Quarterly Outlook

JANUARY 2018

Fourth Quarter 2017

One lasting impact of the Great Recession is evident in the sense of skepticism it seems to have instilled on investors' psyches.

Market behavior throughout 2017 was, in a word, ideal. Asset prices rose steadily at home and abroad throughout the fourth quarter, closing out a year marked by exceptional returns paired with unusually low levels of volatility. The S&P 500 posted positive returns for each of the 12 calendar months (for the first time on record) while maintaining the lowest average monthly volatility levels since 1970. Ten-year Treasury yields maintained their tightest range since 1965. In essence, investors managed to have their cake and eat it too.

The S&P 500 closed at 2,673.61 on December 29, 2017 for a total return of 6.64% in the quarter and 21.83% year to date. The Information Technology sector continued to outperform the broad market with a total return of 9.01% in the quarter and 38.83% for the year, making it the best performing sector of 2017 by a comfortable margin. Energy and Telecommunication Services were the only sectors to post negative returns for 2017 with returns of -1.01% and -1.25%, respectively. The remaining eight sectors all posted double-digit positive returns for the year.

Equity performance was driven by solid corporate earnings, high consumer and business confidence, global economic expansion, and the passing of the GOP's tax reform bill (largely seen as good for business). Third-quarter GDP growth was revised to 3.2%, the fastest rate in over two years. Despite several years of ultra-low unemployment and easy monetary policy, wage pressures have not yet begun to materialize, and inflation remains below its 2% target.

In its December meeting, the Federal Reserve Open Market Committee continued along the path to interest rate normalization by raising the target federal funds rate another quarter of a percent to a range of 1.25%-1.50%, the third increase of 2017. As was the case with the previous two rate increases, markets appeared to have anticipated the announcements and did not react significantly.

International equities continued to outperform US stocks in the fourth quarter to end the year well ahead of their domestic counterparts. The MSCI EAFE Investable Market Index (representing mid and large cap stocks from developed markets outside the US) grew 25.03% in 2017, while the MSCI Emerging Markets Index advanced a dramatic 37.28%.

Oil prices neared 3-year highs in the quarter and appear to have stabilized around \$60-65 per barrel. OPEC members and Russia agreed in November to keep the current production cuts in place through the end of 2018 as part of an ongoing effort to mitigate the impact of the US shale industry on global energy markets.

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Going Forward: Tandem's Outlook

One lasting impact of the Great Recession is evident in the sense of skepticism it seems to have instilled on investors' psyches. Presented with truly blissful market conditions, investors appear to react not with euphoria but a sort of wary watchfulness. The fear of contributing to another equity bubble may be behind investors' doubts about the legitimacy of an ongoing bull run that continues to defy expectations.

Though we are in the later stages of a secular bull market and higher volatility is sure to return, the fundamentals behind the markets' impressive performance in 2017 have not yet shifted meaningfully, and we may see similar behavior in the short term. Tax-reform optimism may continue to support upward momentum, and US economic indicators provide little reason to expect a recession this year.

Potential sources of market turbulence in 2018 include higher inflation (both in the US and abroad), the flaring up of certain geopolitical tensions, corporate earnings falling short of expectations, and an unexpected interest rate increase by the Federal Reserve (2-3 rate increases are expected in 2018; an unexpected fourth is unlikely to be priced into the market and could result in a correction).

Investors trading on the news were most likely to underperform in 2017. In contrast, the broad, diffuse performance seen in 2017 supports the case for patience and diversification, while the ongoing trend of decreasing correlations between international markets continues to drive the point home.

No matter what the markets are doing, Tandem continues to employ a strict investment discipline while advocating a long-term perspective for clients. We wish you a safe, happy, and prosperous 2018.

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