

# Market and economic update

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**Current economic events**

Jobs continue to expand in the United States as evidenced by November nonfarm payrolls rising by 228,000 jobs, leaving the unemployment rate at 4.1 percent. While survey data have softened somewhat, including the preliminary December University of Michigan consumer sentiment survey and the ISM manufacturing and non-manufacturing November surveys, the levels of these indicators remain consistent with solid economic growth. Of some concern may be the lack of accelerating inflation, as evidenced by average hourly earnings still growing just 2.5 percent over the past year, or that consumer price inflation is still struggling to reach a consistent 2+ percent annual rate, despite the current expansion becoming the third longest since World War II. In our view, economic momentum remains sufficiently strong to continue this expansion through 2018 and to eventually drive inflation higher, supported further by Federal Reserve (Fed) normalization of short-term interest rates.

Growth remains solid in Europe and Japan, with solid November purchasing manager surveys pointing to continued economic strengthening. Despite political risks from European elections and potential North Korea conflict, consumer and business spending continues to improve in these economies. In contrast to the United States, these markets remain early in their economic cycle. Easy monetary policy continues to support activity and improving bank health should lead to further expansion across these major global economies.

**Equity markets**

U.S. equities ended last week mixed, with the S&P 500 and Dow Jones Industrial Average both advancing while the technology-oriented NASDAQ Composite and Russell 2000 retreated. Performance was also mixed among S&P 500 sectors, with seven of 11 sectors advancing for the week, led by Financials and Industrials.

Our thesis remains intact. Increasing earnings, restrained inflation and low interest rates provide valuation support and the basis for U.S. stocks to still trend higher. Near term, higher stock prices, firming wages and stable housing are among items boosting sentiment and expectations for favorable holiday sales.

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[ 1 ] Important disclosures provided on page 4.

Last week, prospects for tax reform impacted performance, with sectors and companies with high effective tax rates (Consumer Discretionary, Consumer Staples, Telecom Services and Industrials) outperforming low tax rate sectors and companies (Information Technology, Real Estate Investment Trusts [REITs] and Energy). In our view, it seems premature to change sector biases based solely on tax reform and market reaction over one week.

- We remain attracted to sectors and companies with pricing power as an anchor to longer-term performance. On balance, we favor companies growing revenue faster than peers, while operating in segments of the market that are growing faster than the broad economy.
- Information Technology was negatively impacted by the prospects of tax reform because the tax rate for many technology companies is low relative to companies within other sectors. However, Technology has attractive growth prospects and could benefit, to the extent that lower corporate tax rates result in higher levels of capex spending.
- The prospects for Energy seem to be improving. Synchronized global growth should help narrow supply/demand imbalances as we look into 2018 and continued lower production costs present an improving backdrop amid firming crude oil prices.
- The Financials sector is a consensus favorite and for good reason. An improving economy bodes well for loan growth, a rising interest rate environment is likely to improve net interest rate margins and regulatory relief should help boost sentiment and overall earnings.
- Absent a looming recession, defensive-oriented sectors (Utilities, REITs and, to a degree, Consumer Staples) seem poised to underperform in the first half of 2018.

Our published year-end 2018 S&P 500 price target is 2,825, with upside, derived by applying a multiple of 19.5 times our 2018 S&P 500 earnings estimate of \$145, roughly 6.5 percent above current levels and consistent with a positive but lower-than-historical return level outlook.

- We expect to increase our 2018 earnings estimate and year-end 2018 price target should Congress pass tax reform legislation, which looks increasingly likely now that both the House and Senate have passed respective bills. Pending the passing of a tax bill into law, our preliminary assessment reflects upside within a zone of between 2,900 and 3,000, roughly 10 percent to 13 percent above current levels.

#### **Fixed income markets**

Bonds remain a fundamental component of well-diversified investment portfolios. However, returns are likely to remain subdued considering yields remain near historic lows. Additional rate hikes in the United States are highly likely and global net central bank purchases are set to fall in 2018. Any increase in inflationary pressures could further strain bond returns and push yields higher.

Longer-term bond yields remain range bound, with the 10-year U.S. Treasury yield trading between 2.32 percent and 2.42 percent for the past six weeks. While yields at the front end of the curve continue to be pushed higher by the expectation for additional Fed rate hikes, trading at the long end of the curve has been driven recently by progress in the tax reform bill and indications that the job market remains tight, despite inflationary pressures remaining elusive in the near term. This week, central bank announcements and inflation data will drive markets, along with any new insights into the likelihood and changes to the Republican-sponsored tax bill.

The Fed is expected to increase the target funds rate by 0.25 percent to a range of 1.25 percent to 1.50 percent this week. With this move already priced in, the focus will instead be on the “dot plot,” an indication of Fed members’ expectations for the funds rate in coming years and over the long term. With inflation still benign for the time being, but with growth expectations steady to potentially higher due to the possibility of fiscal stimulus via the tax bill, the dots are unlikely to change materially. We view the three 0.25 percent rate increases indicated by current Fed median dots for 2018 as appropriate given our expectation for modestly increasing inflationary pressures as we move into 2018.

The European Central Bank (ECB) meets this week, although the most material news is likely to be a possible upgrade to growth expectations. The ECB has already announced they will reduce the pace of asset purchases from 60 billion euros per month currently to 30 billion euros per month from January to September 2018. In the fourth quarter, we anticipate the possibility for a smaller monthly purchase amount before purchases conclude by year-end 2018. The ECB’s taper, combined with the Fed already unwinding holdings, will result in net global central bank purchases in 2018 much lower than recent years and potentially near zero in 2019. This lack of buying pressure in coming years is likely to act as a tailwind to longer-term bond yields across the globe.

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