ECONOMIC & MARKET REVIEW

Fourth Quarter 2017

The last quarter of the year was a good one for both the economy and markets. Equity and bond markets around the globe repeated their positive performance again to close out the year on a strong note. The S&P 500 finished its first perfect year EVER, as it had a positive total return every month of the year.

Fourth Quarter and Trailing 12 Months Performance

	4th Quarter	Last 12 Months
S&P 500	*6.64%*	*21.83%*
Russell 2000	*3.34%*	*14.65%*
Barclays Agg.	*0.39%*	*3.54%*
MSCI EAFE	*4.23%*	*25.03%*
MSCI EM	*7.44%*	*37.28%*

Source: FactSet, Cavanal Hill Investment Management. As of 12/31/2017

Synchronized global growth…now accelerating, continues to be the driving economic force around the world. In the U.S., first quarter 2017 growth was just above 1%, but growth improved as the year moved on. Second and third quarter growth moved above 3%, and estimates for fourth quarter GDP are above 2.5%. 2018 should bring GDP growth at 2.6%-3.0% for the year, possibly stronger. Global growth, aided by the U.S., will also be strong, especially in the Eurozone and Japan. The U.K. and Canada will see positive but slightly more modest growth rates. China has their own set of problems, but growth should be around 6.5%.

Consumer and business confidence have rebounded and continue to move dramatically higher and now are above levels reached just prior to the economic collapse in 2007. Leading indicators have accelerated higher; consumer spending is stronger, home purchases are up as are housing prices. Consumer net worth, relative to income has soared, thanks to rising home and equity prices. Corporate earnings were strong throughout 2017. Credit spreads have come down, indicating little stress on balance sheets. The unemployment rate fell in 2017 and ended the year at 4.1%, among the lowest unemployment rates over the last fifty years. Finally, regulatory relief hasn't received much attention, but I think it is yet another reason why the economy has improved.

Despite the clearly improved economic news, interest rates have been range bound. That's not to say they haven't moved up, but the increase in rates has been modest. The well-behaved interest rate market is certainly one of the most positive aspects of today's environment. To have improving economic growth, earnings growth, full employment and rates to remain low is a huge benefit. The Fed continued their now well-established pattern of small 1/4 point rate hikes through 2017. That pattern will continue in 2018, as the Fed has three additional rate hikes forecasted during the year. There will be a leadership change at the Federal Reserve in 2018 as Jerome Powell takes over as chairman from Janet Yellen. The overall Federal Reserve strategy will remain unchanged even though leadership will change.

On top of an upbeat economy and market comes a tax cut and other tax law changes, which will aid growth as we enter 2018. Corporate and individual tax cuts will go into effect January 1, 2018. Statutory corporate income tax rates go from 35% to 21%. The tax cuts are immediate and large, at $205 billion, and should help boost growth. At a minimum, the tax cuts would help to cushion the blow of any possible geopolitical shock, should one occur. In addition to the tax rate cuts, the law will allow for a lower tax on foreign earned profits and 100% expensing of capital expenditures. This will encourage companies to spend immediately to grow their businesses. The U.S. economy showed improved growth beginning in the spring of 2017. The tax plan should reinforce this growth pattern in 2018.

The tax cuts will be poured into an economy that is already improving. The unemployment rate is already remarkably low and should drop further. This brings the likelihood of higher wage growth and increasing inflation. Even if core CPI increases to an average of 2.2% for 2018, it would still be too low to negatively impact equity market multiples. The low real rate of inflation coupled with low volatility is set to continue into 2018. This is something to watch closely though. Finally, it’s a very good environment for the U.S. and international economies and I expect the bull market to continue.

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Disclosures

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