The *Philadelphia* Story

A Quarterly Commentary on the Economy & the Financial Markets January 2018

From: *Philadelphia* Investment Management Group

OVERVIEW

- *The U.S. and Global Economies Continue to Expand*
- *Supporting Growth Will be the Actions of Central Banks*
- *Equity Markets Can Move Higher, But the Degree of Growth May be Slower*
- *Fixed Income Returns Will be Negatively Affected by Higher Interest Rates*
- *Financial Markets, in General, Will Experience Increased Volatility*

THE ECONOMY

The U.S. economy headed into the fourth quarter powered by one of the strongest periods of growth in its nine-year expansion. In addition, reports during the period indicated that most major overseas economies were also looking better. The economy posted 3% annualized growth in two consecutive quarters, something it hasn't done since 2014. And chances are good that the fourth quarter will see growth close to the 3% level.

The drivers of growth included a continued rise in consumer spending, which makes up about 70% of Gross Domestic Product (GDP). This key ingredient grew 0.3% in October, after rising 0.9% in September, the quickest pace in eight years. As a result, the strong stock market has lifted household spirits and, in turn, their willingness to spend more and save less. The national savings rate for the period is expected to be around 3%, the lowest rate of savings since the fourth quarter of 2007.

The U.S. got an additional boost from the prospect of sweeping individual and corporate tax cuts, coupled with a deregulatory push by President Trump's Administration that added fuel to the market rally. Soaring stock prices, easing of the regulatory net around banks, a lower dollar and ultralow interest rates mean overall U.S. financial conditions became dramatically more stimulative in 2017. Likewise, there was a pick-up in business investment, which makes up the other 30% of GDP, while rising real estate values have spurred consumer confidence in recent months.

The global economy, in turn, expanded at a 3.3% rate in the third quarter, the strongest growth in nearly four years, according to Focus Economics. In 2017, the global economy shoved aside concerns about politics and whether the long-running expansion was beginning to fade. Entering the year, anxiety ran high as an unpredictable populist became U.S. President, insurgent nationalist movements threatened to win elections in major European countries, China looked fragile and Japan remained stagnant. Yet, the world enjoyed its most broad-based growth since the financial crisis. The eurozone and Japan appear to have grown at their best rates since 2007 and 2013, respectively. Other catalysts driving global growth were loose financial conditions, especially abroad, along with strong global trade, as well as a rebound in metal prices and other natural resources, which has aided emerging market economies.

For all the political uncertainty, there was no new economic convulsion to rival the U.S. mortgage meltdown or Europe's debt crisis. This gave global central banks' stimulative monetary policies traction, though the Federal Reserve began tiptoeing back from zero interest rates and bond buying. Counterparts in Europe and Japan kept going.

Yet, inflation almost everywhere is lower than central banks want. And the slow pace of recovery since 2008 means there might still be pockets of slack to draw upon. The current expansion, thus, may have a few years left in it.

Going forward, the U.S. economy should continue to ride the wave of positive consumer confidence, increased business investment and the potentially positive fall-out from tax reform. Some estimates also peg corporate tax reform adding at least 0.3% to GDP growth in 2018.

For the financial markets, the growth path of U.S. and international economies is crucial. Indeed, bear markets often coincide with recessions, and the probability of a recession, defined as two or more consecutive quarters of GDP shrinkage, is very low for 2018, according to most estimates, which may limit the possibility of a bear market.

From an investment perspective, 2017 may have been a perfect year. The U.S. economy continued to slowly improve, with unemployment dropping to nearly a 20-year low. As stated, global growth expanded and became more in line, with Europe, in particular, showing strength. And while growth improved, inflation remained tame. This allowed global central banks to keep monetary policy accommodative, even as the Federal Reserve and other policymakers were slowly tightening.

Is it too much of a good thing? With unemployment now below pre-crisis levels in the U.S., Japan and Germany, global growth accelerating and speculation rampant from property prices to bitcoin, this is usually the time to worry about inflation, overheating and monetary tightening. Yield curves are flattening (the gap between short and long interest rates is narrowing), historically a harbinger of slower growth or recession.

