

## 4Q-2017 ECONOMIC AND CAPITAL MARKET REVIEW

**Overview**

- Synchronized global growth kicks in
- US and foreign stocks finish the year strong
- Higher interest rates pressure short-term bonds

**Economy**

Things are good and the new term that describes it is “synchronized global growth.”

The US economy is picking up pace and so are foreign markets. Although annual GDP growth remains around 3%, underlying measures are accelerating here and with our trading partners.

Wage growth is running at 3.2%, up from the summer, and industrial production has ramped higher each month during 2017. Capacity utilization hit 77, and seems headed toward the previous cycle high of 81 in 2007. Consumer confidence is the highest since 2003 and consumer credit is the highest in 5-years.

The Federal Reserve is in tightening mode. It reduced its balance sheet in October, and raised the fed funds rate again in December to a range of 1.25-1.50%. Higher interest rates are bad for bond investors (bond prices decline) and good for the US Dollar, but strangely the dollar weakened in the second half.

Perhaps it's because no one really sees inflation increasing, and doubts the fed's resolve toward further rate increases. Trump seems to prefer a weaker dollar for global competitiveness, and aren't we all somewhat questioning the sustainability of this recovery, still?

Overall, things are good for investors. Inflation is low, economic growth is steady, profits are up, and the

global central banks are proceeding to withdraw stimulus, very slowly. Small interest rate hikes from these historically low levels should not derail the economy over the near term.

**Capital Markets**

All major equity market indexes were higher in the quarter with higher-risk emerging markets leading the way and Asia beating the solid gains in the US.

But bonds started to wither, giving back gains from earlier in the year as yields spiked on short-term maturities in Q4 (note the negative return on T-notes in the table below) and stayed flat on the longer end.

| Major Indexes               | 4Q-2017 | YTD   |
|-----------------------------|---------|-------|
| Short-term Treas. (1-3 Yr.) | -0.3%   | 0.4%  |
| Barclay's Aggregate Bond    | 0.4%    | 3.5%  |
| S&P 500 Index               | 6.6%    | 21.8% |
| Russell 2000 (Small Cap)    | 3.3%    | 14.7% |
| MSCI EAFE (International)   | 4.2%    | 25.5% |
| MSCI Emerging Mkts.         | 7.5%    | 37.8% |
| Bloomberg Commodity         | 4.7%    | 1.7%  |

International returns were again boosted by recovering sentiment and a weaker US dollar. For the year, 37% of the return from foreign stocks can be attributed to the exchange rate. France and Germany were up 29% for the year. Japan, with an 8.5% return during 4Q, was up 25% for the year.

Emerging markets were led by India, Korea and China (up 54% for 2017), as Brazil and Mexico took a breather in the final quarter – well done!

Technology was again the leading sector in the S&P 500, gaining 9% in Q4 and 39% for the year. The

financial sector heated up with an 8.6% gain in Q4 and consumer stocks rose 10%. Utilities and health care were weak with barely 1% gains.

Despite the headlines about the tech sector and its strong quarter and year, “value” stocks beat “growth” stocks in November and December, enabling us to declare the current growth trend over, for now, but this can easily reverse. The outperformance of growth over value during this recent trend-run was the 3<sup>rd</sup> highest for a “trend” (our definition) since I started tracking it in 1993 but exceeded the average length by only two months. The two best trends were during the “dot.com” bubble of 1999-2001.

Demand for oil and gas is outpacing production and prices are on the rise. Commodity cyclicals, including oil stocks, should remain strong as the global economy strengthens. Full employment and wage growth, are enabling consumer demand and this suggests inflation will rise.

Tax reform in the US provides a boost to future earnings and the associated collateral benefits to workers.

The fed and the European Central Bank are targeting 2% inflation before committing to further interest rate hikes. Based on the rolling averages, we’ll record a 2%-plus number by April.

### Strategy

We expect corporate earnings to rise in 2018 and stocks to follow. Nevertheless, stock valuations may get ahead of the cycle and higher interest rates will begin to dampen enthusiasm as the year goes on. One example of cyclicalality will be the semiconductor industry which has likely peaked. An unraveling could spook related groups creating a catalyst for correction.

Our mid-2017 observations remain the focus.

1. Global monetary policy remains supportive.

2. Foreign equity market valuations are lower than the US.
3. Growth stocks have gotten more expensive and the growth vs. value trend is extended.
4. Value stocks may get a boost if interest rates rise, and bank earnings grow.
5. Small cap stock returns have trailed large cap stocks and are poised to improve.

Although technology stocks have been great, new leadership has emerged from the financial, energy, and consumer sectors.

In fixed income, we’ll keep the lower duration target in focus to reduce interest rate risk as yields rise. The total return for bonds will be low, but will prove a safe haven if stocks decline.

We prefer Europe, Japan and the emerging markets over the US. Within the US we like value sectors and small cap stocks.

By spring, it’s appropriate to rebalance portfolios back to long-term targets which most likely means reducing equity exposures, particularly in tech.

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***P.S.-please email or call with questions or comments!***