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Annual Financial Market Update & Look Ahead

January 2018

Running of the Bulls

The bulls took charge the day after Election Day in November 2016, keeping the bears on the defensive throughout 2017. A GOP that controlled all three branches of government ignited early optimism among investors, who had expected easy passage of economic-friendly policies. But instead, gridlock kept investors on pins and needles until year-end, when Congress enacted a dramatic cut in the corporate tax rate and modestly shaved tax brackets for individuals.

Stock Indices*	Q4 Return % Oct. 1, 2017 – Dec. 31, 2017		YTD Return % Jan. 1, 2017 – Dec. 31, 2017
S&P 500 (large)	+6.64		+21.83
S&P 400 (midsize)	+6.25		+16.24
Russell 2000 (small)	+3.34		+14.65
MSCI EAFE (intl.)	+4.23		+25.03
Bond Yields	**Dec 29 Yield & Quarterly Change**		**Yield - % a/o Dec 30, 2016**
3-month T-bill	1.39%	+0.33%	0.51%
2-year Treasury	1.89%	+0.42%	1.20%
10-year Treasury	2.40%	+0.07%	2.45%
30-year Treasury	2.74%	-0.12%	3.06%
Commodities	**Dec. 31 Price & Quarterly Change**		**Year end 2016**
Oil per barrel	$60.42	+$8.75	$53.72
Gold per ounce	$1,296.50	+$13.40	$1,159.10

**Stock indices include reinvested dividends*

Whatever your thoughts are about the president (and lawmakers in general), investors are bipartisan. The long-term focus is on the economy and profits (i.e. the fundamentals). Investors really don’t care which party supports investor-friendly policies. Yes, there are important issues beyond the markets, and elections have consequences. But purely through the narrow prism of the market, it is the economic fundamentals that matter.

For much of the year, improving economic fundamentals fueled bullish sentiment, including the S&P 500 being up for <u>every</u> month in 2017! Let’s review—

1. Global profit growth accelerated after being meager for the past few years.
2. A synchronized global expansion created additional tailwinds for corporate profits.
3. Global growth accelerated.
4. Consumer confidence hit its best reading since late 2000.

5. Small business confidence recorded its second-best reading in over 30 years.
6. The U.S. unemployment rate fell to 4.1%.
7. Gross Domestic Product in the U.S. recorded two-straight quarters of growth above 3.0%.
8. Inflation in the U.S. remains low.
9. U.S. interest rates remain low, and are currently expected to rise gradually.
10. Leading indicators put the odds on a near-term recession at a low level.

Put another way, it was the perfect recipe for 2017's impressive advance.

One more interesting aspect of last year’s rally: there was little volatility. The biggest dip of the year for the S&P 500 totaled -2.8%, the smallest since 1995’s -2.5%. Since 1950, the average intra-year pullback has been -13.6%. It is a timely reminder that a modest pullback in 2018 can not be ruled out.

A Look Ahead

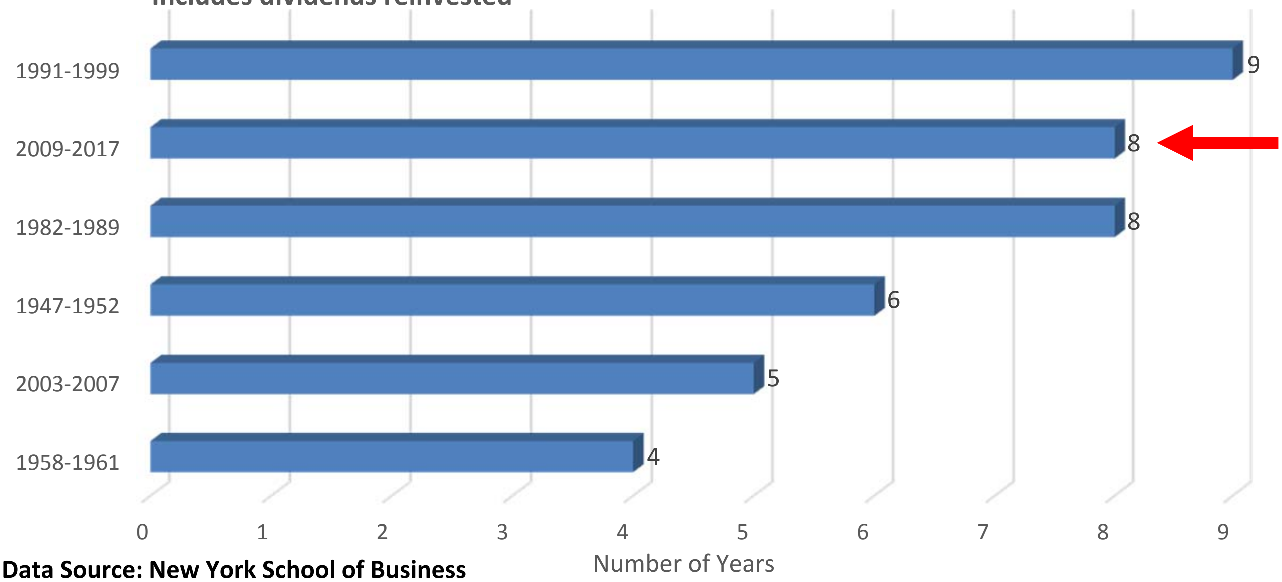
The economic outlook heading into 2018 has not been this upbeat in years, as the U.S economy finished 2017 with strong positive momentum.

