US stocks had a banner year in 2017, rising every month to all-time highs, leading to an annual gain of nearly 20% for the S&P 500 Index, a 25% gain for the blue-chip Dow Jones Industrials, and a monster 28% gain for the tech-heavy NASDAQ Composite. While stocks have generated these levels of annual returns in other good years, it is almost unprecedented to witness them after a nearly 9-year bull market, which is already the second longest in history.
The bull run took in the smaller stocks in the last half of the year, with the Russell 2000 Index of small cap stocks rising over 13% for the year to an all-time high. The only sector to lag badly was the energy sector, which lost ground for the year, although energy stocks recovered almost 20% from their lows at mid-year, as oil prices firmed up to $60 a barrel by year-end, the highest in several years. Increases were driven by OPEC output restrictions and growth in demand as the world economy expanded.

World economic growth was led by the United States, still the world’s largest economy, with US real GDP growth approaching the 3% level in the last half of the year. This strong performance, which helped increase US corporate profits (and thus stock prices), was driven by easy money policy at the Federal Reserve, a weaker dollar, which stimulates exports, and anticipation of much lower corporate taxes in 2018 as a result of tax reform, which was signed into law in December.

Looking first at US monetary policy, the Federal Open Market Committee (FOMC) did raise rates three times in 2017, although each increase was well-publicized in advance by members of the FOMC. The Fed also began, again with much advance notice, the gradual reduction of its massive holdings of long-term Treasury securities and mortgage bonds, which it had acquired as part of Quantitative Easing in the early years of economic recovery from the Great Recession. The bond market displayed superb confidence in the Fed by keeping long-term interest rates low while the “short-end” of the market rose with each hike.
of the Fed Funds rate. This confidence was not at all shaken by the decision to replace Janet Yellen as Chair of the Federal Reserve. The new monetary boss, beginning in February, will be Jerome Powell, who has consistently voted with Yellen (and before her, Bernanke) at all of his FOMC meetings. Other vacancies on the Board of Governors will be filled in 2018, and appointments so far suggest that there will be no sharp changes in monetary policy that might rock Wall Street’s boat.

Jerome Powell will certainly inherit the conundrum of macroeconomic policy: how low can the US unemployment rate fall without setting off inflation? Continued economic growth has driven the unemployment rate in the US to its lowest level in more than a decade (4.1%). With employment still growing steadily, the doctrine of the Phillips Curve suggests that wage inflation should eventually increase, as businesses have to increase compensation to fill a growing number of job vacancies. These wage increases are usually passed on in the form of higher prices to maintain profit margins. And yet price inflation remains quiescent, and is still below the Fed’s target of 2%. And wage inflation is also modest. It may be that this puzzle will not be solved in 2018, with another year of benign inflation, a falling unemployment rate, and steady growth in employment. This would be the ideal scenario for stocks, since the Fed would feel comfortable keeping interest rates low while the economy charges ahead. On the other hand, a pickup in inflation could force the Powell Fed to raise rates more quickly, which would create a headwind for stocks.
The weaker dollar in 2017 was somewhat of a surprise as many traders anticipated a strong dollar as interest rates rose faster in the US than in Japan and Europe. This did not happen, in part because Europe and Japan began growing faster, while the pace of US interest rate increases remained modest. The trade-weighted dollar fell almost 10% in 2017, in an almost straight-line decline. While official US policy for decades has been “we support a strong dollar,” a weak dollar stimulates US growth, since exports look cheaper to foreigners, while at the same time making imports look more expensive to Americans. This weak dollar helps US multinationals in particular, since their earnings in foreign currencies translate into greater earnings in dollars.

Yet the biggest driver for stock prices in the latter half of 2017 was the prospect of a large tax cut for business. This was achieved in December; for 2018, the statutory corporate tax rate was reduced sharply to a flat 21%. Multinationals (which have built up overseas profits to avoid the US taxman) will now be able to repatriate those profits at a favorable tax rate of as low as 8%. The Trump administration has argued that US firms will use those higher profits and repatriated funds to boost investment in the US, and employment and wages for US workers. Although this argument is controversial among economists, rising investment, employment, and wages would certainly stimulate US economic growth and provide further support for rising stock prices. There is no doubt that lower tax rates will boost corporate after-tax profits in 2018 and beyond, which is in itself a big positive for stocks.
Many American consumers will also get a tax cut in 2018, and this prospect supported consumer confidence throughout the year. High consumer confidence is associated with higher consumption spending, which accounts for 70% of US GDP. More confident American households also drove up new home sales in the US to the highest level in many years. This increase will spur even more new home construction, which in turn increases employment in the construction industry, driving economic growth higher.

