

ECONOMIC OUTLOOK

Summary

When the Plains begin to heat up again next summer, this business expansion will be celebrating its tenth anniversary. Now, it's not the longest expansion in modern history but fairly close. Which begs the question, what are some of the warning signs investors should be monitoring? We already have a few developments that are concerning, such as a labor market that is evolving from cool to a little hot and a monetary policy stance that is progressing from loose to moderately tight. An overheating labor market (not there yet) makes the Fed worried about an accelerating inflation outlook. Four rate hikes during this cycle and a likely fifth this month, have caused a dramatic flattening in the yield curve (another signal) with potential negative economic consequences.

Further signposts are an economy that begins to weaken, causing additional softening in demand which results in a decline in the pace of net job creation and a pullback in business investment and consumer spending. Credit conditions then tighten and asset valuations typically drop, normally from cycle highs. This combination of events could upset an overextended economy. Where are we in the economic cycle?

It would seem the seventh or eighth inning but we could go into extra innings. The labor market is ostensibly "tight" but wage growth has been chronically weak. Credit market spreads are near cycle and historical tightness with a strong demand by U.S. and international investors. The most troubling development is a major flattening in the yield curve

with long term rates declining and short term rates increasing. Notwithstanding an exogenous economic shock, the Fed is the central player in determining the timing of the next recession. If they continue raising rates in 2018 and 2019 as they have projected, the U.S. economy will likely slow dramatically and potentially face a recession. We believe the Fed will heed the message of the market and slow down the pace of rate hikes as they continue to undershoot their inflation and wage growth targets. But that remains to be seen.

Positives

Leading economic index came in up 1.2% last month while 0.8% was expected

Consumer confidence at the highest level in 17 years

New home sales hit a cycle high of 685,000 units

Negatives

Pending home sales increased 1.2%, however 3.0% was expected

ISM non-manufacturing index drops to 57.4, however 59.0 was expected

Trade balance fell to -\$48.7 billion, however -\$47.5 billion was expected

EQUITY OUTLOOK

Summary

Equity markets continued to climb in November albeit with a bit more of uncertainty and volatility than in recent months. The S&P 500 has now traded higher in each calendar month of 2017 adding another 3.1% for the month improving the year-to-date return for the index to 20.5%. With earning season now complete, markets focused their attention on the progress of the GOP tax bill, the Russian election probe and the beginning of the holiday shopping season. Growth stocks, which have been responsible for much of the recent rally, have had occasional weak trading sessions during which investors have rotated into more defensive positions. Given the magnitude of the rally in growth stocks, it's not uncommon to see some year-end profit taking and to date there hasn't been a clear change in market leadership. In total, the Russell 1000 Growth Index finished the month up 3.0% roughly matching the 3.1% increase in the Russell 1000 Value Index.

Information technology has been the top performing economic sector for the year (+38.8%) yet joins basic materials as the worst performing sector in November, increasing 1.1% and 1.0% respectively. The top performing sectors for the month were both defensive sectors of consumer staples (+5.7%) and telecommunications (6.0%). It's of interest to note that in spite of their strong performance last month, staples and telecom remain two of the bottom three sectors for the year. We aren't signaling a change in leadership but there has clearly been a fair amount of portfolio rebalancing.

Regardless of whether growth or value stocks grab the reins in 2018, what is clear is the fundamental backdrop for equity outperformance remains intact. Labor markets, consumer/business sentiment and manufacturing remain elevated and/or

accelerating. The holiday shopping season has also gotten off to a solid start which should help to buoy beleaguered retailers. Brick and mortar foot traffic on Black Friday, eroded just 2% by online sales, was considered a win by most analysts. Cyber Monday set a new record increasing 16.5% over last year to \$6.6 billion in sales according to Adobe Digital.

The Senate has now joined the House in passing their version of a tax reform bill and we expect them to settle on a final bill in the coming weeks. Add a reduction in corporate income taxes to an already favorable economic environment and you end up with an appetizing recipe for continued market success. Michael Flynn's cooperation with Robert Mueller's investigation of the Trump administration as well as a change in leadership at the Federal Reserve may create a bit of uncertainty in the intermediate-term. However, the market's momentum may be difficult to stop in the near term which should translate to happy holidays for equity investors.

Positives

Tax reform likely

Corporate earnings momentum

Negatives

Russian election probe creates uncertainty

Equity valuations stretched

FIXED INCOME OUTLOOK

Summary

It is widely expected that on December 13th the Federal Reserve's Open Market Committee (FOMC) will announce the fourth rate hike over the past year (since last year's December hike was on December 14th) and the fifth since the tightening cycle began in December of 2015. The new target range for the overnight lending rate will be 1.25-1.50%. With the economy continuing to exhibit signs of solid growth, the unemployment rate declining to the lowest level in nearly 17 years, the stock market making new record highs and U.S. dollar remaining weak, the FOMC has all the cover it needs to continue its progress towards "normalizing" the rate even if the core rate of inflation has not yet reached their target level of 2% and has actually turned lower in recent months. For two months now, the Fed has also been reducing the reinvestment of securities as they mature from its massive portfolio of security holdings. By not reinvesting, the size of the portfolio will gradually be reduced from a level of about \$4.5 trillion.

With the increasing overnight Fed Funds rate, it seems logical that the yields in the shorter maturity end of the curve should continue to press higher. As of the end of November, the 2-year Treasury note yield had increased to 1.78% after starting the month at 1.60% and the year at 1.19%. The yields on longer maturity notes have not reacted similarly. The 10-year Treasury note yield increased only 3 basis points (bps) to end the month at 2.41%, but this level is actually 3 bps lower than where it started the year. This year's flattening of the 2-year to 10-year by 63 bps likely indicates that most investors are not overly concerned about inflation accelerating materially above the target range or that the Fed will actually raise the overnight rate to the level they forecast to be neutral, neither stimulative or accommodative.

While we believe that two or three additional rate hikes in 2018 or 2019 are likely for the cycle, we do not believe the Fed will increase the rate six or seven times as they currently are projecting. In either case, short rates should continue to move

higher with the 2-year note piercing 2% in the first half of 2018. Longer end rates could trend slightly higher, but we are less optimistic about reaching our 3% target in 2018. Ironically, if the Fed lowers their expectation of rate hikes, longer rates will likely rise, but if they keep calling for a 2.75-3.00% overnight rate, longer yields will stay anchored or even fall as investors forecast their actions, causing the next recession.

Positives

Markets are looking to Fed rate increases as possibly causing the next recession

Year-end investor rebalancing should favor further fund flows into bonds

Brexit negotiations are failing and economic disruptions increasingly likely

German yields fail to move higher and have recently declined

Negatives

Successful tax reforms will increase deficit and required government funding

Inflationary pressures could increase with lower U.S. dollar and disaster rebuilding

Corporate issuance could remain heavy as market remains accommodative

Unknowns

Political follies continuing

North Korea could continue to push buttons, literally and figuratively