JOHNSON INVESTMENT COUNSEL

E-UPDATES

November 2017

Market Index	November Change	Year-to-Date
Standard & Poor’s 500	3.1%	20.5%
Dow Jones Industrial Average	4.2%	25.7%
NASDAQ	2.3%	29.0%
Russell 2000 (small company)	2.9%	15.1%
MSCI EAFE (international)	1.1%	23.1%
Barclays Aggregate Bond Index	-0.1%	3.1%

Monthly Update

Stock Market Streak Continues – S&P 500 Index Posts 13th-Straight Monthly Gain

The global rally continued in November, extending stock market gains in the U.S. and around the world. Stocks have continued to reach new highs supported by economic growth and rising corporate earnings. Global earnings have risen nicely in 2017. Earnings of companies overseas in both developed and emerging markets have picked up after several disappointing years. Growing earnings serves as confirmation that the global economy has gained strength.

Around the world, economic data has shown momentum, in many cases beating estimates. Most of the rise in global stock prices this year can be attributed to earnings growth as opposed to increasing valuations. Valuations have crept up also, and in most markets remain above historical averages. However, thanks to underlying earnings growth, most valuation measures are not nearly at the extreme levels reached in prior peaks.

Tech Stocks Lag in November amid a Shift toward Defensive Sectors

In November the market experienced a rotation favoring defensive sectors over cyclical sectors. This rotation toward more defensive stocks could be a result of a number of factors. The S&P 500 Index technology sector has soared this year. Its year-to-date return of 39% was 16% higher than the second-best sector (health care). But in November the sector was a laggard, gaining just over one percent and finishing next-to-last. Instead, defensive sectors like telecom and consumer staples led the way with gains of 6%.

The shift could be merely a sign of profit-taking in tech stocks. It also could be a sign of doubts about the passage of tax reform and its impact. It could be just a sign of investors anticipating a “sell the news” moment in the stock market if and when tax reform is passed by Congress. Whatever the case, this dynamic is something to watch in the coming months. Given the strength in the economy and corporate earnings along with the potential for a boost from tax reform, this defensive rotation could turn out to be a false sign of a top in the market.

Cincinnati
3777 West Fork Road
Cincinnati, OH 45247
P. 513.661.3100
F. 513.661.3160

Cincinnati | Kenwood
7755 Montgomery Road, Ste 180
Cincinnati, OH 45236
P. 513.389.2761
F. 513.978.0748

Cleveland | Akron
7000 Fitzwater Road, Ste 110
Brecksville, OH 44141
P. 440.877.9990
F. 440.792.4651

Columbus
100 E. Broad Street, Ste 2300
Columbus, OH 43215
P. 614.365.9103
F. 614.365.9943

Dayton
40 North Main Street, Ste 2110
Dayton, OH 45423
P. 937.461.3790
F. 937.461.2969

Monthly Update (continued)

Interest Rate Shifts and the Economic Outlook

Total returns for bonds remain positive for 2017, but the bond market has also been experiencing a rotation of its own. Short-term interest rates have continued to rise even as longer-term rates have held steady. This dynamic is referred to as a flattening yield curve. If this trend continues it will likely lead to increasing discussions of an economic slowdown.

One of the more reliable indicators of recession is known as an inverted yield curve, when short-term interest rates are higher than long-term rates. The spread between rates on 2-year Treasury notes and 10-year Treasury notes is a closely-watched figure. That spread is currently hovering around 0.50%. This means that two more 0.25% rate increases by the Fed without a corresponding increase in long-term rates could result in a flat yield curve, where short-term and long-term rates are at similar levels. The Fed is widely expected to raise their benchmark rate at the December meeting. It's worth noting that a flat yield curve does not always lead to recession. The yield curve flattened in 1994 but the economy continued to grow in subsequent years.

As the yield curve has flattened, other economic indicators have remained healthy and in some cases have even picked up momentum. This has reduced the concern about the direction of the yield curve. Encouragingly, the strength is not confined to the U.S. alone as has been the case to some extent in recent years. Overseas economic activity has continued to improve as well. Low levels of inflation and remaining slack in the labor market abroad could allow for this to continue for some time.

Will Tax Reform Pass in 2017?

Meanwhile, events in Washington, D.C. remain in focus for investors and non-investors alike. Congress is attempting to hash out two issues simultaneously – tax reform and the passage of a budget/continuing resolution to keep the government operational. The process is fluid, and as of this writing both the House and Senate have passed their respective versions of the tax reform bill. Committees of the two chambers have begun work on a reconciliation bill that would then need to be passed by both full houses before going to the President's desk for signature. It's possible a deal could be struck by Christmas.

However, factions within the Republican Party have shown signs of putting up a fight on certain aspects of the tax reform package, which could lead to wrangling and delay if there is enough opposition. Among the sticking points are issues like the Alternative Minimum Tax (AMT), deductions for state and local taxes, property taxes, and mortgage interest, and how low the corporate and individual income tax rates should go. As always, the effect on the national deficit is a point of contention, placing deficit hawks in the awkward position of signing on to further deficits or fracturing party unity by hindering passage of the bill.

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