The Trump administration has also aggressively pursued deregulation of many industries, which can also drive up corporate profits. For example, the banking sector, subject to intensive regulation after the Great Recession, may have many restrictions on it lifted in 2018. Even the energy sector, one of the poorest performing sectors in 2017, may face better prospects in 2018 as restrictions on both onshore and offshore drilling in the US may be lifted.
The few, and brief, periods of weakness in US stock prices in 2017 were tied to domestic and international politics. The small Republican majority in the Senate was unable to hold together and repeal the Affordable Care Act (known as Obamacare). The tax cut bill was passed with only Republican votes in the Senate, further dimming any hopes for bipartisan agreement in 2018. The small Republican majority got smaller when Alabama elected a Democrat to fill Jeff Sessions' vacant seat. The looming Congressional elections in 2018 will add an air of political uncertainty too. The continuing Mueller investigation also hangs as a cloud over the White House. (The plea bargain by Michael Flynn at the beginning of December briefly knocked stocks down sharply, although they recovered almost immediately.)

Internationally, the launching of an ICBM by North Korea in July 2017 unsettled markets briefly. While little is known about the intentions or the capabilities of North Korea (it has made apocalyptic threats against the US and South Korea for decades), threats and counterthreats from the US and North Korea continued through 2017, and will likely continue in 2018.

Almost all stock markets outside the US had strong years in 2017 too. The Japanese stock market, as measured by the Nikkei Index, rose 19%, to the highest level in more than twenty years. The increase was driven by sharply rising corporate profits, and extremely low interest rates, as the Bank of Japan (BOJ) continued its Quantitative Easing program. The Japanese economy has finally responded to the stimulus of easy money and easy fiscal policy, and has been growing steadily after decades of economic stagnation.

European stocks also had solid gains for the year. The blue-chip EUROSTOXX 50 Index gained over 6% in local currency, and this return was then tripled for US investors to 21% by an increase of over 14% in the value of the euro relative to the US dollar. This is of course a key
potential benefit of international diversification for American investors: any fall in the international value of the dollar drives up the return in dollars of stock prices denominated in foreign currency. Gains in Europe were led by Germany (up over 12% in local currency), with France gaining 9%, and Britain lagging with a gain of 7.5%. The German and French gains were magnified by the fall in the dollar versus the euro, and even the British pound rallied nearly 10% against the dollar in 2017. The relative weakness of British stocks was clearly a result of concern over Brexit, and the domestic political uncertainties which it has engendered. The best performer in Europe was Greece, with a nearly 25% gain for the year. Improving economic conditions in Greece allowed the government to issue new bonds to investors in 2017, which may signal that Greece will no longer need to rely on international bailouts. The Greek economy, however, is a long way from economic health, with unemployment still at 23%.

Smaller “emerging” markets also rose in 2017, led by a dramatic 77% gain in Argentina. Argentina’s President Macri has instituted economic reforms which have helped the economy grow rapidly. The gain in 2017 came on top of a 45% gain in 2016. (These gains, of course, come with the larger risks and higher volatility of emerging markets investing: in 2013, the Argentine market fell 40% in a matter of months, and in recent years, the international value of the peso has declined sharply.)

Hong Kong was another excellent performer in 2017, as its Hang Seng Index rallied 36% for the year. Investors should note, however, that the Hong Kong Index suffered a sharp decline in 2015-2016.

THE 2018 OUTLOOK

The US bull market in stocks will likely continue in 2018, although the steady rise of 2017 may not be replicated in 2018. Investors had essentially a free ride in 2017, with extremely low volatility for almost the entire year. It would be unlikely, although not impossible, for stocks to rise as smoothly in 2018. It is more likely that investors will have to “earn their stripes” in 2018 and ride out some volatility, much as they did in earlier years of this bull market. Corrections could appear at any time, and possible catalysts could be international instability (North Korea), or domestic instability (the Mueller investigation, the mid-term elections, or changes in US trade policy.) The US Federal Reserve could also give the markets pause if it unexpectedly raised short-term interest rates more quickly in response to an upward turn in inflation. Bull markets around the world are also likely to continue, with Europe and Japan both poised to show more rapid economic growth, combined with the continuation of very low interest rates.
About Dan Seiver:

As Chief Economist at Reilly Financial Advisors, Daniel enhances the firm's global macroeconomic approach and outlook, ensuring that all portfolios are managed within context of the global economy.

Daniel is a member of the Economics faculty at Cal Poly-San Luis Obispo, where he has taught Introductory Economics, Money and Banking, and Intermediate Macroeconomic Theory, and published his research in the Journal of Wealth Management. He was on the Finance faculty at San Diego State University from 2005-2013, where he taught International Business Finance, Investments, Personal Finance, and Managerial Economics. While at SDSU, he received the Finance teaching award in 2007, and the International Business teaching award in 2011. From 1978 to 2005, he was a Professor of Economics at Miami University (Ohio), where he taught ten different courses in economics, and had over 20 refereed publications in professional journals. He also coauthored an MIT Press book on regional economic policy, and a Probus/McGraw-Hill book on investment strategy. Daniel was a consultant to the Center for Naval Analyses, and the investment adviser to the Population Association of America for many years.

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