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Monthly Investment Report

February 2018

***SUMMARY:* Positive economic and corporate earnings news drove stock prices to new highs in January. In the U.S., all three major equity indexes returned well over 5.5%, while foreign stocks generally did even better, with returns boosted by a weak dollar, which fell to its lowest level in three years. Returns on U.S. bonds were negative as interest rates spiked to three-year highs. Still, we're optimistic that the good times will endure as lower corporate and personal income tax rates kick in and employment and wage growth continue.**

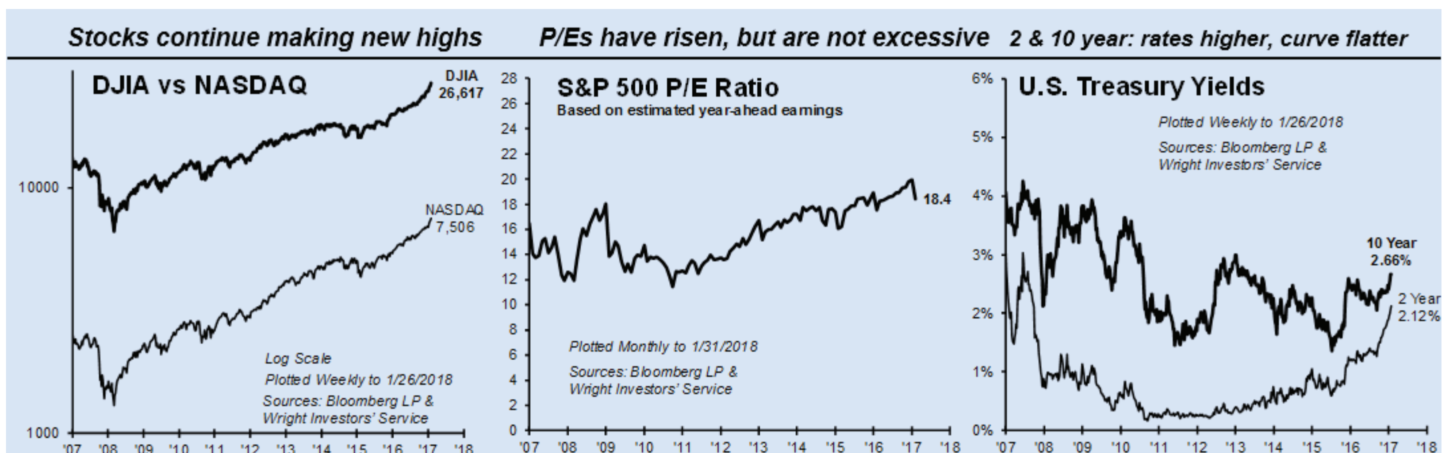
Stocks got off to one of their strongest starts to a year in January. After recording one of their best years ever in 2017, the bull market got even stronger entering 2018. In the U.S., the Dow Jones Industrial jumped 5.9%, its best month in over a year, while the S&P 500 was close behind with a 5.7% total return, its strongest month in nearly two years. But they placed far behind NASDAQ, which rose 7.4%. Smaller-cap stocks continued to lag the big-cap indexes, but in other time periods their returns would have been more than respectable, with the S&P MidCap 400 and SmallCap 600 returning 2.9% and 2.5%, respectively. Consumer discretionary stocks were the best performers among the S&P 500, returning 9.3%, followed by tech stocks, which rose 7.6%. Only two sectors, utilities (-3.1%) and real estate (-1.9%), which are sensitive to higher interest rates, had negative returns.

Foreign stocks also had strongly positive results, in many cases outperforming American equities, boosted by a continuing weak dollar. At the World Economic Conference in Davos, Switzerland, Treasury Secretary Steven Mnuchin said "a weaker dollar is good for trade," which pushed down an already-weak greenback to a three-year low against other major currencies. The MSCI Europe ex U.S. index rose 6.3% in January, helped by a more than 3% rise in the euro to its highest level against the dollar since 2014. But Chinese stocks were the best performers, returning 12.5% in dollar terms as both Hong Kong and Shanghai stocks surged and the renminbi also gained 3% against the dollar. Emerging markets gained 8.3% while Japan rose 4.6%.

But bonds had weak returns as interest rates jumped. In the U.S., the Bloomberg Barclays aggregate fell 1.2%, its biggest loss to start the year since 2009, as the yield on the Treasury's benchmark 10-year note jumped 30 basis points to end the month at 2.71%, its highest level since April 2014. Foreign bonds did better, mainly due to the weak dollar. The Bloomberg Barclays global aggregate ex U.S. returned a positive 3.0% although the yield on the 10-year German bund, the European benchmark, jumped 27 bps to 0.70%, its highest level in more than two years. In commodities, oil prices continued to surge, with U.S. crude ending January at nearly $65 a barrel, up nearly 50% just since last June and its highest mark since late 2014.

The Economy

The rise in stocks and interest rates is being driven primarily by a strengthening economy, both in the U.S. and globally. Fourth-quarter U.S. GDP growth came in at 2.6% annualized following two straight quarters of 3%+ growth. Nonfarm payrolls increased by a better-than-expected 200,000 in January and well



ahead of December's upwardly revised total of 160,000. The unemployment rate held steady at an 18-year low of 4.1%. Most importantly, perhaps, wage growth rose 0.3% for the month and 2.9% compared to a year earlier, the strongest year-over-year gain since June 2009. Those numbers are boosting consumer confidence and spending. Retail sales rose 0.4% in December, down from November's 0.9% increase. But sales for the year rose 4.2% over 2016, the strongest annual increase since 2014. Personal-consumption expenditures, a broader category, also rose 0.4% in December, as did personal income. The Conference Board's consumer confidence index began the new year at 125.4, up more than two points from its December reading of 123.1, which was revised upward by a full point.