Still, accelerating economic growth does not always dovetail with a strong equity market and would continue to be a headwind for the fixed income markets. Many economists believe the U.S. economy cannot help but stay in what has historically been the sweet spot, the proverbial "Goldilocks" economy of 2% to 3% growth.

Rising inflation would likely create a headwind for the markets. It would give the Federal Reserve ample reason to squeeze things more tightly than current expectations. Three to four interest rate increases are expected in 2018. An unexpected surge in economic activity and inflation would lift the number and magnitude of increases, which probably would not sit well with the equity or fixed income markets.

Now, what if the economy continues to expand and grow to the upside? In addition, what if corporate tax reform in an age of 4% unemployment works too well, fueling rapid wage growth? What if the economy grows in the 3% to 4% range in 2018? Let us hope that the economy does not grow too fast. The equity markets do not like inflation and they especially do not like wage inflation in an age when productivity gains are hard to achieve.

FINANCIAL MARKETS

EQUITIES

Soaring stock prices around the world added more than $9 trillion in market value to equity markets in 2017, the biggest one-year swell since the financial crisis. Almost every major yardstick for global stock prices ended the year with double-digit percentage gains, as improved economic growth and sturdy corporate profits coerced investors to buy. At the same time, global central bankers mostly kept their economic stimulus measures in place.

In the U.S., the S&P 500 ended 2017 up 21.83%, including dividends, an advance that added roughly $4 trillion to the Index's market value, according to Thomson Reuters. What is interesting is that about one-quarter of the market value creation came from the five largest U.S. companies by market value: Apple, Alphabet, Amazon.com, Facebook and Microsoft.

Investors have rallied around the technology and internet giants' rapidly growing businesses and bright prospects, carrying each of these stocks at least 30% higher for the year and adding $1 trillion in market value. Tech stocks, in turn, have supported other global marketplaces.

Despite ending on a sour note the last two weeks of the year, it is hard to argue that the year could have gone much better, as reflected in the following table:

	Equity Returns*				
Index	**4th Qtr**	**3rd Qtr**	**2nd Qtr**	**1st Qtr**	**YTD**
S&P 500	6.64%	4.48%	3.09%	6.07%	21.83%
Dow	10.96%	5.58%	3.95%	5.19%	28.11%
NASDAQ	6.27%	5.79%	3.87%	9.82%	28.24%
Russell 2000	3.34%	5.67%	2.46%	2.47%	14.65%

*Total: price change + reinvested dividends

The NASDAQ, which includes technology, finished up 28.24%, while the Dow gained 28.11% and the S&P 500, as stated previously, rose 21.83%. The S&P 500 managed to finish in positive territory each month on a total return basis, the first time that has ever happened. Small cap stocks, as measured by the Russell 2000, have also achieved positive returns but lagged the larger indices basically due to the global growth, which had a major influence on larger world-related companies. Performance began to pick up in the second half due to the recent cut in corporate taxes. Smaller companies tend to be more U.S. centric in their operations and, as such, could benefit more from a corporate tax cut than would larger companies.

With stocks of all sizes ending the year strong and nine of the 11 sectors in the S&P 500 posting positive returns over the year, the market shows broad-based strength as we move into the new year. Growth stocks have outpaced value stocks in most periods since the end of the financial crisis, as reflected in the following table for 2017. That, to a degree, is an anomaly; and for ten years, investors have been waiting for the reversion. Value stocks tend to rise during periods of economic growth, coupled with higher inflation expectations. Last year saw modest economic growth but no inflation.

