

January 2018 Outlook

Key Points

- Risk of Recession: Low
 - Federal Reserve Rate Hikes: 2-3 times
 - Inflation Expectation: 2%
 - U.S. Gross Domestic Product Growth: +2.5%
 - U.S. Earnings Growth: +8% - 10%
 - U.S. Stock Returns: Mid-to-High Single Digits
 - Fixed Income Returns: Flat-to-Low Single Digits
 - Global Economic Growth: +3.7%
 - Oil Prices: Mid \$50's per barrel
 - Government Issues: Tax Reform, Infrastructure, and Regulatory Relief
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Fiscal and Monetary Policy Set the Stage for Markets in 2018

Building off of a successful 2017 will lead to potentially slower, but continued growth in 2018 resulting in a low probability of a recession. To achieve the anticipated growth in 2018, we will need to see a shift in economic drivers. Since the '08-'09 Financial Crisis we have relied on the government to stimulate the economy through monetary policy. We are coming to an end of that era and entering a period where markets will rely more heavily on company fundamentals as well as fiscal policy. To some, this is referred to as "Market Normalization", something we have not seen in the past decade.

We are entering the end of a business cycle in the U.S. The bull market has been long and strong since 2009, and we have seen numerous all-time highs in all of the U.S. stock indexes. According to most Wall Street analysts and economists, we are in the late stages of a mature business cycle. This means that we are nearing the peak of economic growth throughout the U.S., but we may have a couple years left before we see any large decline in economic activity. Globally, the business cycle is not as mature and there may be more room for economic expansion compared to the U.S. These global markets will help fuel investor returns in 2018, where gains may be harder to come by domestically.

We estimate that U.S. Gross Domestic Product (GDP) growth will remain around the 2.5% level for 2018. Economic indicators suggest that our economy is still in an expansion mode, albeit slower than preferred. One of these economic indicators, the unemployment rate, is at the lowest level since the Financial Crisis ('08-'09). This is encouraging news except that wage inflation, another economic indicator, has failed to keep pace. We are putting people to work, but they are not making a salary that is keeping up with the increasing cost of living. Other economic indicators such as home sales, producer price index, and consumer confidence remain high and will help to continue U.S. GDP growth.

One of the key factors to watch in 2018 is the shift from monetary policy, which has been boosting the economy and market returns, to more of a fiscal policy driven economy. The Federal Reserve (Fed) has been taking steps since the Financial Crisis ('08-'09) to help stimulate the economy. These actions by the Fed, often referred to as "Quantitative Easing", will be coming to an end throughout 2018 and beyond. This will shift the responsibility over to fiscal policy to support economic growth.

In his second year as President, Trump will be pushing hard to get the agenda promised in the campaign passed through Congress. There are still unresolved government issues that may reach a conclusion in 2018. The passage of any new legislation would help bolster the economy and support domestic markets. We have already seen movement on tax reform, but infrastructure spending, regulatory relief, and healthcare reform still remain unresolved.

News of The House and Senate passing their own versions of the tax bill in late 2017 created a surge in U.S. markets, with the Dow Jones Industrial Average gaining around 350 points in one day. Since Congress agreed on the final bill and it was signed into law by the President, we see more room for stocks to increase. This may set the stage for additional fiscal policy to be introduced, which could provide an unexpected boost to markets in 2018.

Expectations for U.S. Stock Market returns are mid to high single digit growth among many Wall Street analysts. This would be much lower than the 21.83% that we saw in 2017. There is an expectation that more value oriented stocks will become the focus rather than some of the growth names that had large gains throughout 2017. This is evidenced by the pullback in technology companies during the beginning of December. This was the first time since March that we saw volatility creep back into the market. The strength of the economy remains a focal point as new legislation reforms come through Congress that could have mixed effects on different industries.

Steady economic growth should be the main contributor to market gains, but the new tax bill should help bolster returns. This bill, as it is currently written, may not provide the large tax rate decrease for some S&P 500 companies, as many investors expect, but it will allow companies to bring back profits from overseas at a lower tax rate (repatriate). This would potentially increase capital expenditures, create jobs, and increase output, thus increasing corporate earnings and national GDP growth.

The real winners with the tax bill will be smaller domestic companies. These companies typically do not conduct much business abroad and therefore are being taxed at a higher effective rate, than most S&P 500 companies, because they cannot shelter cash offshore. These smaller companies will be able to use their tax savings to reinvest in their business and boost profits going forward.

Estimated earnings growth for U.S. companies of 8%-10% will help fuel the rise in stock prices. Some analysts believe the passing of tax reform could immediately add up to 5% in earnings growth just from reduced taxes. Some, if not all, of this increase is already priced into the market.

