The Weekly

Special Edition: Expectations for 2018

Peapack-Gladstone Bank, Private Wealth Management

January 5, 2018

As of 01/05/2018		Wk	Wk		YTD
		Net	%	Div	%
STOCKS	Close	Change	Change	Yield	Change
DJIA	25,295.87	576.65	2.33	2.07	2.33
S&P 500	2,743.15	69.35	2.58	1.84	2.58
NASDAQ 100	6,653.29	256.87	4.02	1.01	4.02
S&P MidCap 400	1,936.27	35.70	1.87	1.49	1.87
Russell 2000	1,560.01	24.50	1.52	1.33	1.52

TREASURIES	Yield	**FOREX**	Price	Wk %Change
2-Year	1.96	Euro/Dollar	1.19	-1.03
5-Year	2.28	Dollar/Yen	113.06	1.17
10-Year	2.47	Sterling/Dollar	1.36	-0.65
30-Year	2.81	Dollar/Cad	1.24	1.28

Source: Thomson Reuters & Bloomberg

Economy

Despite the attention received by the Tax Cuts and Jobs Act (TCJA) we are only expecting a modest increase in 2018 GDP growth. Quarterly GDP figures should surpass 2.00% in 2018, but without a pickup in productivity growth it will be a challenge to achieve 3.00% growth for the entire year. Productivity did move higher in the third quarter, but it has only advanced by 1.5% over the last year and 0.8% over the last five years. Business equipment spending is a key component of productivity gains, and this segment has picked up significantly over the last twelve months. We like to focus on "core" shipments (non-defense capital goods ex-aircraft) and these figures have increased by approximately ten percent over the last year. Another important component will be job gains and improvement in the labor force participation rate. The unemployment rate is currently at 4.1%, and the participation rate is now at 62.7%. We also keep a close eye on the U-6 measure of unemployment, which topped out at 17.1% during the Great Recession and now resides at 8.0%. In the past year payrolls are up an average of 173,000 per month. Monthly employment gains should be similar in 2018, with the average settling in between 150,000 – 160,000. The consumer enters 2018 on strong footing, as we have seen confidence levels soar, retail sales data post impressive numbers, and monthly job gains very consistent month to month. On the negative side the personal savings rate has plummeted to 2.9% a 10 year low, and the lowest level since just before the last recession began in late 2007. Historically speaking when savings rates get down to 2% - 3% it usually implies that there is no more pent-up demand, and the economic expansion is running out of steam. Recently personal income and consumption figures were reported and the year-over-year numbers were impressive (+3.8% and +4.5%). Finally and probably the biggest wild card for 2018, the Federal Reserve. The Fed has been increasing interest rates, and will continue to do so. It appears the Fed will increase rates 3-4 times in 2018, and the increases will be modest (+25 basis points). At the moment inflation is under control (core CPI +1.7% year-over-year), but if inflation data comes in stronger the Fed will have to be more aggressive with their rate increases. A more aggressive Fed is positive for fighting inflation, but not positive for an economic expansion now entering its tenth year.

COMING UP NEXT WEEK		Est.
01/08 Consumer Credit	(Nov)	19.50B
01/09 JOLTS Job Openings	(Nov)	-
01/10 Wholesale Inventory, R MM	(Nov)	0.7%
01/11 PPI Final Demand MM	(Dec)	0.2%
01/12 CPI MM, SA	(Dec)	0.2%
01/12 Retail Sales MM	(Dec)	0.5%

