A continued solid economy along with the anticipation of the passage of a tax reform package continued to propel the market further this past quarter. Following up on stellar market performance during the first three quarters of the year, 2017 was a great year for stocks. In fact, pretty much all areas of the equity markets finished the year significantly higher than where they started. After a number of years of disappointing performance, we also saw a resurgence of international equities in 2017. Generally, bonds also saw positive returns in 2017; but of course, their returns were quite muted compared to stock returns.

The Economy

The US economy remains quite strong, with its upward trend intact. As various headwinds in the form of political infighting and geopolitical tensions continue to be obstacles, economic data in many segments remains on a solid trajectory. The Bureau of Economic Analysis reported its third estimate of third-quarter 2017 gross domestic product (GDP) of 3.2%, down slightly from the prior estimate, but a notch higher than the second quarter’s 3.1% reading. The employment situation also made gains, with an average of approximately 170,000 jobs added each month. At the same time, the unemployment rate remained steady at 4.1%. The Federal Open Market Committee (FOMC) modified its interest rate policy by raising the federal funds rate target by 0.25% to a range of 1.25% - 1.50%. Economists expect multiple increases in 2018 as the economy encounters wage pressures.

The global economic environment has benefited from increased demand as well as accommodative monetary policies. The Eurozone economy grew at a 2.6% annual rate in the third quarter, continuing a positive trend begun early in the year. One of the key drivers in the Eurozone was solid domestic demand. Japan is among the Asian economies faring well, posting a seventh consecutive quarterly expansion, its longest streak since
2001. China continues to balance instituting economic reforms with maintaining robust growth, with economists expecting the country’s growth to decelerate to about 6.5% in 2018 from 6.8% in 2017.

**Highlights**

**GDP**

The Bureau of Economic Analysis released the third estimate of the third-quarter 2017 real GDP, a seasonally adjusted annualized rate of 3.2%, up from the second quarter’s 3.1% annualized growth, but down slightly from the 3.3% prior estimate. The consensus among economists is that the economy continues to expand, but some of the underlying components suggest that the expansion is nearer to the end than the beginning. Consumer spending slowed during the quarter, but was offset by an increase in inventories. Inflation began to tick higher in the quarter, with the personal consumption expenditures (PCE) index of prices rising 1.5%, following a 0.3% advance in the prior quarter. Corporate profits rose 4.3% (not annualized) during the quarter. Economists are generally of the opinion that with the economy nearing full employment, wage pressure should begin to pick up.

**HOUSING**

The housing segment continues to deliver results strong enough for analysts to maintain a positive outlook heading into 2018. Existing home sales for November (the latest monthly data available) grew at an annualized rate of 5.8 million units, an increase of about 5.6% from October, and up about 3.6% from a year ago. The inventory of existing homes was slightly more than three months of supply, down from the prior
year. Existing home prices in November were up 1.2% from October, and have increased 5.5% from November 2016. In the new-home segment, the NAHB Housing Market Index, a measure of homebuilding activity, ended the quarter at 74, its highest level since 1999. Analysts believe the housing market should remain strong over the coming months.

**EMPLOYMENT**

The employment situation remained strong in November. Employers added 228,000 jobs during the month, exceeding the consensus expectations of 199,000 new jobs, but falling short of the prior month’s gain of 244,000. The three-month moving average also rose slightly, coming in at 170,000. The unemployment rate in November was 4.1%, unchanged from the prior month. Average hourly earnings increased by a modest 0.2% in the month, and analysts believe earnings will begin to accelerate in coming months.

**FED POLICY**

The FOMC ended its recent December meeting by announcing an increase in the federal funds rate target of 0.25% from 1.25% to 1.50%. The most significant change to the statement accompanying the rate increase was acknowledgement that inflation had declined. The incoming Federal Reserve (Fed) chairman, Jay Powell, has stated that it is very important for inflation to achieve its 2% target, and the FOMC is increasingly concerned that it has yet to attain that level this far into the expansion. The FOMC is data dependent, and although the expectation is that one rate increase per quarter will occur in 2018, it’s possible that if inflation does not begin to pick up, there will be a pause in the tightening regime.

**Interest Rates**

Fixed income securities’ prices and yields were affected by a variety of factors, including the FOMC’s decision to raise short-term interest rates at its recent December meeting; Congress’ passage of tax reform; solid improvement in economic data; and a continued rise in stock prices. The tax reform package was perhaps the headline event of the quarter, with many economists predicting that the reduction in corporate and individual tax rates will give a meaningful boost to the economy over the short and intermediate horizons. However, one implication of the tax cut is that the economy could be in greater peril of overheating, meaning the FOMC will likely exercise greater vigilance when evaluating future rate increases.
If wage pressure materializes relatively soon, as many expect, the FOMC will react quickly to raise rates. It is within this context that yields generally rose during the quarter.

Although many of the same themes from the third quarter carried through to the fourth, the passage of the tax reform package perhaps had the most significant impact. At the beginning of the quarter, analysts gave it little chance of passing so quickly, but Republicans came together to ensure the year did not end without a legislative win. The trend in yields was higher throughout the quarter, but not especially volatile. In addition to the passage of the tax reform package, other factors contributing to the yield changes were the FOMC’s decision to raise short-term interest rates, as well as ongoing tensions with North Korea. Inflation expectations rose modestly, with the Fed’s gauge of five-year forward inflation expectations rising slightly from 1.79% as of September 30.