	S&P 500		
		Returns*	
Sector	**Weight***	**4th Qtr**	**2017**
• Materials	3.0%	6.93%	23.84%
• Industrials	10.3%	6.05%	21.03%
• Telecommunications	2.1%	3.61%	-1.25%
• Cons. Discretionary	12.2%	9.87%	22.98%
• Consumer Staples	8.2%	6.49%	13.49%
• Energy	6.1%	6.02%	-1.01%
• Health Care	13.8%	1.47%	22.08%
• Info Technology	23.8%	9.01%	38.83%
• Utilities	2.9%	0.21%	12.11%
• Financials	14.8%	8.63%	22.18%
• Real Estate	2.9%	3.22%	10.85%

12/31/17
*Price + income
Source: S&P Dow Jones

The growth was reflected in the performance of certain sectors, as stated, i.e., Information Technology, Consumer Discretionary, Materials, Financials and Health Care. Only two areas, Telecommunications and Energy, had slight negative returns, but make up only 8.2% of the full S&P 500 index. Valuations of growth companies, those able to show rising earnings, typically priced at a premium, have soared this year, even as price/earnings ratios of cheap or value stocks have advanced, but at a slower pace. However, they have added support when growth has backed off and are important in a diversified portfolio.

With interest rates still near historic lows almost a decade after the financial crisis, stocks have had plenty of runway for growth. Most strategists expect rates to rise in the next year, but not to levels that would imperil the market to a great degree. High earnings growth should boost investor confidence that the recent surge in stock markets is backed by a broad global economic recovery and the ability of companies to generate returns, not just ever-higher valuations.

Still, there are risks to the rally. The global economy could take a hit from any slowdown in Chinese growth or renewed political crises in developed markets. Also, the indexes' and specific stocks' price/earnings ratios, a measure of how expensive stocks are relative to their potential to make money, is not far from records, a source of investor concern. Valuations are high, but not irrationally so, especially when compared to interest rates, inflation and bond yields. The earnings recession born of the 2008 financial crisis is over, and the global economy is seeing synchronized expansion. The question is whether earnings will remain a support for equities into 2018. We think that they will.

FIXED INCOME

For bond markets, 2017 was a year of going slowly, at least for the benchmark 10-year government rate, which is closely watched for signals on the economic outlook. With the risk of deflation defeated but higher inflation yet to arrive, bonds, in general, are still stuck in no man's land as 2018 dawns. While there are good arguments for higher yields, there are good ones for them staying low, too.

Thus, inflation was the key. Headline inflation rose at the start of 2017, driven by the swing in energy prices in the previous year. But core inflation, less food and energy, showed less upward pressure and wage inflation remained absent, even as unemployment fell in many countries. That meant both rises and declines in bond yields were contained.

The argument for higher yields goes like this. The U.S. economy already was in good shape and now the tax cut is going to boost growth. Unemployment will continue to fall, wages will rise, and with an assist from a healthy global economy, inflation will start to pick up. That will push the Federal Reserve policymakers to raise rates more than the three times expected in 2018. Worries about additional Treasury supply hitting the market should also take hold as the Fed continues to shrink its balance sheet and as the Government issues more debt as a result of the recently enacted tax cuts.

Just because interest rates seem likely to go higher does not mean they will, as we have found out. Maybe the economy won't have as much oomph as people are forecasting, wage growth and inflation won't really pick up, and the Fed will not raise rates by so much. Considering the alternatives, moderately higher long-term rates might be the best investors can hope for.

The calm in 2017 was remarkable. The 10-year U.S. Treasury yield moved in a narrow 0.57 percentage-point range between 2.06% and 2.63% but ended the year at 2.41%, close to where it started at 2.45%, as reflected in the following table. That is the narrowest annual range of the past decade, according to FactSet data, and it is somewhat deceptive: The Note was, in fact, trapped between 2.20% and 2.49% on 82% of the trading days in 2017.

