Retirement Income Solutions

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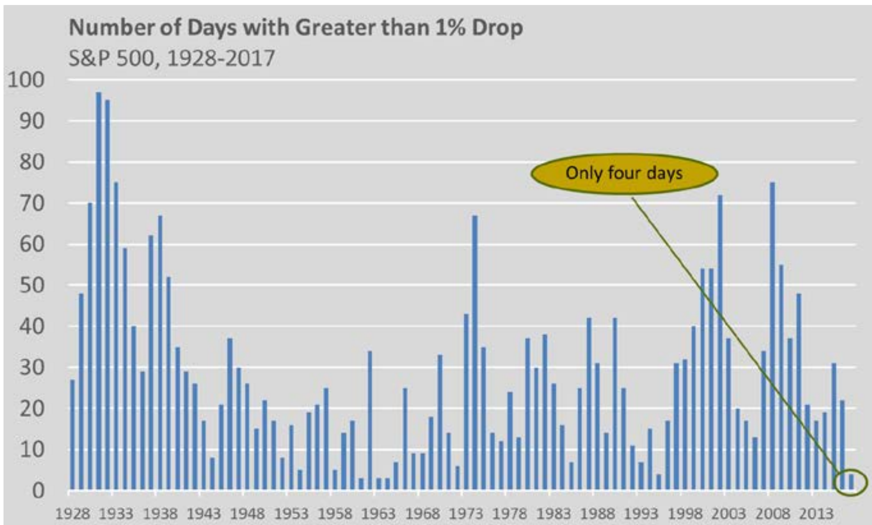
2017 was a Banner Year – Look for a More Normal 2018

February 2018

Summary

The U.S. stock market posted a strong 2017 with returns of almost 22%. U.S., international, and emerging stock markets were all substantially higher in the same year for the first time since 2012. The risk of change from the inauguration of a new President went unnoticed by markets. Perhaps the most interesting aspect of the year was record low volatility.



- ✧ **Stock markets were unnaturally calm.** The stock market fell by more than one percent only four times throughout the year. Such a low number of swings occurred only six times since 1928. Markets overlooked a challenging political environment (concerns over North Korea, uncertainty with U.S. tax reform, the potential for government shutdowns, etc.).
- ✧ **The maximum drawdown in the U.S. in 2017 was only 2.8%!** 2017 was the only year in history that did not see a pullback of 3% or greater. World stocks advanced in every month of the year for the first time in history (the All Cap World Index began in 1988).
- ✧ **The current economic expansion is the second longest in history at almost nine years.** If the expansion that began in 2009 continues until April, it will become the second longest in history (only surpassed by the technology revolution of the 1990s).
- ✧ **Late cycle expansions tend to be strong.** According to BCA Research, "…the 7th and 8th innings of business-cycle expansions are often the most profitable for investors. The S&P 500 has delivered an average annualized real total return of 14.2% since 1950 in the 13-to-24 months prior to past U.S. recessions."
- ✧ **Rising interest rates will be important to watch** but should not weigh on markets if the pace of increases continues to be moderate.

While 2017 was unnaturally stable, a more normal year should follow in 2018. It is unlikely that a recession occurs in the near term, but markets should return to a more common pattern where positive advances are followed healthy pullbacks. Historically, 5% corrections occur every 2.5 months, and 10% corrections occur every 9 months. A more normal year means swings of at least that magnitude are likely. Currently, client portfolios remain at their maximum equity exposure.

The Year in Numbers

2.8 In 2017, the maximum drawdown in U.S. stocks was 2.8%. Analyzing corrections back to the 1920s, the median drawdown was over 13%, almost five times larger than 2017.

3 The Federal Reserve raised interest rates three times in 2017 and is expected to raise the Fed Funds rate another three times in 2018.

4 The stock market fell by over 1% only four days during the year. Such low volatility is rare; only six other years since 1928 has seen less than five days of 1% drops.

18 It has been 18 months since a 5% pullback occurred. The only longer period was in 1958-1959.

22 U.S. stocks (the S&P 500) gained 22% for the year.

37 Emerging markets posted their strongest year since 2009 with a 37% gain.

103 The U.S. economy has avoided a recession for 103 months, which is currently the third longest economic expansion.

24,000 The Dow hit 20,000 for the first time in January 2017 and then hit 24,000 for the first time in November 2017.

