MarketUpdate

Solid December caps strong year for markets

U.S. financial markets were strong throughout 2017 and capped off the year with even more gains in December. All three major indices were up for the month and the quarter. In December, the Dow Jones Industrial Average led the way with a return of 1.92 percent. The S&P 500 Index gained 1.11 percent, and the Nasdaq Composite trailed with a gain of 0.48 percent. For the quarter, the Dow also led the way, up 10.96 percent. Again, it was trailed by the S&P 500 at 6.64 percent and the Nasdaq at 6.55 percent. For the year, however, the Nasdaq claimed the top spot with an impressive gain of 29.64 percent. It was followed by the Dow, up 28.11 percent, and the S&P 500, up 21.83 percent. All three indices remained supported technically at year-end, trading well above their 200-day moving averages.

This positive performance was driven largely by improving earnings growth. According to FactSet, as of year-end, the estimated fourth-quarter earnings growth for the S&P 500 was 10.9 percent, with all 11 sectors projected to grow from third-quarter levels. If we get this level of growth—and analysts have made much smaller downward revisions than usual—it would mark the highest level of annual earnings growth for the S&P 500 since 2011. As fundamental performance ultimately drives long-term returns, this would be a boon for investors.

International markets also had a successful year. The MSCI EAFE Index, which tracks developed markets, gained 1.61 percent for December, 4.23 percent for the fourth quarter, and 25.03 percent for the year. The more volatile MSCI Emerging Markets Index returned 3.64 percent for the month, 7.50 percent for the quarter, and a whopping 37.75 percent for the year. Like U.S. markets, international markets closed the year with strong technical support, trading well above their trend lines.

Fixed income had a more volatile year than equities, as early outperformance was offset by rising rates. The Federal Reserve (Fed) increased the federal funds rate three times in 2017. Although these rate hikes are indicative of the Fed's confidence in the ongoing economic expansion, rising rates can hit fixed income markets—and that is exactly what we saw. Markets currently anticipate two to three rate hikes in 2018, which could have similar effects.

Despite the rate hikes, the Bloomberg Barclays Aggregate Bond Index gained 0.46 percent in December, bringing the quarterly return back to 0.39 percent and capping the annual return at 3.54 percent. The Bloomberg Barclays U.S. Corporate High Yield Index had similar returns of 0.30 percent and 0.47 percent for the month and quarter; however, a stronger start to the year left the index with an annual return of 7.50 percent.

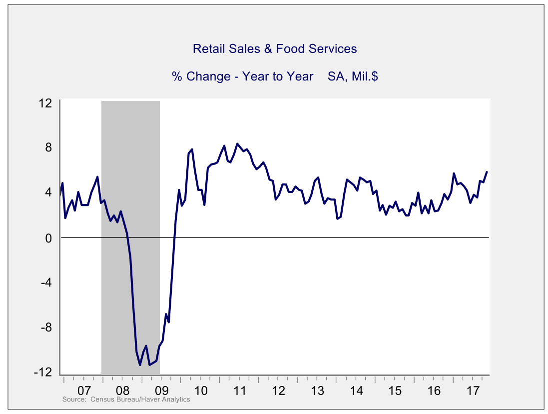
Consumers drive economic growth

The economic news in December was good pretty much across the board, but the best news came from the ever-important consumer. Shoppers helped the year end with a bang, as high confidence translated into much better-than-expected spending heading into the holiday season. Retail sales, which had lagged confidence all year, surprised to the upside, with headline and core sales both increasing by 0.8 percent over October's figures. On an annualized basis, retail spending growth now sits at 5.8 percent, the highest level since 2012 (see Figure 1). This recovery in spending has been a long time coming, and seeing it is a positive sign.

Another positive sign is continued high levels of consumer confidence, which could spark further spending gains. The Conference Board's consumer comfort survey hit a 17-year high in November. Although confidence pulled back a bit in December, it remains at very high levels historically.

Strong job growth also supports confidence and spending. In November, 228,000 jobs were added against expectations for a more modest increase of 200,000. The underlying data was also strong. The unemployment rate remained unchanged at 4.1 percent, and the average hours worked per week increased, indicating strong demand for labor. The one fly in the ointment was wage growth, which came in at 0.2 percent against expectations for stronger growth. Although wage growth remains muted,

Figure 1. Retail Sales Annualized Change, 2007–2017



Source: Census Bureau/Haver Analytics

the tight labor market and healthy growth of the economy indicate that this may be an area where we see faster growth in 2018.