Moreover, the synchronized upturn in global growth not only aids the U.S. economy, it has been a big support for earnings of U.S. multinationals. A reduction in the corporate tax rate is set to support earnings longer term, but it is unclear how much has been priced in by investors.

We are never ones to throw caution to the wind and perspective is in order. Figure 1 illustrates annual winning streaks for the broad-based S&P 500 Index. We are one year away from tying the record for consecutive annual advances going back to 1947 – see Figure 1.

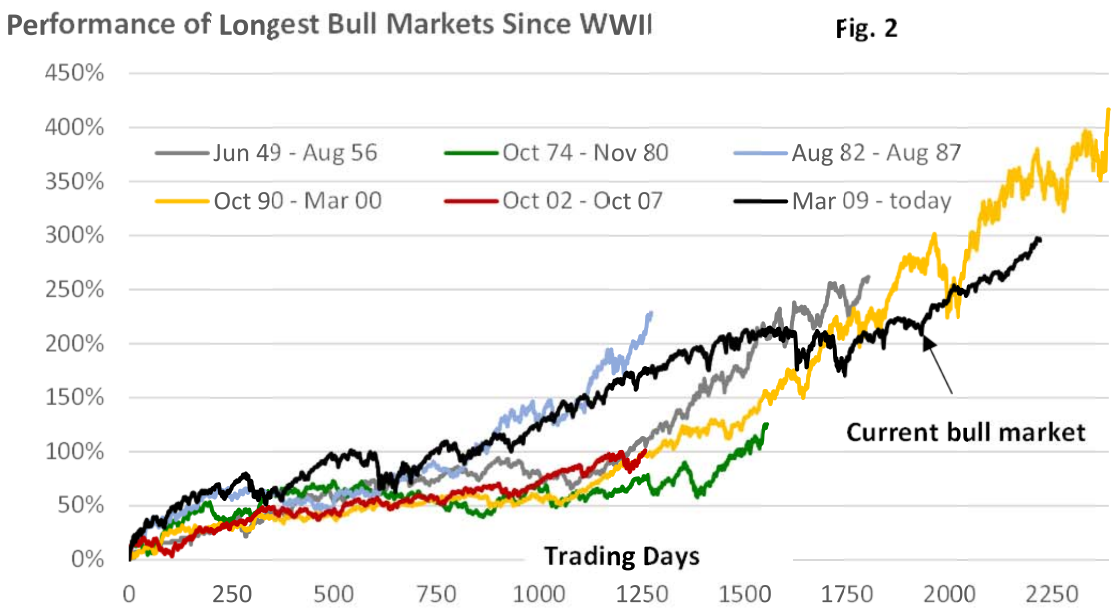
Annual S&P 500 Index Winning Streaks Back to 1947
Includes dividends reinvested

