2018 Outlook

Curb Your Enthusiasm

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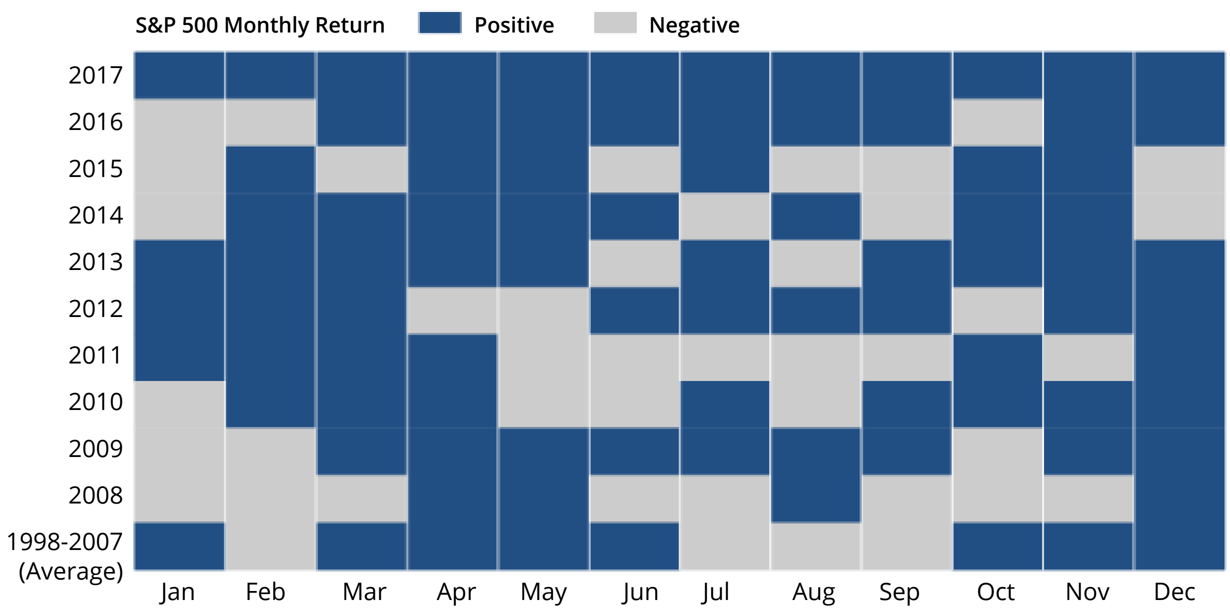
Much to the surprise of many, 2017 was a banner year for the US stock market and a good year for the US economy. The stock market, as measured by the S&P 500 Index,[1] returned 21% for the year and broke records by rising in every single month of the year (see chart). The economy grew by 2.3% as measured by the GDP,[2] up from 1.8% in 2016 and employment growth was also solid, ending the year with an unemployment rate of 4.1%, (down from 4.7% to start the year). Despite the increase in economic activity, inflation remained tame, well below the Fed's 2% target. A strong holiday shopping season, driven by consumers dipping into their savings, helped to offset a rough 2017 for retailers. Overall, from an economic and stock market standpoint, as the president recently stated (not tweeted), 2017 will be a tough year to top.

2017 breaking records in the stock market



Source: GSAM. As of December 29, 2017.
Based on S&P 500 Index from January 1998 through December 2007. **Past performance does not guarantee future results, which may vary.**

[1] S&P 500 - The Standard & Poor's 500 Index (S&P 500) is an index of 505 stocks issued by 500 large companies with market capitalizations of at least $6.1 billion. It is seen as a leading indicator of U.S. equities and a reflection of the performance of the large-cap universe.

[2] Gross Domestic Product (GDP) - Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

2017
records

- Lowest annualized volatility on record (S&P 500 from 1928)
- Lowest intraday volatility on record (again, S&P 500)
- First perfect 12 up-month year for the S&P 500
- Longest streak within 3% of all-time high for the S&P 500
- Most all-time high closes on the Dow in history (from 1910)
- Unemployment lowest since 2000
- Jobless claims lowest since 1973
- Consumer Confidence highest since 2004
- Nonfarm payroll up 86 consecutive months, longest streak ever

Source: Pension Partners 2017 year-in-charts.