Investment Returns

2017 was a solid year for stock investors. U.S. stocks were up 22% over the year – the strongest year since 2013. International and emerging market stocks performed well, posting returns of 26% and 38%, respectively. It was the first year since 2012 when all three equity indices posted double-digit returns.

Investment Returns

As of December 31, 2017

	2017	2016	2015
All Country World Stocks	24.6%	8.5%	-1.8%
S&P 500	21.8%	12.0%	1.4%
Dow Jones Industrial Average	28.1%	16.5%	0.2%
Small Caps	14.6%	21.3%	-4.4%
International	25.7%	1.6%	-0.3%
Emerging Markets	37.7%	11.8%	-14.6%
Bonds (Barclays Aggregate)	3.5%	2.6%	0.5%
U.S. Treasury Bonds	2.6%	1.1%	1.6%
Commodities	5.8%	11.4%	-32.9%

Source: Bloomberg

Also important in 2017 was that interest rates ended the year where they started, despite a strong economy and stock market. Most investor portfolios include a balanced mix of stocks and bonds as a stabilizer and hedge against challenging equity environments. The average high-quality bond earned 3.5%, and U.S. Treasury bonds posted slightly lower returns of 2.6%. Commodities returns were a modest 5.8%.

Unnaturally Calm Year Sets Records

Stock market returns for the year were strong with returns of 22%, but the most impressive characteristic was the stability of the advance. U.S. markets set record highs, and the maximum drawdown in stocks throughout 2017 was only 2.8%.

- World stocks advanced every month in 2017, which is the first year without a single monthly decline since 1988.
- U.S. stocks went a full calendar year without a 3% pullback. This has not occurred in the history of U.S. stocks (data goes back to 1928).
- U.S. stocks have gone over 18 months (June 2016) without a 5% pullback. The only longer period in history was in 1958-1959.

While the low volatility does create a sense of security, it can only last so long. It seems likely that 2018 will return to more normal volatility in equity markets. In the short-run, any pullbacks would be viewed as buying opportunities.

The return of volatility would also signal the return of a more normal business cycle. The swings of the economy have been muted due to monetary policy actions by central banks around the world. Central banks in the U.S., Japan, and Europe pumped money into the global financial system after the crisis, which served as a tailwind to stock and bond returns and calmed markets. One would expect that the removal of that stimulus would then become a headwind for the markets. The extraordinary measures that those banks employed had never been tried before; therefore, the process of unwinding them is also unprecedented.

Third Longest Economic Expansion

It has been nine years since the financial crisis in 2008-2009. The subsequent economic expansion has lasted 103 months, the third longest period of growth in history. By March, the expansion will be the second longest in history. The only longer period was during the 1990s when companies like Dell, Microsoft and Intel created the technology revolution.

In some ways, it seems odd that the lackluster recovery from the financial crisis has not resulted in another recession in recent years. However, a combination of a friendly Federal Reserve and a slow but steady economic advance have maintained a relatively stable environment. Despite many of the worrisome aspects of the economic, political and social environment in recent years, there have only been four corrections exceeding 10% in the past nine years: in May 2010, markets fell by 16% due to the Greek debt crisis; in the summer of 2011, markets fell by 19% due to the European debt crisis; in August 2015, markets fell by 12% due to turmoil in oil markets; and in January 2016, markets fell by 13% due to weakness in corporate profits.

Economic Expansion Following Recession

1929-2017

Recession Date	Length of Subsequent Expansion	Stock Returns During Expansion
AUG '29 – MAR '33	50	234%
MAY '37 – JUN '38	80	71%
FEB '45 – OCT '45	37	14%
NOV '48 – OCT '49	45	90%
JUL '53 – MAY '54	39	86%
AUG '57 – APR '58	24	36%
APR '60 – FEB '61	106	94%
DEC '69 – NOV '70	36	35%
NOV '73 – MAR '75	58	60%
JAN '80 – JUL '80	12	13%
JUL'81 – NOV '82	92	242%
JUL '90 – MAR '91	120	309%
MAR '01 – NOV '01	73	44%
DEC '07 – JUN '09	103*	245%
AVERAGE	**59**	**112%**