Base Interest Rates

	U.S. Treasury Yields				
	Maturity				
Date	**3 mo.**	**2 yr.**	**5 yr.**	**10 yr.**	**30 yr.**
Dec 31, 2016	0.50%	1.23%	1.99%	2.45%	3.13%
Sep 30, 2017	1.04%	1.48%	1.93%	2.33%	2.86%
Dec 31, 2017	1.38%	1.88%	2.21%	2.41%	2.74%
Change:					
09/30-12/31/17	0.34%	0.40%	0.28%	0.08%	-0.12%
12/31-12/31/17	0.88%	0.65%	0.22%	-0.04%	-0.39%

While other assets have soared in 2017, yields on longer-term U.S. Treasury bonds have remained stubbornly low, suggesting little conviction among bond investors that a lengthy span of modest economic growth and paltry wage gains are on the verge of changing.

The premium yield of the 10-year benchmark to the yield on the two-year, a closely watched barometer of economic optimism, called the slope of the yield curve, was down to 0.53 percentage points, less than half of its level from a year earlier. When it comes to the outlook for the economy and interest rate policy, there seems to be a disconnect in terms of what the Fed is saying about rates versus what the market is saying. Although inflation is likely to inch up, it may be lower than people expect it to be.

Nevertheless, the flattening of the yield curve has gone beyond what would be implied by lower inflation expectations alone. It has been driven by rising short-term rates in anticipation of Fed moves, not the slight decline in yields in the longer end of the curve over concerns of weaker growth and inflation.

Overall, the fixed income markets had positive returns for the quarter and year, as indicated in the following table. Given the upward move in short rates and relatively stable long-term rates, the returns were nominal and were basically income earned. The credit area, both corporate and municipal, outperformed governments, related to their added yield pickup as a result of the wider span of credit ratings, which, in turn, adds additional yield over the base Treasury rates.

The lower return within the intermediate maturities was a reflection of the rise in short-term interest rates that was initiated by the Fed during the year. The quest for yield was also evident in longer bonds outperforming their shorter counterparts due to the relative strength of the economy and benign inflationary outlook.

Fixed Income Returns

Index	4th Qtr	YTD
Corp/Govt	0.50%	4.03%
Int. Corp/Govt	-0.18%	2.17%
Long Corp/Govt	2.66%	10.41%
U.S. Government	0.11%	2.44%
- Intermediate	-0.40%	1.08%
- Long	2.18%	8.20%
Corporate	1.12%	6.48%
- Intermediate	0.20%	4.08%
- Long	3.29%	12.50%
- **Quality**		
- AAA	1.71%	7.56%
- AA	0.85%	4.84%
- A	1.10%	5.82%
- BBB	1.17%	7.35%
Municipal	0.75%	5.42%
- Intermediate	-0.46%	2.83%
- Long	1.57%	7.20%

Source: BofA Merrill Lynch

We do, however, expect domestic economic strength may finally aggravate inflationary pressures, supporting domestic growth and risk markets, including corporate and municipal credit, and help drive all interest rates higher in the upcoming quarters. Given these expectations, we feel one should continue to maintain the fixed income area of accounts with a shorter-than-average duration posture and remain overweighted in credit-related areas. While investment grade credits are admittedly tight in yield versus governments, we believe the additional yield will serve as an important buffer against expected rising interest rates.

Going forward, the flatter yield curve is not a recessionary signal. Much of this year's earlier yield curve flattening represented a reversal of the 2016 steepening that accompanied surging economic growth and inflation expectations after the U.S. presidential elections. Markets had bet that fiscal stimulus and infrastructure spending would spur growth and inflation. Long-term yields jumped in response. Those market expectations unwound over the course of 2017 when policy changes were slow to materialize and weak inflation readings became the big surprise.

Persistent global demand for yield has pushed 30-year Treasury yields lower, even as short-term rates have been pushed higher. One could see long-term rates rising further, but not back to prior average levels as global investors seek yield and central banks continue to keep rates lower than normal. While credit areas of the fixed income markets generally follow in line with their base governments, added value can be found in individual sectors, where growth is expected to be better than average, like the equity markets. However, we would suggest staying within the investment grade areas of both corporates and municipals, as it provides the added degree of liquidity to the marketplace.

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