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Market and Economic Trends to Watch in 2018

Tim Courtney, Chief Investment Officer, CIMA®
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As we close the book on 2017, which will go down in history as one of the market's quietest years on record[1], a few trends stand out that have kept markets calm during the second-longest bull market to date[2].

When you combine accelerated U.S. gross domestic product (GDP) growth[3], new profit records[4], healthy consumer confidence[5], synchronized global growth[6] and relatively low interest rates[7], we have a very favorable environment for stocks. In fact, we're in the ninth year of economic recovery since the financial crisis[8]. In 2017, we didn't even have a correction as minor as 3 percent[9].

Furthermore, the worst-performing month in 2017 was March, which still had positive returns equaling approximately 0.12 percent[9].

As we head into 2018, we're hoping for similar economic and market conditions. As we make investment decisions, we will be watching the following three areas for potential disruption.

1. **Interest rates.** The Federal Reserve hiked interest rates three times in 2017, most recently to a range of 1.25 percent to 1.5 percent in December[10]. We at Exencial believe rising interest rates are a healthy sign for the economy, as it shows the market's and the central bank's confidence in continued U.S. growth. We would expect at least two to four more rate hikes in 2018 if the U.S. economy keeps strengthening and inflation continues to creep closer to the Fed's long-term target of 2 percent[11].

   So far, the Fed's decisions have affected short-term interest rates, while long-term rates have only modestly moved higher (the 10-Year Treasury is now close to 2.5 percent) [12]. We're monitoring to see if the market agrees with the Fed's assessment and moves longer-term rates higher.

2. **Global economic growth.** In 2017, the economies of the 45 largest countries across the globe grew in sync for the first time since 2007[6]. We expect that growth to continue in 2018, especially in the U.S.

   We paid our dues from 2014 through the first half of 2016 when the U.S. experienced an economic slowdown[13] and choppy markets. It's been only a year and a half since that time, so we believe the U.S. and the world is positioned well for continued expansion.

   However, we'll be closely monitoring other countries around the world to see if this accelerated growth continues. While we do not expect any major headwinds to impede global growth in 2018, we'll be watching for potential political risks, such as Brexit, global terrorism, geopolitical tensions, etc., that may interfere with continued growth.

OKLAHOMA CITY, OK
9108 N. Kelley Avenue
Oklahoma City, OK 73131

OLD LYME, CT
187-B Boston Post Rd.
PO Box 623
Old Lyme, CT 06371

FRISCO, TX
2601 Network Boulevard,
Suite 400
Frisco, TX 75034

SAN ANTONIO, TX
7373 Broadway,
Suite 400
San Antonio, TX 78209

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3. **Undervalued assets.** In 2017, historically undervalued asset classes like emerging markets and international assets finally bounced back and started performing really well[14]. As we head into 2018, we are hoping that trend continues with small caps.

   We believe small public companies have some advantages over their larger counterparts – they are nimble and should be beneficiaries of the new tax law – but they are valued at a fraction of larger caps[15].

   We'll be watching small cap stocks closely next year to see if they continue trading at a discount to large cap stocks, and whether there's justification for this trend.

While we expect the U.S. markets to continue in a period of growth in 2018, markets will eventually experience a correction as they tend to do even during periods of growth. We will keep monitoring interest rates, global growth and performance of undervalued assets as we look toward the New Year.

Sources:

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