Source: NBER, Bloomberg

Indicators to Watch

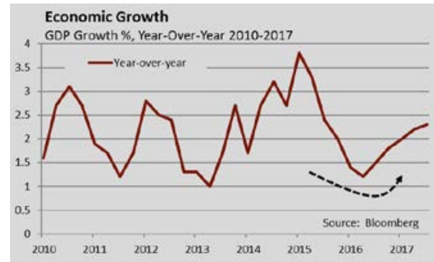
Could the economic expansion continue for 18 more months to become the longest period in history without a recession? Could the stock market exceed returns generated in the 1990s during the technology revolution? It is hard to know for sure, and there is a general nervousness about how long the good news will last. The environment today is very different than that of the 1990s, but the market has been quite resilient over the last year. It is difficult to speculate on how long the market can run; however, there are many indicators that can provide insight into whether the underlying health of the market is changing. Most indicators are still positive today. A few of those indicators and concerns are listed below:

Concern / indicator	Assessment	Comment
Are stocks too expensive?	Neutral	Stocks are expensive by several valuation metrics; however, when viewed in comparison to bonds, the potential return relative to bonds is still favorable. If bonds are expected to earn 1-3% over the next five years, then the risk/return characteristics associated with stocks may be more compelling.
Can corporate earnings continue to grow?	Favorable	Corporate profits recovered strongly after weakness in 2015-2016. Even if double-digit gains are not achieved in 2018, profit growth should be a positive for stocks. New tax legislation should provide a tailwind for profits as well.
When will unemployment signal a warning?	Favorable	As demonstrated in the October commentary, an uptick in unemployment can be an early recessionary warning. Unemployment continues to fall (from 4.7% a year ago to 4.1% in December). No warning signals yet.
Is inflation a concern?	Favorable	A tight labor market should increase wage pressures and thus inflation, but that is not yet reflected in the wage data. Higher inflation seems likely but not yet at a concerning level.
When will rising rates become punitive to the economy?	Favorable	The Fed has raised interest rates five times over the past two years. Rates are still low, and the pace of increases is still friendly, but a combination of three more rate increases in 2018 and increased concerns about inflation would likely create less favorable conditions.
Can the market have another positive year?	Favorable	Stock returns tend to be favorable following a strong stock market year as long as a recession is more than a year away. See subsequent analysis of late cycle bull markets on page 6.
Are investors too optimistic?	Unfavorable	Some of the most concerning data relates to investor complacency, which is a contrary indicator. Consumer confidence is at the highest level since 2001. Confidence can stay at an extreme for an extended period, but overconfidence can lead to negative surprises.

Stocks are expensive by many measures…

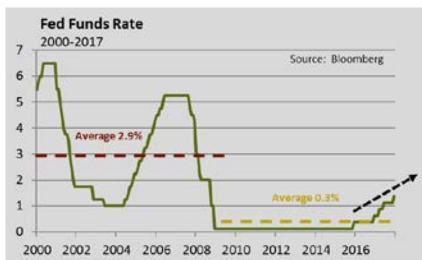
But profits have recovered from 2015-2016 lull…

And economic growth is stable and positive…



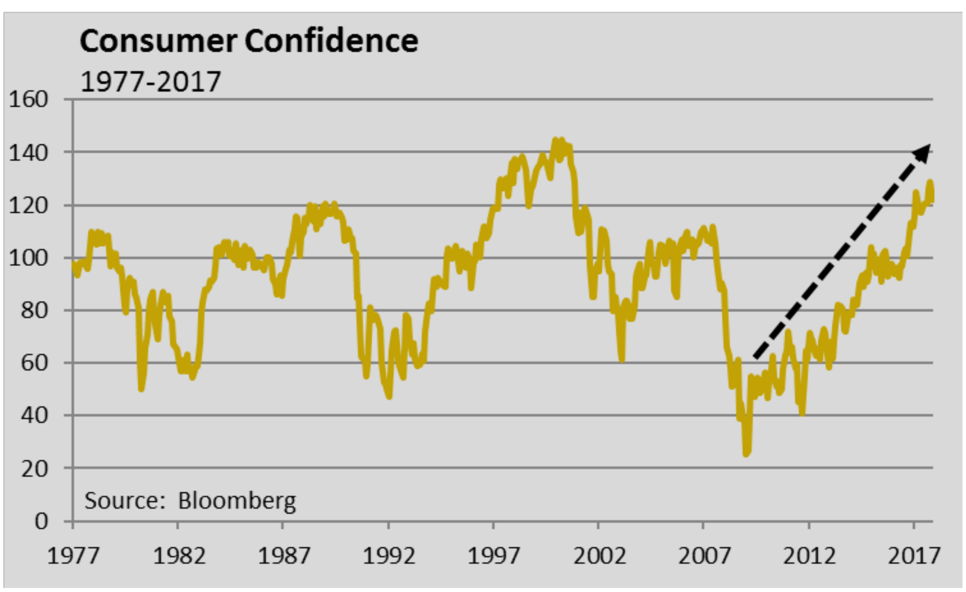
Low unemployment is good, but a reversal (not an issue yet) may signal recession…

