While the cacophony from Washington drowned out most other economic news, the fourth quarter of 2017 actually brought some surprisingly strong economic releases. Though September's jobs report missed expectations, it proved to be a blip, as strong October and November reports showed the US workforce continues to expand. The unemployment rate now stands at 4.1%, a new cyclical low. Business sentiment indices continued to show strong investment and confidence, and consumer sentiment seems to be finally catching up. Retailers posted a banner holiday shopping season in 2017; Mastercard calculated total US retail spending was up 4.9%, marking the largest uptick in six years. Consumers appeared to be spending on bigger-ticket items, as well; December auto sales were better than expected, and existing home sales surged for the third straight month in November to 5.6%, the fastest pace in a decade. With third quarter growth revised to a final 3.2%, the second and third quarters of 2017 now represent the strongest six-month stretch of growth since 2014.

These economic conditions pose something of a quandary. Businesses are investing, shoppers are spending, and the workforce appears close to full employment. Labor demand remains high, whether you refer to surging employment indices, or to the anecdotal refrain about the difficulty in filling jobs made by numerous CEOs during Q3 earnings calls. Yet, wage growth remains sluggish at 2.5%, and inflation remains muted, with Core CPI, a popular measure, actually falling from 1.8% to 1.7% in November.

Against this backdrop, the Republican-controlled Congress passed the largest reduction in US taxes since the Reagan era at the end of December. While much has been written about the minutia of various changes in the tax code, the overall impact may have a greater impact on the economy as a whole: this bill represents fiscal stimulus of nearly a trillion dollars over a ten-year period, for an economy already showing signs of strong growth. How exactly this will affect the economy should prove interesting. With consumer and business spending already strong, the tax cuts could provide a helpful boost to enable wage growth and broaden an economic recovery that, thus far, has favored capital over labor. However, with some evidence that consumer spending may already be rising, there's a risk that the numbers have not yet caught up with the reality, and stimulus on an already hot economy could cause it to overheat. With Jerome Powell taking the Federal Reserve Chair and with five openings for Trump to fill on the 9-person FOMC, how a largely new Federal Reserve manages the balance between growth and inflation could become a dominant theme in 2018.

EQUITY REVIEW

For the stock market, 2017 will be remembered as a truly remarkable year. The S&P 500 accomplished a number of statistical achievements this year which help elevate 2017 in historical context. The index finished green for the 9th year in a row, tying the 1991-1999 streak for the longest ever, and was positive each month of the year, an achievement never seen before. Even more extraordinary was the historically low volatility. The VIX closed the year below 10 for the first time ever, over 10 points below its 20-year average of ~20.5. On average, the S&P experiences roughly fifty 1% daily moves and ten 2% daily moves per year. This year, we had 8 and 0, respectively. Pullbacks have been nearly nonexistent. The S&P hasn't had a drawdown of 3% since November 2016, the longest streak on record dating back to 1928. It is important to remember that since 1980, the average intra-year drawdown for the S&P 500 is nearly 14%! The high returns and low volatility of 2017 were truly extraordinary and unlikely to become the norm going forward.

With that said, the pillars of the current rally should remain tailwinds heading into 2018. As noted in our previous letter, this rally has largely been driven by a synchronized uptick in global economic growth, a continued recovery in corporate profits, and historically accommodative global central banks continuing to provide a backdrop of easy monetary policy amid an absence of meaningful inflation. Markets also received a lift when Congress passed a tax reform bill that lowered the corporate tax rate and provided a lower one-time repatriation tax rate for overseas profits. These changes to the tax law have the potential to add an estimated 7-10% to corporate profits in 2018, a boost to the continued growth already forecast for US companies. The tax bill will likely benefit shareholders via increased buybacks and dividends, but could also benefit workers via higher wages and customers via increased investment in the business leading to better products. The numerous impacts of the tax bill will be something we will be following closely in the new year.

Aside from the impact of tax reform, the team at Appleton will be focused on several items that could stir volatility in 2018. Valuation levels are above average, but it is important to remember that high valuations, in isolation, do not portend doom. Over time, valuation measures have a low correlation with one-year-ahead returns. We will be watching for any news out of Washington regarding the administration's agenda for the year ahead. Infrastructure and entitlement reform are thought to be next for the GOP, who already have an eye on the November mid-term elections. Investors largely ignored any geopolitical flare-ups in 2017, and it will be interesting to see if that trend continues in 2018. Finally, we will be closely monitoring for any signs of inflation and the impact it may have on monetary policy and the yield curve. A flattening yield curve is not a bad omen, but an inverted curve is as sure a sign as any of a subsequent recession following the inversion. However, the team at Appleton does not believe the curve inverts in 2018; thus, a recession does not appear imminent. With that, we advise that our clients stay invested as we start the New Year.

