2018

A LOOK AHEAD AT THE GLOBAL ECONOMY

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This past year proved quite rewarding for global investors as both domestic and foreign stock markets posted some of their strongest gains of the current economic cycle.

Here in the US, that cycle appears to be getting yet stronger as the New Year unfolds. By a range of measures, both consumers and corporations are in a bullish mode, which should lead to sustained earnings growth in a broad range of sectors.

That's not to suggest that investors should be complacent. From central bank policies to political risk to current valuations, there are ample catalysts for a market stumble.

That portends a potentially choppier year ahead for equity markets, although all signs currently point to further gains in 2018.

We'll look ahead at the key drivers for the economy, stocks, and bonds in just a moment, but it's helpful to look back on the market performance this past year.

Tax Promises Fulfilled

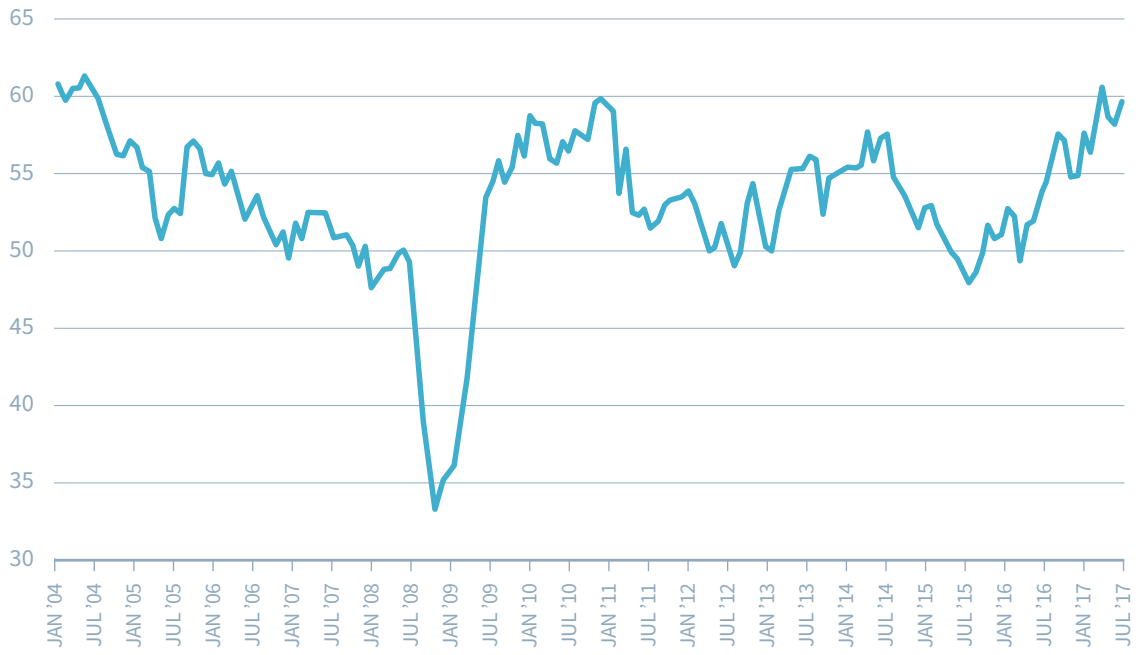
One year ago, we were firmly in the camp that tax reform would prove beneficial to market sentiment. “Not only has the US exited 2016 on a fairly solid note, but an emerging blueprint of government policy changes could provide a tailwind to the many strengthening components already in place,” we wrote in our 2017 outlook.

Perhaps we were a bit too cautious about potential market risks. Rising interest rates, more contentious trade policies, and European political headwinds also appeared as possible wildcards. That led us to suggest that investors needed to remain focused on what could go wrong, not just what could go right.

In hindsight, it’s mostly about what went right. The global investment backdrop provided a set of nearly universal tailwinds, with nary a headwind in sight. Interest rates have remained benign, the EU has steered away from talk of a break-up, trade war rhetoric cooled down, and most importantly, Congress passed an extremely market-friendly tax overhaul.

Exhibit 1

Purchasing Managers' Index



Source: Institute for Supply Management, CataMetrics Management, LLC

Even before that legislation kicks in, the corporate sector remains quite healthy. Orders for durable goods, for example, rose 5.4% through the first 11 months of 2017. That's translating into a more vigorous pace of manufacturing. The Institute for Supply Management Purchasing Managers' Index (PMI – Exhibit 1), which tends to be a leading indicator for national economic activity measures, hit its highest level since 2004 in September.