Equities

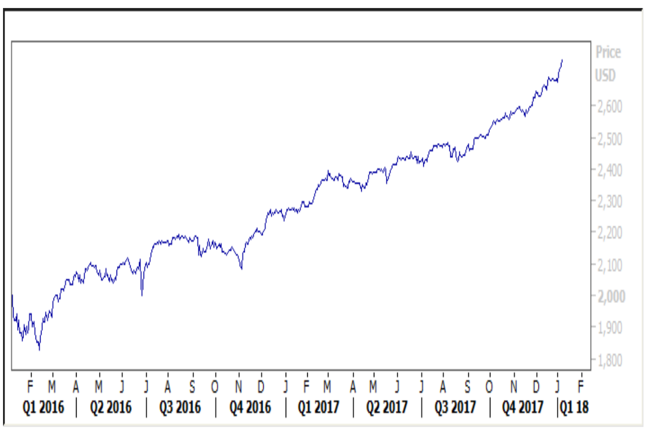
Global equity markets capped off a surprisingly strong 2017 with a robust fourth-quarter advance based on expectations of further economic expansion. Equity investors and most economists are expecting the recently signed Tax Reform and Jobs Act to modestly lift economic growth in 2018. Estimates vary regarding the magnitude of the economic impact tax reform will have, but economists generally agree that the tax law change will positively lift capital spending and corporate earnings. Earnings were the key to the equity market strength last year. Earnings expectations rose throughout 2017 as economic growth exceeded forecasts, particularly in the latter half of the year. Ample liquidity provided by central banks aided global economic activity, suppressed interest rates and encouraged risk taking. We believe that these favorable conditions will persist as we begin 2018.

Some investors are concerned that the continued market gains are "long in the tooth." U.S. stocks have been on an upward trajectory for almost nine years. Over the past 50 years, the average U.S. bull market has been about 4.5 years. Corporate margins (profitability) are most likely at or near their cyclical highs, and the market valuation as measured by the forward multiple on the S&P 500 is 20.6x, the highest in 15 ½ years.

Ultimately, revenue and earnings growth drive stock returns. According to Zacks Investment Research, aggregate analyst estimates for 2018 and 2019 year-over-year earnings growth are 10.6% and 11.3% respectively. This is expected to be driven by revenue growth of 5.3% in 2018 and 3.9% in 2019. The energy, materials, technology and financial services sectors are expected to drive corporate earnings growth over the next 12 months. The impact of the new tax legislation has not yet been fully accounted for in analyst projections. When earnings estimates do increase, the valuation of stocks will become slightly more attractive. The government's policy of regulatory relief and the anticipated effort to increase infrastructure spending could also have a positive effect on corporate bottom lines.

In 2017, equity returns in developed international markets and emerging markets outpaced U.S. returns for the first time in five years. We expect continued strength in 2018. The manufacturing and services sectors are expanding at a faster rate in Europe than in any other region in the world, and the emerging markets lead the world in overall economic growth. Relative valuations outside the U.S. are compelling. Developed international equities and emerging market equities sell at a 12% and 31% discount to U.S. stocks respectively. Synchronized global growth should continue to lift global equity markets higher in the upcoming year.

S&P 500



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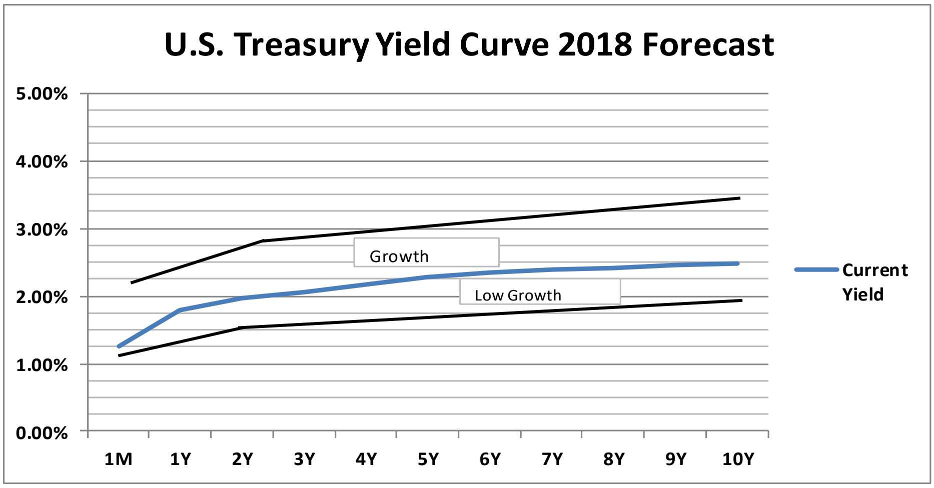

Fixed Income

As the global economic recovery is expected to continue throughout 2018, developed market central banks around the world are anticipated to reduce the growth of their balance sheets that have expanded to a staggering $15 trillion. It is likely that 2018 will still produce net accumulation of central bank balance sheets, however, the runoff should begin in the back half of the year and continue at a measured pace into the future. The declining reliance on extremely accommodative monetary policy is expected as long as coordinated global growth continues and inflation does not accelerate too quickly.

