Q4|2017 - Economic Commentary

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]

Looking Back at the Numbers…

% CHANGE	2017	Q4 CHG	1-YR CHG
AGG	3.54%	0.39%	3.54%
EAFE	25.03%	4.23%	25.03%
S&P 500	21.83%	6.64%	21.83%
Russ 1000 Value	13.66%	5.33%	13.66%
Russ 2000	14.65%	3.34	3.34%

Looking Forward

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. 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]

Wall Street seems primed for a bullish first quarter, charging out of the gate. 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. (For more on our current thinking about the market, please see www.wealthandpension.com //investor-blog-2017-was-a-great-year-can-we-have-another-for-2018 from January 2nd). 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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Citations.

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