CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

December 31, 2017

A Quiet and Productive Year Draws to a Close

Global stock markets rose in price throughout 2017 in a year marked by consistently positive monthly returns.

Economic growth in major economies, strong corporate profits, low inflation and favorable central bank policies all contributed to these gains.

The year just ended is notable for the consistency of the stock market gains month after month, for the fact that European and Japanese markets outperformed the US and for the placidity of it all. Day-to-day variation in US stock prices is the lowest since 1964 and the second lowest on record. The calm in stock markets is the more striking in the context of political upheaval in the US and the notable risk of nuclear war between North Korea and the US. Steady and robust returns in Core's clients' portfolios in the course of 2017 are most welcome; may they continue in 2018!

As the year has unfolded, we have commented in these letters about various factors that have contributed to the fine stock markets. These include 'synchronized' global growth (i.e., the fact that all the world's major economies are expanding), strong gains in corporate profits, low inflation, and accommodative monetary policies by the world's major central banks. As for this latter point, although the Federal Reserve is raising short-term rates and has begun to reduce the level of assets on its balance sheet, its so-far mild monetary tightening is offset by the continued extremely loose policies of the European Central Bank and the Bank of Japan. Both of these central banks continue to buy bonds ('quantitative easing') and to keep short-term interest rates anchored near zero. Indeed, many European and Japanese bonds have negative yields.

The newly-enacted tax legislation is intended to spur the economy and raise wages. Maybe.

It may be unneeded fiscal stimulus that will have minimal effect on the real economy while it fattens the purses of big companies and those already wealthy.

As for global growth, China and India are expected to grow at 6.5% to 7.5%. The major developed economies, including the US, most western European countries, Canada and Australia will likely grow at more than 2%. Britain and Japan will probably grow more slowly than in 2017, but still at about 1.3%. The present forecast for growth of corporate profits of the 500 big US companies that comprise the S&P 500 index is 12%. Yields on long-term bonds remain very near their historic lows. Given these factors, it is reasonable to think that stock markets will climb further as we enter 2018.

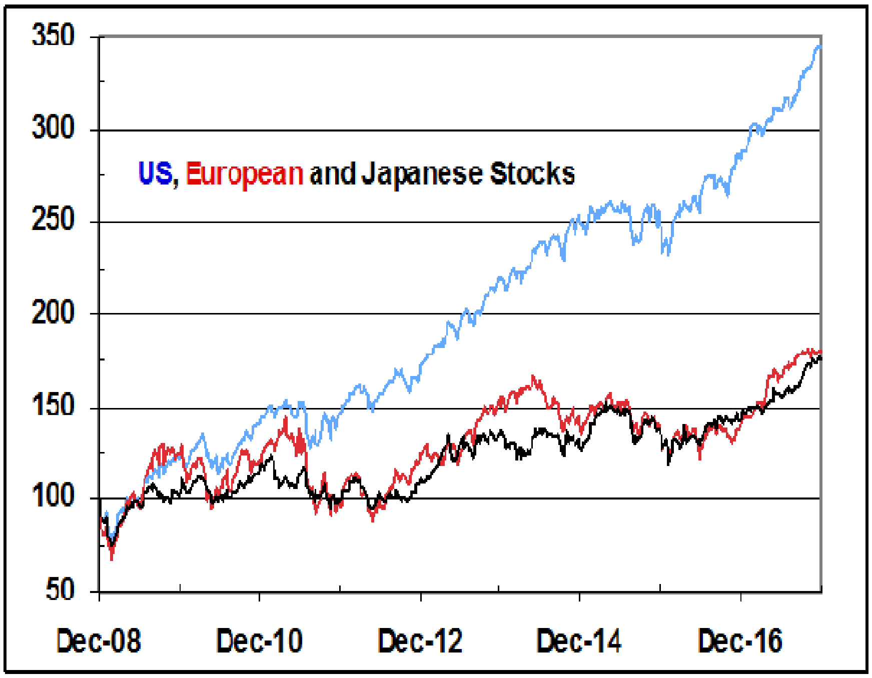
By

Jack Mayberry

The tax legislation. As the year ended, tax legislation was enacted. Notably, it cuts corporate income taxes substantially and lowers rates on personal income taxes. Its Republican authors contend that it will increase corporate capital spending and wages. If so, higher consumer spending will follow and economic growth will accelerate. Should things unfold this way, we can expect the Fed to raise rates and to reduce its balance sheet faster than now anticipated, probably resulting in stock market selling and far greater volatility in stock prices than we saw this year just ending.

Another possible outcome, more likely than the one noted above, is that lower corporate taxes will result in higher dividends to shareholders, more stock buy backs and increased spending on corporate acquisitions. In this scenario and without higher wages and capital spending, economic activity will be largely unmoved by the tax legislation. The Fed will move slowly with its interest rate increases and shrinking of its balance sheet. Bond yields will stay low and bond prices high; stocks will likely continue to increase. Economic stimulation from tax cuts will be muted. The characteristics we have observed for several years, including modest economic growth, low interest rates, low inflation and supportive central banks, will prevail, all to the benefit of asset markets rather than the real economy. We may get an indication of corporate plans during the upcoming weeks when corporate earnings are announced. At least some corporations will likely reveal what effects the tax legislation will have on their profits and what plans they have in light of the changed tax regime.

In 2017, Japanese and European stocks markets outperformed even the strong US market. Expect more of the same in 2018.



Foreign markets. As noted, European and Japanese markets gained more in 2017 than the US. This follows the long period since the financial crisis during which the US market surpassed foreign markets by a large margin. The nearby chart shows the performance of US, European and Japanese stocks from the end of 2008 to the end of 2017, showing by what extent the US stock market outperformed those in Europe and Japan. (The graph shows the indices rebased to 100 as of the end of 2008.)

Although it is not clear from the graph, in the last year, Japan and (especially) Europe outperformed US markets. Valuations of stock markets in Europe and Japan are more favorable than those here, corporate profits are robust and, as noted, their central banks are continuing their aggressive bond-buying programs, providing a tail wind for asset prices. Our expectation is that we will continue to hold substantial European and Japanese equities in the portfolios we supervise and that their returns will exceed those in the US.

One oddity of 2017 arose in currency markets, in which the US dollar fell in value against most Western currencies and the Euro rose quite markedly. This is odd in that currency movements generally (but not always) reflect differences in short-term interest rates. Thus, in 2017, when US short rates rose, while rates in Eurozone countries remained near zero, the rising Euro and falling US dollar proved an exception to the general pattern. Mr. Trump complained during his campaign about the strength of the dollar; perhaps he can take credit for weakening the dollar. Whether the dollar will continue its mild descent while other currencies strengthen is known but to the gods, and perhaps to Mr. Trump.

At all events, from us at Core, the best wishes to you and your family for a healthy, bountiful and peaceful 2018.

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