December 29, 2017

2018 – THE YEAR AHEAD

What a year 2017 turned out to be for the financial markets. It began with both hope and trepidation on the part of many regarding the uncertain economic and political environment following the U.S. Presidential election. It is ending as one of the strongest years for the stock market since the Great Recession.

What caused things to go even better than many—including us—expected? The answer lies in a convergence of several positive factors: economic and corporate profit growth, interest rates, government policy, and investor sentiment. Economic growth in this country and overseas increased from fairly sluggish levels as the year progressed. Corporate profits continued to recover from a flat patch in 2015 and early 2016. Bond market interest rates, after having spiked upward in late 2016, pulled back through the summer before resuming a gradual uptrend in the fall. Tax reform legislation finally passed as year-end approached, while the Federal Reserve has been cautious about reining in monetary stimulus. Finally, investor sentiment has improved markedly, though we would still not call it euphoric.

Given the strong recent performance, many might wonder if the current bull market is coming to an end. After all, it has been nearly nine years since the start of this one, and nothing goes up forever. Some of the more aggressive sectors of the stock market, specifically the technology and internet areas, are sporting particularly optimistic valuations, somewhat reminiscent of the late 1990s.

In 2018 – THE YEAR AHEAD we address this concern about a market reversal. Although the current cycle may be in its later stages, we don’t think it is quite over yet. The stock market is likely to see at least one more positive year, although with more subdued returns than those of the last twelve months. Market volatility, after being surprisingly low in 2017, may also increase. We remind you, however, that while we are attempting to forecast the future, our continued investment success will largely depend on our ability to interpret and adjust to trends and events as they occur and as new information becomes available.

The Economy

The U.S. economy started 2017 growing at a rather modest rate, but picked up steam as the year progressed, with real Gross Domestic Product (GDP) advancing at around a 3% annual rate in the second half of the year. Consumer spending has been fairly steady throughout, at about a 2.5% annual pace, but business spending finally picked up after an extended
cautious period. Companies also built up inventories, possibly as a result of improved optimism about the business environment, and overseas trade actually increased as well. Unemployment continued to decline, with the official rate dropping to 4.1%, widely viewed as being near “full” employment.

The big news on the economic front is the just-passed Tax Cuts and Jobs Act. This legislation is likely to stimulate additional growth in the coming year, by increasing both consumer and business spending. According to BCA Research, its effects could add 0.2-0.3% to real GDP in 2018. Personal tax rates will be lower by around three percent on average, and while there are a number of other provisions that often offset each other, the net result for most taxpayers (but clearly not all) will be lower taxes, putting more money in their pockets. Thus, consumer spending is likely to continue to grow at an annual rate of over 2%, despite consumer savings levels having begun to decline in 2017’s second half and consumer debt levels again on the rise. Housing growth has been somewhat moderate, and high-end home sales could take a temporary hit from the reduced deductibility of mortgage interest on new purchases, but the growing cohort of millennials who are, or should be, forming their own households should continue to drive demand.

Business spending will also likely be boosted by the new law. Corporate tax rates are lowered, some capital investment can be 100% expensed, and international income moves to a territorial system of taxation. Foreign profits must also be repatriated, but at favorable tax rates. So, capital spending should also continue at a pace at least as high as 2017’s. The new administration had already moved to reduce regulation, which appears to have increased business optimism, and this environment continues to be a positive for business plans.

International trade has not yet suffered in spite of rhetoric from the administration regarding changing existing trade deals and selectively imposing tariffs in some industries. However, these policies could have an increasing impact going forward. Continued growth and rising rates in our economy will likely also contribute to a strengthening dollar in the coming year, making our goods a bit less competitive, thereby negatively impacting economic growth on the margin.

Government spending, while not yet boosted by new laws, could increase if any infrastructure legislation makes headway. Such efforts had been put on the back burner, but the Trump administration has indicated renewed interest in passing something in this area on the heels of its success with tax reform. Additional infrastructure spending may rely heavily on private contributions, but, on balance, government spending is not likely to detract from economic growth.

Overall, then, U.S. real GDP growth should continue at a rate above 2% in 2018. With continued job growth, the unemployment rate could go still lower, to below 4%. As the year progresses, we will be watching to see if the economy begins to bump up against capacity constraints, which might cause GDP growth to begin to slow.
Inflation, Interest Rates, and the Bond Market

One of the main economic stories of 2017 was the continuation of low inflation despite accelerating economic growth and employment. Normally, this far into an economic expansion, inflationary pressures would start to become evident. Yet, consumer prices have risen slightly under 2%, with wage inflation not much higher.