Strength in both corporate and consumer spending helped firms in the S&P 500 to likely boost revenue by 6.2% in 2017, according to Factset Research. And that triggered a 9.6% gain in profits. That's the strongest rate of sales and profit growth since 2011. (Of course, since the major market averages rose by 20% or more, earnings multiples have also expanded.)

A sharp drop in corporate tax rates paired with a tax holiday on foreign-sourced profits should have a clear and positive impact on net profit growth, capital spending, dividends, buybacks, and M&A. With that kind of backdrop in place, it's no wonder that the various stock markets continued to make fresh all-time highs throughout 2017.

Watching the Employment Picture

As President Trump took office last January, the US labor market was already showing a pronounced head of steam, as 187,000 jobs per month were created in 2016. Additionally, we noted a year ago, "for people with at least a college degree, the official unemployment rate stands at just 2.3%." That raised concerns that labor shortages would soon emerge and labor costs would soon rise.

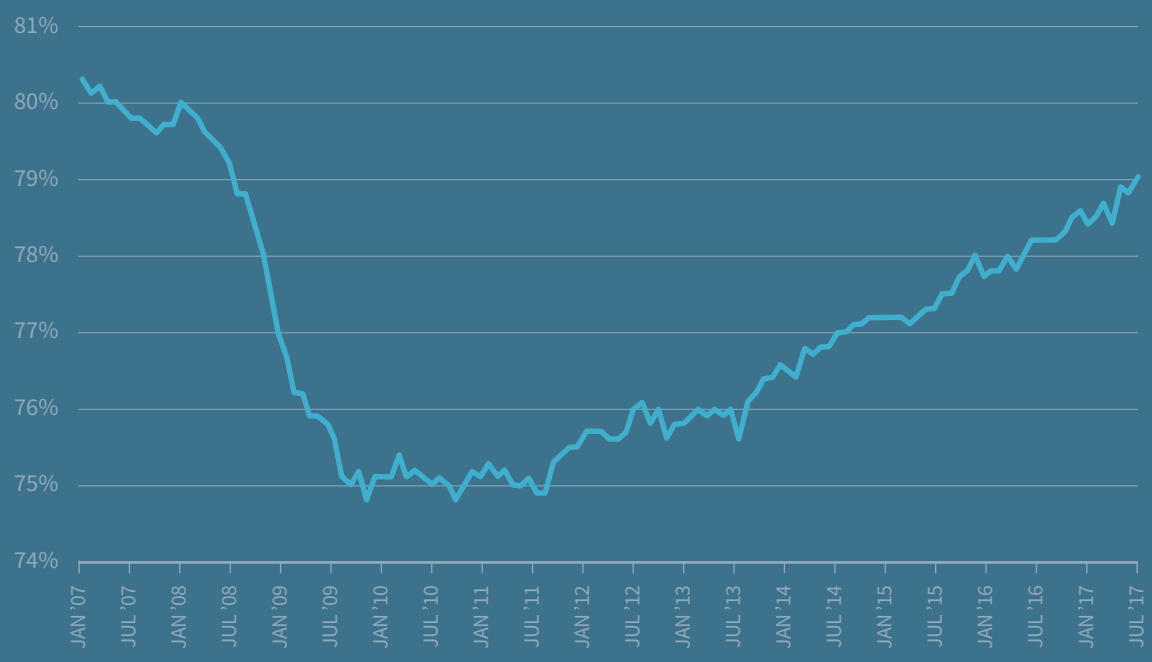
Job creation remained robust again in 2017. An average of around 175,000 monthly net new jobs were created last year, which means that non-farm payrolls have now expanded for a record 87 straight months. Unemployment of 4.1% stands at a 17-year low. Indeed, fully 79% of the 25-54 age group is now fully employed, the highest level since the Great Recession. And a 147-week stretch of weekly jobless claims below 300,000 is the longest such streak since 1970 (see Exhibit 2).

Yet labor costs continue to rise at a less than 3% annual pace, a lower figure than current employment levels might have anticipated. The more salient concern is how employers will be able to continue finding staff to create net new jobs at the current pace. They likely won't. Hiring trends may cool as firms more heavily invest in labor-saving capital equipment.

