# Quarterly Economic Update 4Q 2017

American Trust

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*The Quarter in Brief.* Strong global growth and swelling investor confidence pushed the market higher in Q4. Twenty seventeen marked the ninth straight year of gains for the S&P 500 (+21.83 percent).

*Economic News.* The impact of Hurricanes Harvey and Maria (August and September) had little effect on U.S. output as growth remained above 3 percent for the second consecutive quarter. The final estimate of Q3 GDP growth was 3.2 percent, up from 3.1 percent in the prior quarter.

The labor market rebounded from soft readings in September, averaging 203,667 new jobs per month in the quarter. A rebound in employment (after hurricane related disruptions) helped keep the unemployment rate at 4.1 percent (a 17-year low) for all three months in Q4.

With economic conditions strong (especially on the job front), and fiscal reforms looming, consumer and business confidence soared. The Conference Board Consumer Confidence Index hit a 17-year high in Q4, paving the way for a rebound in spending and a better-than-expected holiday shopping season.

Business optimism accelerated as the passage of tax reform became more and more likely. The Duke University CFO Survey hit an all-time high in Q4, and the NFIB Small Business Optimism Index finished the year at 104.9. The average of 104.6 for 2017 was the highest in the 45-year history of the index. Better economic policies from Washington, slowing regulatory headwinds, and the prospects for future tax savings were most commonly sighted in the report.

As expected, the Federal Reserve raised the target Fed Funds Rate .25 percent in December to a range of 1.25 percent to 1.50 percent, the third hike of the year and the fifth since December 2015. This is on top of the unwinding of its QE program announced in Q2. Fed expectations are for three more rate hikes in 2018 as they bumped their GDP growth outlook for 2018 to 2.5 percent.

The $1.54 trillion tax bill was the largest change to the U.S. tax code in 30 years (since Reagan's tax cut in 1986), and was largely responsible for keeping investor confidence at record levels in Q4. While individual tax payers will benefit from the bill (it cut marginal rates and doubled the standard deduction among other things), the real winner in all of this should be corporations. The bill lowers the top corporate tax rate (from 35 percent to 21 percent), allows for immediate expensing of capital expenditures, and slashes the repatriation tax on money brought back to the states.

The positive implications for U.S. GDP may be relatively small (some economists are estimating it to be less than .50 percent) given that the effective corporate tax rate (the rate companies actually pay) is much less than the top rate. However, the effect on corporate earnings is likely to be higher (estimates are for up to 10 percent additional growth in 2018). Many companies have already announced major pay increases and new business expansion plans citing tax reform as the primary reason.

Also a new phenomenon, the U.S. is no longer the only region driving the global economy. Europe, Japan, and many emerging market countries are now experiencing accelerated growth. The Wall Street Journal reported that all 45 countries in the Organization for Economic Cooperation and Development (OECD) are expected to have positive economic growth in 2017, the first time in 10 years. The International Monetary Fund (IMF) now expects global economic growth to come in at 3.6 percent in 2017 and forecasts 3.7 percent for 2018.

*The Markets.* The fourth quarter capped off a strong year for investors as the synchronized global recovery, growing corporate profits, and skyrocketing investor optimism extended the bull market for a ninth straight year. Nearly all major asset classes finished in the black. Equity returns provided the most upside with domestic and foreign stocks posting double-digit gains.

| Index Performance | Q4 2017 | Q3 2017 | YTD |
|---|---|---|---|
| Domestic Equity | | | |
| S&P 500 | 6.64% | 4.48% | 21.83% |
| Russell Mid Cap | 6.07% | 3.47% | 18.52% |
| Russell 2000 | 3.34% | 5.67% | 14.65% |
| International Equity | | | |
| MSCI EAFE | 4.23% | 5.47% | 25.03% |
| MSCI Emerging Markets | 7.50% | 8.04% | 37.75% |
| Fixed Income | | | |
| Barclays Aggregate | 0.39% | 0.85% | 3.54% |

Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.

Ironically, as the market hit all-time highs, it was experiencing the lowest volatility levels in the last 20 years. While the S&P 500 managed to earn a 6.64 percent return for Q4 and a 21.83 percent return for the year, 2017 marked the first time in history that it posted a positive return in all twelve months. The number of 1 percent daily moves (plus or minus) totaled nine, the fewest in 30 years.

