December 2017

Economic & Market

Forecast

A monthly report issued by the advisors at KPP Financial

ECONOMY

Economic figures continued to strengthen modestly throughout November and the current projections for the fourth quarter sit right near the 3% level. Unemployment is very low and the labor market still has strength. Construction spending is on the rise as Florida and Texas rebuild from the summer hurricane season and there remains limited supply of new single family homes on the market. Multifamily construction continues to slow, but government construction spending is looking strong. Consumers remain optimistic, but their underlying spending trends are failing to accelerate. The low savings rate makes consumer spending dependent on wage growth, which remains modest at 3.4%. Broader income measures show continued deceleration, but we are not in negative territory yet. The Tax cut that is working its way through Congress could be a tailwind to the economy, however the final details are yet to be seen. We will hold judgement until the law is passed.

U.S. EQUITIES

Stocks had a strong month on the back of tax reform momentum. The current view that most business tax loopholes will be maintained while the overall rate drops is a boon for companies. The original thesis was that small companies would benefit the most since they have the least amount of lobbyists to build in loopholes in the tax code. Thus they currently take the brunt of our high base tax rate, despite an overall low effective tax rate for corporations. The current bill will help many large companies and should help many small businesses that are structured as pass through entities. Although the changes in the tax code will hurt middle income consumers, it should help low income people as well as the wealthy. Overall that should be a modest boost to consumer spending, but we are unsure of the ultimate outcome due to lack of clarity on the law. Liquidity remains strong which is driving high stock prices despite fundamentals remaining frothy.

FOREIGN EQUITIES

Equities abroad were flat in November as expectations of ECB money printing slowing gathers steam and financial problems in China look to be increasing once again. North Korea remains an issue, but President Trump seems hog tied like his predecessors as what to do about continued provocations. With the strong markets elsewhere over the past year, the value proposition of foreign stocks over US looks less appealing, yet we are still seeing better values in foreign markets. As the Fed tightens liquidity, don't be shocked to see heightened volatility begin overseas before it ultimately hits our markets. Typically risk off pulses start in less secure markets than our own.

FIXED INCOME

The Fed is likely to raise rates in December and will likely hint at a continued path towards normalization. The rise in cryptocurrencies has to be on their radar as yet another reason to tighten liquidity along with the strong rise in capital markets. The tax cuts will also give them confidence that the economy can stand higher rates going into 2018. However the tax rates will affect the more expensive housing markets and thus the mortgage market to some degree. The ultimate effect on prices will play out over time so the impact on the mortgage market should be gradual and not create a huge shock. Yield spreads on high yield bonds have widened modestly and default rates on bank cards continues to rise slowly, both are important indicators of corporate and consumer health. The bond market overall remains healthy with yields range bound and investors continuing to be happy with getting low reward for taking on credit risk. We continue to be selective in our fixed income choices.

COMMODITIES

Crude oil remains strong, while natural gas remains range bound. Shale production is projected to start increasing again soon which should cap upside for both. Precious metals have been weak lately based on the expectation of the Fed hiking rates, but overall prices remain range bound and they often rally post Fed announcements. Agriculture prices remain weak and are in a downtrend until further notice, however many stocks in the sector remain good values and have begun to gain strength. The overall downtrend of a weak dollar is telling us to expect general commodity inflation in the short to medium term.

Recommended Portfolio Weightings

As of November 30, 2017

Equity Sectors

Overweight	Neutral	Underweight
Consumer Staples	Consumer Discretionary	Technology
	Materials	Telecom
	Utilities	Health Care
	Energy	Industrials
		Financials

Asset Classes

Overweight	Neutral	Underweight
Precious Metal Commodities	Emerging Market Stocks	U.S. Mid-Cap Stocks
Long-Term Investment Grade Bonds	International Developed Stocks	U.S. Large Cap Stocks
Resource Commodities	Short-Term Investment Grade Bonds	High Yield Bonds
Cash Alternatives	Agriculture Commodities	U.S, Small-Cap Stocks
International Developed Fixed Income	Intermediate-Term Investment Grade Bonds	International Emerging Market Fixed Income
REITs		

Fixed Income

Overweight	Neutral	Underweight
TIPS	U.S. Treasuries	Municipal Bonds
	Mortgage-backed Securities	Preferred Securities
	Agency Securities	Corporate Bonds
		Bank Loans

Economic & Market Forecast

Data Point	Current	Year-end Projection
S&P 500	2,647	2575-2625
NYSE	12,627	12,200 -12,700
10-Year	2.42%	2.3-2.5%
Crude Oil	$57.40	$55-59
Gold	1,277	1,275-1,325
Dollar Index	93.05	90-95
Effective Fed Funds Rate	1.16%	1.41 %

Disclaimers

There is no assurance that any of the target prices or other forward-looking statements mentioned will be attained. Any market prices are only indications of market values and are subject to change. Past performance is no guarantee of future results.

The prices of small and mid-company stocks are generally more volatile than large company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.

Technology and Internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

There are special risks associated with investing in preferred securities. Preferred securities generally offer no voting rights with respect to the issuer. Preferred securities are generally subordinated to bonds or other debt instruments in an issuer's capital structure, subjecting them to a greater risk of non-payment than more senior securities. In addition, the issue may be callable which may negatively impact the return of the security. Preferred dividends are not guaranteed and are subject to deferral or elimination.

Income from municipal securities is generally free from federal taxes and state taxes for residents of the issuing state. While the interest income is tax-free, capital gains, if any, will be subject to taxes. Income for some investors may be subject to the federal Alternative Minimum Tax (AMT).

Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline of the value of your investment. Investing in fixed income securities involves certain risks such as market risk if sold prior to maturity and credit risk especially if investing in high yield bonds, which have lower ratings and are subject to greater volatility.

All fixed income investments may be worth less than original cost upon redemption or maturity.

Although Treasury Inflation-Protected Securities (TIPS) are considered free from credit risk, they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate, and deflation risk, which may cause the principal to decline and the securities to underperform traditional Treasury securities. TIPS have special tax consequences, generating phantom income on the "inflation compensation" component of the principal. A holder of TIPS may be required to report this income annually although no income related to "inflation compensation" is received until maturity.

The yield, average life and the expected maturity of mortgage-backed securities are based on prepayment assumptions that may or may not be met. Changes in prepayments may significantly affect yield, average life and expected maturity.

Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility. These risks are heightened in emerging markets.

Investments in the energy sector are subject to the adverse economic events within that industry. A downturn in the energy sector of the economy, adverse political, legislative or regulatory developments or other events could have a large impact on a portfolio's investments in this sector.

Exposure to the commodities markets may subject an investment to greater share price volatility than an investment in traditional equity or debt securities. Products that invest in commodities may employ more complex strategies which may expose investors to additional risks.

Real Estate investments have special risks, including possible illiquidity of the underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions.

Additional information available upon request.

Past performance is not a guide to future performance.

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