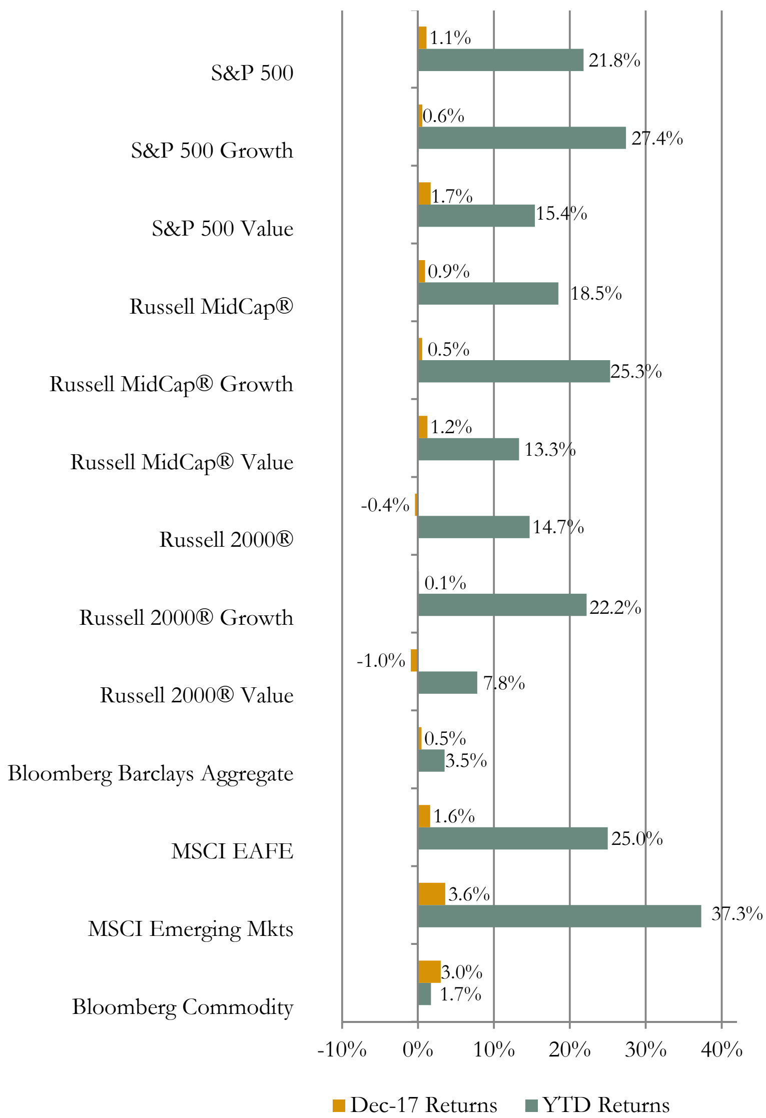
Monthly Market Summary – December 2017

The equity market records kept coming during December. In the U.S., the Dow Jones Industrial Average, S&P 500, and Nasdaq Composite each hit several new all-time closing highs. The S&P 500 also made a new record. For the first time ever, the index had a positive return for each month of the calendar year. In the United Kingdom (U.K.), the FTSE 100 index hit a new record high on the last trading day of the month. The equity market advances were supported by more good economic news. In the U.S., housing market data was particularly strong. The number of housing starts and the number of building permits issued each rose more than expected while existing and new home sales reached 10-year highs. The holiday shopping season began with a strong start as retail sales increased 5.8% in November compared to the prior year. U.K. and euro area manufacturing data was particularly strong. Manufacturing orders in the U.K. were at the highest levels since 1988 and euro area new orders rose to the highest level since 2000. In Japan household spending increased more than expected at a rate of 1.7% over the prior year and the unemployment rate declined to 2.7% which is the lowest since 1993. Trade data for China showed that global growth is strong as is economic activity within China. Exports from China rose 12.3% in the last month and imports rose 17.7% in U.S. dollar terms. Both reports were higher than expected.

Market Indices – December 2017



Market participants were also focused on the U.S. Congress as it worked to finalize its tax reform bill. Late in the month President Trump signed the Tax Cuts and Jobs Act into law. The bill includes major changes to both the personal and corporate tax codes through numerous provisions. Many strategists expect the new tax law will provide a modest boost to the U.S. economy. Tax cuts for individuals may increase household disposable income which could boost consumer spending. Tax cuts may increase corporate profits which could enable companies to increase capital spending and other growth-oriented actions. The tax cuts and corresponding boost to economic activity could be positive for equity prices, but the impact will vary by sector and company. Strategists also warn that higher economic activity in an already tight labor market could lead to higher inflation and then higher interest rates.

As expected, the Federal Reserve Open Market Committee (Fed) raised the target range for its federal funds rate by 0.25% to a range of 1.25% to 1.50%. The median of Fed members' latest projections for the federal funds rate indicates three 0.25% rate hikes in 2018 and two in 2019 if economic data continues to meet Fed expectations. The long-term forecast for the policy rate was raised to 3.1% from 2.9%. The People's Bank of China nudged interest rates higher on loans to banks and on its medium-term lending facility as part of its deleveraging campaign. Analysts are closely watching the moves to control leverage which could slow the Chinese economy.