If the economy progresses according to the FOMCs most recent projections, the Fed funds rate should end 2018 at 2.125%, which implies 3 rate hikes over the course of the year. The Fed funds futures market is not quite as optimistic and sees the Fed funds rate ending the year at 1.94%, which implies a little more than 2 rate hikes over the next twelve months. The next FOMC decision is scheduled for January 31st and the implied probability of a rate hike currently stands at 0%. The second FOMC decision of 2018 occurs on March 21st and right now it looks like there is an 81.7% chance of a 25 basis point rate increase. If wage inflation continues its upward trend and overall inflation rises above the Fed's current forecast moving forward, the Fed may find itself increasing rates 4 times over the course of the year.

U.S. yield curve flattening was the theme in 2017 after the 2-year and 10-year U.S. Treasury spread closed the year at 52 bps, down from 126 bps at the beginning of the year. According to Bloomberg, the forward curve is predicting continued yield curve flattening as the Fed gradually increases frontend interest rates and the long-end of the curve remains relatively range bound. Over the course of 2018 the 2-year and 10-year U.S. Treasury spread is forecasted to decrease an additional 7 bps to a spread of 45 bps according to the forward curve. In economic circles, the flattening of the U.S. Treasury curve is natural during periods of monetary tightening and is not currently an indication of an impending U.S. recession because the 2-year Treasury is still over 50 basis points above the effective Fed funds rate. Once the front end of the yield curve out to 2 years becomes inverted it means the Fed has most likely lifted rates too far and economic turbulence may be approaching. At the end of 2018, the benchmark 2-year and 10-year Treasuries are expected to be 2.09% and 2.54%, respectively and it seems unlikely for yield curve inversion unless inflation expands more rapidly than anticipated.

Credit spreads are starting the year at extremely low levels. With the investment grade and high yield option adjusted spreads at 90 and 351 basis points, respectively it would be surprising to see additional spread compression over the course of the year. Liquidity costs are increasing which could add a slight uptick to the currently low default rates. With respect to municipal bonds, institutional demand should be softer in 2018 given the reduced tax benefit with the corporate tax rate being lowered from 35% to 21%. However, individual investors should still see relative value in municipal bonds as the top federal tax bracket was reduced only 2.6% and a cap of $10,000 was placed on local property and state income/sales taxes. Municipal bonds should also see a modest benefit from a reduction of supply coming from the elimination of advance refunding bonds.

The Major Tax Changes:

Cut corporate taxes permanently and temporary cuts for individuals.

Business tax provisions:

- Corporate tax rates lowered to 21% from 35%.
- Repeal the corporate alternative minimum tax (AMT).
- Full and immediate expensing the cost of certain equipment purchased after September 27, 2017 and before January 1, 2023 for corporations.
- Repatriation – Tax accumulated overseas cash at 15.5% and non-cash holdings at 8%, down from 35%.
- Pass-Through Business Income – Deduct 20 percent from their business income, subject to limits at $315,000 for married couples, or half for single taxpayers.

Individual tax provisions:

- Individual Tax Brackets - Seven individual tax brackets remain starting at 10% and reaching 37%, down from a maximum rate of 39.6%.
- Repeal the Affordable Care Act's individual mandate.
- Expand the standard deduction for individuals $12,000 and $24,000 for joint filers. Personal exemptions repealed.
- State and Local Tax Deductions – The deduction is capped at $10,000, which includes the combination of property taxes and either sales or income taxes.
- Mortgage Interest Deduction – Limit the deductible mortgage interest on newly purchased first or second homes to loans of $750,000 or less.
- Medical Expense Deduction – Reduce the threshold to 7.5 percent of adjusted gross income for 2017 and 2018.
- Child Tax Credit – Double the credit to $2,000 per child younger than 17 through 2025. Raise the phase-out threshold to $400,000 and cap the refund portion at $1,400 in 2018.
- Estate Tax – Double the thresholds so tax will apply to fewer estates. The higher thresholds would sunset in 2026.

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