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# 2017 REVIEW AND OUTLOOK FOR 2018

2017 turned out to be a much better year for stocks than many investors and investment analysts expected. Despite tumultuous headlines on an almost daily basis, stocks performed well last year mainly because corporate profits exceeded expectations. Stock market conditions were also positive last year because investors correctly predicted that Congress would pass a bill to reduce corporate income taxes. Lower taxes for corporations should result in higher corporate earnings in the future, which is beneficial for stock prices. Finally, the stock market also performed well last year because interest rates remained low, encouraging investors to seek higher returns in the stock market rather than what they could have obtained in fixed income investments. Due to these positive events, the S&P 500 Index finished 2017 up 19.4%, while the Dow Jones Industrial Average gained 25.1%. As expected, bonds did not perform as well as stocks last year; the Bloomberg Barclays U.S. Intermediate Government/Credit Index returned only 2.14% in 2017. *

Corporate profits generally beat expectations last year mainly because the global economy strengthened. Economic conditions improved in many foreign countries, which provided a significant benefit to U.S. corporations that sell their products globally. U.S. corporate profits also improved last year because the U.S. dollar weakened. When the dollar weakens, U.S. exports typically grow because U.S. goods appear less expensive to foreign buyers. Also, when U.S. corporations translate their overseas revenues derived in strengthening foreign currencies back to weaker U.S. dollars, they obtain more dollars, thereby benefiting from foreign currency exchange rates. The weak U.S. dollar particularly helped large companies that do business overseas to outperform last year.

Reducing the corporate income tax rate is seen as a positive for stocks not only because it lowers taxes for corporations, but because corporations may use their tax savings to increase dividends paid to shareholders. Some companies may also use their tax savings to buy back stock and pay down debt. If corporations have less debt, they are less susceptible to rising borrowing costs when interest rates ultimately rise to higher levels.

As a result of these positive factors, stock market volatility has been subdued for quite some time. For example, it has been an extraordinarily long time since the stock market corrected by more than 5%. Additionally, although the major stock market indices have appreciated, much of these gains have been due to significant increases in a relatively small amount of large company stocks that represent a large percentage of the indices, which are market- or price-weighted. In addition, over 20% of the stocks in the S&P 500 Index actually declined last year.** Therefore, not all stocks in all industries have participated in the stock market rally, and this lack of market breadth is concerning.

There are other concerns that could make 2018 more volatile than 2017 for both stocks and bonds. For example, it is possible that if the growth rate of the global economy continues to strengthen, inflation may become a concern for the Federal Reserve Board and bond investors, leading to higher interest rates. These higher interest rates could provide competition for stocks from fixed-income investments that would then pay higher yields. Additionally, some of the geopolitical concerns that did not negatively impact stocks in 2017 could become problematic in 2018.

The next stock market decline will likely be a correction, rather than the beginning of a long-term market decline. Long-term, severe bear markets typically coincide with or are caused by structural economic problems. As long as the economy continues to grow at a moderate pace and corporate earnings remain strong, short-term corrections could become good buying opportunities for stocks this year. We are also optimistic that the recovery in foreign stocks that began last year will continue into the future. Regarding fixed income investments, we continue to favor short-term bonds, rather than long-term bonds, since they are less sensitive to inflation and rising interest rates.

As always, please contact us if you have any questions or concerns regarding your investments or the financial markets in general.

* *Index returns were obtained from the Wall St. Journal and Bloomberg Barclays Indices on December 30, 2017.*

*** Information was obtained from Morningstar.*

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