Economic Update

A Review of 2017

Politics dominated the headlines during the greater part of 2017, but the most significant event from an economic perspective came on Dec. 22, when President Trump signed the Tax Cuts and Jobs Act into law. This marks the biggest change to the U.S. federal tax code that we have seen over the past few decades.

The law's effect on individuals is mixed, but its effect on businesses is mostly positive, and it should result in increased earnings for corporate America. Recently a number of companies have even announced year-end bonuses citing the new tax law as the reason. While it eliminates many current corporate tax deductions, it more than makes up for these lost deductions by reducing the corporate tax rate from 35 percent down to 21 percent. The new law also eliminates the corporate Alternative Minimum Tax. On the downside, the Congressional Budget Office estimates that the new law will increase the deficit by $1.4 trillion over the next decade.

While the U.S. stock market was flat for the remainder of the year following the signing, that is typical of the old trading adage to "buy the rumor, sell the news." The market gains were made when the bill was being crafted during the months before. For the year as a whole, the U.S. market experienced strong returns. This was despite a particularly destructive hurricane season which, according to Moody's, resulted in combined U.S. property damage of over $200 billion.

U.S. Economy

Business sentiment remains very high. The most recent Chicago Purchasing Managers Index came in at 67.6 for December, which is the survey's highest reading since March 2011. Readings above 50.0 predict economic expansion. Not surprisingly, business investment surged throughout 2017, particularly in the second half of the year. Borrowing costs are still relatively low, and with new measures to encourage capital expenditures being introduced as part of the tax overhaul, this stronger momentum in business investment will likely continue for at least the first half of next year as well.

Jobs growth appears to have temporarily stalled, however. Only 148,000 new non-farm jobs were created during December and the unemployment rate remained unchanged at 4.1 percent. Wage growth is still relatively low as well. Seasonally-adjusted average hourly earnings increased 2.5 percent between December 2016 and December 2017. This compares to a 2.9 percent increase in wages during the year prior. However, given the current business sentiment, it wouldn't be a surprise to see both jobs and wages improve over the next quarter or two.

Wage growth, in particular, would be helpful for consumer sentiment, which has also stalled of late. The most recent reading in December fell to 95.9. The uncertainty of tax reform was mentioned by nearly 30 percent of survey respondents, with roughly an equal split between positive and negative assessments of the change. For better or worse, this uncertainty should clear up when the new paycheck withholding

amounts take effect in early 2018 and people can see at least the initial effect that the new tax code will have on their personal finances.

Based on our continued strengthening economy, the Fed recently raised the fed funds rate 25 basis points at their meeting in mid-December. The new target range is between 1.25 percent and 1.50 percent. Unlike many prior raises, however, the vote was not unanimous this time. Two voting members dissented from the decision based on their concerns about our flattening yield curve and what it might mean for a potential recession. But these concerns seem unfounded now given the aforementioned strong data that has come in since the meeting. The committee also re-affirmed their expectation that rates will be raised three times during 2018, matching the number of increases made during 2017.

International Economy

Perhaps one of the biggest surprises of 2017 was the stability of Eurozone politics after years of disarray. After Brexit in the U.K. and the election of Donald Trump in the U.S., many observers saw the potential for similar populist uprisings in France, the Netherlands and Germany, any of which could have put the common euro currency in jeopardy. However, none of these actually came to pass and, as a result, the euro strengthened and Eurozone GDP surged.

The future growth prospects for the European Union continue to look strong as well. Markit's Euro Area manufacturing PMI survey reached 60.6 in December. This represents the highest reading in more than two decades. New orders also rose at a record pace.

Germany leads the way, with a manufacturing PMI survey reading of 63.6. After being considered "the sick man of Europe" immediately following reunification, Germany quickly rebounded and now has had the strongest economy in Europe for a number of years. For example, the country currently creates 10 percent of total global exports despite having only roughly 1 percent of the global labor force. It is also one of the few countries that consistently either balances its federal budget or runs surpluses. In some respects they benefit more than any other country from the common currency since a relatively weak euro helps make them very competitive. However, this comes at a cost as they often bear the brunt of having to bail out some of their less competitive neighbors.

The improved global economy has also benefited emerging market countries, which have had a very strong year in terms of market performance. The momentum could continue into 2018 as well, as December manufacturing PMI readings for each of the BRICs (Brazil, Russia, India, and China) are all at, or are at least close to, multi-year highs. Other developing countries, such as Taiwan and parts of central/eastern Europe are experiencing similarly strong PMI readings as well.