Large cap stocks (S&P 500) outperformed small caps (Russell 2000) in Q4 and the full year—a bit surprising given the late push of tax reform—as small cap stocks would seemingly benefit more from U.S. tax cuts. That now makes three out of the last four years that small cap stocks have under performed.

Developed International stocks (MSCI EAFE +4.23 percent) trailed U.S. equities in general for Q4. However, a 10 percent drop in the U.S. dollar and further economic improvement in Europe and Japan helped the MSCI EAFE Index (+25.03) outperform most domestic equity asset classes for the year. Emerging market equities remained the darling of 2017, up 7.50 percent in Q4 and 37.75 percent for the year, with leadership coming from China and India.

The .25 percent increase in the Fed Funds rate contributed to further flattening of the yield curve. Ten-year Treasury yields closed the year at 2.40 percent, up from 2.33 percent at the end of Q3, but down from 2.45 percent a year ago. At the same time, two-year Treasury yields ended the year at 1.89 percent, up .42 percent from Q3 and .73 percent higher than the beginning of the year. The higher rates limited the return of the Barclays Aggregate Index (+.39 percent) for the quarter, but the index did manage to post a 3.54 percent return for the year.

Growing investor optimism helped push all eleven sectors into positive territory in Q4. Consumer confidence and a better than expected holiday season helped the Consumer Discretionary sector (9.86 percent) perform best in Q4. Financial stocks (8.63 percent) reacted favorably to higher interest rates, and Information Technology (9.01 percent) was helped by continued leadership in a narrow group of large tech names, affectionately referred to as FAANG. In fact, the FAANG stocks—comprised of Facebook, Amazon, Apple, Netflix, and Google—were largely responsible for the 38.83 percent year-to-date return in Information Technology. These five stocks alone represented nearly 25 percent of the total return for the S&P 500 in 2017. Energy and Telecom were the only sectors that were negative for the year. Most economically sensitive groups performed the best, while defensive yield-oriented sectors fared the worst in 2017.

| S&P 500 Sector Performance | Q4 2017 | Q3 2017 | YTD |
|---|---|---|---|
| Consumer Discretionary | 9.86% | 0.84% | 22.98% |
| Consumer Staples | 6.49% | -1.35% | 13.49% |
| Energy | 6.02% | 6.84% | -1.01% |
| Financials | 8.63% | 5.24% | 22.18% |
| Healthcare | 1.47% | 3.65% | 22.08% |
| Industrials | 6.05% | 4.22% | 21.03% |
| Information Technology | 9.01% | 8.64% | 38.83% |
| Materials | 6.93% | 6.05% | 23.84% |
| Real Estate | 3.22% | 0.93% | 10.85% |
| Telecommunications | 3.61% | 6.78% | -1.25% |
| Utilities | 0.21% | 2.87% | 12.11% |

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*Outlook.* As of year-end, the market is up 372 percent (price only) from its March 9, 2009 low. That makes this bull market the second longest in history, and there is little evidence that it wants to stop.

After all, things are pretty good. Monthly job growth is averaging between 150,000 to 200,000 and the business climate is strong (both ISM Manufacturing and Non-Manufacturing Indices remain well above expansionary levels). The synchronized global recovery is gaining momentum and tax reform should provide a tailwind to the U.S. economy. Further deregulation and possible infrastructure initiatives could also provide support.

Maybe the biggest risk going forward is if central banks tighten financial conditions too rapidly in response to positive economic momentum. The U.S. and England are the only major countries currently raising rates, but more are sure to follow. A less accommodative stance by the world's central banks would likely lead to higher rates.

Stock valuations have been supported by low interest rates for a very long time. The S&P 500 now trades at 18.2 times forward earnings (compared to 16.0 historically). A move higher in interest rates would require better earnings to support current valuations. So far we've gotten that, and tax reform will likely provide immediate help to sustain that momentum.

The market is already up over 4.0 percent in the first two weeks of 2018. With valuations at a premium and monetary policy more restrictive, the bears wonder how much longer this can last. However, with the global economy this good and alternative asset classes relatively unattractive, it wouldn't be surprising if the bull market in stocks continues.