Finally, the strength of the housing market points to healthy consumer sentiment. Homebuilder confidence increased again in December to levels last seen in 1999. This increased confidence translated into more housing starts, which now sit at the second-highest annualized growth level since 2008. Homebuilder confidence has been driven, and matched, by buyers. Both existing and new home sales beat expectations last month, with existing sales growing 5.6 percent and new home sales rocketing up 17.5 percent. Some of this growth is still likely due to the effects of the hurricanes in the third quarter, but the overall strength of the housing market should not be dismissed.

Businesses also confident—and spending

Sentiment remained strong for businesses last month, as industry surveys remained in healthy expansionary territory across the board. Supported by this confidence, business investment spending also registered solid growth. Durable goods orders increased by 1.3 percent in November, offsetting a decline in October. Core orders, which exclude volatile transportation expenditures, declined slightly, but that was offset by a positive revision to October's strong growth.

Finally, business output was also solid in November. Both industrial production and manufacturing output grew by a steady 0.2 percent. Although this headline figure may not jump off the page, it comes on top of a very strong gain in October following a rebound from the hurricanes.

Persistent political risk looms over markets

As was the case for much of 2017, the major source of risk to the markets remains political. International risks include the ongoing Brexit process, as the United Kingdom and the European Union negotiations continue, as well as the continuing attempts to form a German government. In Asia, North Korea remains a major risk factor, with war a very possible outcome.

Here in the U.S., the passage of tax reform removes one source of risk, but we still face a new deadline to avoid a government shutdown in the middle of January. With both parties locked into confrontational modes, and with significant policy differences at stake, political risk remains substantial—and could rock markets. The markets largely ignored politics in 2017, but we can't assume we will be that lucky in 2018. The biggest risk here is that politics might damage the confidence that is driving growth.

2018 starts with lots of momentum

With high confidence, continued job growth, and likely increase in wage growth, consumers enter 2018 in good shape. Similarly, with high confidence, increasing spending, and improving economic fundamentals, the business sector looks likely to keep growing. Combine all that with reduced regulation and the possible positive impact of tax reform, and we could see even faster growth in 2018. At a minimum, we certainly enter the year with a great deal of momentum.

Although politics will likely continue to dominate the news cycle, strong fundamentals should keep driving the economy and markets forward. More volatility is quite likely, though, possibly at worrying levels. The calm of 2017 is unlikely to last through 2018, and we need to remember that markets can go down as well as up. As always, a well-diversified portfolio that matches investor goals and time horizons and takes advantage of long-term growth opportunities remains the best path forward.

All information according to Bloomberg, unless stated otherwise.

Certain sections of this commentary contain forward-looking statements based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. Diversification does not assure a profit or protect against loss in declining markets. All indices are unmanaged and investors cannot invest directly into an index. The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The Nasdaq Composite Index measures the performance of all issues listed in the Nasdaq Stock Market, except for rights, warrants, units, and convertible debentures. The MSCI EAFE Index is a float-adjusted market capitalization index designed to measure developed market equity performance, excluding the U.S. and Canada. The MSCI Emerging Markets Index is a market capitalization-weighted index composed of companies representative of the market structure of 26 emerging market countries in Europe, Latin America, and the Pacific Basin. It excludes closed markets and those shares in otherwise free markets that are not purchasable by foreigners. The Bloomberg Barclays Aggregate Bond Index is an unmanaged market value-weighted index representing securities that are SEC-registered, taxable, and dollar-denominated. It covers the U.S. investment-grade fixed-rate bond market, with index components for a combination of the Bloomberg Barclays government and corporate securities, mortgage-backed pass-through securities, and asset-backed securities. The Bloomberg Barclays U.S. Corporate High Yield Index covers the USD-denominated, non-investment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below.

Co-authored by Brad McMillan, senior vice president, chief investment officer, and Sam Millette, fixed income analyst, at Commonwealth Financial Network.

© 2018 Commonwealth Financial Network®