January 2018

Economic Comment and Market Outlook

The US equity market finished 2017 on a strong note, capping off an exceptional year marked by record highs and the lowest volatility in half a century. Robust corporate earnings and expanding global economic activity powered the market's steady climb. A successful end-of-the-year push to cut the corporate tax rate served as the icing on the cake and helped propel the S&P 500 to a total return of 21.8% for the year. For equity investors, 2017's performance provided solid confirmation of the bull market that has prevailed since March of 2009, a period during which the S&P 500 appreciated by a staggering 376%. Although 2017 will be a tough act to follow, equity markets enter the new year with strong tailwinds. With global growth firm, earnings robust, and monetary policy still accommodative, we expect the climate to remain favorable for our portfolio investments in 2018.

By many measures, 2017 was a banner year for the US stock market. It was the first year ever in which the S&P 500 posted positive total returns in all twelve months. The index began 2017 at the lowest value it would see all year and went on to record 62 new highs, versus its long-term average of 14 per year. Perhaps more remarkable than the consistency of gains was the lack of volatility that accompanied them. As of the end of the year, the S&P 500 had not experienced a pullback of 5% or more in 18 months, the second-longest streak since 1929, and the sharpest drawdown of the year was only 3%. There were only 8 days in the year in which the index rose or fell by more than 1%, making 2017 the calmest investment environment in 50 years. Newspapers may have been full of concerning stories, but those headlines did not seem to bother investors. Despite the coverage of Russian election meddling and brinksmanship over North Korea's nuclear weapons, the VIX Index, a measure of the market's expectation of near-term volatility, dipped to its lowest levels on record. Apparently, investors learned to ignore the noise and focus on the continued recovery in corporate earnings fueling the surge in equities across the globe.

For the first time in seven years, many foreign stock indices surpassed the performance of their US counterparts in 2017, aided by a modest decline in the value of the US dollar. Measured in local currency terms, the MSCI EAFE Index returned 15.8%, and the MSCI Emerging Markets Index returned 31.0% for the year. Those returns increased to 25.6% and 37.8%, respectively, when translated into dollars. Further emphasizing this point, even within the US market, globally-exposed businesses outpaced more domestically-focused ones for most of the year. The weaker dollar, while partly a reflection of political factors, mostly stemmed from strengthening economic performance overseas and anticipated changes in the trajectory of monetary stimulus from the world's central banks. Although the pace of economic activity in the US improved in 2017 relative to 2016, other countries saw greater upward revisions to their growth forecasts. Notably, Eurozone GDP grew 2.5% year-on-year in the third quarter, a level not seen since before the 2011 European debt crisis. Japan likewise enjoyed better-than-expected economic growth in 2017, with third quarter GDP coming in at 2.5% annualized. Overall, the International Monetary Fund expects that improved economic growth across most advanced and emerging countries pushed the rate of global growth up to 3.6% for 2017. This synchronous economic expansion in turn helped companies deliver on earnings, enabling equity returns to breakout in 2017. According to figures from Thomson Reuters, global merger and acquisition activity of $3.5 trillion remained at historically high levels, exceeding $3 trillion for the fourth consecutive year. Although last year's momentum will be hard to replicate, the broad-based expansion in economic activity and firmer commodity prices in the back half of 2017 suggest there is further room for the global economy to grow, which bodes well for equities in 2018.

The Federal Reserve lifted short-term interest rates three times in 2017 to a target range of 1.25%-1.5%, and in October began slowly reducing its holdings of Treasury and mortgage securities, continuing a very gradual exit from a posture of aggressive monetary stimulus. The two-year Treasury yield rose 69 basis points to 1.89%, paced by the increases in the Fed funds rate, but longer-term bond yields barely budged, with the yield on the 10-year Treasury note drifting down from 2.5% at the start of the year to 2.4% at year-end. The net effect was a pronounced flattening of the yield curve over the course of 2017. With minimal change in the level of long-term interest rates, the Barclays Aggregate Index of fixed income instruments returned 3.5% for the year. Jerome Powell has taken over from Janet Yellen as the head of the Federal Reserve, but all indications are that the institution will follow the same gradual course. Outside the US, policymakers in Europe and Japan also seem afraid to impair economic growth just as it gathers some momentum, so we expect global monetary policy to remain generally accommodative in 2018. As a result, longer-term interest rates should remain at low levels, supporting higher valuations for a variety of financial assets.

At the start of 2017, our expectations were for robust corporate earnings to support the market's advance, and the companies delivered. Last January we projected that S&P profits would grow 9% by year-end and that the typical Sarofim portfolio would achieve a higher growth rate of 16%. While fourth quarter numbers have yet to be reported, current estimates put 2017 S&P earnings near $130 per share, which is right in line with our expectations. S&P earnings growth was buoyed by a recovery in energy earnings, which quadrupled off a low base, and very strong performance by technology companies. The typical Sarofim portfolio now appears on track to exceed our original expectations, targeting a 17% rate of earnings growth in 2017. Therefore, while valuations did increase over the year, solid earnings growth accounted for most of the return for the Sarofim portfolio. Furthermore, some of the valuation increase may have been recognition that profits are likely to see another meaningful rise in 2018 on a mix of organic growth, lower corporate tax rates, and improved access to repatriated foreign earnings.

The impact of tax reform has occupied the minds of many investors in recent months. Ultimately, we believe a lower tax burden and the repatriation of foreign earnings will provide further support for an already solid fundamental backdrop. Prior to considering tax changes, we were expecting an 8% increase in S&P profits and another 16% for the typical Sarofim portfolio in 2018. We now believe tax reform has the potential to boost S&P earnings by $10 per share, or an additional 8%, bringing the index's profit increase for 2018 to almost 16%. While most observers often target smaller, more domestically-oriented firms as the biggest beneficiaries of this new law, our analysis indicates it will have a more positive impact on the typical Sarofim portfolio's earnings than on the S&P 500. We expect some of our holdings in the technology, media and entertainment, transportation, consumer, and financial areas to see significant benefits. Then, over the next several years, companies participating in more competitive industries are very likely to compete away some of these extra after-tax profits, passing the benefit to their customers or to the consumer, but we expect the pricing power and superior competitive positions of our portfolio companies to enable them to preserve a much greater portion of the increased levels of profitability.

Though the current bull market in the S&P 500 is just three months shy of its ninth birthday, many investors are only now reconsidering their reluctance to embrace the stock market. In our July 2014 letter we noted that equity allocations within institutional and individual investment portfolios had fallen significantly over the previous decade and that many investors had been missing out on the market's rebound after the Great Recession. As mentioned in a recent Barron's article by Andrew Bary, the large university endowments, commonly viewed as the "smart money," have maintained their emphasis on more illiquid, fee-laden alternative investment categories and eschewed US stocks. We believe most investors have followed this approach or something resembling it, which has significantly trailed the US equity market and even the traditional 60/40 blend of stocks and bonds for the past 3, 5, and 10-year periods of time. To finish on a similar note as that 2014 letter did, we remain confident in our ability to produce strong results, powered by the superior businesses in our clients' portfolios. Rather than view our primary activity as trading stocks, we always view ourselves as investing in businesses and thinking like owners. Demonstrating those beliefs, our firm and its principals are investing their savings right alongside our clients in those businesses. While we expect volatility levels to rise from what we experienced in 2017, we believe equity markets have the potential to continue their advance, supported by improving global growth, strong earnings results, tax reform, and accommodative monetary policy. We encourage you to contact us if you have any questions, and we thank you for your continued trust and confidence in Fayez Sarofim & Co.

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