FIXED INCOME REVIEW

The world of Washington, DC was once again a driving force for the fixed income markets; although, it was not President Trump's tweets but the workings of the Federal Reserve that drove the markets. Persistently low unemployment rates increased the Fed's concern that inflation, especially wage inflation, might reappear after years of dormancy. In an effort to be preemptive, they raised rates three times during 2017, lifting the overnight rate a combined 0.75% to a range of 1.25% to 1.50%. The Fed also embarked on a policy to shrink its massive $4.5 trillion balance sheet, although the initial scope of this plan has been quite modest. In the face of this combined effort, inflation remained benign, evidenced by the CPI dropping to 1.7%, and the Thompson Reuters CRB Commodity Index only increasing a scant 1.95% over the course of the year. With the Fed raising short-term rates and investors seeing no signs of runaway inflation, the yield curve flattened dramatically. The spread between 2-year and 10-year Treasury declined 69 basis points from 122 to 53 basis points.

The consensus outlook for investment grade corporate bond spreads entering 2017 was very different than what actually transpired. There were many who suggested that the solid performance of credit spreads in 2016 could not continue, as spreads were well below the 30-year average at year end. However, spreads did the opposite amidst strong demand and solid corporate profits, with investment grade spreads ending 2017 at the tightest levels in ten years. The Bloomberg Barclays US Agg. Corporate OAS index began the year at 122 basis points, which proved to be the 2017 high, and slowly trickled down to end the year at 93 basis points. We witnessed a slight widening of spreads in the middle of the fourth quarter, as volatility arose amid the Senate tax reform bill being piecemealed together with little detail and an uncertain chance of passing.

It was another strong year for issuance, as a record $1.6 trillion of new taxable investment grade debt was added to the market, 1.5% higher than 2016. Early in the year, companies aggressively tapped the market on the premise that rates were going to rise and the uncertainty surrounding the new administration would bolster volatility. Again, the reality proved more sanguine than the expectations. After the January rush, issuance slowed with only $322 billion brought to market in the first quarter. The prospect for supply in 2018 is expected to be lighter, as corporate balance sheets benefit from repatriation, lower taxes, and strong economic growth. Should secondary market demand remain high, credit spreads are likely to be supported at their current levels with the potential to tighten further.

The municipal market typically takes it cues from the Treasury or corporate markets, but in 2017 all markets were beholden to Washington, DC. In the fourth quarter, tax reform took center stage and uncertainty of its contents and passage led to an onslaught of municipal issuance. As issuers rushed to the market in anticipation of limitations making their way into the tax bill, municipal issuance in December was at an all-time high. Total issuance for the year came in at $436 billion, just shy of 2016's record. Fortunately, the pickup in supply was offset by strong municipal fund inflows, as funds took in $18.1 billion over the course of 2017. We expect issuance to decrease in 2018, continuing the net negative issuance trend we have experienced in recent years. This waning supply and stable demand from investors should continue to support the municipal market.

We see general municipal credit stability carrying on through the first part of 2018. The economy should continue to grow, strengthening the labor and housing markets, household incomes and consumer spending, and supporting growth in the various tax revenues that state and local governments rely on. While we see broad stability, we note that there are a number of long-term challenges for state and local governments, specifically increasing fixed costs and expenditures (pensions), a decrease in federal support, and some shifting demographics that we continue to monitor and incorporate into our credit decisions.

As we previously stated, new Chairman Jerome Powell is set to take over for Janet Yellen in February, and the team at Appleton will be monitoring the new leadership at the Federal Reserve. While Powell is perceived to lean dovish, investor consensus is for the Fed to raise interest rates anywhere from two to four times in 2018. We will be watching for any changes to the yield curve, inflation, productivity, and fiscal policy that could cause the Fed to diverge from their current path. Overall, the combination of improving economic conditions and a historically accommodative Fed should provide a constructive environment for both equities and fixed income as we look into 2018.

As always, we welcome your comments and questions. Please contact us if there are any changes to your financial situation or investment objectives. Appleton is also now active on Twitter: follow us on Twitter at @AppletonPtnrs.