Given 2017's solid economic and market performance, our investment recommendations held up well for the year on a relative and absolute basis. Our overweight positions in international (developed and emerging) and underweight in intermediate bonds contributed to strong performance.

2018
key focus areas

Markets Have Room to Run

We believe that we will continue to see a global expansion in 2018 and beyond. The strength and durability of the economic expansion should not be underestimated. While some investors fear the end of the market cycle is near, economies can run beyond their potential for a long time before turning. Stock valuations have risen, market volatility has stayed low and many investors' perceived risks have not materialized – making markets more vulnerable to temporary sell-offs that are impossible to predict. We believe we are positioned well to take advantage of market corrections when they occur.

> Oh yeah, and there is a BIG TAX CUT, with far-reaching implications — more on that later.

The Eurozone and Japan are playing catch up to the US economic expansion. We also expect lower returns for taking risk in 2018 across the board. Rising profitability will likely continue to power equity returns, especially in emerging markets, but earnings growth could wane. We continue to maintain our overweight stance on developed international and emerging markets.

Taxes

Of course, by now we all know about the new tax law. We think the law will have a massive effect on the economy, both short- and long-term. There are about $1.5 trillion of cuts and trade-offs in the new law, but here are some highlights:

- Most individuals will see more money in their pockets. By our calculations, an average taxpayer will get a cut from the larger standard deduction and lower rates. That means more money in the economy for the consumer.
- Most (note, we say most) corporations will pay lower taxes. The theory here is that the US needs to be competitive globally (we agree) and more money at the corporate level, coupled with new rules to allow expensing of business assets, will stimulate business investment in the US.
- The small business tax environment has undergone a revolutionary change that helps owners of 'pass-throughs' (Subchapter S corporations, LLCs, and sole proprietors). These changes are the biggest we've seen since the Eisenhower Administration, and will be stimulative to smaller businesses.
- Repatriation means that multinationals are likely to bring money back to the US from overseas. Apple is famous for its $230 Billion hoard, as are Microsoft and many other large multinational corporations. What they do with the money is to be determined.

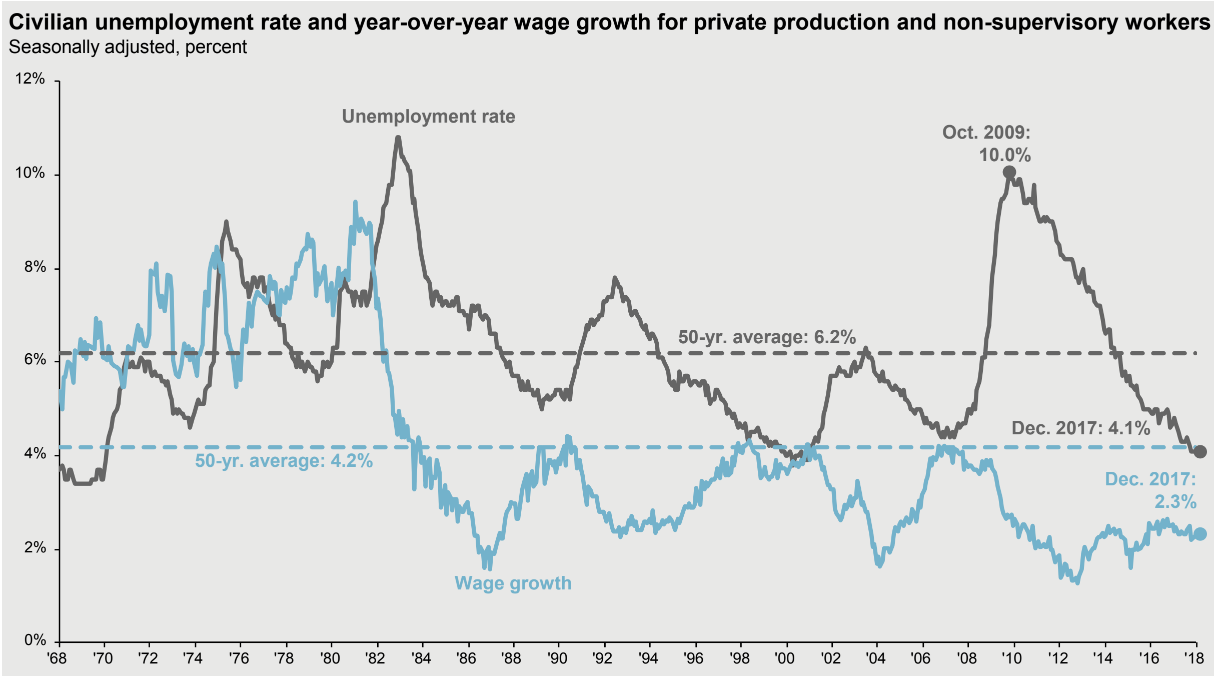
All in all, the tax law will be a stimulant, but that means we will have growth in an economy that is close to full employment. What does this mean for labor?

