

01/22/18**Quarter in Review****The Markets**

In the fourth quarter of 2017 the US showed resilience in its recovery from the damage that the hurricanes caused earlier this year. Both initial and continuing claims for unemployment insurance were back down to pre-hurricane levels and 4th quarter GDP estimates were tracking 3.0% by year end. The shooting tragedy in Las Vegas again brought gun regulation to political stage as did the five-year anniversary of Sandy Hook shooting. But D.C. was concentrated on getting tax reform done and achieved lowering the corporate tax rate to 21%. This came at the cost of state and local tax and mortgage interest deduction limits. Lastly the president nominated Jerome Powell to be the next Federal reserve chairman. Likened to Janet Yellen in style and temperament, Powell however lacks the academic credentials of many of his predecessors. His work on wall street, at the Department of the Treasury and the Federal Reserve was enough to calm the market apprehension. The vice chair has yet to be nominated and after Yellen departs there will only be 3 of the 7 Fed Board Members in their seats. We did see a rate increase in December and the Fed has 3 more forecasted for 2018 with the market thinking more like 4.

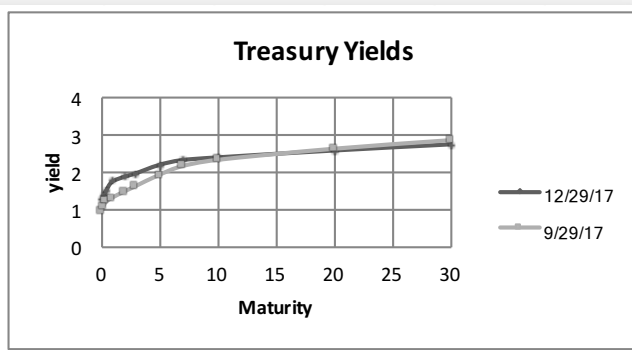
Internationally things seemed to quiet down a bit on the Korean peninsula, replaced with secession noise from the Catalans in Spain. China started to remove impediments to foreign investing, while Venezuela defaulted on its debt. Germany's election results have made forming a coalition government difficult as the coalition agenda is seeing resistance from the Social Democratic party. Just last week the British government's Brexit Bill passed to the next stage with a vote in the House of commons. The 4th quarter saw the bill defeated and only with a number of amendments did it finally get through. More interesting is Facebooks opening of a probe into Russian involvement in the Brexit vote.

The quarter's performance was positive across all asset classes. Emerging market equity returned above 8% for the quarter and close to 35% for the year. Commodities, due to a rally in oil, was up over 6% for Q4 but only up slightly above 2% for 2017. US equities had a very strong year, with growth far outpacing value. Value equities were up close to 10% on the year across large, mid and small caps. Fixed income, even with the rate increases, performed ok, with long bonds up over 6%, intermediates only returning 4% on the year, and short-term bonds up about 1.5%. High Yield and Global bonds performance much better, up 7% and 9% for the year.

Interest Rates

The Federal Reserve increased the target range for the Federal Funds rate by another 25bps in December to 1.25% - 1.50%. The effective rate has been around 1.42% since the meeting except for a few days over year end. The reduction in balance sheet hasn't affected the back end of the interest rate curve in the slightest. In fact, the 20 and 30-year treasuries actually rallied 5 and 12 bps during the quarter. The front end has definitely felt the effects, steepening more than the rate increase.

Years	12/29/17	9/29/17	Difference
0.08	1.28	0.96	0.32
0.24	1.39	1.06	0.33
0.5	1.53	1.2	0.33
1	1.76	1.31	0.45
2	1.89	1.47	0.42
3	1.98	1.62	0.36
5	2.2	1.92	0.28
7	2.33	2.16	0.17
10	2.4	2.33	0.07
20	2.58	2.63	-0.05
30	2.74	2.86	-0.12



The Primary Mortgage Market Survey from FHLMC showed the 30-year conforming balance fixed rate mortgage has ticked up over the quarter from 3.83 to 3.99%. 15-year conforming balance moved up more from 3.13 to 3.44%. The Mortgage Bankers Association weekly survey showed average 30yr-Fixed Conforming Balance rates at 4.30% (with 0.54 pts) while Jumbo 30-yr Fixed Rates were 4.25% (with 0.36 pts). Average 15-Year fixed rate mortgages were at 3.77% (with 0.44 pts). This Mortgage Bankers report on applications has increased 4.1% from a week ago, while refinancing increased 4% as well. The purchase index was up 3% from a week ago.

Leading Economic Indicators

The Conference Board's leading economic indicators (LEI) increased to 130.9 for the quarter ending November 2017. Although only 6 of the 10 factors contributed positively this month, the measure was up five tenths from October. Average weekly claims, manufacturers new orders for capital good, and building permits were negative. Two of ten data points were estimates and so close to zero that they were almost meaningless. The ISM New Orders, Leading Credit Index, Interest rate spread, and consumer expectations for Business Conditions contributed the most to the LEI this month. We will have to wait a couple of day to see how December fared, but with the continued climb in the stock market the LEI will probably show a continued expansion.

Jobs

At the time of this write up **nonfarm payrolls** posted an increase of 148,000 jobs for December (consensus was 190k). The Household survey was up 104,000 jobs. Both number were below their statistical significance, and thus it could have meant we created zero jobs for the month. The labor force participation rate of 62.7 (for each month in Q4) and the **unemployment rate held steady at 4.1%** as of December 2017. With the Fed scheduled for three rate increases, the street's economists fear an unemployment rate in the low threes by year end and inflation higher than the two percent target. Futures though only show the likelihood of a two-hike year.

