2018 Market Outlook: It's Getting Late

By SCHWAB NEWSROOM | JANUARY 08, 2018

The economy and the stock market were buoyant in 2017. Broad-based global economic growth and strong earnings helped push the S&P 500® Index up more than 19% for the year.[1] The bull market is now deep into its ninth year.

Should investors look for more of the same in 2018? Or is the party nearly over?

Not quite yet, according to the Schwab Center for Financial Research's *2018 Schwab Market Outlook*. Global economic growth will likely continue to lift earnings in 2018—but we do appear to be entering the later stages of the market cycle, SCFR says. And with valuations high in both the stock and bond markets, investors should exercise some caution.

"We anticipate solid growth in 2018 and don't see a recession on the horizon," SCFR experts say. "However, with markets priced for ongoing moderate growth and low volatility, the risks we're monitoring include the potential for higher inflation and more central bank tightening than expected."

Here are some of the highlights of Schwab's 2018 outlook:

Economic growth likely will lift earnings, benefiting stocks. With a tight labor market, wage growth may accelerate, along with inflation.

Schwab Chief Investment Strategist Liz Ann Sonders says capital spending by businesses and improving productivity should keep the economy growing in 2018.

A tight labor market may lead to accelerating wage growth, which in turn could drive inflation. That could prompt the Federal Reserve to tighten monetary policy by raising short-term interest rates more than expected to help keep inflation in check and prevent the economy from overheating.

"Stocks tend to correctly anticipate economic recessions, and although we don't see one on the horizon in 2018, tighter monetary policy could bring bouts of volatility and elevated risk," Liz Ann says.

Broad global growth and falling correlations across stock markets bolster the case for global diversification.

All of the 45 major economies tracked by the Organization for Economic Cooperation and Development grew in 2017, and that will likely continue in 2018.

"While risks from politics, central bank policies and military threats haven't gone away, investors have recognized that the global economy isn't as vulnerable to such things as it was in the past decade," says Schwab's Chief Global Investment Strategist Jeff Kleintop. "Like a giant cluster of balloons—one or two could fail—and the world's economy would remain aloft for 2018."

Meanwhile, stock market correlations across major countries have fallen to the lowest levels since the mid-1990s.[2] Low correlation means the stocks of the various countries tend not to move in the same direction at the same time, which can enhance the benefits of diversification.

"The return to the lowest average correlation across stock markets seen in 20 years implies globally diversified investors may benefit from less volatility without sacrificing return on the path to their financial goals—in essence decreasing risk without decreasing return," Jeff says.

The Federal Reserve is poised to raise rates at least two or three times in 2018.

The Fed has been tightening monetary policy for two years through rate hikes, and more recently by reducing its bond holdings. Stronger economic growth, a tight labor market and the prospect of tax cuts could mean U.S. inflation reaches or exceeds the Fed's 2% target in 2018.

That is likely to keep the Fed on track to tighten short-term interest rates at least two or three times in 2018, according to Kathy Jones, chief fixed income strategist at the Schwab Center for Financial Research.

During 2018, the yield on 10-year Treasury bonds may exceed 2.6%.

Strong investor demand for bonds has kept bond yields (which move inversely to bond prices) low for years. The 10-year Treasury bond yield hasn't moved above 2.6% in three years.

"2018 could be the year that bond bears finally awaken from their long slumber, sending Treasury bond yields above the three-year high of 2.6%," Kathy says. "Economic growth is picking up both globally and domestically and fiscal policy is becoming more expansive."

More importantly, Kathy says, the era of extremely easy money is coming to an end.

"The Federal Reserve is tightening monetary policy through rate hikes and balance sheet reduction," Kathy says. "The European Central Bank is planning to gradually reduce its bond buying program. Even the Bank of Japan is seeing some success with positive inflation while focusing on keeping 10-year bond yields at zero or above. As the easy-money era gradually recedes, we see more upside risk in yields than downside."

To read more about Schwab's expectations for the coming year, check out the *2018 Schwab Market Outlook*.

[1]Source: S&P Dow Jones Indices. Price return for the S&P 500 was 19.42% for calendar year 2017.

[2]Based on average correlation (daily one-year rolling correlation of one-month percent change) in MSCI indexes for countries in the Group of 20 (G20) plus Spain. Source: Charles Schwab, Factset data for MSCI indexes, as of 11/01/2017.

What you can do next

- Changing economic conditions can affect how each component of your portfolio performs. It's impossible to predict which one will be the top performer in any given year—that's why diversification is so important. Want to talk about your portfolio? Call Schwab at 800-355-2162, visit a branch, or find a consultant.
- Watch Schwab experts discuss other market and economic topics in the Schwab Market Snapshot.

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Investing involves risk including loss of principal. Fixed income securities are subject to increased loss of principal during periods of rising interest rates. Fixed-income investments are subject to various other risks including changes in credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications and other factors. High-yield bonds and lower-rated securities are subject to greater credit risk, default risk, and liquidity risk.

International investments involve additional risks, which include differences in financial accounting standards, currency fluctuations, geopolitical risk, foreign taxes and regulations, and the potential for illiquid markets. Investing in emerging markets may accentuate these risks.

Diversification strategies do not ensure a profit and do not protect against losses in declining markets.

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S&P 500® Index is a capitalization-weighted index of 500 stocks from a broad range of industries. The component stocks are weighted according to the total market value of their outstanding shares.

MSCI provides a wide variety of indexes, all of which are governed by rules-based methodologies. The performance data cited above are based on average correlation (daily one-year rolling correlation of one-month percent change) on the MSCI indexes for countries in the Group of 20 (G20) plus Spain.

(0118-8BN0)

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