Foresters Financial 2018 Outlook

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A year of opportunities

Overview

2017 can be characterized as a return of more robust U.S. economic growth. While this expansion has been fairly steady, it has been below growth rates typically experienced after a severe recession. Markets reacted positively to better growth, with the S&P 500 posting a 20.49% gain since the beginning of the year (as of 11/30/2017).

Currently, there are signs of an improving overall economic environment. The U.S. economy is showing stronger GDP readings, the unemployment rate is ticking lower, and labor participation is improving. All of these factors present a fairly positive picture for investors.

Internationally, economies look better as well, with Europe, Japan and the emerging markets posting better-than-expected economic data, and China showing signs of a soft landing.

The overall brightening outlook for business has translated into improving earnings for U.S. companies. Where earnings growth over the last several years had been achieved through improving efficiencies and share buybacks, more recently, companies have seen earnings growth along with positive revenue surprises.

A great tide of monetary policy

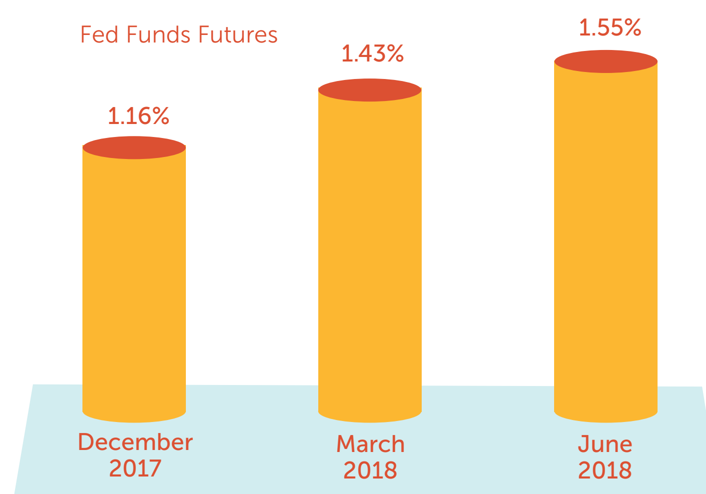
After a decade of nearly zero interest rates, the Federal Reserve (the Fed) has clearly embarked upon a path of rate increases and has also initiated the unwinding of its balance sheet positions in U.S. Treasurys and mortgage-backed securities (MBS) debt. Similarly, the European Central Bank is also poised to taper its asset purchasing program. In November, the Bank of England finally pulled the trigger on its first interest rate hike since the start of the financial crisis. Only the Bank of Japan stands as an outlier as it continues to embrace its expansionary monetary policy.

With this tide of global monetary policy, many observers think that 2018 will be a year of higher interest rates and we share in this opinion. However, for several reasons, we believe that rates will likely move in a relatively narrow range. First, demand is a primary driver for interest rate levels. Foreigners have been reliable buyers of U.S. Treasurys for some time and that trend has continued, with no reason to expect it to change dramatically in the near future. Second, inflation remains in check and the Fed, based on its recent meeting minutes, indicated that inflation has not risen as it expected. It is challenging to envision a scenario in which inflation rises to 2% in the coming year. Against this backdrop, we expect interest rate movements to be fairly contained.

Disconnect exists between the Fed and investors

Focusing on monetary policy and market expectations, the Fed has been suggesting that it may hike interest rates three times in 2018; however, as shown in *Exhibit 1*, this is not the market's expectation. According to the futures market, only a single increase is being priced into the Fed futures yield curve for next year. With investors and policymakers being out of sync on this front, there could be some unexpected volatility in the market. We will continue to monitor this dynamic and its potential impact to investors.

Exhibit 1: Market expecting only one rate hike in next 12 months



Source: Bloomberg, 12/14/2017.

