KayneCast

A Podcast Series by Kayne Anderson Rudnick

Episode 57

A Market Review of 2017 and an Outlook for 2018

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Global equities performed spectacularly in 2017, with the S&P 500 Index returning 21.8 percent and foreign markets, as measured by the MSCI EAFE Index, posting a return of 25 percent. Emerging markets stocks, after several years of underperformance, were the star performers in 2017, returning 37.2 percent. The S&P 500 generated gains every single month last year, making 2017 the first calendar year in history with no monthly losses in the key equity index. Markets were also characterized by low levels of volatility and minimal drawdown throughout the year. Growth stocks across the market-cap spectrum significantly outperformed value stocks in 2017, the opposite of what occurred in 2016. By sector, technology and health care stocks outperformed energy stocks in particular.

Bonds continued to inch up through the end of the year, with the Bloomberg Barclays U.S. Aggregate Bond Index capping off the year with a gain of 3.5 percent. Emerging market debt was up 9.3 percent, high yield was up 7.4 percent and California municipal bonds returned 5.6 percent. Despite the Federal Reserve's raising short-term interest rates three times in 2017, the 10-year U.S. Treasury yield remained relatively steady, dipping slightly from the 2.44 percent at the beginning of the year to 2.40 percent to end the year. The 30-year bond yield fell from 3.07 percent to 2.74 percent.

Here are the key factors that fueled superb returns for global equities in 2017:

1. Corporate earnings grew solidly, with growth rates accelerating in the U.S., Europe, Japan and many emerging market countries. This is the first time since the financial crisis that earnings were improving across the board, not just in the U.S.

2. Inflation remained very much in check despite the improvement in global growth rates. Wage growth has been tepid, oil prices are still down materially from 2014, and global business competition continues to be fierce. Inflationary expectations are the key determinant of longer-term interest rates.

3. Despite the poor approval ratings, President Trump has so far created a more pro-business environment by rolling back numerous regulatory burdens in many industries, particularly in banking. Optimism among small businesses has dramatically improved over the course of the year. Additionally, corporate America is a clear winner in the tax reform act passed late in 2017.

So what's the impact of this tax reform legislation? Well, there is little doubt in our minds that the corporate tax cut to 21 percent is beneficial to business overall. Companies will, for the most part, have increasing free cash flow, which can be applied to more capital spending, stock repurchases, increased dividends and/or acquisitions. Any of these choices made wisely by management should benefit shareholders in the future. Additionally, repatriation of foreign cash could lead to a significant increase in merger and acquisition activity in the coming years.

However, Wall Street analysts are simply making accounting adjustments to corporate tax rates and applying them to S&P 500 earnings-per-share for the next year and across all industries. It is doubtful it will work this way. Industries like trucking, airlines, apparel, hardware, energy and banking, which are very fragmented and almost perfectly competitive, are likely to pass these savings right back to their customers. This may not happen immediately but should over time, as one or more of the participants choose to go for market share and force the competition to follow price declines or risk losing market share. It is likely that only businesses with proprietary protections and unique innovative products will be able to retain the free-cash-flow benefits of tax reform. In other words, tax reform isn't going to result in making a commodity business a better business over time. Clearly, some of the future benefits of this tax overhaul plan have been already priced into the equity market, but not all of it.

So, what's next? After a year of stellar returns for equities, the question on many of our investors' minds is: "How long can this continue?" No one knows this answer for sure. But it is difficult to see any significant impediments to growth over the next year or two. We are keeping a close eye on the flattening of the yield curve into 2018. If the curve continues to flatten this year and ultimately invert, equities would likely experience at least a meaningful correction, if not more. If wage growth and/or oil prices were to accelerate considerably, that could also upset the longer end of the bond market and prove to be a catalyst for at least a short-term correction.

Bitcoin and other cryptocurrencies are surrounded by massive enthusiasm and speculation, but even a potential meltdown in that speculation seems unlikely to have any substantial fundamental impact on the more traditional asset classes, such as stocks and bonds.

So, what should investors do? Investors should review their asset allocation and make sure they can "sleep at night" with their current equity exposure. The outlook for 2018 is favorable overall, but to expect a repeat of 2017 would be unreasonable. More volatility and drawdowns are anticipated in 2018 as markets return to more normal conditions. 2018 should continue to provide investors with mid-to-high single-digit equity returns but most likely not without a bumpy ride along the way.

We will continue to own high-quality businesses that can shine in good and bad times and have competitive protections. We thank you for your continued trust and support and wish you all a healthy, happy and prosperous new year!