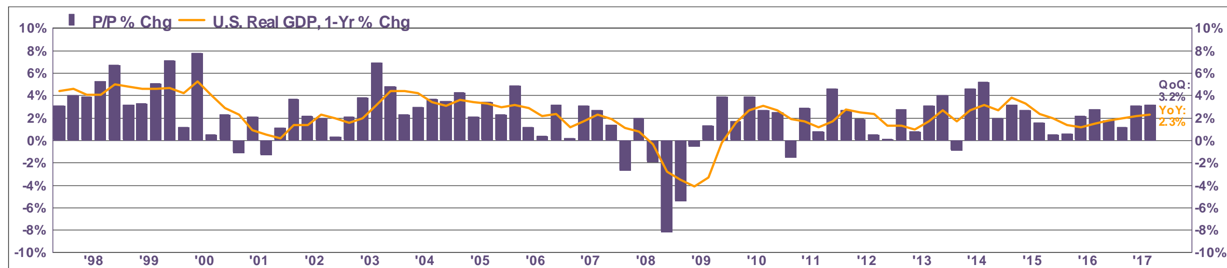
Overview

How does one best describe 2017? The Ultimate Reality T.V. Show? Or how about the title from the 1963 comedy movie it's a Mad, Mad, Mad, Mad World? Let's go with the title from the motivational book, The Power of Positive Thinking. Despite all the contentious and wonderfully entertaining drama from the U.S. political environment, significant increases in consumer confidence and business optimism resulted in the strengthening of the U.S. economy and frequently drove stock markets to all-time highs. The fundamental trends of the U.S. economy remain solid and in the near-term should continue to be supportive of further economic and corporate earnings growth. Given recent strong equity market performance, we will be reviewing portfolio asset allocations and rebalance accordingly.

The Economy

The U.S. economy strengthened in second and third-quarter 2017 posting annual growth rates of +3% and were driven higher by increases in business investment and consumer spending. This trend has continued into fourth-quarter 2017 evidenced by the Federal Reserve Bank of New York currently projecting a 3.9% U.S. GDP growth rate for the quarter. If fourth quarter GDP posts a +3.0% growth rate, it would mark the first time in almost thirteen years (3Q2004 to 1Q2005) in which there were three consecutive quarters of +3% growth.

Chart 1 – U.S. Real GDP



The phrase, "marks the first time since", or a derivation thereof, was quite common throughout 2017. Recent instances include: November unemployment rate of 4.1% marked the lowest rate since December 2000; consumer confidence reached a 17-year high of 128.6 in November; small business optimism rose sharply in November to a level of 107.5 which marked the highest level since July 1983; home builder confidence in December soared to its highest level (74) since July 1999; new and existing home sales in November reached their fastest annual sales pace in over ten years; and manufacturing activity in September marked its highest level (60.8%) since May 2004.

Chart 2- Small Business Optimism

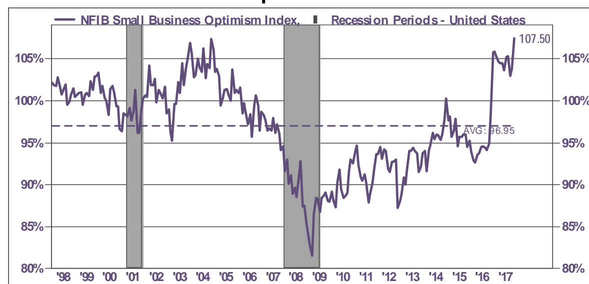
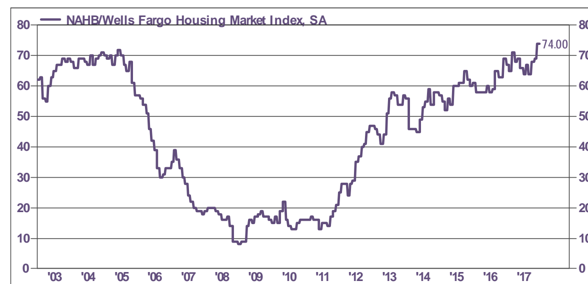


Chart 3 – Home Builder Confidence



Even though the pace of economic growth has accelerated, skepticism persists if this growth rate improvement can be sustained. Some economists contend tax reform, protectionist trade initiatives, and stricter immigration policies will lead to higher deficits, less global trade, lower earnings, labor shortages and tepid economic growth. Other economists argue that the combination of tax reform, lower regulations and improving global economies are the right ingredients for further business investment and expansion, job creation, higher wages and sustained moderate multi-year growth.

