Review & Outlook – 4Q 2017

The calendar turns over to 2018 leaving behind one of the least volatile years for equity markets in history. The S&P 500 returned 21.8% in 2017, finishing the fourth quarter up 6.6%, with a intra-year dip of only 3%.

With the start of the new year, investors can be sure of two things: 1) every so-called market forecaster will release their predictions for markets in the coming year and 2) those predictions will all be wrong. A CNBC headline from last January 3 proclaimed the 2017 forecasts "the most bearish outlook in 12 years." Strategists predicted the S&P 500 to close the year at 2,362, a return of 4% and the highest forecast foresaw a close of 2,500. The actual value on 12/31/17 was 2,674, nearly 7% above the most optimistic forecast. Predictions regarding the 10 year Treasury yield were similarly well-intentioned and wrong.

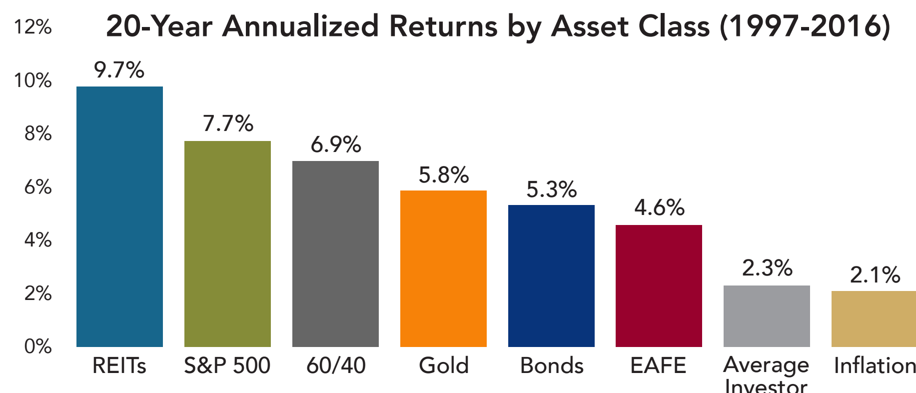
Since market predictions contain little value, we prefer to look as objectively as possible at the economic and market data as they appear, ignoring the noise of the commentators and short-term speculators while remaining broadly diversified. From a data perspective, the U.S. economy looks to be accelerating. Unemployment hovers around 4% as it has for a number of years and GDP growth topped 3% for the second and third quarters. At the same time growth is accelerating, Congress recently passed a large fiscal stimulus in the form of tax cuts. Most consumers expect a tax increase. But just 5% will see their taxes rise, forming low expectations and increasing the likelihood of a positive surprise for many.

Corporate tax rates were also cut, dropping the effective rate from 25.2% to 19.7% for companies in the S&P 500 and even greater reductions for small cap companies. The new tax law incentivizes capital expenditure and investment over debt fueled share buybacks, a positive for economic growth. Federal spending may also increase by $200 billion this year and President Trump has repeatedly talked about a large infrastructure plan, providing further fiscal stimulus.

The strong recent performance of markets and the length of the economic expansion have created a narrative that investors are too optimistic and we must be near the end of the business cycle. It's true; the U.S. is about 40 quarters into the recovery from the Great Recession against an average recovery of 25 quarters. However cumulative GDP growth has been just 15% vs. a historical average of 23%; economic cycles do not occur on fixed time schedules, Australia for instance last had a recession in 1991.

From a valuation standpoint, the S&P 500 appears fully valued, though nowhere near the bubble levels of 2000. In addition, the earning recession of 2015 and early 2016 has ended and operating earnings growth is increasing in the U.S. and globally. Japanese business sentiment is the highest in ten years and GDP growth is well above the 20-year average. Eurozone consumer confidence is at a 17 year high, the unemployment is at a post-recession low of 8.8%. Though the Federal Reserve has started to raise interest rates and decrease its balance sheet, monetary policy globally is still accommodative and global central bank balance sheets will not start to contract until at least late 2019.

While market forecasts are entertaining to read they can breed overconfidence, impatience and emotional reactions to abruptly change strategies. Frequently switching strategies based on short-term forecasts and overreacting to good and bad news are just two of the reasons the average investor has earned a miserable 2.3% annually over the last 20 years while a 60% equity, 40% fixed income portfolio returned 6.9% over the same time period. Closing that performance gap requires a disciplined long-term investment strategy focused on remaining diversified and patient, an increasingly rare trait. We are honored to continue to be that patient, long-term oriented investor on your behalf.



Source: JP Morgan Asset Management