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It was an unexpectedly stellar year for U.S. stock markets in 2017 – up about 22% thanks to a stronger economy, falling unemployment and expected tax breaks for companies that finally materialized in the last hour.

There were four key market events that shaped results at the end of the year. First, despite the Fed's efforts to increase short-term interest rates, long-term rates continued to decline. When there is little difference between short-term and long-term rates for bonds of the same credit quality, economists refer to this as a "flattening of the yield curve". Simply put, it means that investors remain skeptical about the prospect of future economic growth, which points to a bearish sign for stocks. Second, stock returns, especially foreign stocks, far surpassed expectations, In fact, emerging market stocks led all other categories, up 31% last year. Developed international stocks increased by 27% so diversified portfolios that had global exposure really paid off. Third, the dollar weakened relative to most other currencies worldwide, which contributed to as much as 10% of the added return of foreign equities over domestic. Fourth, we've had last-minute legislative changes, most notable on taxes – corporate taxes will be much lower, and some companies will see a big pile of cash overseas freed up.

Interestingly, some economists see a potential rally in investment-grade corporate bonds this year, after a modest year in 2017. They point to the new tax code which allows companies to repatriate their overseas cash after paying a one-time tax. That, in turn, could make it more likely that firms will pay down debt and less likely that they will take on new leverage, i.e. issue new bonds. As the theory goes, this shortage in supply could drive up bond prices. Whether or not this trend materializes, bonds remain an important stabilizing component of many of our clients' portfolios.

So what lies ahead for 2018? According to Wharton Finance Professor, Jeremy Siegel, most of the good news of tax reform has been baked into the stock indexes, and he predicts markets will take a breather in 2018. We think that stocks still have room to move higher based on a few factors - improved corporate earnings expectations on the heels of the new flat 21% corporate tax rate, an historically low 4.1% unemployment rate and a new Fed Chairman in Jerome Powell, who, many expect will continue Janet Yellen's soft stance on interest rates.

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Sources:
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Corporate Bonds and the Tax Law, Barron's, Jan. 8, 2018