# Economic & Market Quarterly

# Winter 2018

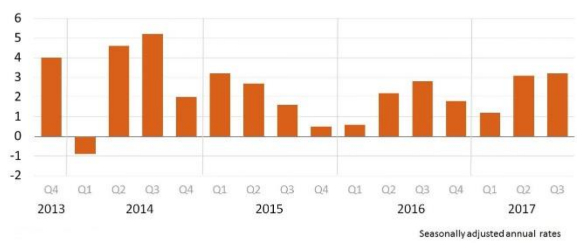
*This summary is provided by BMT Wealth Management.*

## Synchronized Global Growth

Domestic economic growth accelerated in the middle two quarters of 2017, after a slow start to the year.

The graph below highlights U.S. Real GDP growth by quarter over the last four years. Growth in the third quarter came in at a strong +3.2%, after an almost equally strong +3.1% in the second quarter. These reports were a welcome increase from the readings below 3.0% in most of 2015 and all of 2016, and the generally sub-par growth for this long-dated economic expansion.

**Real GDP:**
**Percent Change from Preceding Quarter**




*Source: U.S. Bureau of Economic Analysis*

Looking across to the Eurozone, Real GDP has also been expanding, albeit at a slower pace than in the United States.

In the third quarter, Eurozone Real GDP expanded at a pace of +0.6%. It is important to note that the Eurozone had been mired in negative growth from late 2011 through early 2013, before turning positive. The International Monetary Fund (IMF) is forecasting 2.0% Real GDP growth for this region in 2018.

Turning to the Emerging Markets, the IMF is forecasting growth in the area of +5.0% in 2018. From a regional perspective, the most rapid growth within developing economies is predicted in Asian countries. Specifically, China is expected to register 6.5% Real GDP growth this year.

## Tax Cuts and U.S. Real GDP

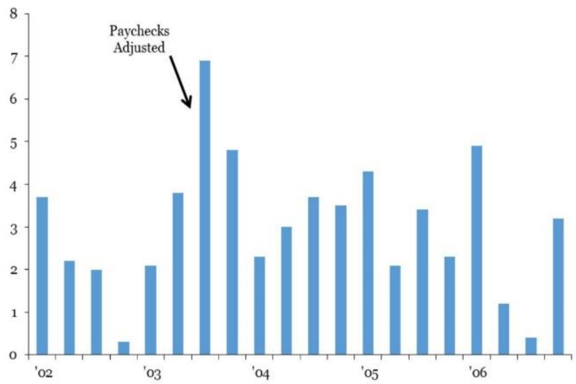
The topic that has dominated Main Street and Wall Street over the last several months has been whether tax reform would be enacted.

The Tax Cut and Jobs Act was signed into law by President Trump on Dec. 22, 2017, and became effective on Jan. 1, 2018. The legislation is designed to lower corporate and individual income tax rates, with the dual goals of making U.S. corporations more competitive globally with a less onerous tax structure and providing U.S. individual taxpayers with more after-tax income.

For individuals, the IRS has indicated that the new withholding rates could be effective as early as February. It is anticipated that the reduced levels of withholding should have a positive impact on consumer spending (almost 70% of GDP) and thus Real GDP.

To put things in historical context, in the tax cut of 2003, paychecks were adjusted by July 1 of that year. It is important to note that the positive impact on GDP began shortly thereafter, in the third quarter of 2003, as illustrated in the following graph.

**Quarterly Real GDP, 2003 – 2006**
**% Change**




*Source: Strategas Research*

## A Good Year for Global Equities

Equity markets around the globe ended 2017 the way they started the year, in full rally mode. The S&P 500 Index advanced 6.64% in the fourth quarter, bringing its return for the year to 21.83%.

Smaller-cap stocks, as measured by the Russell 2000 Index, moved higher by 3.34% during the three-month period, to close out 2017 with a total return of 14.65%. While small-cap stocks lagged for the year, they were coming off a year when they had handily outperformed the S&P 500.

The strong returns in the equity markets are clearly noteworthy. So, too, is the relative lack of volatility. Much was written on this topic throughout 2017, and with the year now complete, the final statistics empirically demonstrate this fact.

According to data compiled by Dorsey, Wright & Associates, of the 251 trading days in 2017, the S&P 500 generated daily returns within +/- 1.0% on 96.8% (243) of the days. Further, no single trading day saw an advance or decline on the S&P that exceeded 2.0%.

Putting this in historical context, Dorsey Wright indicates that 2017 saw the highest percentage of trading days within +/- 1.0% in over 50 years, since 1964.

Looking outside the United States, both International (MSCI EAFE) and Emerging Markets (MSCI EM) equities posted returns that exceeded the S&P 500 for the year. This was the first time that had happened since 2012.

Emerging Markets stocks produced the best returns, with the MSCI EM Index up 7.44% for the fourth quarter and 37.28% for the year.