Domestic markets still have some room to grow, but some consider the market "fully-valued" or even "overvalued". This means that while companies can grow organically, they will need some help from the government in the form of new policies to reach the upper range of estimates.

Many analysts estimate fixed income markets to be flat or grow in the low single digits throughout 2018. There are some strong headwinds facing fixed income markets that are only beginning to show their impact. The Fed is committed to raising interest rates in an effort to control inflation and give the U.S. a buffer in case of a recession. During the Financial Crisis ('08-'09), the Fed continually lowered interest rates and began their "Quantitative Easing" program to help stabilize the economy. We went through the last decade with interest rates at their lowest levels in recent memory, and that is beginning to change.

U.S. Treasuries will be impacted the most by rising interest rates. High quality corporate bonds should continue to outperform Treasuries in 2018. Corporate bonds typically have a higher yield because there is an inherent risk that the company may not be able to pay back the debt when the time comes. With a strong and growing economy, the risk of large high-quality companies not being able to pay their debt is low. High yield bonds and other less interest rate sensitive investments should continue to outperform their higher-quality counterparts.

The estimated number of times the Federal Reserve will raise rates in 2018 is two to three throughout the year. A rising interest rate environment, something which has not been seen since 2008, will benefit many banks, insurance companies, and other financial institutions. With higher lending rates, banks can charge more for mortgages and other loans. This would positively impact their earnings and growth for 2018. Insurance companies will be able to invest their funds at higher rates which should also benefit their earnings throughout 2018.

We need a buffer in interest rates to give the Fed room to introduce monetary policy as a means to fight any sort of recession that may be looming in the distance. Along with raising rates, the Fed is also discontinuing the "Quantitative Easing" program by decreasing their balance sheet. This will be a gradual process throughout 2018 and beyond. Both of these actions will lead to increased interest rates for investors and, ideally, a slightly higher inflation rate.

The general expectation for inflation for 2018 is hovering around 2%. This estimate mirrors the goals of the Fed. We barely got to the 2% mark in 2017, which is a concern given the strength of the economy. Inflation, partially due to low interest rates, has not been keeping pace with the growth of the economy since the Financial Crisis ('08-'09). The Fed will use the target inflation rate of 2% as a guideline when creating new policies, which is still lower than the 77-year average of approximately 3.8%.

A higher inflation rate will show that companies are able to charge more for goods and services. This will be a sign that company revenues should be growing and margins should be expanding. All of this points to higher earnings and may justify higher stock valuations going forward.

Global economic growth is poised to continue during 2018 with estimates of a 3.7% increase for developed international markets and emerging markets. While most indicators put the U.S. markets in late stages of the business cycle, we see that foreign markets are still lagging behind in the recovery. Valuations and economic fundamentals appear to be more favorable outside of the U.S. in 2018, even with the substantial returns for investors in 2017. While we don't expect the same level of returns we saw this year, we do see that there is more room to grow abroad. Many of the expectations for foreign markets rely on the U.S. economy's continued growth. If the U.S. markets falter in 2018, it would cause a ripple effect across all global markets and would negatively impact our expectations.

The view of global bond markets is slightly more negative. In developed markets, just like in the U.S., there is an expectation on rising interest rates. This would put downward pressure on the value of bonds, specifically in Europe and Japan. The European Central Bank (ECB) has set forth plans to begin their own version of ending "Quantitative Easing" which would be a catalyst for rate increases. Japan's interest rates have actually gone into negative territory in the recent past. There is nowhere else for rates in Japan to go but up, putting pressure on the prices of the bonds.

Emerging market debt may also feel the effects from the ECB policies. Emerging markets are still in an economic recovery stage, and this will help to stabilize their bond markets. One glaring issue is that debt from these countries is very expensive when we look at valuation, and therefore carry more risk of the bonds declining in value.

Oil prices are expected to stay in the range of mid \$50's per barrel of West Texas Intermediate (WTI) Crude. This expectation changes little from the prices that we saw throughout 2017. Large, multi-national oil companies can still maintain a profit and maintain their dividends at these prices, but earnings are far from the days when WTI was over \$100 per barrel.

In summary, we are entering 2018 on a generally positive note. We think monetary and fiscal policies will exert a strong influence on how markets perform. There have already been new policies that have gone into effect, but have not yet been felt. Most analysts feel we are still in the late stages of economic recovery, but do not assume we are going to see the same level of returns as we saw in 2017. There is still some room for growth both domestically and internationally. There will be areas of the market to take advantage of, but gains may be harder to come by in 2018 compared to 2017.



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