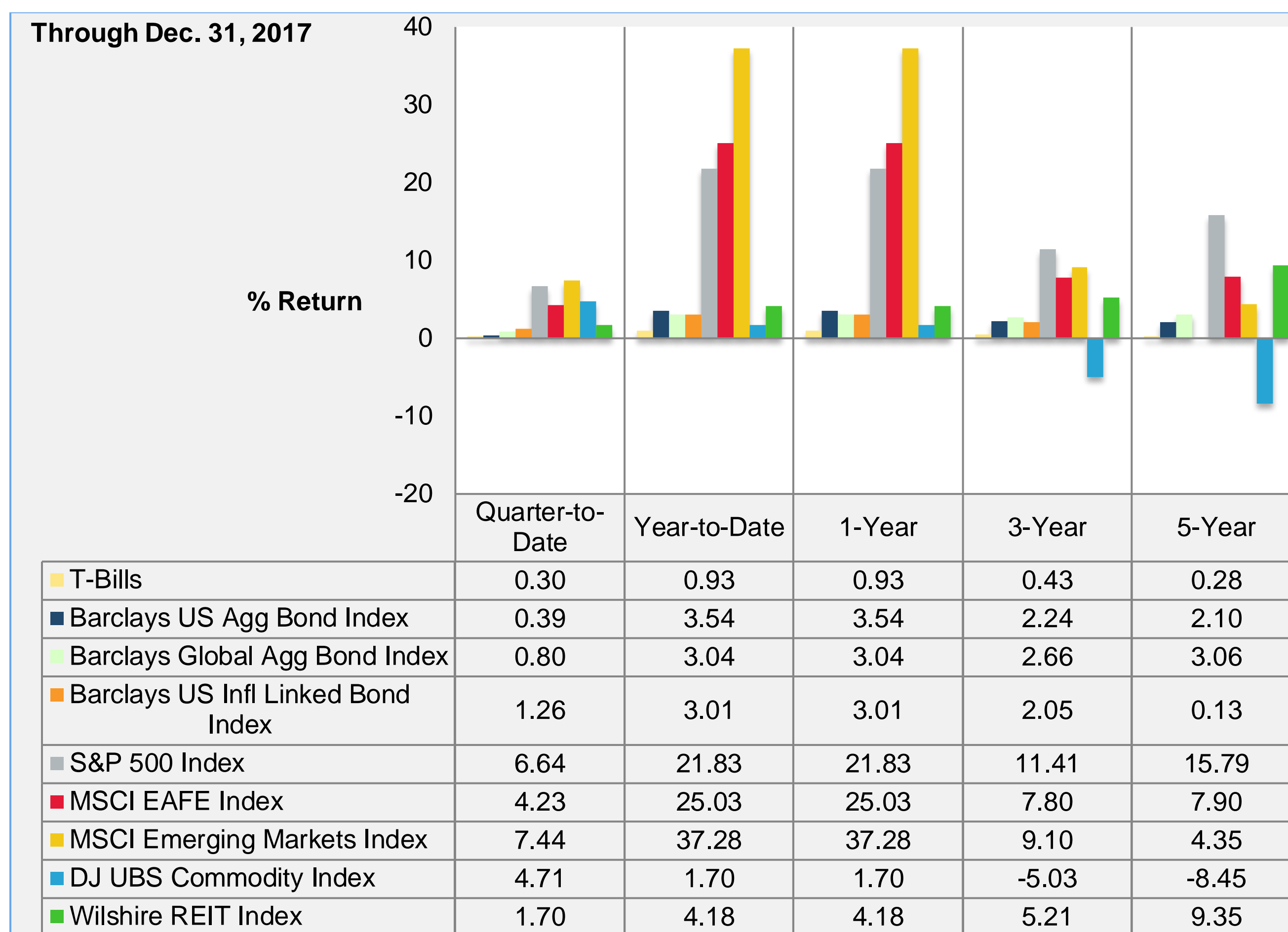
Markets

Another one of the most remarkable things about 2017 was the complete lack of market volatility. The largest intra-year decline in the S&P 500 was 3 percent as compared to an average intra-year decline of over 14 percent during the last 37 years. Large-cap equities outperformed small-cap equities for the year due to healthy global growth and a weaker U.S. dollar. Altogether, the S&P 500 Index gained 6.64 for the last three months and closed the year up 21.83 percent. Developed international equity markets did even better, outperforming the S&P 500 for the year in dollar terms for the first time since 2012. The MSCI EAFE Index was up 4.23 percent for the quarter and 25.03 for the year.

Emerging markets also continued their steady march upwards. During the fourth quarter of 2017, the MSCI Emerging Markets Index was up 7.44 percent and is now up a total of 37.28 percent during the last 12 months. Alternatives such as commodities and real estate did not fare as well, however. The DJ UBS Commodity Index gained 4.71 percent for the quarter while the Wilshire REIT Index was up 1.70 during the same time. For the year, the two asset classes are up 1.70 percent and 4.18 percent respectively.

Bonds eked out modest gains for the quarter to finish the year on a positive note. The Barclays U.S. Aggregate Bond Index gained 0.39 percent during the previous three months and is now up 3.54 percent year-to-date. The Barclays U.S. Inflation-Linked Bond Index gained 1.26 percent for the last three months and is now up 3.01 percent for the year. Global bonds, as measured by the Barclays Global Aggregate Bond Index, also continued to eke out small gains, earning 0.80 percent for the quarter. This index is now up 3.04 percent for the year thus far.

Not shown in the chart below is bitcoin, which closed the year up a staggering 1,348 percent! While it may be a bubble, there is no telling how high it will rise before the bubble pops, or even if it pops at all.



