

QUARTERLY ECONOMIC UPDATE

A review of Q4 2017

QUOTE OF THE QUARTER

“Don’t look back: something may be gaining on you.”

- Satchel Paige

QUARTERLY TIP

For the next five years, businesses can write off 100% of the cost of capital expenses from 2018. Both corporations and pass-through firms can take advantage of this federal tax provision.

THE QUARTER IN BRIEF

The final quarter of 2017 was a great one for stocks: the Dow Jones Industrial Average, S&P 500, and Nasdaq Composite all posted 3-month gains of better than 6%. Landmark federal tax reforms were approved and signed into law. Bitcoin was welcomed to two major futures exchanges, and it surged and plunged crazily. Oil and gold prices rose. Home buying accelerated, even though mortgages grew more expensive and listings remained thin. Domestic indicators showed continued strength in consumer spending and hiring as well as a pickup in economic growth. The Federal Reserve made another interest rate hike and started to reduce its balance sheet, while the European Central Bank prepared to wind down its long-running stimulus. All in all, it was an eventful and positive quarter for investors.¹

DOMESTIC ECONOMIC HEALTH

Without question, the fourth quarter’s major story was the passage of the Tax Cuts & Jobs Act. The new law created night-and-day changes in the Internal Revenue Code, nearly all effective January 1. Its most dramatic changes were arguably the ones benefiting businesses: it slashed the corporate tax rate to 21% and let the majority of pass-through companies deduct the first 20% of income. The legislation also took the individual estate tax exemption north to \$11.2 million, put the standard deduction at \$12,000, and did away with dozens of longstanding deductions, plus the personal exemption. In 2019, it removes the individual mandate for health insurance. Most of the above changes are set to expire after 2025, barring renewal in Congress.²

Consumer spending improved in the quarter. The Department of Commerce recorded a (revised) gain of 0.2% for October and a 0.6% rise in November. Retail sales were up 0.4% in October and 0.8% a month later.^{3,4}

Those numbers reflect consumer optimism, affirmed by fall readings for the key U.S. consumer confidence indices. The University of Michigan’s monthly sentiment gauge actually declined during the quarter from 100.7 to 98.5 to 95.9, but these numbers are still well above historical averages. As for the Conference Board’s index, it hit a remarkably high peak of 128.6 in November and ended Q4 up at 122.1.^{3,5}

October and November were the best months for job creation since the middle of 2016, with the Labor Department recording net payroll growth of 244,000 hires in the former month and 228,000 in the latter. The main jobless rate reached 4.1% during November, while the rate for both unemployment and underemployment (the U-6) ticked up to 8.0%.^{6,8}

The Institute for Supply Management’s twin purchasing manager indices fell a bit from their lofty Q3 heights, but their fall readings were still superb. ISM’s services PMI went from 60.1 in October to 57.4 in November. Its factory PMI was at 58.7 for October and 58.2 a month later. Hard good orders, as measured by the federal government, fell 0.4% in the tenth month of the year, but rose 1.3% in the eleventh.³

Consumer and wholesale prices increased 0.4% in November. For the Producer Price Index, the advance replicated that of October; the Consumer Price Index was up only 0.1% the prior month. The Federal Reserve’s core PCE price index advanced just 0.2% for October and 0.1% for November.^{3,7}

Speaking of the central bank, it started unwinding its vast securities portfolio and hiked the federal funds rate another quarter point in December, resulting in a new target range of 1.25%-1.5%. Among the economic indicators that likely fostered that decision was the final federal government assessment of Q3 growth: a strong 3.2%. The Fed also raised its projection of 2018 GDP to 2.5% from its previous forecast of

2.1% and its latest dot-plot indicated three rate hikes for the new year.^{3,8}

GLOBAL ECONOMIC HEALTH

While Spain grappled with the Catalonia region's desire for independence and the United Kingdom contended with European Union demands involving its Brexit, there was much good news concerning the overall E.U. economy. The jobless rate across its 28 member countries continued to descend, falling to 7.4% in October. Inflation, barely above 1.0% at the end of 2016, increased to 1.8% in November. The European Central Bank kept interest rates steady in the quarter and announced it would buy fewer bonds per month; its monetary stimulus is expected to last through Q3 2018. In December, the ECB projected 2.3% growth for the E.U. economy in 2018.^{9,10}

Economic data streams from the Asia-Pacific region offered plenty of positive news this fall. While the Caixin/Markit manufacturing PMI for China reached a 5-month low of 50.8 in November, manufacturing PMIs in Asia's leading electronics producers were up. Japan's factory PMI hit a peak unseen since 2014 in November, while manufacturing PMIs in South Korea and Taiwan respectively displayed their best readings since mid-2013 and mid-2011. South Korea's Bank of Korea raised interest rates in Q4, becoming the first major central bank in Asia to hike in three years.¹¹

