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# 2017 WAS GOOD FOR THE ECONOMY; 2018 COULD BE EVEN BETTER

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## KEY TAKEAWAYS

This week, we provide an overview of a solid 2017 for the economy.

Although manufacturing could be near a peak, history suggests that this isn't a major near-term recession warning.

With the new tax law signed, we have upgraded our economic views for 2018.

**Similar to this week's *Weekly Market Commentary*, this *Weekly Economic Commentary* will look back at 2017.** In addition, it will discuss why a potential peak in manufacturing surveys isn't a major concern, and provide an overview of our economic views for 2018 following passage of the new tax law.

## WRAPPING UP 2017

2017 was an impressive year for equities, as many countries closed out the year at new all-time highs. The fixed income markets also responded favorably, as demand for both sovereign and corporate bonds remained strong with inflationary pressures still benign. Driving much of the impressive gains in financial markets were strong economic growth and a synchronized increase in global earnings.

In the United States, some of the most meaningful economic developments included:

- **GDP growth.** Gross domestic product (GDP) growth saw the usual first quarter weakness, coming in at only 1.4%. Things turned around in the second and third quarters though, as growth rose above 3.0%. The fourth quarter number is scheduled for release in January, and there is potential for yet another 3.0% number. Should we see growth over 3.0%, it would be the first stretch of three consecutive quarters over 3.0% since before the financial crisis.
- **Employment picture.** Although the December employment report was below expectations (148K versus 190K Bloomberg consensus), it still showed a record 87 consecutive months of jobs growth. Additionally, more than 2 million jobs were created in 2017, the seventh consecutive year to crack this level.
- **Earnings.** The increase in S&P 500 Index earnings is expected to come in over 10% for the full year, which would be the first double-digit annual increase since 2011. Corporate profit growth was not simply a domestic phenomenon, though, and earnings in both developed and emerging markets were similarly strong. We will take a closer look at global economies and earnings in next week's *Weekly Economic Commentary*.

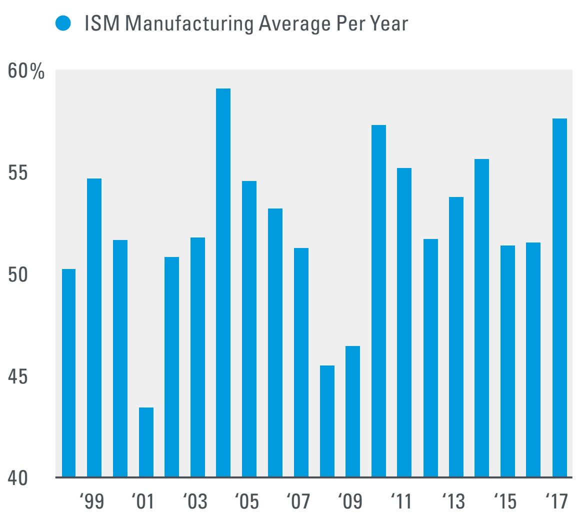
Other positive domestic economic developments include strong holiday spending, consumer confidence readings near 17-year highs, small business confidence levels at multi-decade highs, record construction spending, and the strongest manufacturing data in 13 years.

## WHAT COULD A PEAK IN MANUFACTURING MEAN?

Although manufacturing only accounts for about 12% of total GDP today, we still think it is quite important to the overall health of the economy. As Figure 1 shows, the average Institute for Supply Management (ISM) Purchasing Managers' Index (PMI) reading for 2017 came in at 57.6, which was the highest level for a full year since 2004.

> The Institute for Supply Management's Manufacturing Index is a diffusion index based on monthly surveys of purchasing managers at around 300 firms in the United States. A level above 50 represents expansion, while a level below 50 represents contraction.

**1 A 13-YEAR HIGH IN MANUFACTURING**




Source: LPL Research, Bloomberg 01/05/18

Indexes are unmanaged and cannot be invested into directly.
Past performance is no guarantee of future results.

With the ISM PMI cracking 60 in September for only the seventh time going back the past 30 years, the question many are asking is whether we have seen a peak in manufacturing growth. Although we do not yet know if September was the peak, historically such peaks have usually occurred mid-cycle and have not been a warning sign for the end of that cycle. Looking at the previous five economic cycles going back to the late 1970s, it has taken the United States 45 months, on average, to enter a recession following a peak in the ISM. For example, the most recent cycle saw the ISM peak in May 2004, some 44 months before the recession began in January 2008. With flattening yield curve concerns growing and worries that manufacturing could be peaking, it is important to keep in mind that economic expansions could potentially continue for several years after a peak in manufacturing.