Exhibit 2

Employment Rate (Ages 25-54 years)

Source: Bureau of Labor Statistics, CataMetrics Management, LLC



Automation is rapidly being adopted in manufacturing and retail, while other industries such as healthcare are now gearing up to deploy a greater use of technology that reduces direct labor needs. Remote healthcare monitoring, tele medicine, and hospital floor robotics are just a few examples of this trend.

Such productivity-boosting investments may help keep general cost pressures in check. How long the US economy can maintain a 4% unemployment rate and sub-2% inflation rate remains to be seen. But for now, we are surely in a Goldilocks economic scenario.

While on the topic of labor market slack (or lack thereof), President Trump is expected to pursue an infrastructure investment program in early 2018, though it is unclear if there are enough able-bodied workers to fulfill any sort of massive works program. (For that matter, budget deficit implications of an infrastructure spending boost may blunt any such movement on this front.)

Consumer Strength (With Some Caveats)

While there are few signs of the kind of consumer-spending bubble we saw a decade ago, we are clearly in a robust phase of the consumer spending cycle. That's crucial when you consider that consumer spending accounted for nearly 70% of GDP in 2017 (see Exhibit 3).

At year's end, for example, 2017 holiday retail sales, excluding autos, rose 4.9% versus the same period last year, according to Mastercard SpendingPulse. That was the largest year-over-year increase in six years.

Consumers have been in a good mood all year. The Conference Board notes that its consumer confidence surveys hovered between 120 and 130 throughout 2017. The average reading was at its highest level since 2000 (see Exhibit 4).

And that confidence is leading to robust spending on durable goods as well. While auto sales were largely flat in 2017, they remain near the cyclical peak.

And the housing market is on notably firmer footing. Through the end of November 2017, new home sales were up 9.1% from 2016 levels to the strongest pace since 2007. The National Association of Home Builders predicts that sales of new homes will rise another 5% in 2018. The only wildcard in that forecast is the recent tax legislation, which altered incentives for home ownership.

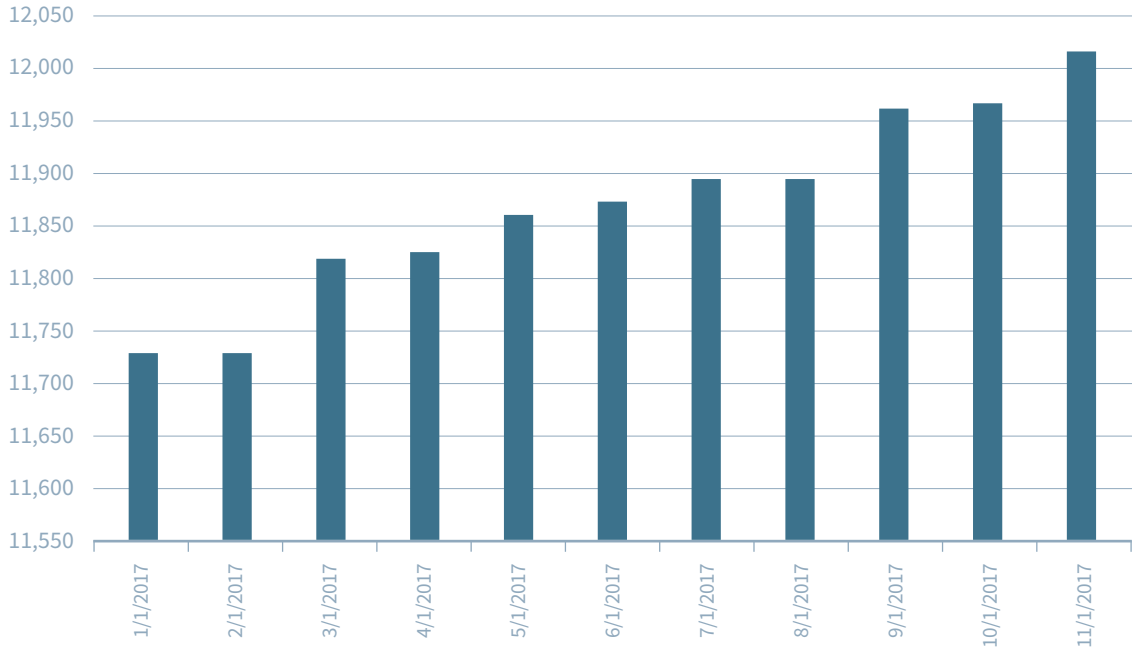
To be sure, lower-income consumers are also boosting spending, though perhaps at unsustainable levels. The delinquency rates on subprime auto loans, for example, have been rising steadily and now stand at levels last seen in 2009. Outstanding credit card debt rose 11% in the third quarter from the same period in 2016, while credit card delinquency rates rose 16% (year-end data are not yet available). Meanwhile, the personal savings rate dipped below 3% in November for the first time since November 2007, notes the Commerce Dept.