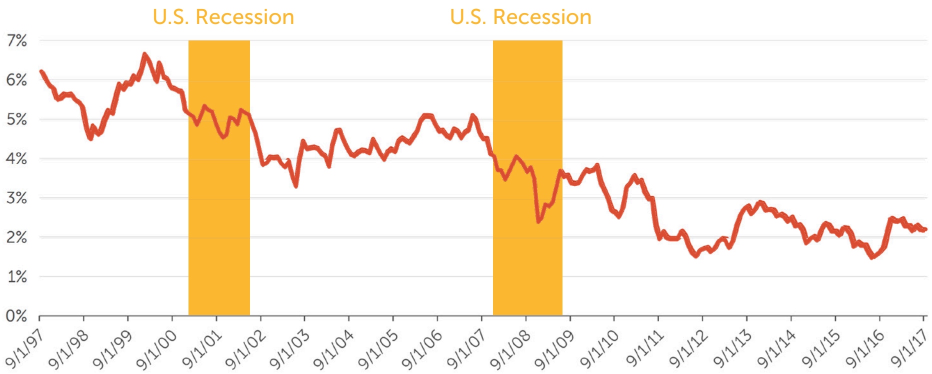
Four reasons why the Fed could increase rates faster than anticipated

Up until now, the Fed's course of action has been announced well in advance and we have confidence that this process will continue to be the norm; however, events sometimes dictate that a change occur in approach. We see four possible reasons that might cause the Fed to speed up the pace of its interest rate hikes.

1. No "real" tightening has occurred.

Perhaps somewhat surprisingly, financial conditions are easier today than one might have expected at the beginning of 2017. In fact, the 10-year U.S. Treasury yield is lower today *(see Exhibit 2)* than it was at the beginning of the year when it was trading at 2.45%. Also, inflation remains stubbornly low, while U.S. unemployment has been moving steadily downward *(see Exhibit 3)*. Hence, the typical effects in the economy that one would expect to see from a Fed tightening cycle seem to be missing. Despite this lack of apparent tightening, the Fed expects that its gradual pace of tightening will eventually have an impact on the economy so we consider this rationale to have a low probability of contributing to a sudden move by the Fed.

Exhibit 2: 10-year Treasury lower than beginning of 2017



Source: Bloomberg, 10/31/17.

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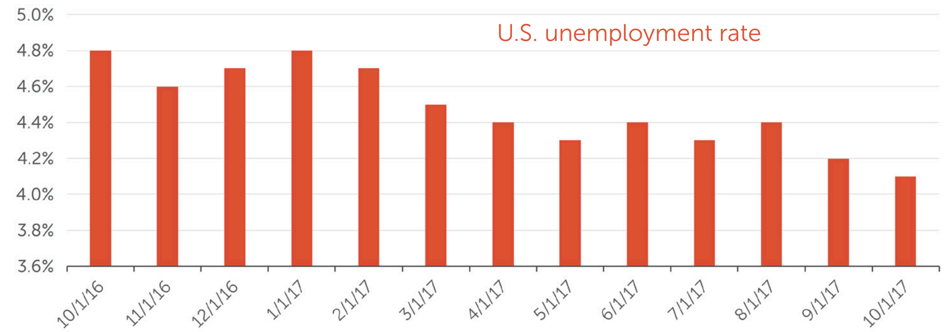
Exhibit 3: U.S. workers continue to find jobs

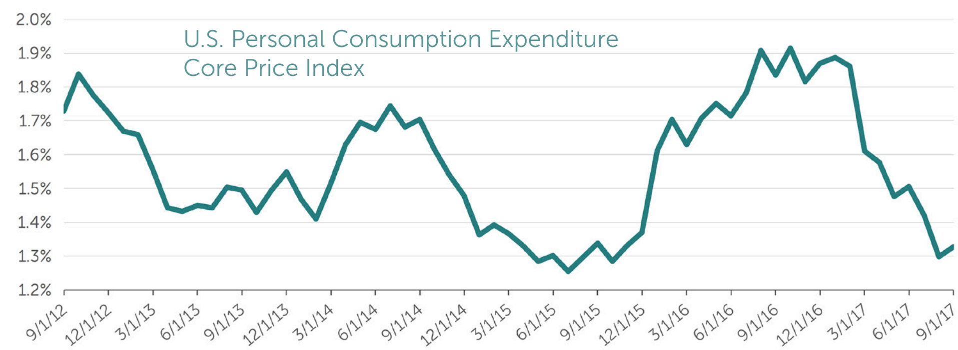


Source: Bloomberg, 10/31/2017.