The MSCI EAFE Index of International stocks finished out the year higher by 25.03%.

While non-U.S. equities did well in 2017, as the chart below displays, they still lag the S&P 500 by a wide margin when looking at longer-term (five-year) results. Performance of the S&P 500 Index is indicated in blue, the MSCI EAFE is in gold, and the MSCI EM is in orange.

**Five-Year Cumulative Total Return**
**In U.S. Dollars**
**2013 – 2017**

*Source: FactSet, Inc.*

## Fixed Income: More Flattening

The U.S. fixed income market continued a familiar theme in the final quarter of the year – a flattening yield curve and tightening credit spreads.

U.S. Treasury yields increased along the intermediate part of the yield curve, with the two-year U.S. Treasury yield and 10-year U.S. Treasury yield rising 40 basis points (0.40%) and eight basis points (0.08%), respectively.

Overall, the yield curve flattened by 32 basis points (0.32%), the difference between the shift in the two-year and ten-year part of the U.S. Treasury yield curve.

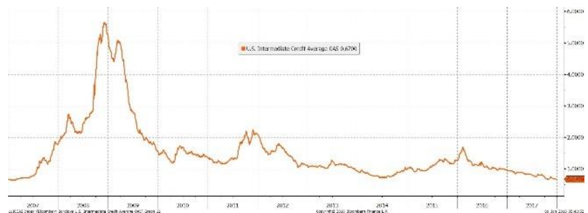
The Federal Reserve's (the Fed's) monetary policy actions during the year provided a boost to short-term yields. The Fed raised the Federal Funds Target Rate by 25 basis points (0.25%) in the fourth quarter, to a new range of between 1.25% and 1.50%.

It was the third time the Fed altered its primary policy rate in 2017, and it is expected to raise it three more times in 2018.

The Fed has been monitoring economic data very closely, looking for any indication that the current economic expansion and healthy labor market is triggering any unwelcomed signs of higher inflation. Thus far, price stability has remained well within the Fed's comfort zone of 2.0%.

Positive economic growth and low inflation have provided a benign environment for U.S. corporate bond issuers. The Bloomberg Barclays U.S. Intermediate Government Credit Index was down -0.20% in the fourth quarter of 2017; however, U.S. credit issuers were able to squeeze out a modest gain of 0.11%. The positive performance compared favorably to intermediate U.S. government bonds, which were down -0.40%.

**U.S. Credit Spreads Ended 2017 at Tightest Levels in More Than a Decade 12/31/2006 – 12/31/2017**



*Source: Bloomberg Finance L.P.*

While a flatter yield curve and tightening credit spreads were common themes in the taxable bond market, tax reform and its impact on municipal bond issuance were the primary areas of focus in the final quarter of 2017.

The municipal bond market registered a new monthly record of deals in December 2017, over $60 billion, triggered by issuers rushing to raise money before new tax law changes took effect in 2018.

As part of tax reform, advance refundings, a popular way for municipalities to lower their funding costs, will no longer receive favorable tax-exempt interest treatment. The new tax law is expected to reduce municipal bond supply in 2018 – a potential positive for municipal bond performance.

## Final Thoughts/Outlook

In early 2017, the initial euphoria regarding President Trump's fiscal policy initiatives was starting to wane, and we mentioned at the time that there was somewhat of a dichotomy between reported economic activity ("hard data") and forward-looking, business/consumer survey data ("soft data").

Fortunately, the optimistic views captured in the "soft data" translated into stronger economic growth and commensurate gains in both corporate earnings and revenue growth towards the second half of 2017. Financials markets, especially risk assets, reacted quite favorably to this dynamic.

The million-dollar questions are, "Where do we go from here from an economic growth perspective" and "At what valuation levels will the markets be fully discounting this late-cycle acceleration?"

Unfortunately, we do not have a crystal ball. But, after reviewing various economic indicators and how the economy and financial markets reacted to previous tax cuts in 1986 and 2003, we think this expansion could continue throughout 2018, barring some exogenous geopolitical event or central bank policy blunder. We would not be surprised to see economic growth rates in 2018 resemble those experienced during the back half of 2017.

Financials markets are clearly trading at higher valuations in early 2018 compared to 2017, but high valuations do not necessarily slay a bull market, at least on a shorter-term basis.

If interest rates remain stable or gradually drift higher, economic growth momentum continues, and inflation, or expectations of future inflation, do not dramatically accelerate, we think the market will more than likely continue to trade at elevated market multiples over the course of 2018.

We do have some concerns about the degree of investor complacency, though, given very low levels of market volatility, and a case could be made that a routine market correction is overdue.

Late-cycle investing can be challenging, as higher risk assets continue to get bid up in price. However, we think that diligent analysis at the asset allocation level and individual security level, for both equities and fixed income, could bode well for active managers and their clients in the coming year.



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