## TAX LAW AND OUR 2018 FORECASTS

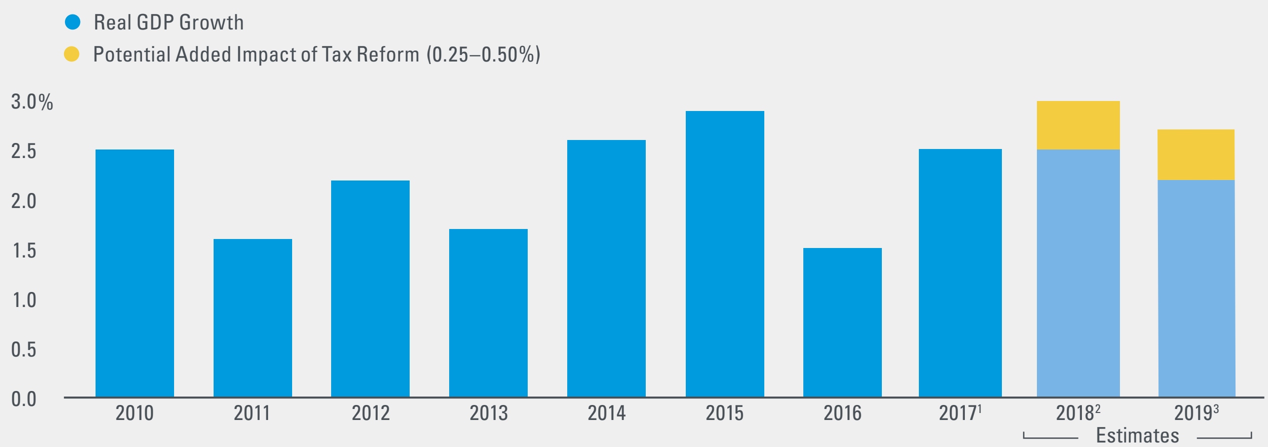
Given recent clarity on the new tax law, we upgraded our forecasts for economic growth, corporate earnings, and S&P 500 returns for 2018. In our *Outlook 2018*, we forecast annual U.S. economic growth to come in at 2.5% with steady consumer strength, a potential pickup in momentum thanks to fiscal support, with added support from improved business spending. The fiscal support came a little sooner than we expected, however, with the passing of the new tax law before the end of 2017. With businesses and individuals now able to plan ahead with greater certainty, we have raised our projections for annual U.S. economic growth to a range of 2.75%–3.0% over the next year [Figure 2].

We look for the benefits of the new tax law to further support gains in personal consumption and business investment, potentially providing a lift to the overall economy. Additionally, we continue to believe that interest rates may likely rise gradually considering moderate inflationary pressures, and we expect the 10-year Treasury to trade within a range of 2.75%–3.25% in the coming year.*

## CONCLUSION

Given how solid 2017 was for the economy, we think the economic expansion still has strong momentum behind it in 2018, which could further support the bull market. For more on our key themes for 2018, please refer to our *Outlook 2018: Return of the Business Cycle*. And, for more information on the potential economic, earnings, and market impact of the new tax law, please refer to our *Investment Implications of the New Tax Law* commentary. ■

**2 SIGNING OF TAX BILL INTO LAW MAY ADD 0.25–0.50% TO 2018 AND 2019 GROWTH ESTIMATES**




Source: LPL Research, Bureau of Economic Analysis, Bloomberg 12/26/17

[1]2017 uses actual data for the first three quarters combined with the Bloomberg-surveyed consensus estimate for the fourth quarter.

[2]2018 is LPL Research's Outlook 2018 estimate, with the added section representing the potential impact of the tax bill.

[3]2019 is the Bloomberg-surveyed consensus, with the added section representing the potential impact of the tax bill.

The 2018 & 2019 estimates may not develop as predicted.

## IMPORTANT DISCLOSURES

*As noted in *Outlook 2018: Return of the Business Cycle*, LPL Research forecasts flat to low-single-digit returns for the Bloomberg Barclays U.S. Aggregate Bond Index, based on its expectations for a gradual pickup in interest rates across the yield curve. LPL Research also expects the 10-year Treasury yield to end 2018 in the 2.75–3.25% range, based on its expectations for a modest pickup in growth and inflation.

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

Any economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

This information is not intended to be a substitute for specific individualized tax advice. We suggest that you discuss your specific tax issues with a qualified tax advisor.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments, and exports less imports that occur within a defined territory.

International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. These risks are often heightened for investments in emerging markets.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal and potential illiquidity of the investment in a falling market.

Because of its narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price. The market value of corporate bonds will fluctuate, and if the bond is sold prior to maturity, the investor's yield may differ from the advertised yield.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

International debt securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards. These risks are often heightened for investments in emerging markets.

## INDEX DESCRIPTIONS

Purchasing Managers Indexes are economic indicators derived from monthly surveys of private sector companies, and are intended to show the economic health of the manufacturing sector. A PMI of more than 50 indicates expansion in the manufacturing sector, a reading below 50 indicates contraction, and a reading of 50 indicates no change. The two principal producers of PMIs are Markit Group, which conducts PMIs for over 30 countries worldwide, and the Institute for Supply Management (ISM), which conducts PMIs for the United States.

The S&P 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.



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