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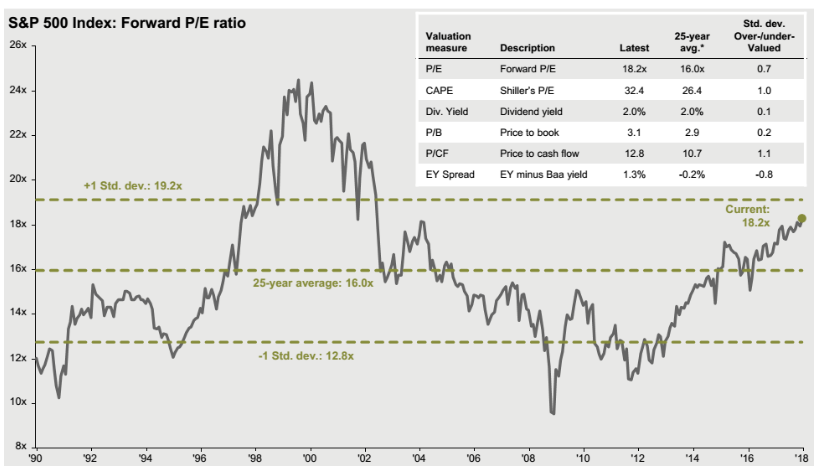
2018 – What to Expect

At first glance, one would say 2017 was a great year. And in most cases, it was. With the Dow and S&P 500 up so much it sounds great. But those indices invest in "large" companies. My point is that it depends on the size and style (growth vs. value) of where you invested. FYI, Large Cap Growth averaged 30.2% last year but Small Cap Value only did 7.8%. And bonds (an important part of asset allocation) did 2 – 4 %. So, a well-diversified asset allocation did about 14 ½ % last year, up from 8.3% in 2016 (and down 2% in 2015)! Source: Barclays.

Economically, it looks even better in 2018. GDP should do slightly better than 3%. And earnings for the S&P 500 should grow in the 11 – 12% range, maybe better. This earnings growth appears to "already" be in the market (see Chart #1 below).

Chart #1



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	18.2x	16.0x	0.7
CAPE	Shiller's P/E	32.4	26.4	1.0
Div. Yield	Dividend yield	2.0%	2.0%	0.1
P/B	Price to book	3.1	2.9	0.2
P/CF	Price to cash flow	12.8	10.7	1.1
EY Spread	EY minus Baa yield	1.3%	-0.2%	-0.8

Source: FactSet, FRB, Thomson Reuters, Robert Shiller, Standard & Poor's, J.P. Morgan Asset Management.
Price to earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since December 1989, and FactSet for December 31, 2017. Average P/E and standard deviations are calculated using 25 years of FactSet history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-month consensus dividend divided by most recent price. Price to book ratio is the price divided by book value per share. Price to cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure.
*P/CF is a 20-year average due to cash flow data availability.
Guide to the Markets – U.S. Data are as of December 31, 2017.

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Yes, the market is overvalued, but not in the danger zone. And the earnings growth should help sustain a moderate growth in the equity markets for 2018. Plus, you should expect more stock buy backs and increased dividends, mostly because of the new tax law.

On the downside, we see the Federal Reserve putting a damper on the market (taking away the proverbial punchbowl before the party gets out of hand)! We expect another 3 interest rate hikes in 2018. Yes, it will likely be another bad year for bonds. Investors should contemplate more foreign and high yield bonds in their asset allocation. HINT – watch for the yield curve to change – become "inverted". This is where short-term bonds yield more than long-term bonds. This is a potential big problem – and one of the

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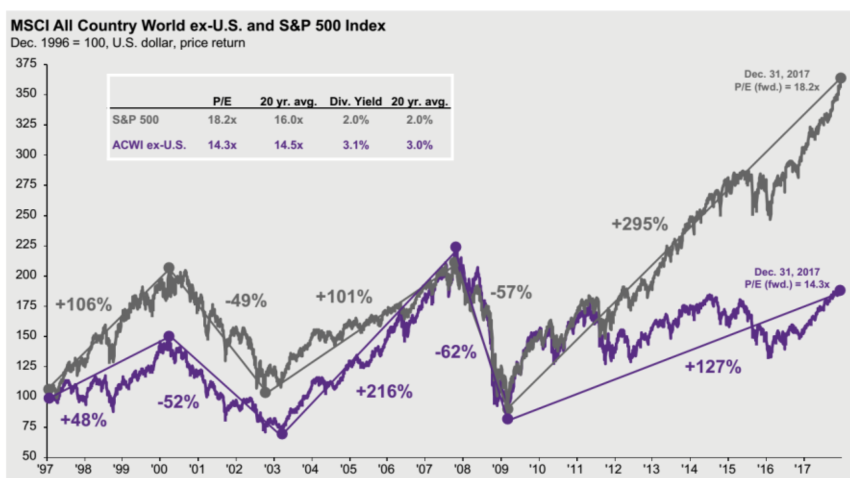
markets best predictors of a recession. It's a major "go to cash" signal. We will be watching this closely. TIPS index is a good indicator.

Another headwind is the low unemployment. Below 4% unemployment historically starts inflation, especially wage inflation. Also, the lack of workers keeps corporate earnings from growing more. Keeps a cap on corporate earnings.

So… how to play 2018? We still like equities, and expect the market to be up 8 – 10%. And start looking at value investments vs. growth. Growth is overvalued, and value is not. The markets love to play this "game". And the "secret sauce" is foreign stocks, especially emerging markets (see Chart #2).

Chart #2



Source: MSCI, Standard & Poor's, FactSet, J.P. Morgan Asset Management.
Forward price to earnings ratio is a bottom-up calculation based on the most recent index price, divided by consensus estimates for earnings in the next twelve months (NTM), and is provided by FactSet Market Aggregates. Returns are cumulative and based on price movement only, and do not include the reinvestment of dividends. Dividend yield is calculated as consensus estimates of dividends for the next twelve months, divided by most recent price, as provided by FactSet Market Aggregates. Past performance is not a reliable indicator of current and future results.
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Most foreign companies look like the U. S. two years ago – lots of potential. Plus, the strong U.S. economy will help too. Bonds will be a drag – concentrate on high yield and foreign, plus shorter-term bonds. A well-done asset allocation should come close to double digits!

Let the Show begin!!

If you would like to discuss the market and/or your account(s), please call me at 713.428.2050, x2 or via email to josborn@houcap.com.

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