

Congress Pulls a Rabbit out of Its Hat as the DOW Surpasses 25,000!

By Bob Deitrick, CEO

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Sixty days ago, the tide was not looking good for the White House or Congress with their tax bill. The prospect of tax legislation passing looked bleak after GOP candidates Ed Gillespie lost in Virginia and Senate candidate Roy Moore lost 4 weeks later in Alabama. Having said that, Congress pulled a rabbit out of its hat - not unlike Bob Gaudio of The Four Seasons who did the same thing in 1962. Gaudio pulled a rabbit out of his hat by writing the hit song, ***Sherry***, which took him 15 minutes to write. Originally Gaudio and Frankie Valli called the song "Jackie Baby" in honor of our first lady. In the studio, they changed the song to "Terri Baby", and then to ***Sherry***. The song was The Four Seasons first #1 single and was on the top of the Billboard singles chart for 6 weeks in the autumn of 1962!

Congress accomplished a major milestone and pulled a rabbit out of its own hat by passing their version of ***Sherry*** before Christmas. When the pros on Wall Street got back to work last week, they applauded by buying up stock. ***Last week was the best first week to a New Year since 2006.*** Moreover, we believe this trend continues through the year. This is a great start to the New Year as corporations are basking in the light of a tax cut, which will benefit affluent tax payers, small to large corporations and shareholders who benefit from stock "buy-backs".

Most importantly, our clients benefit from the new law as it keeps the bull cycle moving!

Nearly everything went right in 2017. The U.S. economy remained in a moderate expansion mode with low inflation while the global economy improved and showing greater growth for the first time in 5 years. ***Last March, in two newsletters, we conveyed to our clients we expected a breakout year for equities might take shape - and that is precisely what happened.*** The equity-friendly environment caused stock prices to increase every month for the first time in history. International equities provided strong returns also – especially the emerging markets. Other risk-asset classes, like high yields and floating rate bonds experienced solid returns also. Overall, 2017 was a solid year for the markets.

The lead story of 2017 was the resilience of the American consumer and the never-ending string of positive earnings surprises, which were followed by upward revisions. Memories of the Great Recession kept the bears alive, but their argument is weaker today than ever before in our view. ***U.S. equity valuations are moderately high historically. However, we believe valuations are reasonable today relative to other asset classes. Keep in mind, as Steven and I conveyed in November, bull markets don't die of old age or over-valuation.*** Something negative must be the catalyst for a downturn, and those negative factors, like higher inflation and interest rates are absent going into 2018.

Steven and I portend a favorable year for equities this year and here are 7 reasons why we believe this to be the case:

U.S. real GDP will reach a nominal rate of 5%.

The negative impacts from the Bush financial crisis of 2008 are gone. The strength of the American consumer combined with a significant corporate tax cut should lead to a return to normal growth. ***In late 2017, GDP rose above its pre-recession level. In the past, this has been the catalyst to an average of four to six years of economic expansion.***

Global expansion continues with fewer countries in recession in the History of the World.

Unemployment is at the lowest level in 50 years. Wage growth highest since the Recession. We expect unemployment to fall modestly in 2018, dropping below 4%. Keep in mind, full employment is ~ 3.5% so there is not much room to go here. We saw wages starting to rise late last year and expect that trend to continue as a shortage of trained workers, strong corporate profits, and favorable corporate conditions manifest.

The 10-year Treasury yield will approach 3% again for the first time since 2014.

Interest rates will increase in 2018, with a modest pickup in inflation. We expect to see a flattening yield curve as the Fed raises rates faster than the curve moves up in yield, but a flattening curve is not a good predictor of equity prices. Consider these facts: ***During the last major bull cycle during the Clinton years, the 10-year treasury yield ranged from 4.7% - the low in January of 1999 - to a high of 6.65% when Clinton entered office in January of '93... So, we are not worried about interest rates hovering under 3% today.***

We did NOT have a correction at all last year, is there one in store for 2018?

The short answer to that question is yes. While Steven and I expect a good year and this bull market to become the longest in history, we do expect 2018 to be a bumpier ride than 2017. Solid earnings, benign inflation and a major tax cut are the foundation for our cheerful outlook. Keep in mind *that corrections in the market are healthy, so when one happens, it's not time to panic, instead, it's a time to reflect on how well things have gone over the past 8.5 years.*

Equities beat bonds for the 7th consecutive year for the first time in a century.

From 2012 to the middle of 2016, stocks outperformed bonds even though bonds did well. We believe this trend continues as interest rates rise this year which will put pressure on interest sensitive assets like quality corporates and treasuries. A major decline in equity prices is unlikely as growth continues and earnings improve.

Telecom, technology, financials, health care, pharma and biotech should outperform utilities, energy and possibly materials.

As Charles Howard, business magnate, top Buick salesman and the owner of the thoroughbred Seabiscuit might have said: ***This isn't the finish line, the future is the finish line and tech is the future.*** The tech sector features companies with strong earnings and solid balance sheets so it will likely outperform. Health care is well positioned demographically among the defensive growth sectors. We believe telecom will be an outperformer as it was out-of-favor last year and is poised for a comeback. Utilities have poor growth prospects with higher interest rates, while the sectors of energy and materials are expensive. However, if Congress gets an infrastructure bill passed in 2018, that will change the outlook for these sectors. ***We believe active management may beat passive management in the coming year.***

Please call us to review any questions or thoughts and to set up your next review this quarter, if you would like. We will have seminars on the new tax law and its' impact on you, sometime in late-March or April. ***We wish you and your family a Happy and Prosperous New Year and Steven and I look forward to seeing you soon.***

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