Lastly, gasoline prices appear poised to make a slightly larger dent in paychecks now that oil prices have moved back to the $60 per barrel range. Home heating bills for much of the northern half of the country will also be elevated this winter, which may crimp discretionary consumer spending in the near-term.

Still, on balance, the stars are aligned for further wage gains, fuller employment levels, still-benign financing costs, and a continued expansion in new household formation. That sets the stage for another 5% increase in consumer spending in 2018.

Exhibit 3

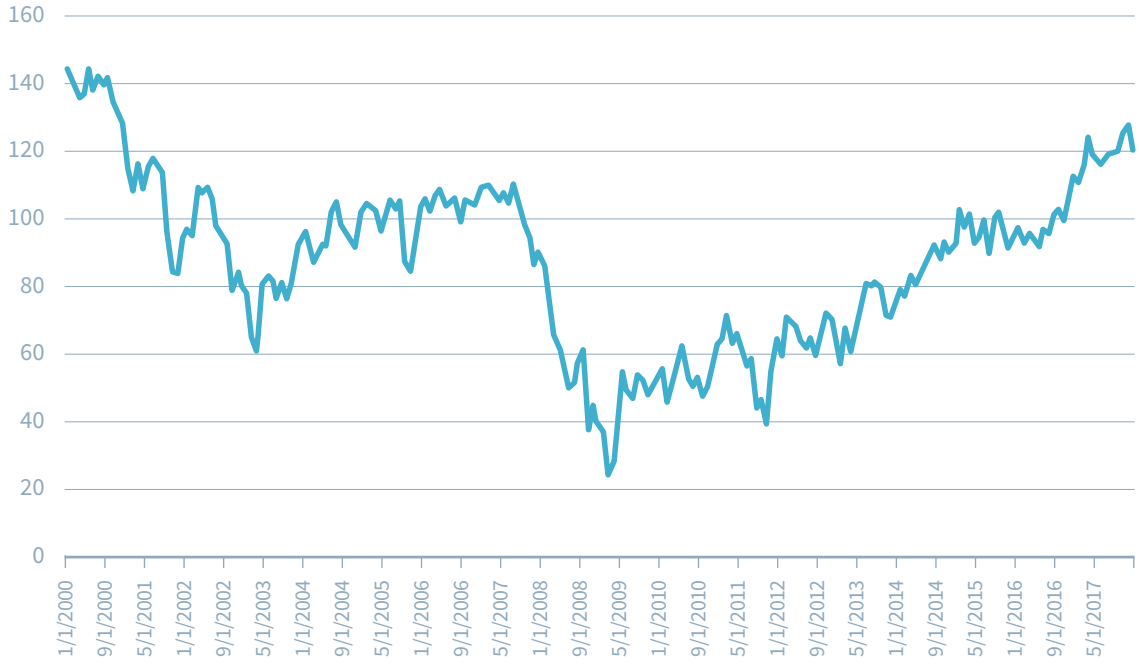
Real US Personal Consumption Expenditures - billions



Source: Bureau of Economic Analysis, CataMetrics Management, LLC

Exhibit 4

Conference Board Consumer Confidence



Source: Conference Board, CataMetrics Management, LLC

The Long Elusive 3% Growth Rate?

It is hard to overstate the differing impacts of 2% and 3% economic growth. The former is too tepid to create any sort of sustainable spending momentum, while the latter can unleash a torrent of pent-up investment.

You would have to go back to 2005 to find the last time the US economy grew at least 3% for three quarters in a row. Yet that may be what's in store for the economy in 2018. It surely ended 2017 on an improving note. The Bureau of Economic Analysis reported second-quarter GDP growth of 3.1% and third-quarter growth of 3.2%. The Federal Reserve's "GDPNow" economic forecast anticipates 2.8% growth in the fourth quarter. We believe that is low.

