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WEALTH MANAGEMENT

2018 Investment Outlook: Good, but Not as Good

How many times have you gone to the theater to see your favorite movie's sequel only to be a bit disappointed? Even when I can appreciate the new movie, I'm left feeling that it did not capture the magic of the original. Still good, but not as good.

I expect something similar when we compare 2018 to 2017. While 2018 will have a difficult time living up to 2017's stellar returns, we believe the markets should still have a more-than-decent showing. Central to this generally optimistic view of the markets is our expectation that the global economy is fairly healthy. Broad-based synchronized growth, which began in 2017, should continue into 2018 and deliver real gross domestic product (GDP) growth of 2.7% in the U.S. and 3.8% globally. With that growth, financial markets should be positioned to deliver a solid year of returns.

There are several themes that will help shape the markets and our strategic investment positioning in the coming year.

Global Monetary Normalization

After a decade of extraordinary measures to stimulate the economy, the Federal Reserve (Fed) has taken the lead on removing monetary stimulus from the global monetary system. Although the Fed has achieved part of its dual mandate, with unemployment hitting 4.1%, inflation is still below its long-term target of 2%. The Fed should continue to be patient in its timing of raising rates, with three projected rate hikes likely in 2018. In contrast, other central banks, such as the European Central Bank (ECB) and the Bank of Japan (BOJ), are projected to remain accommodative throughout most, if not all, of 2018. The ECB has indicated that it will reduce its bond-buying program, but extends it through late 2018. Meanwhile, the BOJ has added to its purchases while keeping rates at zero.

Fiscal Stimulus

As monetary policy begins to normalize, fiscal policy should help spur growth. At this late stage in the economic expansion, we expect the newly-passed U.S. tax bill to have a greater impact on corporate profits moving forward than on overall economic growth. Most domestic companies will benefit from the cut in corporate taxes, whereas the uptick in consumer spending will likely be more modest.

We will be closely monitoring the hand-off between monetary stimulus to fiscal stimulus (tax cuts, infrastructure spending, etc.) and its influence on the ultimate pace of Fed tightening. While we are only anticipating the tax legislation to provide a modest boost to U.S. growth, a faster-than-expected pickup in economic activity may put additional pressure on the Fed to raise rates at a faster pace than current consensus suggests. While this is not our base case, we will continue to monitor the situation closely throughout 2018.

Inflation and Rates Drift Upward

Inflation remained muted and below the Fed's 2% target throughout 2017. While one should never turn their back on inflation, we expect it to only drift modestly higher in 2018, held down by demographic trends and technological advances. This should lead to only modestly higher interest rates, allowing the Fed to continue to tighten monetary policy gradually. As a result, the yield curve should continue its flattening trend, led by the short end of the curve, while long-term rates should remain tethered to low interest rates globally.

Yield Curve Dynamics

The shape of the yield curve is a closely watched economic indicator with broad market ramifications. The shape is often measured by the spread between the two-year and 10-year Treasury note yields, which fell from 1.28% to 0.52% by year-end. Historically, an inverted or flat yield curve (one in which short-term yields equal long-term yields) has been a precursor to recession. The resulting flattening of the yield curve has thus caught many industry experts' attention. While we expect additional flattening of the yield curve in 2018 to be the most likely outcome, we will be monitoring the curve's shape throughout the year to determine what signals it could be sending regarding the economy. However, we do not anticipate a negatively sloped yield curve or recession in the next 12 to 18 months.

Increased Dispersion

Correlations among stocks (the degree to which the price of stocks moves together) are near 10-year lows. The combination of low correlations and rising interest rates historically has been supportive of active managers' ability to identify winners versus losers. We believe 2018 will continue to offer a strong backdrop for active management, a continuation of a trend we saw in 2017. Security-selection opportunities will also be prevalent across asset classes including bonds and alternative investments.

Earnings-Driven Equity Gains

In 2018, we expect global equity gains to be driven by earnings growth in light of a pickup in economic growth. Given our expectation that tax reform will lift profit levels, we estimate operating earnings for S&P 500 companies will range between $150 and $155. With the backdrop of slightly rising interest rates, we expect little in the way of P/E expansion, or the amount investors are willing to pay for earnings. We believe, however, that a strong earnings backdrop will more than offset a flat-to-even, slightly declining P/E multiple, resulting in moderate equity gains for 2018.

The new tax legislation helps support our domestic equity bias with an overweight to small and mid cap stocks. Global diversification also remains important in light of synchronized growth and earnings momentum, with exposure to international developed large and small cap stocks and emerging markets. Although we expect more modest equity returns and perhaps a bumpier ride in 2018, we continue to believe the path of least resistance for global equities is higher.

Market Volatility/Geopolitical Risk

After unprecedented calm in the markets and impressive equity returns in 2017, it is easy for investors to have high expectations. However, it's important not to assume the continuation of this trend, as we are likely to see volatility move back toward its historical average in 2018. There is the potential for negative surprises to exacerbate volatility in the year ahead. Several events that may result in market volatility include further tensions with North Korea or faster-than-anticipated policy tightening that derails growth or political uncertainty, to name a few. While we do not see these headwinds derailing this bull market, we continue to recommend the incorporation of fixed income, alternative investments and customized hedging strategies into a well-thought-out investment portfolio in order to help buffer pullbacks.

Conclusion

All things considered, we remain optimistic as we enter 2018. The coordinated pattern of growth across developed and emerging markets, still-accommodative monetary policy and a slight drift higher in inflation and rates should provide the foundation for smaller gains across financial markets. We continue to believe investors will benefit from a modest overweight to equities, an emphasis on yield within a diversified mix of fixed income holdings, and the inclusion of lower correlated investments. Equally important, we believe an active approach to security selection should be an important component of returns moving forward.

While 2018's financial markets may not live up to 2017's steady and stellar returns, just like most sequels, they should still be more than acceptable.

Jeff Mortimer