Market Commentary

Fourth Quarter 2017

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The fourth quarter of 2017 was another positive one for US equities, wrapping up a very strong year for stocks. The benchmark S&P 500 Index had a total return of 6.6% during the fourth quarter which brought its total return to 21.8% for the full year. From the February 2016 lows, the S&P 500 has now risen an astounding 52% on a total return basis through the end of 2017. More surprisingly, since Election Day 2016, the market has yet to decline as much as 3% at any time in the 14 month period. The level of rising stock prices along with extremely subdued volatility is extremely rare in history. We continue to look for a modest pullback of three to five percent in the major indices to consolidate the gains over the past 22 months. Thus far, we don't see the catalyst to initiate the pullback. The 10-year Treasury note yielded 2.41% at year-end, modestly higher than the 2.33% yield at the end of September and nearly unchanged from the 2.45% at the end of 2016. Returns for most fixed income holdings were modestly negative during the quarter as higher short-term rates combined with deficit concerns to push rates higher across most maturities.

Economic and Market Outlook

While we could easily fill several pages with our views of the recently enacted tax reform bill, in this commentary we will focus on those areas that we believe are most likely to affect financial markets and the economy in general. The significant decline in tax rates for corporations is the most important for US companies. It will not only reduce the overall tax burden – particularly for those domestically focused companies that have not had the opportunity to shelter income from taxes in overseas domiciles – but we believe will provide an impetus for investing in profit producing opportunities in the U.S. This may pave the way for a private-public partnership on infrastructure as well. The boost to corporate earnings will be a step up and has the potential to provide another underpinning for stock prices, supporting the significant move higher in the past two years. Last year we had cautioned about rushing into "Trump trades" immediately following the election, and that patience has been rewarded.

We believe the stock market rally in 2017 was built on declining regulatory pressures, global economic growth, and higher earnings by US Companies. This is much different than a market that rises on declining interest rates and P/E multiple expansion alone. The anticipated decline in corporate tax rates, and its coincident increase in corporate earnings, reduces the forward P/E multiple on the S&P 500 by more than one full multiple point to 17 times estimated earnings compared to 17.9x at the end of 2016.

Oil prices continued to firm, continuing a trend that began earlier in 2017. During the final week of 2017, West Texas Intermediate Crude reached its highest level since the summer of 2015, surpassing $60 per barrel. For the quarter, oil rose approximately 17% from $51.77 on September 30 to $60.42 at year end. Based on global economic growth forecasts, we believe the fair value for oil is in the $50-$60 area with a likely range of $45-$65 for the intermediate term.

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Yet another short-term resolution to the US debt ceiling and spending occurred in the waning days of 2017, punting the issue into mid-January, rather than coming up with a longer-term budget spending authorization. We have long lamented these short-term patches which, along with omnibus spending plans, simply lurch Congress from potential crisis to crisis. It is beyond stupid to have the government and its leaders spending time every few weeks working on short-term resolutions rather than setting budget and spending priorities annually. Other potential headwinds for financial markets include long-simmering geopolitical risks in North Korea and the Middle East (the recent uprisings in Iran bear watching), the myriad of Washington investigations and the risk that interest rates increase more rapidly than currently expected. None of these are expected to derail the long-running bull market, but each bears watching as we move through 2018.

Portfolio Positioning

Client portfolios have been positioned during 2017 for steady, modest economic growth. With the expectation of stronger growth in the US over the next year or so, we are monitoring interest-sensitive areas for potential changes. The huge move higher in equities vis-à-vis fixed income over the past two years has many institutional managers announcing they will be increasing their exposure to bonds in 2018 (and thus reducing equities). We do not find equity markets to be meaningfully above fair value based on current growth estimates and interest rates. We are monitoring the path of interest rates and the relative attractiveness of fixed income to equities as rates move higher. With no clear signs of inflation moving above the Federal Reserve's stated goal of 2%, it is difficult to make a case for meaningfully higher long-term interest rates in 2018. This is borne out by the fact that the 10-year Treasury yield was essentially unchanged during 2017, despite 75 basis points in hikes by the Federal Reserve. The other risk factor we are closely watching is investor complacency which is a by-product of the current decades low volatility readings.

Conclusion

As we look to the New Year we see a number of positive factors for both economies and financial markets. Synchronized and improving global growth, low inflation readings, and accommodative monetary policies in most developed nations set the stage for improving corporate earnings in 2018 and beyond. With the market moving higher in a nearly straight line without so much as a decline of 3% for over 14 months, we continue to be vigilant for signs of an impending pullback.

Finally we hope you and your families enjoyed the holiday season. We wish each of you a happy and healthy New Year in 2018. While each year begins with questions on markets and the economy, we hope we have answered most if not all questions you may have. If you have any concerns or questions on the markets or your investment portfolio, please let us know.

Happy New Year!

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