So, will we finally reach the elusive 3% growth target in 2018? Most strategists currently predict that GDP growth will fall short of that mark this year. Morgan Stanley, for example, forecasts growth of 2.5% and believes that the economic expansion is now approaching the late stage of a recovery. Nomura Research and Credit Suisse both project 2018 US GDP growth of 2.7%.

It will be interesting to see how the Fed responds to the projected economic firming and the recent tax legislation. New leadership at the Fed may look to raise interest rates at a pace that is faster than currently anticipated (which we'll discuss in a moment). Then again, if inflation fails to build in the face of advancing economic growth, the pace of rate hikes may not be quite so vigorous.

We're also watching for signs of reversal in how Quantitative Easing (QE) will play out. The Fed plans to shrink its balance sheet by a total of $1 trillion by the end of 2019. How that will impact long-term interest rates is an open question.

For now, we will set aside the discussion around expanding budget deficits in the US. Goldman Sachs forecasts that the annual federal deficit will swell from $664 billion in 2017 to around $1 trillion by 2019. The amount of federal debt crossed the $20 trillion threshold this past September. The bond market may need to reckon with that red ink in coming years, but the topic appears to be on few investors' radars right now.

A Market That Only Moves in One Direction?

The S&P rose an impressive 20% in 2017 and is now up 35% since the start of 2016. The key distinction between those two years was the smoother upward ride this past year.

Indeed, the stock market's steady rise throughout 2017 was quite unusual. The S&P 500 never fell more than 3% in any single trading session during the year and, in fact, never fell by that amount during a multi-day or multi-week stretch. You have to go back to July 2016 (during the Brexit vote) to find the last 5% market pullback. (Merrill Lynch strategists note that 5% pullbacks typically appear an average of three times each year.)

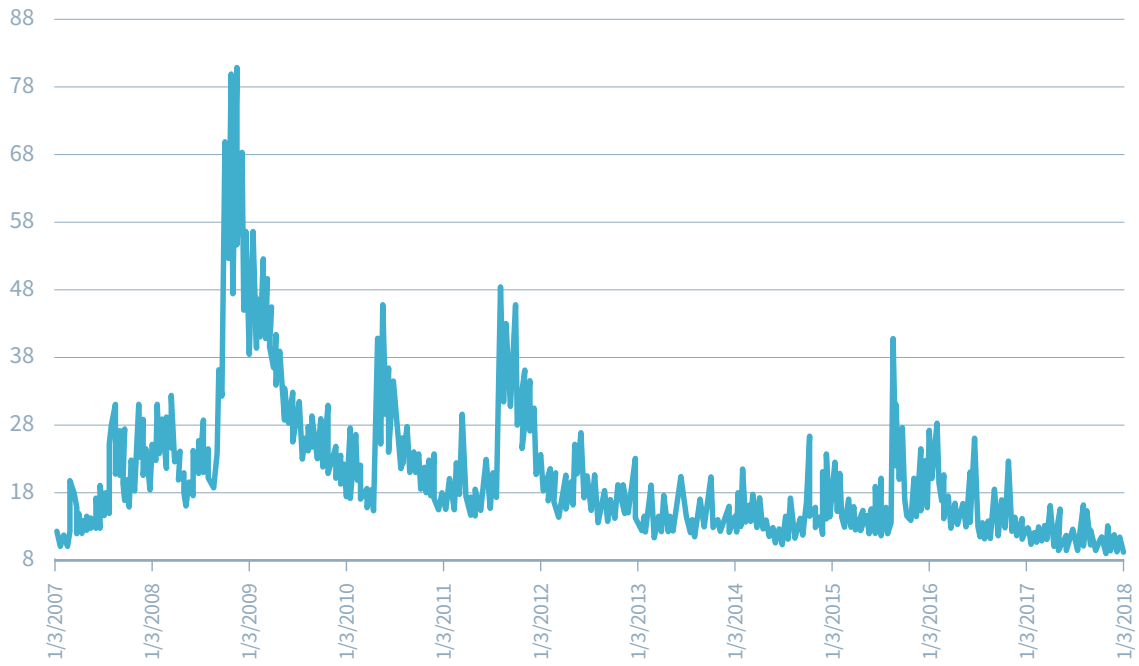
For its part, the Dow was up 1.92% in December (total return) and rose in 13 of the last 14 months. That kind of winning streak hasn't happened since 1959.

In response to the steadily rising market, volatility gauges fell in 2017 to the lowest levels since 2006/2007. Indeed, "shorting the VIX" has become a proven profitable trade for many investors in the past few years (see Exhibit 5).