Fed controlled interest rates are still low. At what level do they become punitive?



Inflation is rising but just recently to target levels…

The biggest concern today is excessive optimism and investor overconfidence. Although most economic data is positive, investors are becoming complacent and vulnerable to negative surprises.



Late Cycle Expansions Can Be Strong For Stocks

As discussed in previous commentaries, stock market pullbacks associated with recessions are the most damaging. Seven of the last nine bear market declines (those over 20%) were associated with recessions. It is also important to note that markets typically identify a recession before it happens. The lag between market peak and recession start is roughly 7 months. As the bull market matures, it will be important to monitor recessionary indicators.

Stock Returns & Recessions

1950-2017

Recession Date	S&P 500 Peak (months from recession)	S&P 500 Trough (months from recession)	Peak-to-Trough Decline
JUL '53 – MAY '54	- 7 mos	+1 mos	-12.5%
AUG '57 – APR '58	-13 mos	+4 mos	-20.3%
APR '60 – FEB '61	-9 mos	+6 mos	-12.1%
DEC '69 – NOV '70	-13 mos	+6 mos	-38.3%
NOV '73 – MAR '75	-11 mos	+10 mos	-53.8%
JAN '80 – JUL '80	0 mos	+2 mos	-18.2%
JUL'81 – NOV '82	-8 mos	+12 mos	-29.9%
JUL '90 – MAR '91	-2 mos	+3 mos	-20.9%
MAR '01 – NOV '01	-7 mos	+18 mos	-50.4%
DEC '07 – JUN '09	-2 mos	+14 mos	-56.1%
AVERAGE	**-7 mos**	**+8 mos**	**-31.2%**

Source: BCA Research

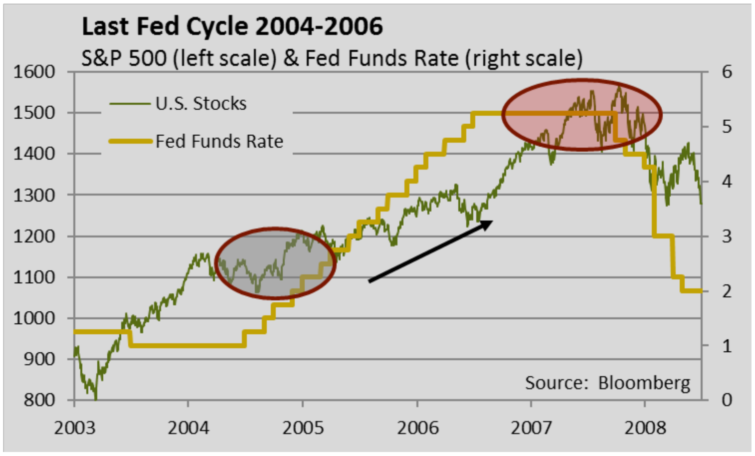
Since it has been so long since the last recession (2008-2009), it seems especially worrisome that a recession could bring a bear market in the near term. This is a concern, but most recessionary indicators are not yet showing warning signs, and often the strongest market returns occur at this point in the cycle. According to BCA Research, "In fact, history suggests that the 7th and 8th innings of business-cycle expansions are often the most profitable for investors. The S&P 500 has delivered an average annualized real total return of 14.2% since 1950 in the 13-to-24 months prior to past U.S. recessions." If the next recession does not occur until 2019-2020, then stock returns should continue to be positive in 2018.

