SPRINGWATER
WEALTH MANAGEMENT

Fourth Quarter 2017 Market Commentary

With Congress passing the broadest overhaul of the US tax code in three decades in late December, the stock market concluded 2017 near yet another all-time record. The benchmark S&P 500 index rose over 22% for the year. The broader Wilshire 5000 index was up 21%. The tech-heavy NASDAQ rose 27.2%.

The stock market was driven broadly upward by both actual and anticipated dynamics. Inflation remains low in historical terms. The US Labor Department indicated that inflation was 2.2% for the 12 months ending November 2017. Unemployment is also low, registering at 4.1% in December of 2017, according to the Bureau of Labor Statistics (BLS). Wages have not grown significantly since the Great Recession and remained flat when adjusted for inflation over the 12-month period October 2016 through November 2017, according to the BLS. Interest rates continue be very low, despite the Federal Reserve Bank raising rates 5 times since December of 2015. The last move, in December of 2017, brought the Federal Funds Rate to 1.25-1.5%. The biggest driver of the stock market's performance, however, has been corporate profits. The fertile economic climate helped US companies, led by NRG Energy, Align Technology, Vertex Pharmaceuticals, Wynn Resorts and Boeing, post strong profits throughout 2017.

The market was also fueled by anticipation. Investors are hoping the "The Tax Cuts and Jobs Act", which reduces the corporate tax rate to 21%, will spur US companies to buy equipment, raise wages and broadly invest in their operations. The legislation will also reduce taxes for many middle-class Americans, who are expected to spend more on goods and services. The Trump administration has promised to roll back regulations which it claims hinder businesses. The President will also roll out in January a promised infrastructure spending proposal. Such fiscal policy should spur the economy.

There are reasons to be cautious about the stock market. Many stocks are over-valued based on historical measures that relate a company's stock price to the company's historical or projected earnings. These "P/E" ratios suggest stocks may be significantly over-valued. When this occurs, the stock market almost always goes through a corrective period during which prices drop and valuations normalize.

Interest rates may be telling us that an economic recession is in the distance. The relationship between short- and long-term interest rates for bonds issued by the US Treasury is expressed graphically in a "yield curve", with yield on the vertical, or "Y", axis and maturity (length of the bond) on the horizontal, or "X", axis. In a normal interest rate environment, long-term interest rates are higher than short-term interest rates. So, the curve is convex, rising from left-to-right.

When short-term rates exceed long-term interest rates, the curve becomes "inverted." This is often a sign of a pending recession. While the yield curve is not currently inverted, it is flattening. Investors will be watching the yield curve carefully in 2018, as the Fed has indicated it plans to raise (short-term) interest rates 3 more times this year.

The US faces domestic economic challenges that may eventually threaten economic growth and, as a result, the stock market. The nation's debt is $20 trillion and growing. Congress continues to pass (tax and spending) legislation that produces chronic budget deficits. The deficit for the 2018 fiscal year is projected by some budget experts to be in excess of $1 trillion. Numerous economists and policy analyst have indicated that such deficits are unsustainable. Also, if the Federal Reserve decides that that economy is overheating in reaction to tax stimulus, tight labor markets and renewed inflation, it may alter course and raise rates more than expected. Such unplanned rate increases will not be well received by the stock market.

There are also geopolitical threats to the stock market that include the potential for conflict on the Korean Peninsula, tensions in the South China Sea, renewed conflict in the Middle East and the stand-off in Ukraine. Should any of these areas flare up, the stock market will inevitably react adversely. Terrorism anywhere in the world, but particularly in the US and Europe, has the potential to rattle the markets.

So, investors should remain vigilant. The general economic environment seems conducive to continued upward movement in the stock market. However, there are threats lurking beneath the surface which should not be ignored.

Benchmark Returns

For comparative purposes, the S&P 500 index (a proxy for large US stocks) returned +21.8% for the twelve months to December 31, and rose +6.6% in the fourth quarter.

The Russell 2000 (a proxy for small US stocks) returned +14.7% for the twelve months to December 31, and rose +3.3% in the fourth quarter.

The Wilshire 5000 index (a proxy for the broad US stock market) returned +21.0% for the twelve months to December 31, and rose +3.3% in the fourth quarter.

The MCSI EAFE index (a proxy for large international stocks) returned +25.0% for the twelve months to December 31, and rose +4.2% in the fourth quarter, as measured in USD.

Finally, the MSCI Emerging markets index returned +37.2% for the twelve months to December 31, and rose +7.4% in the fourth quarter.

In the fixed income segment, the Bloomberg Barclays US Aggregate Bond Index returned +3.5% for the twelve months to December 31.

Looking Forward

At Springwater, we continue to advocate a prudent, proven investment approach that is focused on controlling what can be controlled – asset allocation, diversification, taxes, expenses and, most importantly, emotions. Over the long-term, investors have historically been rewarded for taking stock market risk with higher returns. We see no reason to expect that this will not continue.

As always, we remain available to answer any questions or comments you may have, and committed to helping you navigate the periodically choppy seas of successful long-term investing.

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For those of you that are not already doing so, we encourage you to follow us on Twitter (at @SpringwaterWM) and/or on Facebook (at https://facebook.com/SpringwaterWealth/). We're conscious of the "information overload" that everyone faces these days, and by using social media we can share with you our thoughts, observations and ideas in the least intrusive manner possible.

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