January 2018

Economic & Market

Forecast

A monthly report issued by the advisors at KPP Financial

ECONOMY

The global economy ended 2017 on a strong footing. GDP in the 4th quarter will likely end near the 3% level mainly driven by increased corporate confidence and increasing demand for housing. Weekly earnings continue to rise for the average American and at an accelerating clip. Personal consumption expenditures continue to rise at a faster clip than incomes are growing. This has driven consumer debt levels to an all-time high and the savings rate to the lowest levels since 2005. The tax cuts should help the economy maintain momentum this year, but much still relies on the strength of the credit markets as central banks begin to drain liquidity in earnest. Still, tax cuts for most American's should keep the consumer spending for most of the year as long as the equity markets hold up. Industrial production and durable goods new orders continue to accelerate and vehicle sales continue to be resilient in the face of declining used car prices. Overall for 2018 we expect an economy that outperforms 2017, but with more volatility expected.

U.S. EQUITIES

Stocks finished the year with strength once again, which was the theme for almost every month of the year. This was an anomaly from a historic perspective and has conditioned investors to buy the dip. This is also creating panic buying that is common in the late stages of a bull market. Valuations remain extremely elevated and most if not all of the tax cuts are priced into the market. The reduction in global liquidity from central banks is the biggest risk to the market in 2018. This means that most likely we see a 10-20% pullback in the market at some point in the year, but the big question is what level does that start at? Growth stocks were all the rage in 2017, but we see value investing reasserting its strength in 2018 due to extreme divergence in performance recently and lower liquidity levels. We expect the market performance in 2018 to be modest overall with some opportunities in beaten down sectors. Only a recession will drive a larger drop in the market which we do not foresee without a major economic shock.

FOREIGN EQUITIES

Stocks abroad finished fairly flat in December, but overall had a stellar year as the economies in Europe and Asia accelerated on the back of Central Bank liquidity and low expectations. The weakened dollar also was a tailwind for foreign asset prices in 2017 and we expect that to continue to a lesser extent in 2018. Value opportunities are still easier to find abroad, but less so than a year ago. There is increased political risk in 2018 due to the talks over NAFTA and President Trump's rhetoric about the leaders of many other foreign nations. The uprising in Iran is something to watch, but is unlikely to break out into a major disruption this year. North Korea will remain on everyone's radar this year, but war remains unlikely.

FIXED INCOME

Given the surge in prices for cryptocurrencies and elevated asset prices in general, global Central Banks are likely to increase their pace of normalization of interest rates. This will make 2018 a year where debt markets are vulnerable to shocks due to tighter liquidity. We expect interest rates to rise this year after a range bound and overall flat 2017. High yield credit spreads remain low, but have begun to rise, which must be watched as an indication of tightening liquidity conditions. The ECB and BOJ plan to reduce their money printing efforts this year which will officially usher in an era where Central Banks are shrinking their balance sheets as opposed to expanding them which has been their mantra since 2009.

COMMODITIES

Oil had another strong month to end the year and ended 2017 about $10 a barrel higher than it started. 2018 will likely be a more range bound market for prices as shale oil supply increases and OPEC strategy shifts less aggressive. Gold and silver prices had a tremendous close to the year as prices rallied sharply in the back half of December. We expect much higher prices in 2018 as inflation picks up and the dollar remains weak. Overall, we expect more upside for commodities and inflation in the next year, but specific supply and demand dynamics will shape various areas of the market.

Recommended Portfolio Weightings

As of December 31, 2017

Equity Sectors

Overweight	Neutral	Underweight
Consumer Staples	Consumer Discretionary	Technology
Utilities	Industrials	Health Care
Materials	Energy	
	Telecom	
	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
International Developed Fixed Income	REITs	Short-Term Investment Grade Bonds
Cash Alternatives	Agriculture Commodities	U.S, Small-Cap Stocks
	Intermediate-Term Investment Grade Bonds	International Emerging Market Fixed Income
	Resource Commodities	High Yield Bonds

Fixed Income

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

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Data Point	Current	Year-end Projection
S&P 500	2,674	2625-2725
NYSE	12,809	12,500 -13,500
10-Year	2.41%	2.7-2.9%
Crude Oil	$60.42	$65-70
Gold	1,309	1,475-1,525
Dollar Index	92.12	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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