2. Inflation rises unexpectedly.

Despite current evidence otherwise, there is a chance that we could see a sudden spike in inflation. Wage growth has been largely stagnant of late, but if there was a dramatic uptick in wage levels, it could prompt the Fed to hasten the pace of its rate increases in an attempt to cool off the economy. Given the available data, though, this remains an unlikely event, in our opinion *(see Exhibit 4)*.

Exhibit 4: Inflation appears contained

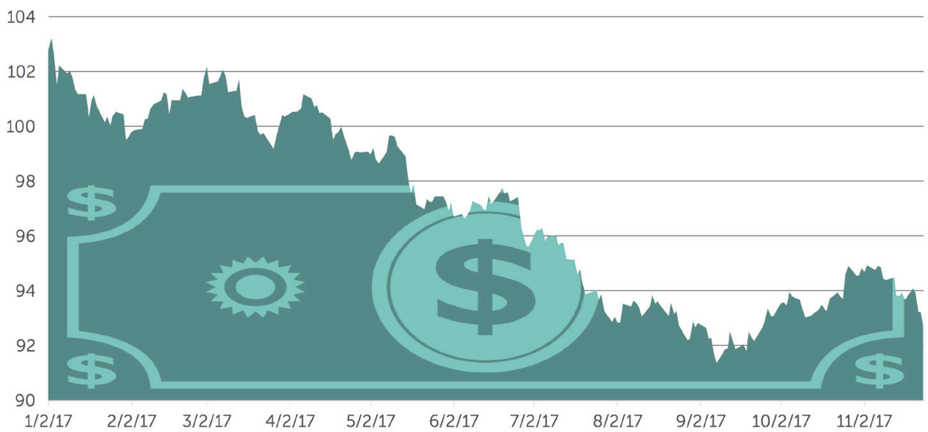


Source: Bloomberg, 9/30/2017, shown as YoY SA.

3. U.S. dollar falling.

The greenback has fallen roughly 10% during 2017 *(see Exhibit 5, next page)*, largely due to political uncertainty in the U.S. and accelerating growth overseas, and had been in a downward trend until roughly mid-September 2017. A declining dollar could start to boost import prices, and given the knock-on effect on inflation, might be seen as a catalyst for Fed action. Since September, however, the dollar has rallied, the U.S. lowering the likelihood that the Fed will feel it necessary to act more quickly.

Exhibit 5: U.S. dollar has stabilized



Source: Bloomberg, 11/30/2017

4. Passage of tax reform.

The new tax bill signed by President Trump on December 22nd might cause the Fed to accelerate its pace of interest rate tightening. Lower taxes, helped by heightened consumer and business spending, could stimulate the economy and cause an increase in inflation. This is particularly a risk since the economy is already at full employment. The full impact of the tax policy changes is still under some debate but the legislation will surely have a significant influence on the U.S. economy in 2018.

Fixed income by sector

U.S. Treasurys: This is a sector that has witnessed strong demand from overseas buyers. Foreign central banks, in particular, have been large investors, buying $3.1 trillion in Treasurys for the year ending 9/30/17 compared to $2.8 trillion at the end of 2016. We would expect demand from foreign investors to remain high, even with higher interest rates.

Agency MBS: This is a fixed income sector that is likely to come under some pressure in the coming months. In particular, the Fed's tapering of its program of buying MBS is a noticeable decrease in demand going forward. As a separate distinction, we do think that commercial MBS could be attractive in 2018.