Labor

We are nine years into the US economic expansion. If economic growth comes in between 2% and 3%, the unemployment rate will likely drop below 3.5% (from 4.1%). The challenge for companies will be pressure on wages and difficulty finding employees. If this materializes, it will likely lead to an economic slowdown in 2019 and drive inflation. As the unemployment and wages chart shows, unemployment has steadily declined since 2009 but there has not been much wage growth.

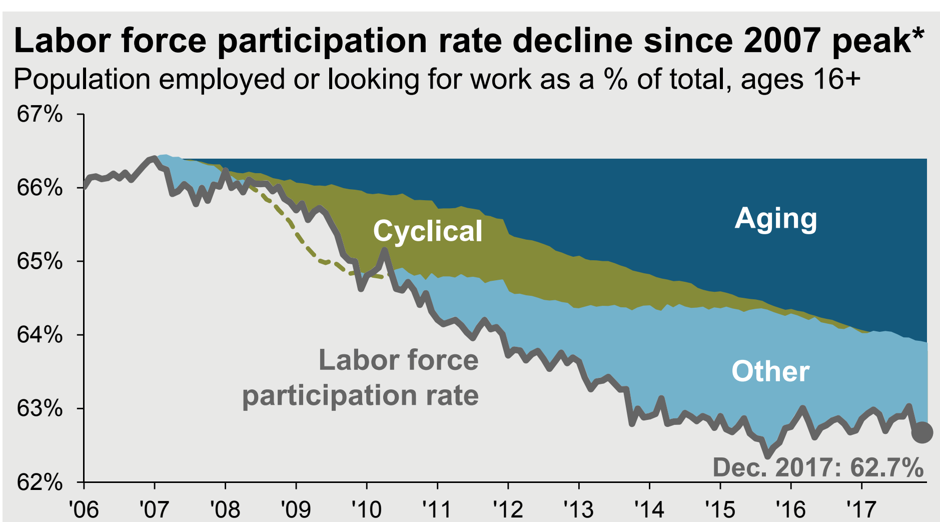
If we look deeper into what has been going on in the labor markets, the labor market perspectives chart provides insight. Since the Great Recession, labor force participation has declined, in part due to an aging population, which arguably would have occurred regardless of the economic downturn. The "other" component can't be explained by aging or cyclical issues. If economic growth is as strong as the current political administration predicts, there will be higher demand for workers, and the "other" category would likely contract in 2018-2019. If the workers don't come from the categories below, they will have to come from immigration (potentially opening a political can of worms).

unemployment and wages



Source: BLS, FactSet, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – U.S. Data are as of December 31, 2017.

labor market perspectives



*Aging effect on the labor force participation rate is the estimated number of people who are no longer employed or looking for work because they are retired. Cyclical effect is the estimated number of people who lose their jobs and stop looking for work or do not look for work because of the economic conditions. Other represents the drop in labor force participation from the prior expansion peak that cannot be explained by age or cyclical effects. Estimates for reason of decline in labor force participation rate are made by J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – U.S. Data are as of December 31, 2017.

Higher Interest Rates and Inflation Make a Comeback

Global inflation will be a focus for 2018, with the expectation of a modest increase in the US interest rates. We expect the Federal Reserve to make slow but steady increases in its lending rate in 2018. Recent US tax legislation will support near-term growth and support the Fed's pace for increasing interest rates. Inflation in the US should trend around the 2% target. The Fed is likely to increase rates three to four times (0.25% each time) in 2018. In Europe, however, inflation may remain low through 2019. We continue to include inflation-protected, floating rate and strategic income securities in our portfolios, which tend to hold up well in inflationary and rising interest rate environments.