Housing ended an otherwise strong year on a rather sluggish note, as higher home prices and mortgage rates and a continued lack of inventory put a damper on sales. Sales of existing homes fell 3.6% in December but sales for full-year 2017 rose 1.1% to 5.51 million, the best performance since before the housing meltdown began in 2007. Sales of newly-built homes dropped 9.3% to an annual rate of 625,000, which was still the fourth best month since the end of the Great Recession. Pending home sales were up slightly. On a positive note, the U.S. homeownership rate rose to 64.2% in the fourth quarter from 63.7% a year earlier, the first year-on-year increase in 13 years.

On the inflation front, price increases remained moderate. The headline consumer price index rose 0.1% in December and 2.1% for the year, but the core rate – excluding food and energy prices – rose 0.3% for the month, the biggest one-month increase in nearly a year, and 1.8% compared to a year earlier. The core personal consumption expenditures index, the Federal Reserve's main inflation indicator, rose 0.2% for the month and 1.7% for the full year, still below the Fed's 2% target rate.

Investment Outlook

With January drawing to a close, the equity rally started to struggle a little bit. One reason is the sheer length and breadth of the rise in stocks, which has many people asking themselves, "How much longer can the good times continue?" Another reason is rising interest rates, now at their highest levels in several years. Still, the rally hasn't been built on smoke and mirrors but on strong fundamentals, such as better-than-expected corporate earnings. The tax reform law, which hasn't really fully kicked in yet, has already given the economy a big lift, notably the billions of dollars in raises and bonuses many corporations have given their employees plus aggressive expansion plans. It's likely to continue to boost the economy going forward. Indeed, the Atlanta Fed's GDP Now forecaster is calling for 5.4% growth in this year's first quarter, more than double the previous quarter's performance. Corporate earnings continue to support today's lofty equity valuations. Interest rates are likely to move higher, but let's not forget that they are still well below historical norms. The rise in rates is also likely to be gradual, even if there are the occasional spikes, as we saw last month. The Fed, which took no action at its January monetary policy meeting, has signaled three or four rate increases this year, likely starting at its next meeting in March. But an economy currently growing at a 3% annual rate – if not more – should easily handle that. Nevertheless, it's always wise to be cautious, which is why we recommend maintaining a diversified portfolio of quality stocks and bonds.

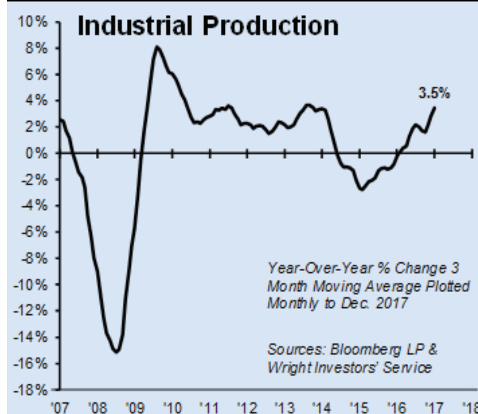
February 2018

Total Investment Returns — 1/31/2018

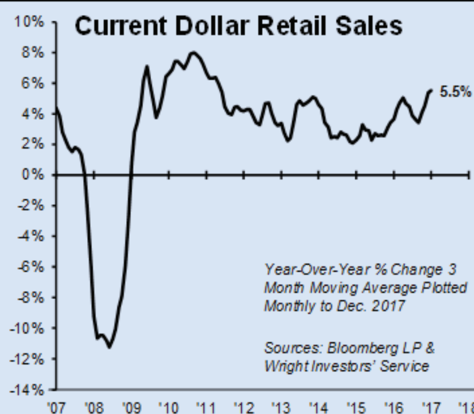
	January	Last 12 Mos.
Dow Jones Industrial Average	5.9%	34.8%
Nasdaq Composite	7.4%	33.4%
S&P 500 Composite	5.7%	26.4%
S&P MidCap 400	2.9%	17.6%
S&P SmallCap 600	2.5%	16.6%
MSCI World ($)	5.3%	25.8%
MSCI World ex U.S. ($)	4.7%	26.2%
Bloomberg Barclays U.S. Aggregate	-1.2%	2.1%
90-Day Treasury Bills	0.1%	0.9%
Consumer Price Index NSA* (Dec 2017)	-0.1%	2.1%

*NSA: Not Seasonally Adjusted

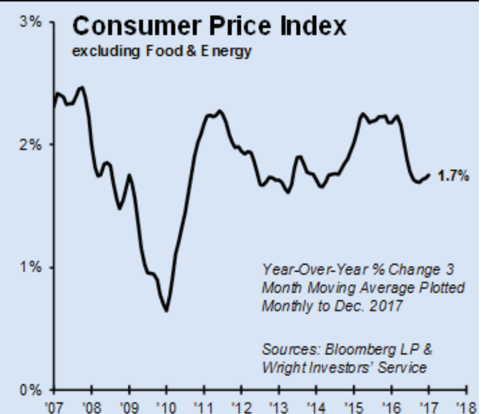
Manufacturing gaining foothold



Consumer spending rebounding



Core inflation low & stable



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