## ECONOMIC OUTLOOK

### *Summary*

As we begin another calendar year, I want to take a slight detour from some of the hard core economic data and focus on a few of the potential impacts from tax reform. To begin with, it has been over 30 years since Congress passed any meaningful tax reform. This implies that many of today's investors, portfolio managers and political pundits haven't witnessed this kind of fiscal change in their adult lifetimes. There has been much written about who wins and loses in this legislation and polling data suggests that the middle class believes they will be paying more in taxes from the recent passage of tax reform. That will not be the case and most tax policy analysts project a lower tax burden for about 95% of U.S. taxpayers.

So, what are the likely short-term impacts from this bill? Lower withholding taxes for many workers will boost after-tax incomes for most working Americans. History suggests that large portions of this income will be spent and circulated into the real economy. Corporations and small business owners are the biggest beneficiaries of this new tax law. Their spending behavior is more difficult to forecast but a few items are likely. Increased stock buy-backs and dividends from publically traded companies have occurred in the past and should follow a similar pattern once again. Small business owners, who create most of the jobs in the economy, have felt oppressed by burdensome governmental regulations, technological change and soft domestic demand, have many reasons to be optimistic. Immediate expensing of capital equipment for companies of all sizes will help kick start some level of capital spending which has been chronically weak during this business cycle.

Adding it all up suggests that the economic growth potential in 2018 and 2019 is probably being underestimated by a variety of constituencies. Can we grow above 3.0% for the year? Yes we can. Will average hourly wages show a decent uptick this year? It's quite likely. Will inflation show a sizeable increase this year? Possibly, but not likely. There are many secular, supply side factors that have yet to be extinguished that can help meet higher demand levels without too much pricing impact. This all suggests that 2018 may be a year for Main Street and a less certain one for Wall Street. This bull market has certainly helped investors with financial assets and now maybe Main Street will get a bigger bite of the apple as a result of tax reform. They just don't know it yet. Deficit impact? Larger than expected.

### *Positives*

Existing home sales hit cycle high at 5.53 million units

New home sales hit cycle high at 733,000 units

Personal spending up .6% last months

### *Negatives*

Payroll employment disappointed last month gaining only 148,000, 193,000 expected

Trade balance widened last month to -50.5 billion

ISM non-manufacturing survey missed consensus, 55.9 vs 57.6



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## EQUITY OUTLOOK

### Summary

Equity markets closed out the month of December just like every other month in 2017…higher. What began as a year of optimistic consumer and business sentiment ended with the S&P 500 advancing an impressive 21.8%. For the second consecutive month, value stocks (led by energy and telecom) bucked the 2017 trend by outperforming growth stocks. The Russell 1000 Value climbed 1.5% where the Russell 1000 Growth added just 0.8% in December. For the year, though, growth stocks returned 30.2% while value stocks rose 13.7%. Nine of the 11 economic sectors in the S&P 500 finished the year higher, with only energy and utilities finishing in the red.

With the dollar sliding relative to foreign currencies, international equities were among the best performers in the final month of 2017. Both the emerging markets (MSCI EM +3.6%) and developed international (MSCI EAFE +1.6%) outperformed domestic large cap equities (S&P 500 + 1.1%) in December. This continued the trend that spanned most of the year as developed markets finished 25.0% higher and emerging markets rallied a whopping 37.3%.

Equity market momentum and analysts' expectations signal that stocks should continue to advance into 2018, but history recognizes the difficulty analysts have had in predicting market performance year to year. Bears would argue that the markets may have already discounted many of the positive developments. What's clear though is fundamentals are improving and recently passed tax cuts will only help to further accelerate corporate earnings growth. Low interest rates should also continue to push investors into equity markets, but it's difficult to predict how long rates will linger near current levels. While stock indexes may be unlikely to repeat the banner year we experienced in 2017, we do believe the equity outlook remains positive in the near future.

Perhaps the most significant concern is expectations for stocks may be a bit too lofty. Given the extended length of the current bull market and relatively stretched valuations, equity markets could suffer a meaningful pullback should there be any economic setback or geopolitical disruption. However, we view these potential negatives as low probability events at this time and believe conditions support the risk/reward characteristic for equity markets.

From a domestic versus international perspective, the synchronized global expansion should result in meaningful earnings growth on both fronts. However, international stocks have more room for multiple expansion relative to historic norms and therefore we remain positive on international markets in 2018.

### Positives

- Synchronized global expansion
- Corporate earnings momentum and lower tax rate

### Negatives

- Rising consumer and federal debt
- Aging economic expansion



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## FIXED INCOME OUTLOOK

### *Summary*

In mid-December, the Fed increased the overnight lending rate to a range of 1.25-1.50%. This was the third increase for the year and the fifth since the tightening cycle began in December of 2015. The 2-year Treasury note yield continued its trajectory sharply higher. Since early September it has steadily climbed from 1.26% to end the year at 1.88%. This is the highest yield since the final quarter of 2008. For the year the yield is up almost 70 basis points (bps).

Conversely, the 30-year bond saw its yield drop another 9 bps during December to end the year at 2.74%. For the year, the 30-year yield was down about 33 bps. The 10-year yield was basically unchanged for the month, but at 2.41%, still ended the year 4 bps lower than where it began the year. Being little changed for the year, the 10-year was just about the inflection point of the yield curve flattening. The spread between 2 and 30 year yields declined 102 bps for the year with 73 bps coming from a narrowing 2-10 year spread and 29 bps coming from the 10-30 spread.

Forecasters, economists and investors are split on the outlook for 2018 with some calling for one or two rate increases and others looking for up to four. We believe that we are most likely to see two rate hikes for the year, but also consider the possibility of three. It seems reasonable that a Fed Funds rate at or just above the target inflation rate would achieve a "neutral" policy (neither stimulative nor accommodative). If the economy were to experience shortages of input materials or labor, and prices were to increase more rapidly than desired, then additional tightening would be justified, but there is no evidence of that happening yet.

The yield curve should continue to flatten as the Fed increases the overnight rate and longer rates have a muted reaction. To this point, investors are either convinced that global demographic trends and low productivity will continue to cap aggregate demand and global growth or they believe that the Fed will error and push the short rates so high that a recession ensues. We believe the Fed can walk the fine line between normalizing rates after an exceptionally long period of accommodation without causing the next economic downturn. If we are correct, long rates should eventually begin to grind higher along with shorter rates. We remain hopeful that we will see 3% on the 10-year Treasury note in the first half of 2018.

### *Positives*

The Fed rate may be causing the next recession by pushing short rates too high

Investors are likely to rebalance by selling stocks and buying bonds

The U.S. 10-year note is about 2% higher yielding than comparable German debt

### *Negatives*

Tax reform will increase deficit and required government funding

An infrastructure bill could also increase the budget deficit

A weaker U.S. dollar increases import prices and contributes to higher inflation

### *Unknowns*

Trump's ability to get other agenda items accomplished with mid-term elections

Global tensions: North Korea, Russia, China, Syria, Iran....



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