Making Sense of Finance

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Fourth Quarter 2017 Review

STOCK MARKET

The fourth quarter of 2017 was a remarkable finish to an outstanding year for U.S. stocks. In the last three months, both the S & P 500 and Nasdaq Composite rose over 6%. The Dow Jones Industrial average gained more than 10% last quarter. One of the themes running through the entire year was the lack of volatility in the market. There were only eight days in 2017 with movement more than 1% in the S & P 500 index, and not one day with a movement more than 2%. Stock market investors have been satisfied with the status quo of good earnings growth, low interest rates, and an upbeat labor market. Significantly the latest cause for optimism as an investor are lower corporate tax rates due to the passage of the Tax Cuts and Jobs Act which has dramatically reduced the U.S. corporate tax rate to 21% from 35%. The anticipation of this legislation last quarter helped to drive up the market, in particular those companies that have relatively high tax rates due to the type of business they operate and where they do the most business (in the U.S. versus overseas). Also, this act has brought back the lowering of the tax rate for repatriated cash (cash returned to U.S. from earnings generated in foreign countries).

Last quarter technology stocks were among the best performing sector as they have been all year. Also in the fourth quarter consumer discretionary stocks, in particular retailers did better than the overall market indexes. Partially due to high consumer confidence levels which have led to more spending, but another contributing factor, as previously mentioned, was the impending lowering of corporate tax rates, which for the most part should greatly benefit U.S. retailers as these companies have some of the highest effective tax rates among publicly traded companies. Financial companies performed well in the fourth quarter as the continuing rise in interest rates (up to a certain level) boosts many financial institutions income. The Federal Reserve raised the Fed Fund rate target for a third time for 2017 in December as expected. And although energy stocks were laggards for the full year, in the second half they began to shine helped by an increase in the price of oil (up over 15% last quarter). Laggards were among the interest rate sensitive sectors, which tend to not perform as well as the aggregate market when interest rates are on the rise. This includes groups such as utilities, real estate investment trusts (REITs), and

Making Sense of Finance

Everyone and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 plus years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

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telecommunication stocks.

Foreign stock markets maintained their upward trend in the fourth quarter. Although the gain (+4%) of the MSCI EAFE index (developed foreign markets) was slightly less than the S & P 500 last quarter, the EAFE index (which is measured in dollar terms) outperformed for 2017. Since this is a US dollar based index, part of the reason it did well was the strength in foreign currencies versus the U.S. dollar last year. At the beginning of 2017 one Euro bought U.S.$1.06. Currently that amount is $1.22, an increase of 15%. All things being equal if you hold a stock denominated in Euros it has appreciated 15% over the past year in U.S. dollar terms, assuming no change in price. However, it was the Emerging Markets that were the best performing for the quarter and year. In times of broad global economic growth, this is not unusual. According to the Dow Jones Global Indexes, countries such as Argentina, China and India had large gains in 2017. Our closest neighbors, Canada and Mexico, although posting gains, did not perform as well as most other markets.

BOND MARKET

The fourth quarter amounted to a non-event for bonds with barely any gains, especially when compared to stocks. The Barclays Aggregate Bond Index, which is a measure of intermediate term domestic investment grade bonds, rose less than one half of a percent last quarter, and only 3.5% for all of 2017 on a total return basis. U. S. Treasury yields increased in the fourth quarter (bond prices decreased), and continued to rise early into 2018. Most investors have been expecting a rise in interest rates for some time. And although the 10 Year Treasury yield, (now at 2.55% versus 2.33% at the beginning of last quarter) has risen, it is still at relatively low levels compared to its historic average.

In general, long term bonds fared better than short term bonds last quarter as the Federal Reserve continued its "tightening" strategy as was previously laid out to the public. Corporate bond credit spreads narrowed slightly for investment grade bonds, as a favorable credit environment continued. Municipal bonds outperformed Treasuries at the end of 2017, and it is anticipated that demand for municipal bonds in high tax states will increase due to the lessening of state and local tax deductions dictated in the new tax reform law.

OUTLOOK

The new tax code should be a boon to corporate profits and most Americans. Our outlook has not changed much over the past year. In a low interest rate environment, stocks deserve higher valuations, and with corporate tax rates being cut dramatically, the recent rally seems justified with no obvious bubble. In addition, the new tax law will make it easier to bring a portion of the estimated $3 trillion back to the U.S. We think this momentum could continue for the next 18-to-24 months by stimulating the economy and spurring even higher corporate profits. We expect real estate to hold its own, except for the retail space, where the trend to on-line sales will likely continue. Banks should also continue to benefit from a slowly rising interest rate environment. Eventually, though, we will see another downturn, but we see no signs of systemic weakness as of now.

Bonds are going to face headwinds for many years, but rising rates are a good sign that the economy is getting back to normal. Bond prices will continue to lag, in our opinion, but this should be irrelevant for individual bond holders that hold to maturity. A proper laddered bond portfolio will offer higher income to retirees when rates increase and make investing a little more predictable.

The one bubble we observed is that of Bitcoin. Over the past few years Bitcoin and crypto currencies have been in the media spotlight, yet everyone who is interested in it has very little idea what it is; a clear sign of a bubble. One should think of crypto currencies as a "digital gold" that can be mined and traded peer-to-peer. This technology is so new that it is difficult to value. For sure, there was a bubble already that popped when Bitcoin traded at over $20,000 and has recently dropped to about $10,000 in just a few short weeks. So, what does an investor do when they can't figure out a reasonable valuation? *Answer:* NOTHING, unless you just want to literally take a gamble, in our view. Taking a look at the history of the Internet and the history of gold prices, our conclusion is that crypto currencies are here to stay but will be volatile, similar to the internet in its infancy. What happened to AOL, Yahoo, or Myspace? They did incredibly well in the beginning, just to be replaced with better versions of themselves and fade into history. And how has gold done over the last 100 years; up only about 1% per year on average.