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Corporates: At this time, there are very encouraging signs for corporate bonds due to strong corporate earnings and a high level of investor demand from both local and offshore investors *(see Exhibit 6)*. Credit fundamentals remain stable and leverage metrics have been kept in check. Issuance volumes have been high, with 2017 being the fifth consecutive year of more than $1 trillion in new issues coming into the market. The sector continues to offer solid performance. Yields are still sufficient to garner foreign interest. Even if overseas central banks reduce their current purchasing programs, we still believe that foreign participation will remain a significant part of the market next year. Furthermore, potential tax reforms, in particular a lower corporate tax rate should positively impact corporates. Overall, we favor financials over industrials, especially money center banks that are extremely well-capitalized and highly regulated, minimizing their exposure to event risk.

Exhibit 6: Corporate bond snapshot

US Corporate Master Index

		Change (bp)		
	November 3, 2017	Week	Month-to-Date	Year-to-Date
High Grade	102	23	1	-28
Financials	90	1	1	-36
Industrials	107	3	1	-24
Utilities	107	1	1	-23

US High Yield Master II Index

		Change (bp)		
	November 3, 2017	Week	Month-to-Date	Year-to-Date
High Yield	352	8	1	-70

Source: BofA Merrill Lynch, CreditSights, 11/3/2017.

High Yield: We are positive on the High Yield sector due to the expected and continued low number of defaults, although valuations are stretched in this market. It is worth mentioning that energy-related companies form the biggest component of the market and, hence, this sector could be affected by market events like a sudden move in the price of oil.

Municipals: The performance of the Municipals market in the coming months may depend mainly on the fallout from the new tax law. Although private activity bonds (sold for a variety of projects including hospitals, colleges and airports) retained their tax-exempt status, the elimination of advance refundings (bonds used to refinance bonds beyond 90 days from their call date) will pose a challenge to the new issue supply; hence, to some extent, driving municipal bond prices up. Recent issuance levels are shown in *Exhibit 7*. Inflows, up $27.9 billion on a net basis through 10/31/17, have been a positive story during 2017.[1]

[1] *Source: Morningstar, 10/31/2017.*

Exhibit 7: 2017 Municipal issuance down versus prior two years

Estimated long-term minicipal bond new issue volume ($billions)

	2014	2015	2016	2017	Change
January	16.3	28.3	24.2	33.7	39%
February	17.1	32.0	30.1	23.0	-23%
March	14.8	42.7	41.2	33.4	-19%
April	17.2	40.3	34.6	30.6	-11%
May	16.5	32.7	40.0	35.9	-10%
June	10.4	35.4	44.8	37.3	-17%
July	14.1	34.4	27.4	26.9	-2%
August	10.9	30.8	45.3	41.4	-9%
September	11.7	23.0	37.5	26.8	-28%
October	16.0	30.4	54.0	40.7	-25%
November	16.3	23.2	29.9	–	
December	16.2	20.6	18.6	–	
YTD through October	**145.0**	**330.0**	**379.1**	**329.9**	**-13%**
Full year total	177.4	373.8	427.6	329.9	

Source: MSRB, Bloomberg, 10/31/2017.

For equities, tax reform is the key in 2018

As we approach year end, most of the major equity sectors (Energy and Telecoms being the notable exceptions) have performed well, with many producing double-digit returns on a year-to-date basis.[2] This performance represents the ongoing stock market rally that has occurred since President Trump took office. The so-called "FANG effect", which takes its name from four high-performing tech stocks—Facebook, Amazon, Netflix and Google (now known as Alphabet)—has been a leading force in the market. Stock valuations are high, recently hitting 18x trailing earnings per share.[3] Having said that, while we may not consider the market to be overheated, we do feel it is nearly fully valued. Leading this momentum has been solid earnings growth supported by an annualized GDP growth rate of 3% *(see Exhibit 8)*, a low interest rate environment and companies being focused on expense mitigation.