	Quarter-to-Date	Year-to-Date	1-Year	3-Year	5-Year
T-Bills	0.30	0.93	0.93	0.43	0.28
Barclays US Agg Bond Index	0.39	3.54	3.54	2.24	2.10
Barclays Global Agg Bond Index	0.80	3.04	3.04	2.66	3.06
Barclays US Infl Linked Bond Index	1.26	3.01	3.01	2.05	0.13
S&P 500 Index	6.64	21.83	21.83	11.41	15.79
MSCI EAFE Index	4.23	25.03	25.03	7.80	7.90
MSCI Emerging Markets Index	7.44	37.28	37.28	9.10	4.35
DJ UBS Commodity Index	4.71	1.70	1.70	-5.03	-8.45
Wilshire REIT Index	1.70	4.18	4.18	5.21	9.35

Source: Morningstar. Past performance does not guarantee future results. An investment cannot be made directly in an index.

(Refer to the end for index definitions.)

Outlook

Absent inflationary pressures or a significant new development coming out of North Korea, it is hard to see how the U.S. economy could have a bad year in 2018. GDP growth has been solid and the global economy seems to be experiencing a strong synchronized upswing. Meanwhile interest rates are still relatively low, which makes borrowing relatively cheap. Add in the weakening dollar and the fiscal stimulus created by the new tax law, and GDP growth in excess of 2 percent seems virtually assured.

Altogether, equities still look attractive relative to fixed income due to the prospects of continued rate increases coming from the Fed. However, market valuations in the U.S. do appear to be a bit stretched. Europe is also experiencing growth and their market valuations seem a lot more reasonable than ours. Therefore, it would not surprise us to see the 2017 outperformance of international equities continue during 2018.

Barclays US Aggregate Bond Index: The Aggregate Bond Index is a broad-based benchmark that measures the investment grade, dollar-denominated, fixed-rate taxable-bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS. The Aggregate rolls up into other Barclays Capital flagship indices such as the multi-currency Global Aggregate Index and the Universal Index, which includes high-yield and emerging markets debt. The Aggregate Index was created in 1986, with index history backfilled to Jan. 1, 1976.

Barclays Global Aggregate Bond Index: The Global Aggregate Index provides a broad-based measure of the global investment grade fixed-rate debt markets. The Global Aggregate Index contains three major components: the Aggregate (USD 300mn), the Pan-European Aggregate (EUR 300mn) and the Asian-Pacific Aggregate Index (JPY 35bn). In addition to securities from these three benchmarks (94.0 percent of the overall Global Aggregate market value as of Dec. 31, 2010), the Global Aggregate Index includes Global Treasury, Eurodollar (USD 300mn), Euro-Yen (JPY 25bn), Canadian (USD 300mn equivalent) and Investment Grade 144A (USD 300mn) index-eligible securities not already in the three regional aggregate indices. The Global Aggregate Index family includes a wide range of standard and customized subindices by liquidity constraint, sector, quality and maturity. A component of the Multiverse Index, the Global Aggregate Index was created in 1999, with index history backfilled to Jan. 1, 1990.

Barclays Global Inflation-Linked Index: The Global Inflation-Linked Index (Series-L) includes securities that offer the potential for protection against inflation as their cash flows are linked to an underlying inflation index. All securities included in the index have to be issued by an investment-grade-rated sovereign in its local currency. The list of eligible currencies is the same set of currencies eligible for inclusion in the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) represents a stand-alone multi-currency index exposed to the real yield curve for each relevant currency. As such, the index does not contribute to the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) was created on Oct. 31, 1997.

S&P 500® Index: A market capitalization-weighted index of 500 widely held stocks often used as a proxy for the stock market. It measures the movement of the largest issues. Standard & Poor's chooses the member companies for the 500 based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. The returns presented for the S&P 500 are total returns, including the reinvestment of dividends each month.

MSCI EAFE Index: The MSCI EAFE® Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure developed-market equity performance, excluding the U.S. and Canada. As of April 2002, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

MSCI Emerging Markets Index: The MSCI EMF (Emerging Markets Free) Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of April 2002, the MSCI EMF Index consisted of the following 26 emerging-market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey and Venezuela.

DJ UBS Commodity Index: Dow Jones-UBS Commodity Index℠ and Dow Jones-UBS Commodity Index Total Return℠ The DJ-UBSCI℠ family includes both the DJ-UBSCI℠, which is calculated on an excess-return basis, and the DJ-UBSCITR℠, a total return index based on the DJ-UBSCI℠. The former reflects the return of underlying commodity futures price movements only, while the latter reflects the return on fully collateralized positions in the underlying commodity futures.

Wilshire US REIT Index: Introduced in 1991, the Wilshire REIT index is intended as a broad measure of the performance of publicly traded real estate equity securities. The index is market-capitalization weighted of publicly traded real estate securities, such as Real Estate Investment Trusts (REIT), Real Estate Operating Companies (REOC) and partnerships. The index is composed of companies whose charters are the equity ownership and operation of commercial real estate.