U.S. economic growth estimates have been on the rise as the Federal Reserve recently raised their 2018 real GDP estimate to 2.5% from 2.1% and FactSet's 2018 consensus estimate, which incorporates 70 economist forecasts, has risen to 2.5% from 2.3%. Longer-term calendar year projections have risen slightly so essentially economists are waiting to see the proof in the economic pudding before adjusting their longer-term outlooks.

Our position continues to be that the underlying strength in the economy should be supportive of moderate economic and corporate earnings growth into 2018, which is vital to sustaining current stock valuations.

Capital Markets

Heading into 2017, in anticipation of fiscal and regulatory policy changes, business, consumer and investor confidence was on the rise and this trend strengthened throughout 2017. In terms of quantifying the high level of investor confidence, look no further than the S&P 500 Index last year. The abeyance of volatility was pronounced as there were only seven trading days last year in the S&P 500 which saw a closing price movement greater than +-1%, which is very low by historical measures and indicative of investor complacency in taking on risk. This level of confidence and complacency, as well as improving economic and earnings growth, drove equity markets sharply higher for the year.

Table 1 – 2017 Equity Index Total Returns as of 12/29/2017

Equity	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
MSCI Emerging	3.59	7.44	37.28	37.28	9.10	4.35	1.68
NASDAQ	0.48	6.55	29.64	29.64	14.72	19.40	11.26
Dow Jones Industrial	1.92	10.96	28.11	28.11	14.36	16.37	9.28
MSCI Developed	1.61	4.23	25.03	25.03	7.80	7.90	1.94
S&P 500	1.11	6.64	21.83	21.83	11.41	15.79	8.50
S&P 400	0.22	6.25	16.24	16.24	11.14	15.01	9.97
Russell 2000	-0.40	3.34	14.65	14.65	9.96	14.12	8.71

Higher inflation was another anticipated theme heading into 2017. Post-election, the yield on the 10-Yr Treasury bond rose sharply rising from 1.78% on 11/4/2016 to 2.44% on 12/30/2016. Stronger economic growth and a tightening labor market were expected to lead to higher wages and overall higher inflation.

As 2017 unfolded, despite a stronger economy and labor market, inflation remained tame while the Federal Reserve continued to raise short-term rates. This resulted in a significant flattening of the yield curve as shorter-term yields rose and longer-term yields remained stable or lessened. The 2-Yr Treasury began the year at 1.26% and ended the year at 1.91% while the 10-Yr Treasury began the year at 2.44%

and ended the year at 2.43%. The yield curve flattening also impacted bond market returns as longer maturity bonds outperformed shorter maturity bonds.

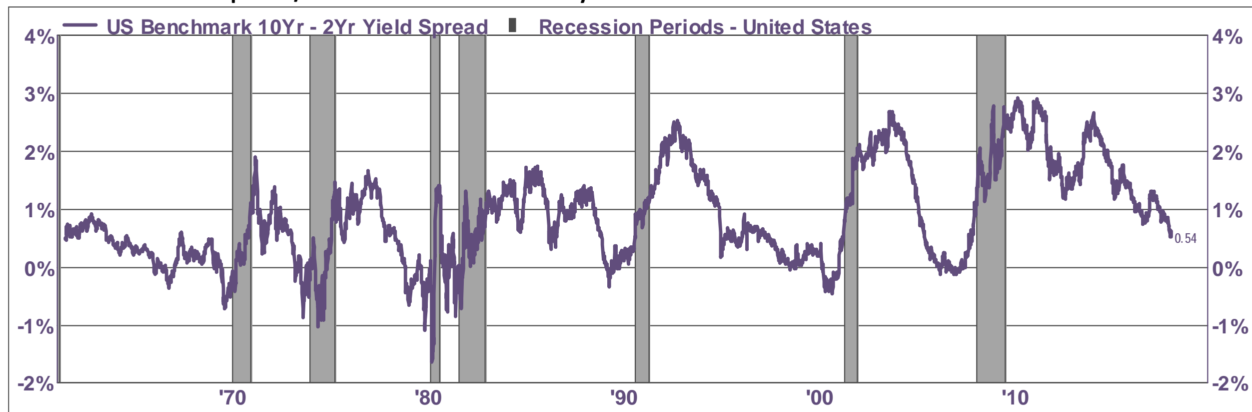
Table 2 – 2017 Bond Index Total Returns as of 12/29/2017

