THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – DECEMBER

US Markets and Economy:

US stocks finished 2017 just the way they started it: going up steadily, and breaking records almost every month. All indexes set all-time highs in December. For the year, the broad-based S+P 500 Index climbed over 19%, even without including dividends. Both the NASDAQ Composite (up 28% for the year) and the Dow Jones Industrials (up 25%) did even better. In a sign that the long rally was not limited to large-cap stocks, the Russell 2000 Index of small-cap stocks rose a respectable 13% for the year.

Stocks were driven higher in December by the congressional passage of a massive tax cut bill, which will lower the statutory tax rate on corporate profits to 21% from 35%, putting the US more in line with other developed countries. Many American firms will thus see a significant increase in their after-tax profits. Multinational businesses, which have been parking billions of dollars abroad to avoid the 35% rate, will also have incentives to bring some of those profits back to the US at a more favorable rate. Taxes will also be cut for a variety of American individuals and households, in particular, those who do not itemize deductions and those who use “pass-through” business entities to channel their incomes. These tax cuts could further stimulate real economic growth, which in recent quarters has already picked up to the 3% range, near the top of what most economists think is the maximum rate the US economy can grow in the long run.

Faster economic growth could also drive up the rate of growth of corporate profits. Anticipation of these cuts, combined with steady growth in monthly employment, and a very low unemployment rate has driven consumer confidence to a very high level, which bodes well for consumption spending in 2018.

Another ¼-point increase in the Fed Funds rate in December did nothing to cool the enthusiasm for stocks. Monetary policy remains easy, with the real Fed Funds rate (nominal rate minus inflation) at around zero. The Powell Fed will raise rates gradually in 2018, which will mean at least another year of easy money, which is more fuel for the bull market. The only reason the Fed might “take away the punchbowl” faster is if inflation rises beyond the Fed’s stated target of 2%.
In December, the Fed’s chosen measure of inflation, the “core” PCE Index, remained well below 2%, giving the Fed more reason to keep short-term interest rates increasing at a leisurely pace.

Although it seems that the path of least resistance for stocks should still be upward, US stocks could hit “speed bumps” in 2018, set by either domestic politics or foreign affairs. In 2017, these led to brief and relatively mild selloffs.

**World Markets and Economy:**

European stocks again fell behind their American counterparts, with the EUROSTOXX 50 Index of blue-chip European companies down for the month of December. For a change, the index was not pulled down by British stocks, which have been languishing as Britain lurches slowly and uncertainly towards Brexit. For the month, the FTSE 100 Index rose over 5% to a new recovery high, even as Prime Minister Teresa May’s government searched for a Brexit strategy which the European Union will accept. The German market was weak in December, as Angela Merkel’s party prepares to begin talks in January on a coalition government with the more-liberal SPD party. This political uncertainty has offset the favorable news on economic growth in Germany, although the DAX Index still managed a respectable gain of 12.5% for the year. The rest of Europe is growing strongly, with Eurozone economic growth approaching 2%, the best in years. With ECB monetary policy still easy, the European outlook for 2018 is bullish.

Japanese stocks were essentially flat in December, but the gains for the year exceeded 19%. With monetary policy still very easy, and the economy growing steadily with positive inflation, Japan could continue to rally in 2018. The latest November economic data show an acceleration of growth, with both retail sales and industrial production up strongly for the month, and inflation running above zero, an accomplishment for an economy bedeviled by deflation. Japan may have finally turned the corner on its decades-long bout of economic stagnation.

**OUTLOOK:**

We are still in the strongest seasonal period for US stocks, with support for stocks coming from tax cuts, easy money, and more rapid economic growth around the world. January is historically an excellent month for stocks. Europe and Japan have joined the US party, so that all major world economies are growing at the same time. Political uncertainties aside, the long bull market in stocks should continue.