Continued Obsession with Cryptocurrencies (e.g., Bitcoin)

There are currently over 1,300 cryptocurrencies (and that number is growing fast) that are actively traded and even more in circulation. Creating a new "coin" consists of merely launching a program that is basically a mathematical algorithm (albeit a very complex one). A lot of attention has been directed to Bitcoin and its meteoric rise. Its price has been rising (and falling rapidly at times), though its share of the total cryptocurrency market has been falling. Bitcoin represented 80% of trading a year ago, while it now makes up less than 50%. At the end of 2010, one Bitcoin was worth 30 cents. At the end of 2017, it was above $13,000. Others on the rise include Ethereum, Litecoin and Ripple. The top 20 cryptocurrencies had a combined market cap of $494.4 Billion at the end of 2017, up about 2,891% from the $17.1 billion valuation at the beginning of 2017.

Cryptocurrencies are certainly not something you can hold in your hand and the value is based entirely on your trust in the mathematics behind the algorithm, the exchange it is on and the willingness of the market to accept it. In the most fundamental terms, cryptocurrencies don't really "exist" but are a representation of a transaction. This makes them very different from traditional "real" currencies. As we know, what goes up quickly can also fall just as fast. When the US government rejected an effort to create a Bitcoin-based exchange-traded fund in March, the price of Bitcoin on the Bitfinex market plunged by almost one-third in just over a week.

There are certainly unique positives for cryptocurrencies, particularly if you live in Venezuela or Zimbabwe where their currencies are worthless; however, the negatives, particularly in developed countries, are unchartered territory.

We have significant concerns about something that anyone with a PC can create, that essentially is referred to as a medium of exchange as soon as it is created, mined or trades the encryption keys - it is essentially the wild-wild west right now. As Warren Buffet would point out, invest in businesses you can understand.

value of bitcoin

Source: Bloomberg

Geopolitical Issues Abound

We are watching four geopolitical trends in 2018 - broken into their simplest terms:

1. North Korea

a. Peaceful or muted resolution to current issues – good for markets
b. Military conflict (nuclear or otherwise) – bad to very bad for markets

Near term expectation:

The window for a preventative military strike by the US is passing. If no action is taken, the US will have to focus on containment. However, this situation is in flux and the two Koreas may resolve the issue on their own.

2. US Trade Policy

a. Free and fair global trade – good for markets
b. Restrictive trade, increased tariffs or trade wars – bad to very bad for markets

Near term expectation:

The US continues focus on a protectionist, US-first agenda. It is likely that we will see more selective trade measures take place, particularly with Asia as well as the World Trade Organization as a whole.

3. Unrest in Iran and the Middle East

a. Regime change in Iran/Saudi Arabia – good/bad for markets
b. No change in regime in Iran/Saudi Arabia – bad/good for markets

Near term expectation:

The US does not want to see another North Korea situation take place in Iran. The outcome of the Iranian nuclear deal will be critical. The US will likely team up with Saudi Arabia and Israel to add pressure the current Iranian administration and Hezbollah.

4. Global Oil Markets

a. Increased drilling off US coasts/increased supply – lower oil prices, lower prices for consumers, range of impact for oil companies as market moves toward a modified equilibrium.
b. Decreased supply – higher prices, bad for consumers, opposite range of impact for producers/oil companies

Near term expectation:

Supply will continue to increase and the pro-drilling administration will pave the way for that to continue. Saudi Arabia will focus on rebalancing the oil supply on world markets in the wake of the expected rise in US shale production.

2018
looking ahead

As we look ahead for 2018, we will consider all of the above, as well as the impact of a potential government shutdown, mid-term elections and the impact/probability of infrastructure spending (topical blogs to follow). In summary, we see improving economic fundamentals in emerging markets going forward and broadening global growth, which may offer investors meaningful potential during the year. Given our outlook, we believe the probability of a US recession is low for 2018 with increased risk in 2019.

LJPR has produced a number of videos addressing a range of timely issues. They can be found ljpr.com/taxreform or on our YouTube video channel youtube.com/user/LJPRvideos.

Happy New Year!
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LJPR FINANCIAL ADVISORS

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manage and keep more money

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