Is inflation therefore just about to pick up, or are there some underlying structural causes that are suppressing its resurgence, particularly for wages? It’s probably some of both. Technological advancements have changed the nature of work in many industries. In markets where there are not enough workers to fill new types of jobs, wage inflation is already increasing. At the same time, some higher paying manufacturing jobs have been replaced by lower paying work in service industries. One cause is mathematical. As baby boomers retire at what is often a time of peak earnings, new millennial workers are entering the workforce at entry-level pay. Also, with economic growth at below-average rates compared to past cycles and lingering scars from the Great Recession, some workers may be more interested in job security than demanding increased wages.

Whatever the causes, we think that 2018 will be the year when wages do finally start to move at least somewhat higher, as ever-lower unemployment leads to increased competition among businesses for qualified workers. Supplementing that will be continued moderate but positive inflation for goods, as the prices of energy and other commodities work gradually higher due to solid demand in a growing economic environment. Additionally, while the tax law changes may stimulate more economic growth, such growth adding to an already healthy economy could increase inflation at a faster rate than many expect.

Interest rates remain relatively low for now, with the benchmark ten-year U.S. Treasury note yielding about 2.5% as the year closes, near 2016 year-end levels. The recent trend has been gradually upward, and we expect this to continue as the economy approaches full utilization. If inflation starts to accelerate, this could alarm bond market investors, which would likely result in higher bond rates. The Federal Reserve might also feel compelled to increase the speed at which it raises the short-term Federal Funds rate if it becomes concerned that the economy is overheating. Right now, we are expecting three quarter-percent increases over the course of next year from the current level of 1.25%, in line with what the Fed has suggested it would like to do.

One thing we watch to tell us if the economic cycle may be coming to an end is the shape of the “yield curve,” the interest rate available at each maturity in the bond market. As the Fed raises short-term interest rates, they may increase faster than longer-term interest rates, leading to a flattening of this curve. In instances when the curve has become inverted (short rates higher than long rates), this has been a very reliable leading indicator of the coming end of an economic cycle. The curve has been flattening, but is not yet close to inverted. We will be monitoring this carefully.

As we see interest rates continuing to rise in a growing late-stage economy, we are maintaining a somewhat defensive posture regarding bond investments. We recommend a
shorter-than-average maturity for a bond portfolio, and continue to emphasize high quality. While corporate bonds still provide some yield pick-up over U.S. Treasury securities, that spread continues to grow narrower, and, at this point in an economic cycle, we begin to anticipate the time when economic growth will slow, stress on weaker corporate borrowers will mount, and spreads over Treasury yields begin to widen. We don’t think that time is now, but we are focused on increasing the credit quality of the corporate bonds we own, as current holdings mature. Taxable municipals have been a good, high-quality alternative that we have increasingly used in portfolios that otherwise own corporate bonds. For high-tax-bracket clients, tax-exempt municipal bonds still make sense, although their yields relative to taxable bonds are not as high as they were a year ago.

**The Stock Market**

2017 was notable not only for how strong the stock market was, but also how steady its path. Volatility was at all-time lows, and the major market indexes did not suffer even a four percent drop at any time during the course of the year. That is quite a result, given the uncertain environment in which the year began. Political and geopolitical headlines came along with regularity, but stock market investors mostly chose to ignore them, focusing instead on the steadily growing economy and corporate profits. Some additional boost likely occurred toward year-end as investors anticipated tax-law reform.

Most sectors of the stock market participated in the year’s advance. With a sense of déjà vu from 2015, technology was by far the leader, as sentiment toward the group improved and earnings growth was generally strong. On the other hand, energy lagged as oil prices first declined and then recovered, though not enough to overcome investor skepticism toward the group. Large-cap stocks generally outdistanced mid- and small-sized ones. International stocks, after lagging domestic holdings for years, also performed well.

Given our forecast of continued economic and earnings growth, we expect another up year for the stock market in 2018. However, the strong move this past year probably already discounts at least some of the economic benefits of tax reform, so we see a more subdued result next year. We could even see some profit taking in the new year, and would not be surprised if this precipitated a market correction. We would not view any correction with alarm and would likely use it as a buying opportunity if some stocks that have gotten ahead of themselves were available at cheaper prices. It is also possible that investor sentiment continues to be so positive that it overrides the impulse to lock in some recent gains.

