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Equity Markets Rise in Q4 Despite Hurricanes and International Tensions

Global equity markets continued to advance throughout the year and pushed stocks to all-time highs as global economic growth strengthened and corporate earnings growth continued to improve. Despite two major hurricanes and the threat of nuclear war with North Korea, markets rallied on increasing investor sentiment fueled by low market volatility, low unemployment and the passage of domestic tax reform proposals. Overseas, foreign developed and emerging markets performed well as global growth improved dramatically, easy monetary policies remained in place and the U.S. Dollar weakened significantly.

The Bureau of Economic Analysis revised the estimate of third quarter 2017 GDP upward from 3.0% to 3.2% and the initial estimate of fourth quarter 2017 was 2.6%. At the end of September, the annual unemployment rate declined from 4.2% to 4.1%, below the long-term average. Emerging market equity, international large and small cap stocks as well as domestic large cap stocks were the best performing asset classes for the year. No major asset classes posted negative returns for the year; however, U.S. Treasuries and natural resource stocks were relatively muted.

U.S. equities continued to push higher in 2017 with the Russell 3000 Index returning +6.3% for the quarter and +21.1% for the year. For the first time in history, the S&P 500 ended every single month of a calendar year with a gain, extending its run to 14 straight months dating back to 2016. The quarter and year witnessed steady gains on the back of strong corporate earnings, a weaker U.S. Dollar and a rebound in the price of oil. Major tax legislation, passed and signed into law in late December, which includes a substantial reduction in the tax rate paid by corporations on domestically earned income, was a further tailwind for equity markets and investor sentiment. U.S. economic activity was strong as 2017 GDP growth was 2.3%, job growth remained solid and the U.S. dollar depreciated – finishing the year down 9.9%.

In a continuation from the first nine months of the year, growth outperformed value across all market capitalizations as large cap growth stocks were the best performing style, gaining +7.9% for the quarter and +30.2% for the year. Also, nine of the eleven sectors performed positively for the year with information technology (+38.4%) and consumer discretionary (+24.1%) leading the way; conversely, telecommunication services (-1.4%) and energy (-1.1%) were the only sectors in negative territory as investors rewarded stocks with higher growth potential.

International developed stocks exhibited improved returns as the MSCI EAFE Index finished ahead of domestic equities for the third consecutive quarter ending the year a +25.0% return in U.S. Dollar terms, but only +15.2% in local currency as most developed and emerging currencies appreciated against the Dollar. The U.S. Dollar weakened significantly, falling 9.9% most notably due to improving economic fundamentals outside the U.S as well as speculative positioning towards short dollar positions.

Emerging markets equities finished the year strong with a +37.3% return, in U.S. dollar terms. Asian and Latin American emerging markets returned +42.8% and +23.7%, respectively, benefitting from steady global growth and strong corporate earnings growth. While from a valuation perspective, developed and emerging international stocks look slightly attractive relative to more expensive U.S. stocks, there is still short-term earnings risk from slowing growth in China, a rise in protectionism or continued political turbulence.

After raising rates in June, the Federal Reserve elected to raise rates by 0.25% at its December meeting and set the Fed Funds rate range to 1.25% to 1.50%. Looking into 2018, the Federal Reserve's dot plot suggests that Federal Open Market Committee members expect three hikes for the year, similar to expectations priced by Fed Funds Futures. During the fourth quarter, Jerome Powell was nominated to replace Janet Yellen as chairman of the Federal Reserve, the Senate confirmed this nomination in January 2018.

The yield curve flattened in 2017, as short-term bond yields rose approximately 0.90%, while longer-term ten- and thirty-year rates fell .05% and 0.32%, respectively. Investment-grade corporate bonds returned +6.4% for the year as spreads narrowed, outperforming Treasuries by 4.1%. In 2017, the Barclays U.S. TIPS Index returned +3.0% as breakeven rates rose and the Barclays U.S. High Yield Index rose +7.5% with spreads falling throughout the year. Local emerging markets debt continued their strong performance, finishing the year with a +15.2% return due to currency gains and a decline in yields.

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