The ISM survey for manufacturing jobs has been on a decline since Q3 down to a 57 level in December but still expansionary. Manufacturing employment in the BLS survey was up about 79k jobs in Q4. Year over year manufacturing employment is up about 196k jobs. The Q4 2017 jobs numbers were positive, and should not derail the Fed's current interest rate hike plans.

Industrial production

Q4 Industrial production numbers were off the charts, up 2.57%, and up 3.56% year to date. This is in comparison to a negative 0.46% in the third quarter, and 0.82% for all of 2016. Since the quarter was positive and inflation was positive this quarter was labeled a "growth" period. The report was a bit mixed with a revision to November, but the drivers of motor vehicles and parts and a robust utility growth (cold winter), were supported by sound mining production. This will have a great effect on Q4 GDP, and adds support to the early January equity returns. The ISM index wasn't as positive as Q3 but still posting a 59.7 well above the 50 level for growth. Only the Inventory index dropped below 50, and remained there for the entire quarter. The inventory level contraction was due to problems in the "supply chain to deliver materials and services meeting production schedules," as stated in the ISM report. But the report went on further to say that levels above 42.9 were consistent with expansions. In total the manufacturing sector looks healthy heading into 2018.

Housing

Single-family new home sales were 733,000 units per year as of December 2017, reversing the early year trend lower. The three-month average is solidly above 600k units per year in the fourth quarter. Looks like the cracks in the housing sector were only the ones the cement truck brings when pouring foundations. Year over year single family homes sales are up 26.6% (with a 90% confidence interval at plus or minus 16.6%). **Existing home sales increased to 5,810,000** on an annual basis ending November. The S&P/Cash Schiller 20 city composite index has risen 6.38% in the twelve months ending October 2017. **The October report had all 20 cities reporting positive growth** a good sign for the overall market. The markets have yet to react to the new tax bill, reducing the mortgage

interest deduction and state and local tax deductions from people's federal bill. This will surely have an effect on home prices in those regions. As the Fed's balance sheet starts to shrink more in the latter half of this year there should be some pressure on the back end of the interest rate curve. Then we should see some more substantial rises in mortgage rates, which should slow refinances and possibly reduce transactions in those areas greatest affected by the tax over hall.

The Consumers

The Conference Board's consumer confidence index stood at 122.1 as of December 2017. This is above the year's average and the fourth quarter numbers were a substantial improvement compared to prior quarters. The one grey spot was the December report which was slightly less optimistic outlook for business and job prospects in the short term. The University of Michigan survey was also strong for Q4, but off the high of 100.7 in October. As of this write up the preliminary January numbers are down again (third straight month since October) at 94.4. **The personal savings rate hit a ten-year low at 2.9%** and hasn't been this low since prior to the 2008 recession! Total consumer credit is **1.2 Billion dollars** above where it was before the 2008 recession. Of which **98.2% is in nonrevolving consumer credit**. I wonder where the next recession will come from?

Personal income and outlays showed increases throughout the November report except for the personal savings rate mentioned above. Real Personal consumption expenditures on durable goods were up 7.06% for the twelve months ending November. Real personal income less transfers also moved back above the 2%-point year over year.

Lastly consumer credit expanded at a 5.33% annual rate ending November 2017. Revolving and Non-Revolving consumer credit are now expanding at 5.69% and 5.2% year over year. The consumer looks very healthy but I am now growing concern about the debt levels and savings rates.

Inflation

As of December, CPI was up 2.12% over the past twelve months, close to but bit off the September level. Forecasts for lower and lower unemployment rates might finally push the number up this year. Energy pulled back a bit in December, except for fuel oil which was up over 15.2% for the year. Core inflation was up 1.8% for the year, with the subcomponents of transportation services and shelter up over 3% for the year. Looking back a year ago CPI was up 2.09%. These inflation numbers look to be in control and the Fed probably has ammo to raise the rates another 3 to 4 times this year without hurting the economy now that the tax bill has passed. However, the Fed itself only estimated a 25 bps lift to real GDP from the tax cut. In some instanced companies have said they will pay some of this tax savings out to employees, while others have stated plans to hire workers over the next several years. None of which looks like it will overheat prices in the country. Jerome Powell will keep the course steady and not leave a legacy of raising too fast or too slow.

In Closing

We are now **102 months** into an economic expansion with the **average expansion being 42 months** (and the longest being 120 months) for the past 33 cycles. The yield curve flattened more as the front-end increased above the December rate increase. I could have easily copied and pasted last quarters closing comments as almost everything is the same. The LEI is up, Industrial production had a very strong quarter, home sales up and house price appreciation is above 6%. The consumer has just started to pull back though (in opinion only), thinking that in the short run things aren't going to be as the good as they just were. Inflation is at 2% again after taking a little dip in the middle of year, jobs are strong and real personal income less transfers seems to be on a good trajectory.

I rebalanced the portfolios in the beginning of the year. I didn't take off any risk and put a little more into small cap equities as per the model. The main reason that the model is calling for the allocation is how small caps did during the last recession. They performed much better, or less worse, than large or mid-caps did. It is hard to swallow as large caps are cruising and emerging markets are as well. Hopefully the dollar will start to rally (helping the small caps) as interest rates rise this year and flows come back into the dollar. I will be watching very carefully this year for the first signs of a recession but feel we are still 12 to 18 months out. Indicators across the board have to light up red though, not just one, (Like IP did back in 2015) before I start taking off risk. The next 6 to 12 months will be an interesting time period where the Fed will decrease the balance sheet and maybe even the ECB will stop its QE.