A growing role of index investing through buying exchange-traded funds (ETFs) is thought to be playing a role in tamping down price swings. Stable macroeconomic factors such as consistent "beat-and-raise" quarters from many firms and a lack of exogenous market-shaking events are also playing a role.

Exhibit 5

Chicago Board of Options Exchange SPX Volatility Index



Source: Bloomberg, CataMetrics Management, LLC

Yet volatility continues to bear close monitoring. There is a growing sense that the extended bull market may eventually lead to a long-awaited bout of profit-taking. And rising volatility is often a marker for many investors to head for the exits, creating a sort of self-fulfilling prophecy.

For now, it's hard to anticipate a shift away from the current trend of "beat-and-raise" results, if only because firms and the analysts that follow them have grown accustomed to establishing a low bar that is easily surpassed.

So what kind of exogenous events might shake the market out of its low volatility mode? For starters, as we noted earlier, interest rate policies will no longer follow the same predictable path of recent years. The Federal Reserve is expected to raise rates at least three times in 2018. A survey by Bloomberg anticipates four rate hikes in 2018, while Credit Suisse thinks the Fed will pause after two hikes at mid-year "as growth momentum slows and financial conditions tighten." The European Central Bank (ECB) and the Bank of Japan (BOJ) are unlikely to start raising rates before late 2018.

Moreover, long rates may rise even faster than short rates—if US economic strength leads to firming price pressures. If historical short- and long-term spreads are any guide, 10-Year Treasuries should already be yielding close to 4%.

Of course, in recent periods, the yield curve has actually been flattening. Ten-year yields are just half a point above two-year bond yields, a gap that has closed by half in the past 12 months. That's often a sign of slowing economic growth and rising recessionary chances (which by itself would be a major exogenous event for the market). But no such slowing is in evidence.

Fed policy of late has been to raise rates and then look around and see how markets and the economy react. If they raise once a quarter or less, this will likely not lead to any significant near-term volatility. But it is always important to remember that Fed policy right now is actively working to slow the economy, on the margin.

So, we'll need to wait and see how 2018 plays out. The economy appears quite healthy, the Fed appears on track to serially raise rates, and, at some point, the bond market may be knocked out of its current slumber.

