Market Review and Outlook—January 5, 2018

The 2017 Rising Tide Raised All Boats The chart below shows that every listed investment class made money in 2017 (and in the past quarter, and the past 3, 5, and the past 10 years). Investors simply could not go wrong. While the bond and the real estate returns for 2017 were low, there were some terrific gains, with over 25% from foreign stocks and over 35% from tech funds. The average 60%-stock fund gained over 13% in 2017.

Bonds Tread Water—With the US economy rising very steadily, and with expectations of further growth, the Federal Reserve Bank (the Fed) raised the Fed-rate ¾% in 2017. The bond market also saw rising rates, but only at the short end—long-term treasury bonds actually had yields fall. Intermediate- and long-term bonds will likely avoid painful rising rates until inflation rises.

Inflation AWOL—With plenty of capital, and plenty of capacity in our factories, inflation won't wake up until wages do. Despite unemployment falling from 4.6% to 4.1% in 2017, wage growth actually fell slightly. With no real pressure, inflation in 2017 fell, from 2.1% to 1.7% (we use the core CPI figure, which excludes the volatile food and energy components, and we are using data through November 30th).

Passing the Buck—The US dollar fell 7% in 2017. This helped foreign stocks outperform US stocks. It also helped US companies sell more goods/services overseas. We don't share predictions for future movements of the US dollar, but we do share our hopes. In this case, we hope that the US dollar is fairly stable in 2018, neither rising nor falling much.

Black Gold, Texas Tea—Oil prices rose 20% in 2018, as inventories were worked down from over 2 billion barrels to under 1½ billion—quite a decline. As with the US dollar, we aren't banking on strong rise or fall in oil prices in 2018; we would be satisfied with stability. That said, global economic activity is very solid, which could lead to rising oil demand. We will need to wait to see if the supply can continue to rise, as it has for several years.

The 2017 stock gains were substantial, and investors who haven't been rebalancing throughout 2017 are well-advised to rebalance ASAP. Failing to rebalance after such a strong year produces greater losses when stocks next decline, and they will decline, at some point. When the shrubs in your front yard grow too high and block your window, you prune them; you cut them back. **After 2017, investment portfolios need pruning**. There are many positive economic themes that we hope will boost 2018; however, there are also risks. This balance of opportunities and risks warrant balancing your investment portfolio with stocks and bonds. Balance in all things…

Category	3 Months	12 Months	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.20%	+0.56%	+0.22%	+0.14%	+0.42%
Intermediate Term Bond	+0.28%	+3.70%	+2.24%	+2.07%	+4.11%
Intermediate Muni Bond	+0.38%	+4.60%	+2.34%	+2.35%	+3.68%
Large-Cap Stock	+6.42%	+20.44%	+9.69%	+14.23%	+7.61%
Mid-Cap Stock	+5.43%	+15.81%	+8.06%	+13.22%	+7.82%
Small-Cap Stock	+3.56%	+12.27%	+8.69%	+12.98%	+8.12%
Foreign Large-Cap Stock	+3.94%	+25.17%	+7.74%	+7.28%	+1.81%
Real Estate	+2.04%	+6.21%	+5.14%	+8.68%	+6.76%
Natural Resources	+7.11%	+16.29%	+4.67%	+2.25%	+0.21%
Technology	+5.78%	+35.31%	+16.68%	+19.45%	+10.30%
Moderate Allocation (60% stocks)	+3.46%	+13.30%	+5.93%	+8.07%	+5.56%

The data in this table comes from Morningstar and is as of December 31, 2017.

Great Results in 2017—Six of the seven predictions came through for 2017 (marked in blue), and the only miss (in red) was slight. I called for foreign stocks to do the best, and they did, rising over 25%. I expected fine results from US stocks, and they did very well. Growth outperformed value, by a hefty amount. Real estate sharply underperformed most stocks, yet I was too pessimistic and they gained more than I expected, slightly over 6%. As predicted, General bonds gained less than 4%, while High-yield bonds did well, earning more than 6%. These 2017 predictions were probably my best predictions in many years.

