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After a stellar year in 2017, stocks continued their upward climb in January. Volatility which had been mostly absent in 2017 picked up a little towards the end of the month but not enough to derail returns. The S&P 500 posted an impressive gain of 5.7% for the month. The small cap stocks in the Russell 2000 index were not up as much but still posted a respectable 2.6% gain. International stocks in the MSCI EAFE index were up 5.0% for the month while emerging markets surged 6.7% the first month of the year. Yields on the ten-year US Treasury also jumped from 2.4% to a new high of 2.72%. Because of the increase in yields, bond prices fell resulting in a -1.2% loss for the Barclays Aggregate Bond Index.

The initial estimate for fourth quarter GDP growth came in at 2.6%. Although lower than the 3.1% and 3.2% of the prior two quarters, it was not worrisome because inventory levels were down and will need to be replenished. JPMorgan believes inventory restocking will provide a boost to first quarter growth which could buck the trend of the past few years where first quarter GDP growth was a drag on annual GDP growth. Consumer spending and investment spending has already been strong and tax reform will likely fuel more spending by both individuals and corporations. GDP growth for 2018 could top 3%. The growth has not been limited to the US as global manufacturing has been growing at its fastest pace since 2011.

Corporate profits have also fueled stock prices. So far, of the companies in the S&P 500 that have reported 4th quarter earnings, 78% have beat their estimates for earnings and 68% have beat their revenue estimates which is the highest revenue beat ratio since 2010. Earnings have grown 20% year over year and profit margins have been expanding.

Looking forward, most analysts believe financials and energy stocks are the most attractive in the coming year as yields are expected to rise and oil prices have stabilized at higher levels resulting in easy year-over-year comparisons. Technology is also expected to benefit from global growth and strong demand. Industrials could also do well due to strong global growth. Utilities and telecom seem to be the least favorite followed by REITs and dividend paying consumer staples.

The Federal Reserve left rates unchanged after their January meeting. This was Janet Yellen's last meeting as Fed chair before Jerome Powell takes over. In their statement, the committee noted that the hurricanes did not disrupt the macro economy and that they expect the economy to grow at a moderate pace. They also expect inflation to pick up and stabilize around their 2% target. Current expectation is for the Fed to raise rates three or four times in 2018.

If the Fed does raise short-term rates four times, that would put the Fed Funds rate at 2.25 to 2.5% by year end. Although long term rates had not moved much in the prior year when the Fed was raising rates, we will likely see those long-term rates climb in 2018. Ten-year Treasury yields already rose 0.32% in January and JPMorgan believes the 10-year Treasury bond could reach 3% before year end.

Although higher yields can be a headwind to rising stock prices, JPMorgan believes there is still room for stock prices to grow even as yields rise at least until the 10-year yield is near 3.5%. Most analysts expect stocks to outperform bonds again in 2018 as rising rates may result in flat to negative returns for bonds. Many also expect stock volatility to pick up again. Views are mixed as to whether US stocks or international markets will perform better and whether small cap or large cap will outperform. We continue to believe a diversified approach to investing is prudent. If you have any questions, please do not hesitate to contact us.

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