U.S. equity markets reacted to the hike in the Fed's policy interest rate and to solid economic data. However, the biggest impact seemed to be due to reactions to the progress on the tax reform bill. Equity markets rose throughout December with major indices setting several new record highs primarily due to expectations that tax cuts will increase economic growth and provide a boost to corporate earnings in 2018. In general, stocks seen as getting the most benefit from the new tax law rose the most while stocks seen as having little benefit from the new law had the smallest gains. Large-capitalization (cap) stocks outperformed mid-cap stocks and both outperformed small-cap stocks. The S&P 500 and Russell MidCap indices each had a return of about 1% for the month while the Russell 2000 index of small-cap stocks had a small negative return. Value stocks outperformed growth stocks in the large and mid-cap indices while growth outperformed value in the small-cap index. The energy sector had the best or second best returns in each market-cap segment as crude oil and natural gas prices rose. The telecom sector had the highest return in the large-cap index since the sector is seen as benefiting from tax reform and as some investors rotated into the sector as a value opportunity since the sector is one of the two sectors with a negative return for the year. The utilities sector had the worst performance with sizeable negative returns across the market cap spectrum. This sector declined in part because higher dividend stocks had less appeal while short-term bond yields were rising. Information technology was another weak sector since technology companies generally have lower tax rates so are seen as benefiting less from tax cuts. Lower sales forecasts for the new iPhone X also had a negative impact on the sector.

International equity indices posted gains for December and outperformed U.S. equity index returns. The MSCI EAFE index of developed international stocks had a return of 1.6% and the MSCI Emerging Markets (EM) index posted a return of 3.6% on a U.S dollar basis. Currency movements had a positive impact on December returns since the dollar declined. Growth stocks outperformed value stocks in the EAFE index but value outperformed growth in the EM index. The energy and materials sectors had the best returns in the developed international markets while healthcare and consumer staples had the best return in emerging markets. Just as in the U.S., the technology sector was weak in the EAFE and EM indices as investors rotated away from some of the top performing stocks for the year. On a geographic basis, countries with heavy commodity exposure had the best returns as energy and industrial metals prices rallied. The United Kingdom also had among the best returns due in part to reports of strong manufacturing orders and exports. Returns in the European region were weaker due to some weaker than expected economic news from Germany while political issues pressured equity prices in Italy and Spain. In the emerging markets index, Chile had the highest return rebounding from the sharp decline in November after the presidential election. Brazil was one of the best performing emerging market countries not only because of its commodity exposure but also due to positive reaction to the central bank's interest rate cut which dropped the policy rate to an all-time low of 7%. Mexico had the lowest return hurt by worries about trade tariffs.

U.S. bond market returns were positive for the month leading the Bloomberg Barclays U.S. Aggregate Bond index to post a return of 0.5% for December. The 10-year Treasury bond yield rose to 2.50%, the highest level since March, after the tax bill passed which certain market participants viewed as increasing the prospects for faster economic growth and wider deficits. However, the yield declined again and ended the month at 2.40%, which was little changed from the prior month-end yield of 2.42% and the prior year-end yield of 2.33%. The bigger news was the movement in short-term yields reflecting stronger economic growth and the 0.25% hike in the Fed's policy rate target along with confirmation of its plans for further rate hikes in 2018. The 2-year Treasury note yield was 1.89% at the end of December, which was up from 1.78% a month earlier and up from 1.21% at the end of 2016. The yield curve continued to flatten since short-term yields have risen while longer-term yields have been stable to lower. The additional yield on the 10-year Treasury bond over the 2-year Treasury note (spread) fell to the lowest level in a decade. All sectors of the fixed income market posted positive returns for the month. The municipal bond index had the highest return due to high investor demand for tax-exempt income before possible changes to exemptions in the new tax law. Corporate bonds outperformed Treasury bonds as money flowed into the sector as investors continued to search for additional yield.

The Bloomberg Commodity index had a return of 3.0% for December. The industrial metals sector had the best return among the major sectors we track with a return of 9%. The group had a boost from talk by President Trump that infrastructure spending will be a priority for 2018 and from weakness in the U.S. dollar, which makes commodities priced in the dollar less expensive for non-U.S. buyers. The petroleum sector had a return of 6%. The price of West Texas Intermediate crude rose to just above $60 per barrel at month-end, which was the highest price since mid-2015, as U.S. output and inventories declined and demand from China remained firm. The price of gold rose to close the month at $1,305 per ounce as the U.S. dollar declined. The agriculture sector continued to struggle with high supply levels causing prices to fall. The agriculture sector was the only sector we track to post a negative return for the month.

Vogel Consulting, LLC (Vogel) Tactical Recommendations

Our tactical recommendations have not changed. We continue to be positive on the outlook for U.S. and developed international stocks as we see support for corporate earnings growth due to positive global economic growth momentum since most economic data continues to be solidly in expansionary territory and inflation remains muted. However, after the improvements that have been seen in various economic data in the U.S., Europe, and Japan, we expect the rate of future improvement may be lower. In contrast, various emerging markets regions appear to still be earlier in the economic cycle. Therefore, even though emerging markets stocks have had sizeable price gains in recent months, we expect a higher rate of economic and profitability growth in emerging markets than in developed markets in the coming months.

We continue to recommend an equal weight to U.S. large-cap, mid-cap, and small-cap stocks and to developed international equities. We recommend an overweight to emerging markets equities. We continue to favor equities over bonds and retain our underweight recommendation for fixed income investments. Our underweight recommendation is because the return expectation for bonds is modest due to the low level of yields and the prospects for yields to move higher (and prices lower) if inflation picks-up and the Fed continues to hike its policy rate as it has suggested. Within fixed income we continue to recommend a focus on short to intermediate term bonds. We also continue to favor non-Treasury bonds for the yield advantage they provide. We continue to favor hedge fund strategies over fixed income for the lower expected volatility portion of portfolios but also recommend an underweight allocation to hedge funds. Since our expectation is for a moderate rate of inflation to continue, we recommend an equal weight to real assets. We would not be surprised if financial markets experience bouts of volatility as more details emerge about any fiscal, monetary, or political policy changes or if there are delays in implementing these actions. Therefore, we continue to recommend using periods of market strength to raise any cash needed to support spending needs over the coming 12-24 months.