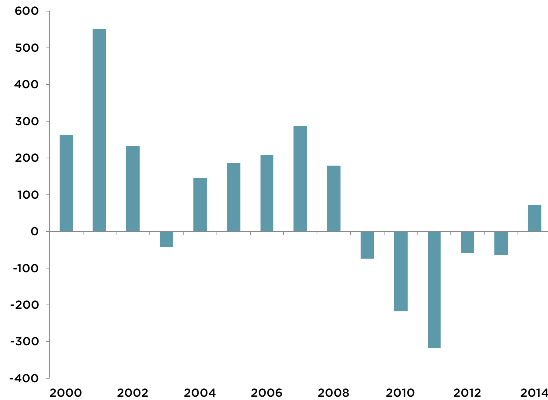
There have been cycles in which inflation started to rise while the economy has still been growing, but they have been the exception rather than the norm. The current expansion, still marked by subdued price pressures six years after the recessionary trough, is thus far falling in line with the long-term trend.

Source: Bureau of Labor Statistics

The public sector is turning the corner

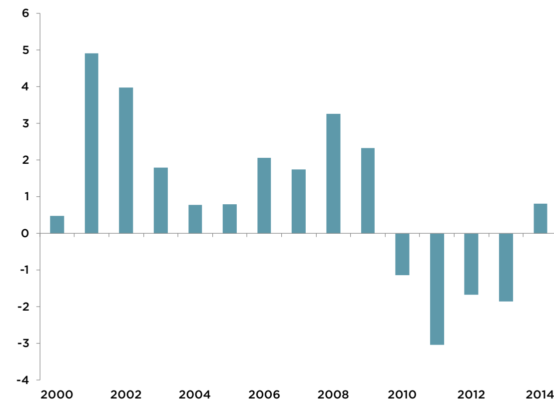
Yearly changes in government employment

Thousands



Annual changes in real government spending

Percent



After five consecutive years of decline, government employment rose in 2014. In addition, government spending was up in two of the four quarters of last year and turned in its smallest annual decline in four years. The public sector lags the private sector and is finally beginning to show signs of responding to the broader recovery that has been in place for more than a half decade.

Source: Bureau of Labor Statistics, Bureau of Economic Analysis

Western states continue to top the job growth table

Changes in nonfarm payrolls

Percent

2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015 YTD
Nevada 5.7%	Wyoming 5.3%	Wyoming 3.7%	North Dakota 1.7%	North Dakota 0.1%	North Dakota 4.4%	North Dakota 7.3%	North Dakota 5.8%	North Dakota 3.2%	North Dakota 4.3%	Idaho 2.6%
Arizona 5.3%	Utah 4.8%	Texas 3.1%	Alaska 1.5%	Alaska -1.1%	Alaska 2.8%	Utah 2.7%	Utah 3.6%	Utah 3.1%	Florida 3.6%	Nevada 1.9%
Idaho 4.4%	Louisiana 4.8%	Utah 3.0%	Wyoming 1.0%	West Virginia -2.2%	Texas 2.3%	Michigan 2.5%	Texas 3.4%	California 3.1%	Texas 3.6%	Utah 1.6%
Utah 4.4%	North Carolina 3.9%	Louisiana 2.5%	Oklahoma 0.6%	South Dakota -2.4%	South Carolina 1.9%	Wyoming 2.4%	California 3.2%	Colorado 3.0%	Georgia 3.6%	Washington 1.5%
Wyoming 4.3%	Arizona 3.6%	Washington 2.5%	South Dakota 0.6%	New York -2.5%	Delaware 1.5%	Texas 2.3%	Colorado 2.7%	Nevada 3.0%	Utah 3.5%	Michigan 1.4%
Florida 3.6%	Idaho 3.5%	Colorado 2.0%	Texas 0.5%	Massachusetts -2.5%	Michigan 1.5%	Tennessee 2.2%	Oklahoma 2.4%	Florida 2.9%	Nevada 3.5%	South Dakota 1.3%
Texas 3.2%	Texas 3.3%	Montana 1.9%	Louisiana 0.3%	Maryland -2.5%	Utah 1.5%	Indiana 2.2%	Hawaii 2.4%	Texas 2.7%	Oregon 3.3%	California 1.2%
Oklahoma 3.1%	South Carolina 3.2%	Nebraska 1.7%	West Virginia -0.1%	Vermont -2.6%	Pennsylvania 1.5%	West Virginia 2.2%	Florida 2.3%	Oregon 2.7%	Colorado 3.3%	Florida 1.2%
Washington 3.0%	Montana 2.9%	North Dakota 1.7%	Nebraska -0.2%	Maine -2.6%	Kentucky 1.5%	Idaho 2.1%	Washington 2.3%	Washington 2.5%	Washington 3.1%	Rhode Island 1.1%
Oregon 3.0%	Nevada 2.7%	Oklahoma 1.7%	Kansas -0.2%	N Hampshire -2.6%	Tennessee 1.4%	Colorado 2.1%	Arizona 2.2%	South Carolina 2.4%	California 3.1%	Hawaii 1.1%