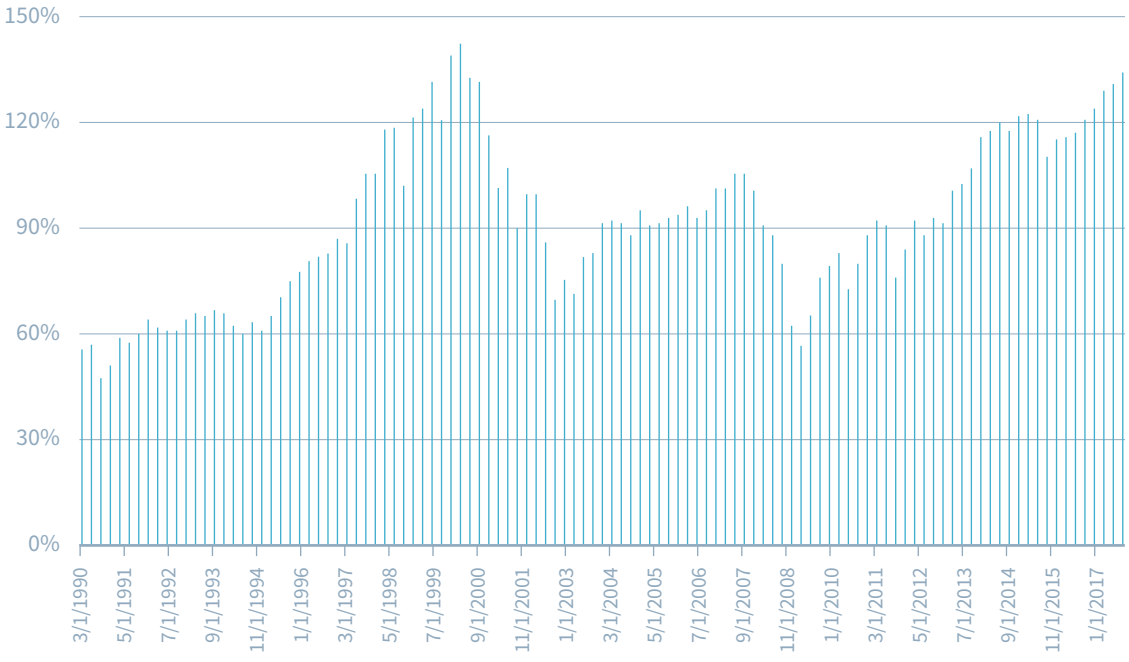
Not a Bubble, but Frothy

The bull market's impressive duration has left valuations elevated, but not at the level of froth seen during the 2000 market top. Companies in the S&P 500 are now trading at roughly 23 times trailing 12-month earnings. This is high by historical averages, but we believe that P/E ratios are driven by inflation and earnings growth prospects, and these appear good right now—as we have noted.

Also, the entire market capitalization of the Wilshire 5000 now stands at around 130% of GDP, according to dshort.com. That's the highest level since 2000, when the reading hit 136.5%. As Warren Buffett remarked back in 2001, "It is probably the best single measure of where valuations stand at any given moment."

Exhibit 6

Wilshire 5000 Index divided by Nominal GDP



Source: Bloomberg, CataMetrics Management, LLC

And the dividend yield on the S&P 500 stood at 1.8% at the end of 2017, well below the 4.37% historical average. Of course, interest rates are also well below historical averages as well. Yet as interest rates rise, equities may come under pressure if they cannot offer comparatively robust yields.

To be sure, investors have placed a strong premium on growth stocks at this point in the economic cycle. The Russell 1000 growth index soared 29.1% in 2017, while the Russell 1000 value index rose a more modest 13.4%.

Will growth still trump value in 2018? Only if investors are willing to tolerate a growing valuation gap. The average holding in the iShares Russell 2000 Growth ETF (IWO), for example, now trades for 25.7 times forward earnings and 4.1 times book value. In contrast, the iShares Russell 2000 Value ETF (IWN) trades for 19.4 times prospective earnings and 1.4 times book value.

While we will refrain from suggesting that the stock market has entered bubble-like conditions, it's important to keep a close eye on sentiment in the tech sector, which surged more than 35% in 2017.

Make no mistake, Information Technology (IT) is now at the heart of so many strategic transformations. And many key tech trends such as cloud computing, artificial intelligence, big data, and autonomous vehicles are still in the preliminary stages of adoption. That makes tech a must-own sector for the long haul. But in light of the remarkable run for these stocks in recent years, it's wise to anticipate choppier trading in tech stocks in 2018, if not outright pullbacks.

Most other sectors should also benefit from the economy's growing strength. But income-producing sectors such as utilities, REITs, and telecoms may continue to lag the broader market in the future if interest rates finally begin to march higher in 2018.

Of course, long-term interest rates were expected to start rising in 2017 but largely stayed range-bound.

In aggregate, S&P 500 sales are expected to expand by 5.6%, and profits are expected to rise 11.8% in 2018, according to FactSet. Those figures would be the best showing since 2011. A 41% rebound in energy industry profits (assuming current oil and gas prices hold) will play a big gain in the S&P 500's profit surge. Materials (18.3%), Financials (16.7%), and IT (13.2%) are also expected to post above-average profit growth.

Note that these forecasts do not account for just-passed tax legislation, which has not yet been formally included in most analysts' bottom-up estimates. Credit Suisse suggests that lower tax rates will help S&P 500 profits to rise by 19.7% in 2018. How much of this tax-related boost has already been priced into stocks is not fully clear.

Watching for Bear Tracks

While the prospects of a bear market are nowhere in sight, history provides a few signposts to monitor that can signal a bull market's end.

For example, bear markets are almost always preceded by at least three rate hikes from a cycle trough. Also, bear markets often occur after bank lending standards have materially tightened. (As noted earlier, subprime lending appears ripe for tighter standards.)

As noted earlier, the yield curve has been flattening, and if yields on 10-Year Treasuries move below the yield on 2-Year bills, that could spell trouble ahead. Five of the past six times that happened, the economy subsequently entered a recession, according the St. Louis Fed. (At year's end, The New York Fed placed an 11% probability of a 2018 recession, which while low, is still the highest reading since 2009.)

Also, keep an eye on sentiment during earnings season. When investors fail to reward strong "beat-and-raise" quarters or punish stocks in firms that deliver merely in-line results, then that is often a sign that investors have an eye for the exits. Lastly, a shift toward value and defensive stocks has often been a harbinger of a subsequent bear market.

