Financial Advisory Service, Inc.

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FAS Monthly Economic & Market Update

December 2017

As of November 30, 2017

Contents

Economic Conditions

Gross domestic product (GDP) for the third quarter of 2017 was adjusted upwards from 3% to 3.3% according to the second estimate released by the US Department of Commerce. While just a slight adjustment, this number is significant because it is the first time in the nine year expansion that economic output came in at or above the Congressional Budget Office's maximum sustainable level, essentially meaning that the economy is running at its full potential. An economy's long-term potential output is the highest level of GDP (output of goods and services) an economy can sustain itself at over a period of time. When an economy is running below its potential output, as it has been since 2008, it creates what is called a negative output gap. For the first time in nearly a decade the US economy has crossed the long-term potential GDP threshold and is slightly above its maximum sustainable level (positive output gap). This means that the US economy is currently operating at near perfect levels strictly with respect to current levels of supply and demand and inflation expectations. Think of it as "the sweet spot." Although consumer spending was adjusted slightly downward in the second estimate, it is clear that demand is still strong and slack in the labor markets is continuing to tighten. Too much of a positive output gap in an economy could lead to rising inflation, which makes a Fed rate hike in December all but guaranteed, especially with tax reform likely on the horizon.

Market Conditions

Despite the small hiccup from early to mid-November when stocks saw their first weekly decline since September due to the status of the Senate's tax reform bill, the markets once again recovered and ended the month notably higher. The Dow Jones Industrial Average, which returned 4.24% in November, reached 24,000 for the first time in history, making this the fifth 1,000 point milestone of 2017 after starting the year under 20,000. Dips like we saw in mid-November are becoming shorter and shorter over time. Up until its small drop in November the S&P 500 had gone 50 trading days without a drop of 0.5% or greater; the longest since 1965 according to the Wall Street Journal. With the bull market continuing to show persistence it's becoming harder to "buy the dip" as investors are sweeping in at the first signs of weakness in hopes of getting in at lower prices. As the yield curve continues to flatten and bond yields struggle to keep up with inflation, investors seem to be more eager to allocate to equities with every opportunity they are given. The Barclays US Bond Aggregate fell 0.13% in November and is up a meager 3.07% for the year compared to the double-digit returns being realized in the broad equity markets.

Index Returns

	Nov '17	YTD
S&P 500	2.81%	18.26%
DJIA	4.24%	25.69%
NASDAQ	2.18%	27.70%
MSCI EAFE	0.88%	19.96%
Barclays Aggregate	(0.13%)	3.07%

Inversion of the Yield Curve

Yet again, U.S. equity markets are on pace to blow economists' projections for 2017 out of the water. As of November 30, the S&P 500 was up over 18% and has continued to climb to record highs heading into December. Most economic indicators are suggesting a positive outlook and continuation of increasing economic growth, at least in the short-run. Long-term projections are slightly more modest. The Purchasing Managers' Index (PMI) is an economic indicator that measures the health of the manufacturing sector and is used as a proxy for overall health in the economy, as it is a leading indicator that is believed to predict whether the economy is headed for a recession or expansion. A reading over 50 indicates an expansion and a reading below 50 indicates a contraction in the manufacturing sector. For the first time in a decade all 29 countries included in the IHS Markit Manufacturing PMI Survey reported a level of 50 or higher, signaling that the global economy is still in an expansionary period.

While economic indicators are painting a rosy picture for the outlook of the economy, there is a common Wall Street term worth making note of: "Bull markets don't die from old age. It's the Fed that kills them." Historically, when an expanding economy looks as though it may become overheated (i.e. increasing inflation) the Fed will step in and begin to raise short-term interest rates in order to slow the

(Continued on Next Page)

Inversion of the Yield Curve

economy. As we have discussed before, as interest rates *increase*, bond prices *decrease*, meaning that if the Fed is raising short-term rates, investors will tend to avoid short-term bonds and move further out on the yield curve into longer dated bonds by selling shorter dated bonds which pulls prices down (yields up) and buying longer dated bonds, pushing those bond prices up (yields down). If the Fed increases interest rates too fast or by too much the bond market could experience what is known as an *inverted yield curve* – short-term interest rates are yielding higher than long-term interest rates and the yield curve is downward sloping. The inversion of the yield curve is typically a leading indicator that the business cycle is coming to an end and that economic activity will begin to slow. If the economy is expected to slow, investors will flood into longer dated bonds in order to lock in long-term rates as they expect interest rates to be cut in the future due to a recession. An inverted yield curve has predicted the last five recessions dating back to the 1980s. A common indicator that investors use to measure the steepness of the yield curve is the 10-year treasury maturity minus the 2-year treasury maturity, known as the 10-2 Year Treasury Spread. With the 10-year treasury yield currently at 2.38% and the 2-year treasury spread currently at 1.80%, the 10-2 Treasury Yield Spread now sits at 0.58%, or 58 basis points (bps). This is the lowest 10-2 year spread in over a decade. The 2-year treasury yield has increased by

(Continued on Next Page)

Inversion of the Yield Curve

nearly 60 bps in 2017 while the 10-year treasury yield has remained fairly flat, falling 7 bps since the start of the year. It can be assumed that the recent rally in the 2-year treasury yield has been due to the anticipation of the rate hike that the Fed has all but promised would come in December 2017.

It is important to note two key points when looking at the state of the yield curve. First, while the 10-2 year spread is low, the yield curve has not yet inverted. Second, an inverted yield curve does not necessarily mean that a recession is coming tomorrow. Historically, a recession has typically not followed for months, if not years, after the yield curve became inverted. So it more serves as a warning sign rather than a surefire signal that a recession is on the horizon. No single indicator should be used to gauge where we are in a business cycle. But there are certain signals in the markets that can be used to anticipate where the economy may be headed. Making directional bets based on limited sources of information should be avoided when constructing or managing a portfolio. However, indicators such as the yield curve are helpful in that they give us reason to discuss risk tolerance and financial and psychological wherewithal to withstand the next correction and/or bear market.

Disclosures & Index Definitions

Under style performance boxes, indexes referenced in the equities section for large, mid and small reference the Russell 1000, Russell MidCap and Russell 2000 stock indices, respectively. The Barclays US Government, Barclays Credit and Barclays High Yield fixed income indices refer to Gov't, Corp, and HY, respectively. Short, Intermediate and Long refer to the time frame of the investments and their positions on the yield curve.

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All dates are as of November 30, 2017 unless stated otherwise.

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Index Definitions

The **S&P 500 Index** is based on the market capitalizations of 500 large companies whose stocks are listed on the NYSE and NASDAQ. This is widely regarded as the single best gauge of large cap US Equities.

The **Dow Jones Industrial Average** is a price-weighted average of 30 actively traded blue-chip stocks, primarily industrials. It is used as a barometer of how shares if the largest US companies are performing.

The **NASDAQ** is a market capitalization weighted index of the more than 3000 common equities listed on the NASDAQ Stock Exchange. These securities include American Depository Receipts, common stocks, real estate investment trusts, and tracking stocks.

The **MSCI EAFE (Europe, Australasia, Far East) Net Index** is recognized as the pre-eminent benchmark in the US to measure international equity performance. It comprises the MSCI country indices that represent developed markets outside of North America, Europe, Australia, and the Far East.

The **MSCI Emerging Markets Index** captures large and mid cap representation across 23 Emerging Markets (EM) countries. With 822 countries, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The **Barclays US Aggregate Index** is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS, ABS, and CMBS.

All index information has been gathered from public sources who are assumed to be reliable, although we cannot guarantee the accuracy or completeness of those public sources.