Equity Market Update

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Equities performed spectacularly in 2017. The market was aided by numerous positive catalysts. First, synchronous global growth enabled economic data to surprise to the upside. Next, central banks around the world maintained their accommodative monetary policies. Third, the US Dollar weakened by its largest amount in 10 years versus other major currencies which aided the results of multinational companies. Fourth, corporate earnings grew at their fastest pace since 2011. Next, volatility evaporated to record low levels providing incentive to buy risk assets. Finally, corporate tax cuts were passed and will be enacted at the beginning of 2018. These events enabled most global indexes to breakout into all-time record territory.

The S&P 500 gained 21.82%, its best showing in four years. The index has produced a positive total return for 14 straight months, the longest monthly stretch in history. For the entire year, the index never traded more than 3.5% below its record high, it smoothest rally in over 20 years. In fact, 2017 marked only the 7th time in history in which the S&P 500 did not have a drawdown of over 5% from the high. Per Goldman Sachs, we are only one month away from breaking a 66-year old record of the longest stretch without a sell-off of 5% or greater. Finally, the S&P 500's return surpassed that of bonds for the sixth consecutive year, the longest streak in 20 years.

The results were much better for the Dow Jones Industrial Average given its different calculation method versus the S&P 500 (price weighted vs. market cap weighted). In 2017, it gained 28.11%. Like the S&P 500, the Dow has also been up for 14 straight months on a total return basis. It also produced 71 record closes, the most ever for the index.

All year long, the NASDAQ produced the best results as technology stocks were the must-have investments. The index was the strongest performer zooming 29.73% on sharp gains in social media, ecommerce, internet portals, semiconductors, and biotech. Despite technology's popularity, the gains within the sector were not widespread. In fact, five companies—Apple, Amazon, Alphabet, Facebook and Microsoft—accounted for 1/3 of the all return made in the US stock market in 2017! Finally, the NASDAQ has produced six straight years of gains, its longest streak since 1980.

The passage of corporate tax relief lifted shares of mid and small-sized companies in the final months of 2017; however, it was not enough to erase their wide underperformance versus their large cap peers. The S&P 400 Mid-Cap Index increased 16.23%, while the S&P 600 Small Cap Index gained 13.15%. Underperformance in midcap and small-cap stocks could be a harbinger for success in 2018, especially if the tax cuts lead to faster economic growth in the US.

With most of the major news headlines centered on the United States, international markets quietly outperformed US stocks in 2017. This was the first time international performance surpassed the US since 2012. Improving economic results in Europe lifted consumer and business confidence in the region to the highest levels in a decade. Broadening growth, along with further stimulus from the ECB and the Bank of Japan, enabled the EAFE Index to return 25.69%. Performance was even better for emerging market stocks. They were the best performing major index in 2017 with gains of 37.51%. Emerging economies benefitted from the broadening of global growth across different geographic regions, the weakness in the US Dollar, and lower valuations compared to US stocks.

All year long, we have written about the remarkable rally in growth stocks. For 2017, growth outperformed value by an astounding 1,657 basis points according to Russell. This marked the widest performance disparity between growth and value since 1999. However, in the final quarter of 2017, it appeared the momentum trade in growth was losing steam. The catalyst was the announcement and the subsequent passage of corporate tax reform. The new law has details that should benefit companies of all stripes, so investors began to focus on valuation once again.

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If sentiment is really turning, this could have major implications for returns in 2018. When investors have attempted to diversify beyond technology in 2017, the winners have been industrials, materials, healthcare and consumer discretionary. However, the biggest beneficiaries of the tax cuts are actually the sectors most investors have shunned—energy, financials and telecommunications. The potential is great for these three sectors because a recent study by Bernstein showed energy, financials and telecommunications as the least crowded trades in the market.

As we enter 2018, the most important ingredients for stocks are the improving global economic picture and the accommodative central banks. For months, we have written about the 45 largest economies in the world being in expansion mode at the same time. This has not happened since 2006-2007. As 2017 ends, the Citigroup Economic Surprise Index is still high in both the US and Europe. This is a good sign for further stock market gains; however, it also creates the possibility for volatility and disappointments as analysts boost their economic forecasts.

The synchronization of global growth also opens the door for central banks to remove monetary stimulus. In 2017, the Fed raised short-term interest rates three times. They also began shrinking their balance sheet by $10 billion per month in October. At their last meeting, the Fed indicated they are considering three additional hikes in 2018. The ECB has also begun the tightening process by reducing their monthly bond purchase program from 80 billion euros per month to 60 billion euros.

Despite their tightening efforts, long-term interest rates barely budged in 2017. This flattened the yield curve to levels we have not seen since 2007. Historically, a flattening yield curve has served as a bad omen for stocks; however, “real” interest rates are currently more attractive than this time last year. This favors stocks and other risk assets. Finally, with the tax cut funneling its way through the system in 2018, the potential for higher interest rates is present.

Above average valuations remain a risk for stocks. Even though earnings have been much better than expected, the rally in stocks has exceeded earnings growth; thereby pushing up valuations. Currently, the S&P 500 trades at 18.2x EPS estimates for the next 12 months. We believe this number will decline as analysts adjust earnings for the tax cuts. Regardless, we are still above the long-term historical average of 15.7x. The trailing PE is 22.5. These are the highest PEs for non-recessionary conditions in 13 years.

With interest rates still low compared to historical standards, stocks are attractive on a relative valuation basis. Despite the insistence from central bankers that they will move at a slow and measured pace, it is fair to say that further tightening will serve as a headwind for stock PE multiples. This puts additional gains from here solely on the shoulders of continued earnings growth and legislative victories in Washington.

As we enter the New Year, the economic recovery is currently the 2nd longest in history. Since 1900, there have been 23 recessions with 21 of them taking place within 8 ½ years after the previous downturn. Currently, economic data does not indicate a recession in the next 12 months; however, many indicators are signaling a transition from the mid-cycle to the late cycle—the possibility of peak profit margins; large cap stocks outperforming mid and small cap peers; full employment; the Fed in tightening mode; a flattening of the yield curve; tight corporate spreads in both investment grade and junk bonds versus US Treasuries; and a high level of investor complacency. When mixed in with above average stock valuations, the potential exists for higher levels of volatility; therefore, we expect stock returns to be more modest in 2018 when compared to the past 12 months.

As a result, we have shaved-off some of our cyclical overweight relative to our benchmarks. Among cyclical sectors, we are currently overweight financials and energy paired with an underweight in materials. In defensive sectors, we are overweight healthcare and telecommunications given their attractive valuations paired with an inline weight to consumer staples and an underweights in utilities and REITs.

On the global scale, we plan to reduce our overweight to US stocks by trimming US large cap. The proceeds will be invested in developed international countries. We believe developed international economies are earlier in the economic cycle than the US. They also possess attractive relative valuations. Finally, we believe the ECB and the Bank of Japan will continue their quantitative easing programs for the duration of 2018. Despite the trim, we are still overweight US stocks, and we plan to maintain our overweight to mid and small-sized companies since they stand to benefit the most from corporate tax cuts and the reduction of regulations from President Trump. Finally, we have an inline weight to emerging markets.

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