Keeping watchful of such markers may be helpful for investors who want to ensure that they have locked in most of the market gains that have been accrued in recent years.

Beyond Our Shores

Across the globe, expanding economic growth fueled impressive stock market rallies. The global economy likely grew around 3.7% this past year, according to the International Monetary Fund. And growth should tick up to 3.8% in 2018, according to Merrill Lynch forecasts.

Perhaps more impressive, all 45 economies of the nations in the Organization for Economic Cooperation & Development (OECD) expanded last year. Globally, just six nations are currently experiencing a recession. That's down from 94 in 2009 and the lowest figure since at least 1980, according to Deutsche Bank.

Europe clearly turned a corner this past year as its economy grew 2.2%, the best showing since the Great Recession. The IMF recently went so far as to call Europe an "engine of global trade." While Germany continues to post region-leading growth rates and confidence levels, even malaise-fueled France is perking up. A key business confidence index (Insee) in that country recently rose to 112, also the best showing in a decade.

The euro-wide economic strength helped the Vanguard FTSE Europe ETF (VGK) rise an impressive 27% this past year. But European equities remain a relative bargain. The average stock in that ETF is valued at 16 times forward earnings. That's compared to a forward multiple of 21.7 times earnings for the SPDR S&P 500 ETF (SPY)

Economic strength and market returns have been even more impressive in Asia. The benchmark MSCI China Index—including stocks listed in China, Hong Kong, and the US—rose nearly 60% last year, and gains were spread across that region. The MSCI Asia ex-Japan Index, for example, surged 47%, while the MSCI Emerging Markets Index rose 29%. Japanese stocks returned nearly 20% last year. Despite such gains, the iShares MSCI Emerging Markets ETF (EEM) is valued at just 13 times forward earnings.

Investors were again reminded of the importance of hedging foreign investments. The US dollar posted its largest yearly drop in nearly a decade in 2017. A rebounding euro was a key theme, as the currency strengthened 14% against the dollar. Notably, dollar weakness has not yet translated into rising import prices.

Another Solid Year Ahead

Global economic momentum should help fuel stock market gains both here and abroad in 2018. From a valuation perspective, European markets offer slightly better value then US equities offer. Neither region will offer the robust growth rates seen in Asia (ex-Japan) and Emerging Markets, and we continue to believe that a globally balanced portfolio will deliver more robust gains that a purely domestic-focused one.

Global bond markets will need to respond to changing monetary policies, which could inject a degree of volatility into both fixed-income and equity markets. So even as the economic and investing backdrop appears to be solid, it will again pay to heed the various data trends that play out in coming quarters. ■

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Before investing in an ETF, you should read both its summary prospectus and its full prospectus, which provide detailed information on the ETF's investment objective, principal investment strategies, risks, costs, and historical performance (if any). The SEC's EDGAR system, as well as Internet search engines, can help you locate a specific ETF prospectus. You can also find prospectuses on the websites of the financial firms that sponsor a particular ETF, as well as through your broker.

Past performance is no guarantee of future results of any ETF.

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The S&P 500 Index is a commonly recognized, market-capitalization-weighted index of 500 widely-held companies, designed to measure the performance of US large-cap stocks. The Russell 3000 Index is a free float-adjusted, market-capitalization-weighted index which measures the performance of the largest 3,000 US companies representing approximately 98% of the investable US equity market. The MSCI All Country World Index [ACWI] is designed to measure the performance of the global equity market and is a free float-adjusted, market-capitalization-weighted index composed of large- and mid-cap stocks of companies located in developed and emerging countries throughout the world. The MSCI ACWI ex-USA Index is designed to measure the performance of the global equity market excluding the US component and is a free float-adjusted, market-capitalization-weighted index composed of large- and mid-cap stocks of companies located in developed- and emerging-market countries. The Bloomberg Barclays US Aggregate Bond Index [BBG Barc Agg] provides a broad-based measure of the fixed-rate US investment-grade debt market. The Bloomberg Barclays Global Aggregate Bond Index [BBG Barc Global Agg] measures global investment-grade, fixed-rate debt from both developed- and emerging-markets. The J.P. Morgan Global Aggregate Bond Index (JPM GABI) provides a broad-based measure of the global fixed-rate, investment-grade debt markets. The JPM GABI is a US dollar denominated, investment-grade index with asset classes from developed and emerging markets. Cash refers to overnight Fed funds.

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