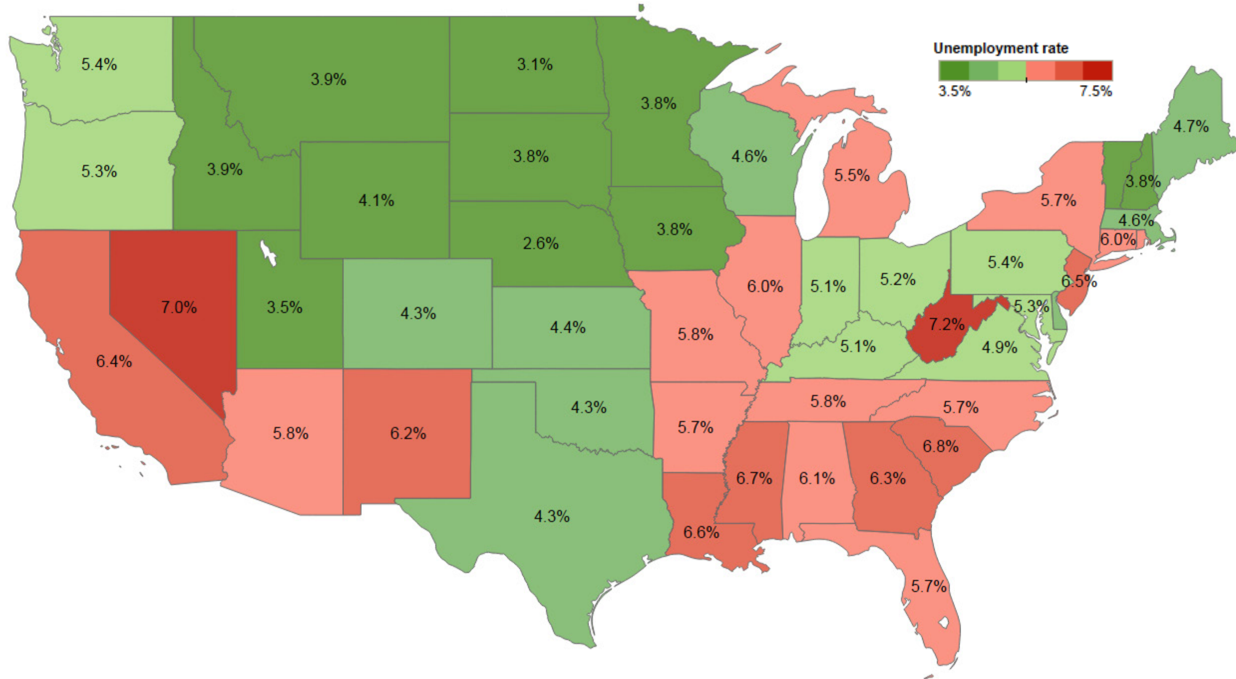
Source: Bureau of Labor Statistics

Nationwide Retirement Institute

Plains states still have the tightest labor markets

Unemployment rate by state

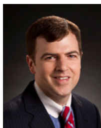
Percent



Source: Bureau of Labor Statistics

Contributors

The experience, intelligence and perspective of Nationwide's staff economists and market analysts assures advisors and clients of a relevant viewpoint that's easy to understand and apply to specific financial planning situations.



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