WORLD MARKETS

The MSCI Emerging Markets index had another fine quarter, ascending 7.09% (it gained 34.35% for the year). Its sibling, the MSCI World, went +5.14% in Q3 (and +20.11% for 2017). Big gains were the order of the quarter: take the Nikkei 225, which had a price return of 11.83% across the last 13 weeks of 2017. Other fine performances: S&P/ASX All Ordinaries, +7.35%; Sensex, +8.86%; Hang Seng, +8.58%; FTSE 100, +4.27%; S&P/TSX Composite, +3.67%.^{12,13}

There were a few minor gains and losses. The CAC 40 went -0.32% for the quarter, and to the east, the Shanghai Composite turned in a -1.25% 13-week loss. The DAX advanced just 0.69% in the fourth quarter.¹³

COMMODITIES MARKETS

Bitcoin futures trading began on both the CME and CBOE Global Markets exchanges in December. That landmark moment further encouraged the cryptocurrency's runaway rally, punctuated by a scary plunge: bitcoin hit \$5,000 on October 13, approached \$7,500 on November 8, hovered around \$10,000 on December 1, neared \$20,000 on December 18, and ended the year just above \$14,600. Some journalists and economists wondered if bitcoin fever amounted to a modern-day Dutch tulip mania, while others were more enthusiastic.¹⁴

Palladium was the other big commodities story of the year; it advanced 13.8% in Q4 on its way to a 2017 gain of 54.3%. Two other major commodities outperformed it in the quarter: cotton rose 16.0%, while WTI crude improved 15.7%. Sugar rose 7.5% for Q4; silver, 2.2%; platinum, 2.0%; gold, 1.6%. As for Q4 retreats, the U.S. Dollar Index slipped 0.8%; soybeans, 2.7%; coffee, 4.1%; corn, 4.6%; cocoa, 7.0%; wheat, 8.5%; natural gas, 10.5%.¹⁵

Regarding the Q4 settlements that perhaps mattered most, gold ended the year at \$1,305.10; silver, at \$16.98; WTI crude, at \$60.10.¹⁶

REAL ESTATE

Mortgage rates climbed higher in the quarter. Freddie Mac's December 28 Primary Mortgage Market Survey revealed the following interest rates: 30-year fixed, 3.99%; 15-year fixed, 3.44%; 5/1-year adjustable, 3.47%. Compare the numbers from the September 28 PMMS: 30-year fixed, 3.83%; 15-year fixed, 3.13%; 5/1-year adjustable, 3.20%.¹⁷

Home buying emerged from a Q3 slump in Q4. Resales rose 2.4% in the tenth month of the year and then 5.6% in the eleventh, according to the National Association of

Realtors. (NAR's pending home sales gauge, incidentally, was up 3.5% in October, but just 0.2% in November.) New home sales, seemingly always volatile, were 1.7% lower in October, but jumped 17.5% in November.³

Looking at other real estate indicators, October brought improvements of 8.4% for housing starts and 7.4% for building permits; groundbreaking increased by another 3.3% a month later, with permits contracting 1.4%. October's S&P/Case-Shiller home price index (released in December) was up 6.4% from 12 months earlier.³

LOOKING BACK...LOOKING FORWARD

As the table beneath this paragraph shows, the blue chips had a phenomenal quarter, outpacing Wall Street's two other major stock benchmarks. The Dow settled at record highs 70 times last year; the S&P 500, 62 times. The gains in the fourth quarter made 2017 the best year for stocks since 2013. The Russell 2000 rose 13.14% for the year, while the CBOE VIX slumped 21.37%. The year-end settlements: Dow, 24,719.22; Nasdaq, 6,903.39; S&P, 2,673.61; Russell, 1,535.51; VIX, 11.04.^{18,19}

% CHANGE	2017	Q4 CHG	1-YR CHG	10-YR AVG
DJIA	+25.08	+10.33	+24.72	+8.49
NASDAQ	+28.24	+6.27	+27.09	+15.81
S&P 500	+19.42	+6.12	+18.87	+8.08
REAL YIELD	12/29 RATE	1 YR AGO	5 YRS AGO	10 YRS AGO
10 YR TIPS	0.44%	0.55%	-0.73%	1.78%

Sources: wsj.com, bigcharts.com, treasury.gov - 12/29/17^{1,20,21,22}
 Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.
 These returns do not include dividends.

Wall Street seems primed for a bullish first quarter. Institutional investors are hopeful that 2018 may surprise to the upside, just as 2017 did. The economy's 2-3% growth will probably continue in the near term, and corporate earnings should get a boost from the tax reforms in the months ahead. All that said, warnings continue to sound that the market is overpriced; the S&P 500 is now trading at about 18x forward earnings. The exuberance around equities does not always feel rational. Nearly two years have passed without a correction in the S&P, and the index had no more than a 2% downturn during all of 2017. Look at this first quarter optimistically, but be aware that the market is still susceptible to left hooks and gut punches from geopolitical events and the gradual erosion of confidence that can sometimes emerge to accompany an aging business cycle. Hopefully, bulls will not slow to a trot as 2018 proceeds.¹⁸

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