Corporate earnings look to have grown by about 10% in 2017, and we think we may see a slight acceleration next year if economic growth remains on track. Real GDP growth of over 2% should provide at least mid- to high-single-digit corporate revenue growth, and lower tax rates mean higher profit margins, more than offsetting somewhat higher labor costs. A rising dollar may put a bit of a damper on overseas profits, but if other economies continue to grow fairly well, higher demand could help revenues from those countries. We expect dividends to grow in line with earnings.
The biggest question will be what valuation investors give to this earnings growth. One of the surprises of 2017 was that the price-to-earnings (P/E) ratio of the overall market—already elevated somewhat from long-term averages—continued to expand a bit further. This reflects a high level of investor optimism, also indicated in several surveys of investor sentiment, so our best guess is that valuations may not expand further, and could even begin to contract. While the current environment of good earnings growth and low interest rates can be consistent with this relatively high valuation level, there is now less margin for error should volatility increase or any unforeseen economic or political events occur. And, while it is possible that investor confidence could push the P/E ratio even higher, that would put the market into riskier territory.

As noted, technology stocks had a particularly good year as earnings growth was strong. However, despite this growth, some valuations in the group remain quite high. Additionally, technology and Internet-related names now constitute the highest percentage of the market’s value since 1999, and we believe that regulatory risk around the world has increased for some of the more dominant companies. As conservative investors, we cannot justify some of the current valuations and so are generally not chasing those. Conversely, while energy stocks have been in the doghouse off and on for several years, we think investor caution has kept the group from rebounding along with the recent increase in energy prices, and some catch-up is warranted.

Industries that benefit from the economic stimulus that the new tax law should bring ought to do well in the new year. Besides energy, these include the financials, capital goods, and some of the technology stocks with still-reasonable valuations. On the flip side of that coin, sectors that do relatively well in a slow-growth environment, such as utilities and consumer staples, could lag the averages.

Healthcare stocks still have some opportunities, although the group is not as cheap as it was a year ago in the face of uncertainty about health care legislation. While no significant legislative changes were enacted and some uncertainty still remains, so too does the demographic tailwind of an aging baby-boom generation and its increasing expenditures on healthcare.

Many consumer-oriented companies have seen the destructive effects of competition from Amazon and other online sellers, and we have been mostly successful at avoiding the victims. There may be selective opportunities among the wreckage, but we are approaching this sector carefully and looking for strong companies with dominant franchises and online strategies of their own.

As the economies of other countries have joined the U.S. in a period of more widespread global growth, we have considered once again increasing our holdings of international stocks. Our clients already have some exposure as many of the larger U.S.-based companies we own in portfolios have significant overseas businesses. Many foreign stock markets have lower valuations (although some for good reason) and improving prospects. We are still evaluating these prospects, but the potential for a strengthening dollar dampens our enthusiasm a bit. Still, we are open to the possibility.
As we progress through the coming year, we will be watching for any sign that the U.S. economy is becoming too strong and overheating. The change in the tax law, while stimulative to the economy in the near term, also carries with it some risk this late in the economic cycle. If economic growth becomes too strong, it increases the chances of higher inflation and more restrictive Federal Reserve monetary policy. These steps would hasten the next recession and with it the next cyclical bear market for stocks. We see no evidence of this at present, but will be on the lookout later in the year. Hopefully, the economy continues on a “goldilocks” path of neither too hot nor too cold, allowing for a still longer expansion and bull market.

**Conclusion**

The investment outlook for 2018 still looks positive to us, although we are clearly well along in the economic cycle. An already steadily growing economy will be further aided by lower tax rates and other related changes, with both consumer and business spending benefiting. U.S. growth will be complemented by increasing growth from abroad, as loose monetary policy continues to take hold there. As our economy moves closer to operating at full capacity, it runs the increasing risk of overheating, and we will be watchful for signs of this, particularly the possible resurgence of inflation.

Interest rates should continue to increase gradually in this environment, with the Federal Reserve moving toward “normalizing” the Federal Funds rate at a level of about 2% by year-end. Longer-term interest rates are also likely to trend higher. Thus, we maintain a defensive position in bond portfolios, and place even greater emphasis on quality in a late-cycle environment.

Economic growth should support continued corporate profit growth, the linchpin on which further stock market strength depends. With market valuations having continued to expand and investor optimism at high levels, we would not rely as much on further valuation expansion going forward, particularly if interest rates and inflation increase. Therefore, we believe that stock market returns, while still positive, will likely be more moderate than in 2017. We would be buyers of any near-term corrections in stocks as the current cycle appears intact, but will also be alert later in the year to any economic overheating and increasingly tight monetary policy that might eventually put an end to the current expansion.

We wish all of our friends and clients peace, joy, health, and prosperity in the New Year, and for many years to come.

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