Fixed income securities generated mixed total returns across the various market segments. The Bloomberg Barclays Treasury 5-7 Yr. Index declined 0.5% for the quarter, but was up 1.9% for the year. The Bloomberg Barclays U.S. Corporate 5-10 Yr. Index advanced 0.5% during the three months. High yield securities, which often follow the performance of equities, posted a gain of 0.5%. High yield has advanced 7.5% on a year-to-
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date basis. Municipals were also positive, as the Bloomberg Barclays Municipal Bond Index rose by 0.8% during the quarter. Prices of non-US fixed income securities also turned in modest gains in the quarter, as the Bloomberg Barclays Global Aggregate ex-U.S. Index advanced 1.6%. Emerging markets bonds continued the positive trends from throughout the year, with the JPM EMBI Global Index rising 0.5%.

Equity Markets

Equity markets racked up another quarter of solid gains, benefiting from anticipation of the tax reform package, an uptick in corporate profitability, and a steadily growing economy. Each of these dimensions was a source of the continued low volatility financial market environment, with the Chicago Board Options Exchange Volatility Index—better known as VIX—remaining historically low. Against this backdrop, the S&P 500 Index finished the quarter with a gain of 6.6%, and advanced 21.8% for the full year. The S&P 500 has now posted positive returns in every quarter except one in the past five years. The last negative return in a calendar quarter occurred in the third quarter of 2015.

The ten primary economic sectors delivered varied performance during the quarter. Consumer Discretionary, Information Technology, and Financials were the strongest performers, generating gains of 9.9%, 9.0%, and 8.6%, respectively. The Utilities, Health Care, and Telecommunications Services sectors were the poorest relative performers, posting returns of 0.2%, 1.5%, and 3.6%, respectively.

The Russell 1000 Index of large capitalization stocks generated a 6.6% total return, and is up 21.7% on a year-to-date basis. Within the large cap segment, growth stocks once again outperformed value stocks. Small cap stocks, as represented by the Russell 2000 Index, underperformed large caps, finishing the quarter with a total return of 3.3%. Small cap growth outperformed small cap value, with the outperformance amounting to more than 14.0% year to date. The

![Non-U.S. Equity Market Returns by Region (U.S. Dollars)](source)

By Region (U.S. Dollars) Fourth Quarter 4Q17

- Japan: 8.49%
- EM (Asia): 8.36%
- EM: 7.44%
- Pacific Ex-Japan: 7.01%
- World (Dev.): 5.51%
- EM (East. Eur.): 4.94%
- World Ex-USA: 4.23%
- EAFE: 4.23%
- Europe: 2.21%
- EM (Latin Am.): -2.34%

Source: Morningstar, Inc.
NASDAQ Composite, dominated by information technology stocks, finished the quarter with a gain of 6.6%, ending the year up 29.6%. The Dow Jones Industrial Average of 30 large industrial companies advanced 11.0%, and closed 2017 with a gain of 28.1%.

Real Estate Investment Trusts (REITs) were once again little changed during the quarter, with the DJ US Select REIT Index gaining 2.0%. Commodities delivered modest gains, with the Bloomberg Commodity Index advancing 4.7% for the quarter.

International stocks performed well on an absolute basis, but generally lagged behind US equities. European economies continue to accelerate, as domestic demand has picked up and monetary policy has remained extremely accommodative. China continues on pace with structural reforms, which will have the effect of lowering GDP growth, but also help deleverage the economy. With that as a backdrop, international stock indices were almost universally higher. The MSCI ACWI Ex-USA Index, which measures performance of world markets outside the US, gained 5.0%. The MSCI EAFE Index of developed markets stocks advanced 4.2%, and was up 25.0% in 2017. Regional performance was mixed for the quarter. Japan was the strongest performer on a relative basis, with the MSCI Japan Index posting a return of 8.5%. China also generated positive returns, gaining 7.6%. Latin America was the poorest performer, declining 2.3%. Emerging markets performance remained robust, as the MSCI Emerging Markets Index gained 7.4%, and finished the year up 37.3%.

**Looking Forward**

The consensus among economists is that the recently passed tax reform package is likely to provide a significant short- to intermediate-term boost to the economy. The $1.5 trillion, 10-year tax cut will benefit corporations significantly, which will see a permanent reduction in their tax rate. Individual tax cuts will expire in 10 years (unless Congress eventually makes them permanent), reducing the long-term impact of the changes. Economists expect the tax cuts to act like fiscal stimulus, increasing GDP growth by as much as 0.5% per year. A fear among analysts is that annual growth increasing to 3%, at a time when the economy is at or very near full employment, may result in overheating. Although wage growth pressure has not been an issue so far, that may change with the impact of the tax changes, and the Fed may be forced to raise rates more quickly than it had previously anticipated. Market analysts have been raising estimates for corporate earnings for 2018, but it is quite possible that the market has already discounted higher earnings. Housing
prices are likely to suffer with the tax changes, as caps on deduction of mortgage interest and property taxes are estimated to have a 4% negative impact on home prices.

The risks to the generally positive economic outlook continue to include geopolitical tensions with North Korea and Iran, as well as the potential for monetary policy missteps by the Fed. In addition, despite the lack of obvious bubbles, most market watchers expect stock prices to be more volatile in 2018 than in 2017, as valuations are more extended and volatility remains near multiyear lows.

While the returns of 2017 are welcomed and appreciated, we want to continue to remind everyone that we are likely to see the return of volatility and a market pullback or correction will happen at some point. We just don’t know when. We continue to advocate diversified portfolios.

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