Economic & Market Overview

as of December 31, 2017

Stock market returns for the fourth quarter of 2017 were strong, capping off what is being described as a "perfect year" for equities in which the S&P 500 Index produced a positive total return in every month. Stock market gains for the year were relatively broad based; however, growth stocks surged 30.2 percent as measured by the Russell 1000 Growth Index, while value stocks gained a more modest 13.7 percent as measured by the Russell 1000 Value Index. U.S. stocks benefitted from a combination of tailwinds including improving GDP growth, a weaker dollar, improving earnings growth, highly accommodative central banks, relatively low inflation, persistently low interest rates and expanding valuations. Bond returns for the year were a much more modest 3.5 percent as measured by the Bloomberg Barclays U.S. Aggregate Total Return bond index.

Heading into 2018, there are plenty of reasons to remain optimistic about near-term market return potential. However, long-term return potential has deteriorated. Over the short run, many of the drivers for 2017 are likely to continue at least initially into 2018. Over the long run the likelihood for at least some tailwinds to reverse and historically high valuations may cap potential gains. The Shiller Cyclically Adjusted Price to Earnings Ratio (CAPE) ended 2017 at 32.6x, the second highest level ever. The CAPE ratio has been a poor predictor of near-term returns but does have a better track record over the long run. Many of the major central banks have also initiated plans to reduce their accommodative monetary policies in 2018. These policies have held down interest rates, particularly in Europe where negative yields have become commonplace. Lastly, there are signs that inflation is finally starting to pick up. The U.S. economic output gap, the difference between what the economy is currently producing and what it is estimated that it can produce, has shrunken considerably. In the third quarter of 2017, the gap is estimated to have turned positive for the first time this economic recovery cycle, meaning the economy is now producing more than its potential. This could lead to accelerating inflation going forward.

Famed investor Warren Buffet has widely been quoted as once saying investors should be "fearful when others are greedy and greedy when others are fearful." While most market strategists don't see peak greed yet, sentiment indicators and enthusiasm in crypto currency suggests markets may be well down this path. Bitcoin, the most popular of the crypto currencies, ended 2017 at $14,311/coin, up 1,403 percent for the year after gaining 120 percent in 2016. Increasing speculative activity could signal the beginning of a market top.

Heading into 2018, we strive to balance near-term return potential with the increasing longer-run risks. We seek to accomplish this through our strict valuation discipline, portfolio diversification, and liquidity.

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