Fig. 1



Data Source: New York School of Business
Last Date: 12.29.17

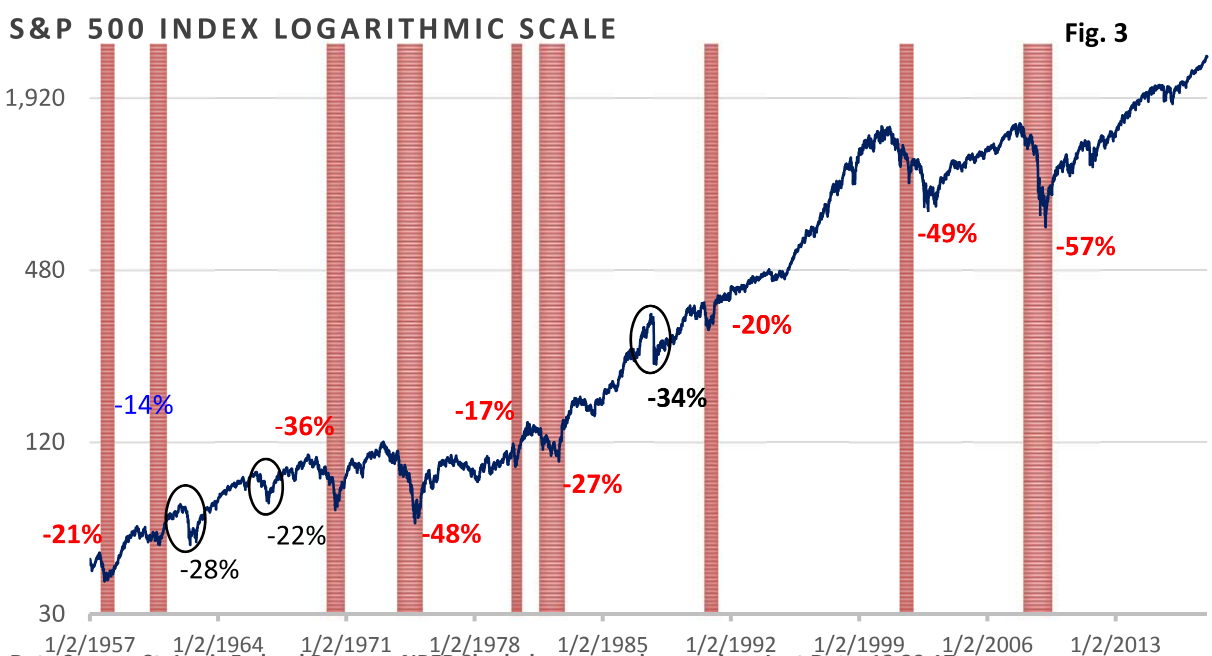
Figure 2 offers another comparison. It highlights the six longest bull markets since WWII and their respective advances.



Data Source: Yahoo Finance, St. Louis Federal Reserve, S&P Capital IQ
Last Date: 12.29.17

The current bull market is the second longest in both longevity and performance.

By itself, the second longest bull market since WWII creates an air of caution (since markets don't go straight up forever), but bull markets don't die of old age or enter a danger zone based only on past performance. The end of a bull market has historically correlated with the onset of a recession. Since the late 1960s, only one bear market – the 1987 Crash – did not align itself with a recession – see Figure 3.



Data Source: St. Louis Federal Reserve, NBER Shaded areas mark recessions Last Date: 12.29.17

Still, any number of events not directly tied to the economic fundamentals could spark a bout of volatility.

Might we see a selloff early in the new year? It is possible if investors book 2017 stock profits in tax year 2018. For example, following 2013's outsized 30% gain in the S&P 500, shares went sideways in the first three weeks of 2014, and then slid 6% over the next couple of weeks. This is not a forecast, just something to consider.

Bigger concerns would surround the fundamentals. If inflation were to unexpectedly heat up, we could see a more aggressive Federal Reserve, one that deviates from its currently stated path of gradual rate increases. Odds of an unexpected jump in inflation are low, but keep an eye on oil prices, which have topped $60 per barrel for the first since June 2015.

Part of the issue of rising interest rates is that they act as a discounting mechanism. In its simplest form, the higher the discount rate (i.e. interest rates), the lower the price that investors are willing to pay for investments. In our base case scenario, we want (and expect) a good economy but not too good. The reason is that if the economy is too strong, interest rates will likely rise more than expected and therefore, many investments could decline in value.

Another concern is that valuations for stocks are not inexpensive. We would contend that while there are good companies available at reasonable prices, they are harder to find today.

So we are in a strange predicament. We have an improving economy in the U.S. and generally around the world, the possibility of rising interest rates, and valuations of most investments at somewhat elevated levels. What should an investor do? We would contend that you need to go back to your financial plan and revisit what the money is to be used for. If it is for a short to intermediate need and you have already met the goal, start trimming. If it is for something longer term, stay the course but be sensitive to allocation. As the old adage goes, bulls and bears make money but pigs get slaughtered. Stay disciplined.

Final Thoughts

We go into 2018 feeling very blessed. We are very fortunate to work with such wonderful clients and hope you feel the same way working with us.

Please let us know if we can assist you in any way. We are always here for you (which also includes your family members or friends).

We are proud to announce that we were recently named again to ***Washingtonian*** magazine's list of the top financial advisors in the DC metropolitan area (January 2018 issue). We constantly strive to be the best that we can be but we could not do it without your support. Thank you.

Hopwood Financial Services, Inc.