Fixed Income	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Barclays High Yield	0.30	0.47	7.50	7.50	6.35	5.78	8.03
Barclays Michigan Muni	1.08	0.86	5.59	5.59	3.18	3.28	
Barclays Municipal	1.05	0.75	5.45	5.45	2.98	3.02	4.46
Barclays Aggregate	0.46	0.39	3.54	3.54	2.24	2.10	4.01
Barclays Municipal 5-Year	0.46	-0.70	3.14	3.14	1.72	1.83	3.54
Barclays Inter Gov't/Credit	0.11	-0.20	2.14	2.14	1.76	1.50	3.32

Yield Curve

The Federal Reserve began raising short-term rates in December 2015, followed by another rate hike in December 2016, and three hikes last year. One primary issue entering 2018 is whether the Federal Reserve will continue to raise short-term rates and invert the yield curve. An inverted yield curve is when short-term rates are higher than longer-term rates and this is important as an inverted yield curve has preceded the last seven recessions.

Chart 4 – 10Yr to 2Yr Spread / Inverted Yield Curve History



Historically, the Federal Reserve raises short-term rates to slow down an overheating economy and curb higher inflation. After the Great Recession, the Federal Reserve held short-term rates extraordinarily low for an extended period to promote economic growth and this time the Federal Reserve is raising short-term rates to try and "normalize" them or bring them back up to a perceived neutral level without negatively impacting economic growth. Here is where it gets rather interesting.

In general, the Federal Reserve controls the short-end of the yield curve while inflation expectations control the long-end of the yield curve. Typically, longer-term yields have a positive "term premium", or a built-in inflation premium, as investors want to account for inflation risk. With inflation having been historically low for many years, there hasn't been much of a term premium.

Reading from the transcript of her last press conference, outgoing Federal Reserve Chair Janet Yellen, was asked if the Fed is complicit in the flattening of the yield curve and if they were worried they are making a policy mistake that could slow the economy? Chair Yellen stated the following exerts, "Now

there is a strong correlation historically between yield curve inversions and recessions, but let me emphasize that correlation is not causation, and I think that there are good reasons to think the relationship between the slope of the yield curve and the business cycle have changed; Well, right now the term premium is estimated to be quite low, close to zero, and that means that structurally, and this can be true going forward, that the yield curve is likely to be flatter than it's been in the past. And so it could more easily invert if the Fed were to even move to a slightly restrictive policy stance you could see an inversion with zero term premium."

Because of the extraordinary monetary policies enacted during the Great Recession, the Federal Reserve contends the relationship between the yield curve and the business cycle has structurally changed. Essentially meaning, in the absence of higher long-term inflation expectations (low term premium), they can raise short-term rates and invert the yield with limited economic impact. In other words, it's different this time. Funny thing about history, it has a way of repeating itself.

In December, the Federal Reserve projected raising short-term rates three times in 2018.

Asset Allocation

In terms of asset allocation, we maintain our neutral asset class weight for stocks and bonds. With stocks, we recently lowered our overweight international position back to neutral in anticipation of higher domestic corporate earnings. With bonds, we continue to maintain a slightly defensive interest rate position and, given tight credit risk premiums, favor higher quality credits. Finally, with the recent strong equity market performance, we will be reviewing portfolio asset allocations and rebalance accordingly.

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Sources: FactSet, Federal Reserve, Federal Reserve Bank of New York, U.S. Dept. of Labor, The Conference Board, National Federation of Independent Business, National Association of Home Builders, Institute for Supply Management, National Association of Realtors, U.S. Census Bureau, & Bureau of Economic Analysis

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