Sector	**2017 Prediction**	**2017 Actual**	**2018 Prediction**
Large-cap US Stocks	More than +4%	+20.4%	More than +6%
Smaller US Stocks	More than +6%	+14.6%	More than +6%
Non-US Stocks	More than +8%	+25.2%	More than +8%
US Growth vs Value	Growth outperforms	Growth +27.6%, Value +15.9%	Growth outperforms
Real Estate	Less than +6%	+6.2%	More than +5%
General bonds	Less than +5%	+3.7%	Less than +5%
High-yield bonds	More than +5%	+6.5%	More than +5%

2018 Predictions—Overall, I expect another good year for risk in 2018, with stocks doing well along with high-yield bonds. I don't expect the gains to be as large as in 2017, however. I expect solid results from US stocks, and stronger results from foreign stocks. I predict that growth stocks will again outperform value, but by a smaller margin, and with smaller gains. I expect continued minimal gains from General bonds.

What is Hot and What is Not?—Stocks have done well, and most indications call for stocks to continue to fare well. The US economy is solid, however its growth beyond 2018 appears hamstrung by very low unemployment. JP Morgan's Global Market Strategist, David Kelly, expects GDP growth to be a 'One-Year Wonder,' with 3% growth in 2018 but 2% afterwards for several years. US stocks are similarly hampered, by their success. Their recent records are largely due to record profits, but area also the product of expensive prices. Just as it is hard to fall out of a basement, it is hard to climb above the roof. For these reasons, we prefer foreign stocks to US stocks, however we still like US stocks, but with some reservations.

There are six stock sectors that we have emphasized in the past, but only four that we currently favor. We continue to like a modest position in real estate, both US and foreign, as a long-term hedge against inflation. We like technology and healthcare as the two sectors from which the next major positive surprise is likely—whether it be a cure for a common, serious disease or whether it be a 'killer-app' which changes our lives. We like financial stocks at this time, as they have shown in the past to be able to fare well when interest rates rise, which we are expecting in 2018 and beyond. We have recently ended our use of a specific energy/natural resource investment sleeve, and a few years ago we tried a gold/precious metals sleeve and gave up on it a few quarters later. We don't feel that either provides compelling value at this time.

Finally, Foreign Stocks Surge Ahead—Foreign companies did well in 2017, and their gains were boosted further by a 7% drop in the US dollar. Foreign economic growth looks very solid, so even without further dollar declines, foreign stocks appear likely to continue to rise in 2018. Stock markets in both developed and developing countries have far to go before reaching record highs, and, unlike the US stock market, are not trading at expensive valuations. For this reason, we continue to have a preference for foreign stocks over US stocks in 2018 and beyond.

Oil and Commodities—Oil recovered well in 2017; however, we don't expect oil to do much in 2018. We also do not expect anything special from commodities in general. Our broad stock funds will continue to hold natural resources, but we no longer feel that a specific allocation is warranted, and fear that such an allocation will drag down 2018 portfolio results.

Inflation—Core inflation fell in 2017 to 1.7%. It is only expected to inch up to the 2% territory in coming years. There simply aren't sufficient reasons for it to rise to worrisome levels. Inflation could rise if historically low unemployment finally drives wage inflation up, or if a major infrastructure deal is struck and strains our resources. But for now, future 2% inflation is too low to warrant fear.

The Great Unwind—The Fed boosted overnight interest rates ¾% in 2017, and could raise them 1% in 2018. Surprisingly, intermediate- and long-term rates barely changed in 2017. While they presented plans, the Fed has yet to begin reducing its massive balance sheet, an unwinding that will take years and should steadily push interest rates upward. Fortunately, the pace has been shared and is modest. As such, we expect low returns for bonds for many years, but are not expecting any big losses from bonds.

We, too, will eventually need to unwind, to cut back our opportunity bonds and boost our quality bonds. Like the Fed, we plan to do this gradually, driven by data. US stock profits jumped in 2017 due to the oil sector recovery, and the 2018 economic growth should help 2018 profits, but the US economic prospects in 2019 are not inspiring. As economic growth slows and interest rates rise, quality bonds become more attractive and opportunity bonds less so. The years of opportunity bonds outperforming quality may be drawing to a close in a bit. Our opportunity bond unwind is inevitable, but we expect opportunity to outshine quality bonds in 2018.