	Stock Returns # Months Prior to Recession		
Recession Date	13-24 months	7-12 months	1-6 months
JUL '53 – MAY '54	21.9%	17.8%	-13.8%
AUG '57 – APR '58	15.8%	-17.0%	13.9%
APR '60 – FEB '61	31.3%	6.6%	-2.2%
DEC '69 – NOV '70	13.4%	-11.0%	-20.7%
NOV '73 – MAR '75	16.9%	-11.3%	-2.7%
JAN '80 – JUL '80	0.5%	6.8%	4.0%
JUL'81 – NOV '82	…	32.2%	-11.2%
JUL '90 – MAR '91	14.3%	22.2%	1.6%
MAR '01 – NOV '01	8.9%	20.0%	-40.6%
DEC '07 – JUN '09	11.6%	13.6%	-6.3%
AVERAGE	**14.2%**	**8.0%**	**-7.8%**

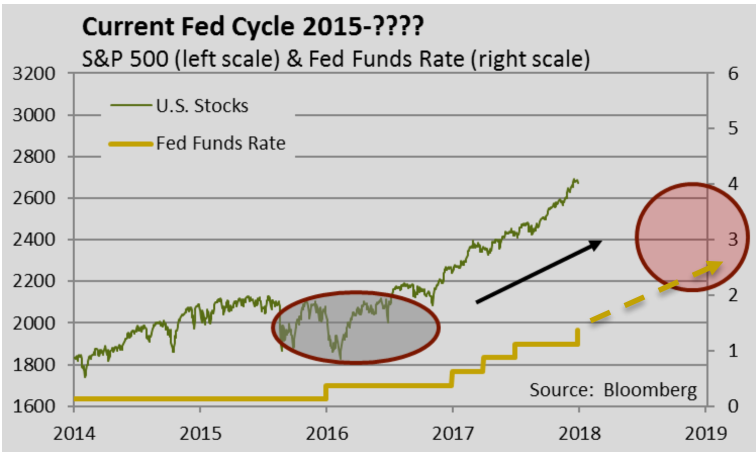
Source: BCA Research

When do Rising Rates Become Punitive for Stocks?

The cost of borrowing (interest rates) impacts economic growth and financial markets. The Federal Reserve has been raising interest rates for two years, which raises the question, "when do rising rates become punitive for the stock market?" Every market cycle is different, but the last Fed rate hiking cycle from 2004-2006 can be a rough guide for how markets react to rising rates. The cycle can be broken into three phases.



In the last Fed rate cycle (2004-2006), rates were raised 17 times over three years. Short-term interest rates hit 5.25% in 2006. Phase 1: It took the stock market six to nine months to absorb the initial increases in the Fed Funds Rate. Phase 2: After markets determined that the economy could handle rising rates, stocks advanced nicely (28% over 2 years). Phase 3: In late 2006, interest rates became too high and restricted economic growth, and stocks fell in response.



In the current Fed rate cycle (2015-????), rates have been raised five times over two years. Short-term interest rates are still below 1.5%. Phase 1: It took the stock market a year to absorb the initial increases in the Fed Funds Rate. Phase 2: After markets determined that the economy could handle rising rates, stocks advanced nicely (33% over 18 months). Phase 3: Interest rates are still low in historical context and compared to the prior cycle. Expectations are for three rate increases to just over 2% in 2018, but those rates are still relatively low (and well below the prior peak rate in 2006). If the Fed raises rates significantly faster than expected in 2018, markets could stumble somewhat. Low rates obviously do not guarantee good stock returns, and stocks could falter for other reasons; however, rates need to rise further before they negatively impact stocks.

Summary

Stocks should outpace bonds over the next three to six months, and odds of a recession are low in the near term. With central bank support gradually ending, and the potential for increased inflation, increased volatility is to be expected. On average, the stock market suffers a 10% drop every nine months. Although 2018 can be a positive year, the smooth sailing of 2017 is unlikely to continue. The return of a more normal business cycle is a healthy sign, but it will take a while for investors and financial markets to become confident the economy is strong enough to continue with less support from the Fed and other central banks.

If you have questions on the investment environment or your portfolio, please call us at 734-769-7727. To find an electronic copy of this document and other recent commentaries, please visit our website at www.risadvisory.com.

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