February 2018

Economic & Market

Forecast

A monthly report issued by the advisors at KPP Financial

ECONOMY

The economy started the year on good footing with industrial production and durable goods new orders making cycle highs. Vehicle sales have been weak on the back of falling used car prices and home sales have taken a hit due to the recent tax changes and higher mortgage rates. The jobs market remained strong and we are finally seeing a pickup in wage growth which is stoking the fears of inflation. Construction spending remains on the rise, but housing starts have begun to decline. The recent tax cuts will drive economic growth, but it will also balloon our deficit which has driven up interest rates. Even though retail sales have disappointed and the savings rate continues to decline, we continue to see real personal consumption rise, albeit at a slower level. Growth for the Q1 looks to be robust, but we are cautious to extrapolate that to the rest of the year.

U.S. EQUITIES

Stocks started 2018 with a bang to the upside with a small pullback near month end. Despite the strong start we see more volatility than last year as central banks pull back their stimulus and interest rates rise. At a certain point, volatility will rear its ugly head as liquidity dries up and high rates hit valuations of the market. Earnings estimates remain strong for the year, but much of that is already priced in after a strong 2017. Certain interest rate sensitive areas like utilities and real estate had trouble to begin the year, but we see value in certain names. Value investing is starting to outperform again which tells me liquidity conditions are tightening to a degree. Overall we continue to see a market that is expensive and prone to volatility as the market adjusts to higher interest rates and less accommodative central banks globally. The current economic recovery has been driven by central bank liquidity and subdued interest rates. We still believe those will be the major driving forces in the market this year despite a more upbeat corporate earnings environment.

FOREIGN EQUITIES

Equities abroad had a similarly good month to begin the year as investors capitulated into the markets worldwide. Countries like Germany and China had fairly volatile ends to the month which could be a harbinger of things to come for risk assets globally. Weakness in foreign bonds is likely sending us a signal that risk taking is waning. We kick off the Winter Olympic games next month which is likely to keep geopolitical risks subdued, but worried about trade wars persist with an administration that keeps inching towards protectionist policies. Worries about North Korea look to be just another scare with little ramification for financial markets. There continues to be better values abroad, but that does not mean much when equity markets are generally elevated throughout the developed world. Emerging market still remain the most attractive.

FIXED INCOME

Interest rates continue their march higher since late last summer as economic activity has picked up and central bank easing has diminished. We continue to see us entering a trend of higher rates over the next few decades, but the rise will likely be slow and choppy. The Fed is likely to raise rates in March and at least one more time this year. The policy shift continues to be priced into the market and we expect the 10-year treasury rate to exceed 3% at some point in 2018. These are levels we have not seen in many years and the financial and economic ramifications of that move should not be underestimated. Markets and economies have been conditioned to operate in an environment where capital is cheap, and how they adjust to moderately higher rates is likely to be disruptive. The high yield bond market has not reacted to higher rates yet, but this is an area to watch for a major break in risk assets.

COMMODITIES

Oil prices remain strong, but with the dollar hitting support and supply from Shale regions rising, we expect we are close to a near term ceiling on prices. Gold remains strong on the back of higher inflation expectations and the weaker dollar. We still expect a precious metals breakout sometime this year. Agriculture prices remain subdued and are not showing great relative strength. In general we like commodities over equities as we have reached extreme ratio levels not seen since 2000.

Recommended Portfolio Weightings

As of January 31, 2018

Equity Sectors

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

Asset Classes

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

Fixed Income

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

Economic & Market Forecast

Data Point	Current	Year-end Projection
S&P 500	2,824	2600-2700
NYSE	13,368	12,000 -13,000
10-Year	2.72%	2.7-2.9%
Crude Oil	$64.73	$60-65
Gold	1,343	1,475-1,525
Dollar Index	89.13	85-90
Effective Fed Funds Rate	1.42%	2 %

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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