

Market Insights

Economy | Capital Markets

Q4
2017

Economy

As we reflect on the past year, two key questions loom large with respect to the economy and capital markets. As the U.S. expansion enters its ninth year—the third-longest since World War II—the obvious question is: How long can this positive environment continue? Meanwhile, the domestic stock market, as represented by the S&P 500 Index, is up almost 300 percent from the credit-crisis low in early 2009, with very little recent volatility. Investors want to know: Will this bull market last another few years, or should they prepare for an inevitable market sell-off?

From an economic perspective, there isn't much evidence to suspect that the nine-year expansion will end anytime soon. For the third quarter, the U.S. economy expanded at the fastest pace in three years on strong business investment and government spending. Two consecutive quarters of greater than 3 percent growth is quite impressive, given the lackluster results since the end of the last recession. While the year-over-year pace of growth is more modest at around 2.3 percent, it has been accelerating since the middle of 2016. Driving this growth has been an up-tick in consumer spending and a business sector more willing to invest in major projects and inventory.

Further, corporate profits rose 4.3 percent in the third quarter, the fastest pace since the third quarter of 2016. This is a critical driver of private-sector hiring and investment decisions, which should bode well for the economy over the next few quarters. Currently, the labor market environment remains one of the best in several decades. The nation's unemployment rate is 4.1 percent, which is the lowest in 17 years. At 2.6 percent, the unemployment rate in American factories and plants is the lowest since 2000. Finally, the jobless rates in mining, education and health care continue to drift lower, and unemployment in business and professional services matched the all-time low. Yet, while jobs appear plentiful, the pace of wage growth is stubbornly muted at around 2.5 percent annually. Still, this robust employment picture appears here to stay.

There are historically two kinds of triggers that have caused the demise of U.S. expansions: inflation and financial instability. Today, core inflation remains below the Federal Reserve's target. This isn't expected to change, as the central bank's cautious and gradual approach to monetary policy normalization (through interest rate hikes and balance sheet runoff) is likely to continue under the Fed's new leadership. Financial instability is more difficult to predict. Nonetheless, the U.S. in general is not an overly leveraged economy and the traditional signs of stress, including an inverted yield curve and elevated corporate bankruptcies, are not yet present.

Considering this relatively calm environment, with modest inflation and solid economic growth, the spotlight remains on

the equity markets, where record new highs seem to post every week. By the numbers, large stocks have tended to outpace small- and mid-capitalized stocks for the year. The S&P 500 Index returned an impressive 21.83 percent for 2017, while the Dow Jones Industrial Average gained 28.11 percent. In foreign markets, the returns were equally impressive. The MSCI Emerging Market Index returned an astounding 34.24 percent, while the MSCI EAFE Index was up 25.04 percent. Returns were more muted in most areas of the fixed-income markets, with government heavy sectors posting around a 4 percent return, as riskier areas generally returned between 6 and 8 percent.

Although these heady returns are appreciated by investors, there is no hiding the fact that domestic equity and bond valuations appear stretched. In fact, many traditional equity valuation measures today rival those at the height of prior stock market peaks of 1929 and 2000. These include the cyclically adjusted price-to-earnings ratio, price-to-sales ratio and several others. Further, in the past 12 months we've seen one of the most profound and prolonged declines in stock market volatility on record. Yet, corporate earnings are growing nicely, and interest rates remain historically low, giving some credence to these lofty valuations. Still, there appears little room for error in any area of the economy, including global monetary policies, geopolitics and economic growth. Quite frankly, at these heightened equity valuations, the near-term return prospects appear muted at best and vulnerable to a pullback at the very least. At a yield-to-maturity of around 2.4 percent on the 10-year U.S. Treasury bond, fixed-income return prospects do not appear much better. The Federal Reserve's massive monetary "experiment" over the past several years has squeezed nearly all returns from this asset class. Normalization of interest rates to higher levels could further impact most fixed-income returns.

Looking ahead, we tend to think the economy has more room to grow. Although the Federal Reserve is methodically raising interest rates and contracting their balance sheet, the environment of low unemployment, solid business and consumer spending, along with contained inflation, should persist to produce reasonable growth in the year ahead. In the capital markets, however, we remain concerned that much of this "good news" is already priced in, particularly in domestic stocks. Ultimately, we are growing increasingly wary that valuations across most asset classes are untethered from reality. History has shown that markets eventually revert to more rationale levels, and it tends to occur quicker than investors think. As we move forward, we will continue to seek investments that balance risk with expected return amidst this positive, yet somewhat concerning, investing environment.

Capital Markets

The yield on the 10-year U.S. treasury bond ended the quarter slightly higher than where it began. Corporate investment-grade and high-yield bonds produced modest returns with absolute yields hovering near all-time lows. Domestic equity market returns were very healthy for the quarter, with larger stocks outpacing mid and smaller stocks. International and emerging market indices continued to produce positive returns during the quarter.

Disclosure: It is not possible to invest directly into an index. The indices listed above are unmanaged and are not affiliated with the Advance Capital Companies.

Market Index Performance(%) As of December 31, 2017

| | 4th QTR | YTD | 1 Year | Annualized 3 Year |
|--------------------------------|---------|-------|--------|----------------------|
| S&P500 | 6.64 | 21.83 | 21.83 | 11.41 |
| Dow Jones Industrial | 10.96 | 28.11 | 28.11 | 14.36 |
| Nasdaq Composite | 6.27 | 28.24 | 28.24 | 13.38 |
| Barclays Aggregate Bond | 0.39 | 3.54 | 3.54 | 2.24 |
| Citigroup BIG Corporate | 1.10 | 6.32 | 6.32 | 3.75 |
| MSCI World | 4.23 | 24.21 | 24.21 | 7.36 |

Economy from a Historical Perspective

| | Latest | Average* | Definition | Comments |
|----------------------------------|-----------|-----------|--|---|
| U.S. Unemployment Rate | 4.10% | 6.14% | Represents the number of unemployed persons as a percent of the labor force | Near historic lows |
| Consumer Price Index | 2.20% | 4.10% | Represents changes in prices of all goods and services purchased for consumption | Trending modestly higher |
| U.S. Capacity Utilization | 77.10% | 80.31% | The greatest level of output that a plant can maintain within the framework of a realistic work schedule, accounting for normal downtime | Has risen slightly recently |
| Gross Domestic Product† | 2.30% | 2.80% | Total value of all goods and services produced indicates strength or weakness of the economy | Positive, slightly below average |
| 10 Year Treasury Yield | 2.47% | 6.43% | Yield on the current 10 year treasury bond | Has increased over the past year |
| Annual Housing Starts | 1,166,000 | 1,437,000 | New privately owned housing unit starts annualized rate | Steadily rising |

*Average from 1966 to Present

† Annualized

Source: Bloomberg

Disclosures: Investments are not insured, and may lose money. Client should be prepared to bear the risks associated with investing.

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