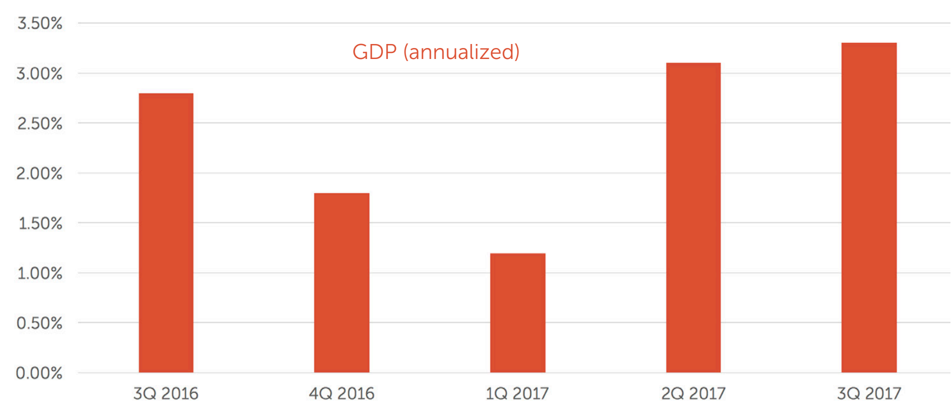
When considering investment style, the gap between Growth and Value is at its widest spread seen in nearly two decades. On a total return basis, the S&P 500 Growth Index has returned 23.4% compared to 9.7% for the S&P 500 Value Index.[4] Clearly, growth stocks have been rewarded during 2017.

Casting an eye toward next year, we believe the Trump tax plan may be a key factor for whether there is an average, or above-average, year in stocks. This legislation could represent the biggest tax cut package since the Reagan administration. Under such a scenario, we can imagine the possibility of the market rally continuing. Substantial money would be freed up for corporations which could generate more M&A activity, organic growth, new products in the marketplace and hiring. Finally, the impact to domestic-focused businesses, notably mid- and small-cap stocks, could be substantial.

Large Cap: U.S. large-cap stocks have risen steadily during 2017, benefiting from both rising corporate earnings and solid economic growth. In our opinion, this trend is likely to continue in 2018, but at a slower pace as high valuations could impact the extent of any market rally in this sector. Large-cap stocks are also more diversified geographically, typically, and conduct business all over the globe. A reduction in corporate tax rates, while beneficial, may have a more muted impact on multi-national companies, although these firms stand to benefit from a potential cut in taxes of foreign earnings held in cash.

Mid Cap: Although they have lagged recently, mid-cap stocks have tended to grow faster and outperform large-cap U.S. stocks over time. They have also been more volatile. We expect them to continue to report higher earnings growth moving forward. Since their prospects are typically tied more closely to domestic conditions, mid-cap stocks (as well as small caps) could benefit nicely from the proposed corporate tax reductions.

Exhibit 8: U.S. growth trending up



Source: Federal Reserve Economic Data, 11/29/2017. Seasonally adjusted annual rates.

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[2]*Source: S&P 500, 11/2/2017.*
[3]*Source: Factset, 11/10/2017.*
[4]*Source: Morningstar Direct, 10/31/2017.*

Small Cap: As mentioned earlier, Growth and higher-risk names have been the clear winners in the size category during the past year. However, we believe that Value and lower-risk, more-profitable names may start to re-assert leadership, especially within the small-cap space, which has notably lagged. The prospects of the Trump tax plan, along with a Value-led market, position this sector to outperform in 2018.

2018 Outlook: Where we see opportunities

	U.S. Equities	Municipal Bonds	Corporate Bonds	High Yield
Headwinds	• Valuations high • Interest rates moving upward • Growth has significantly outpaced Value in 2017	• Uncertainty from tax reform	• Higher interest rate environment • Tight spreads	• Tight spreads
Tailwinds	• Economy and corporate earnings • Proposed tax policy changes	• Proposed tax policy changes	• Decreased issuance • Potential tax policy changes	• Defaults at reasonable levels • Tends to follow equity market
Key takeaways	• Market continues to outperform across sectors • Mid- and small-cap stocks could outperform if proposed Trump tax plan passes	• Proposed Trump tax plan excludes any change in tax treatment for individual investors • Inflows remain positive	• Despite the Fed's rate hikes, bonds continue to rally • Disconnect may exist between Fed and investors regarding the expected number of rate increases	• Stronger issuer landscape than in the past • Not expecting sudden uptick in default rate

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