



Docs Capital Management, Inc.

Tim Schauer, CFA, CPA

Sophit Lee, CFP®

1210 W. Milham Ave.

Suite 201

Portage, MI 49024

269-488-2322

TeamDCMI@docsacapital.com

www.docsacapital.com



Docs Capital

MANAGEMENT INC.

Registered Investment Advisor

Annual Market Review 2017

Overview

The year 2017 was eventful, to say the least. President Trump and Congress tried, without success, to repeal the Affordable Care Act, known as Obamacare. However, the new year-end tax law included the elimination of the individual health insurance mandate. The U.S. economy started slowly but picked up steam as the year progressed. Ten years after its onset, the financial crisis officially came to an end in 2017. The gross domestic product expanded at an annual rate of 3.2% in the third quarter. The unemployment rate fell from 4.7% to 4.1%, while upwards of 2 million new jobs were added. The Federal Reserve, based on the strength of the economy and labor market, began to roll back its stimulus program and raised interest rates three times during the year. The stock market reached several historic highs in 2017. Consumer income rose and purchases increased, but inflation remained stubbornly below 2.0%. Business investment expanded in 2017 and is expected to surge in 2018. The year ended with the passage of sweeping tax reform legislation.



Market/Index	2016 Close	As of 9/29	2017 Close	Month Change	Q4 Change	2017 Change
DJIA	19762.60	22405.09	24719.22	1.84%	10.33%	25.08%
Nasdaq	5383.12	6495.96	6903.39	0.43%	6.27%	28.24%
S&P 500	2238.83	2519.36	2673.61	0.98%	6.12%	19.42%
Russell 2000	1357.13	1490.86	1535.51	-0.56%	2.99%	13.14%
Global Dow	2528.21	2907.67	3085.41	2.38%	6.11%	22.04%
Fed. Funds	0.50%-0.75%	1.00%-1.25%	1.25%-1.50%	25 bps	25 bps	75 bps
10-year Treasuries	2.44%	2.33%	2.41%	0 bps	8 bps	-3 bps

Chart reflects price changes, not total return. Because it does not include dividends or splits, it should not be used to benchmark performance of specific investments.

Snapshot 2017

The Markets

- Equities:** The stock market saw several benchmark indexes reach record highs throughout 2017. Market growth occurred despite several events that could have been challenging, such as the Russian probe, Federal interest rate increases, damaging hurricanes, domestic violence, and a potential struggle over the debt ceiling. Nevertheless, strong corporate profits and a general upswing in domestic and global economic growth helped push equities to new highs. Market volatility was generally low throughout the year, as the benchmark indexes saw very few weeks of negative returns. The large caps of the Dow closed the year with gains exceeding 25%, while the S&P 500 expanded over 19%. The small caps of the Russell 2000, which grew over 19% in 2016, enjoyed a more modest, yet noteworthy, year-over-year climb of over 13%. The Nasdaq gained nearly 30% over last year's closing value, driven by robust performances from the technology sector. Globally, stocks were also higher. The Global Dow

Key Dates/Data Releases

1/2: PMI Manufacturing Index

1/3: ISM Manufacturing Index

1/5: Employment situation, international trade

1/9: JOLTS

1/10: Import and export prices

1/11: Producer Price Index, Treasury budget

1/12: Consumer Price Index, retail sales

1/17: Industrial production

1/18: Housing starts

1/24: Existing home sales

1/25: International trade in goods, new home sales

1/26: Durable goods orders, GDP

1/29: Personal income and outlays

1/31: FOMC meeting report

and the MSCI EAFE each closed 2017 up over 20%, while the Stoxx Europe 600 posted a year-over-year gain of about 10%.

- **Bonds:** As stock prices soared for much of 2017 and interest rates moved incrementally higher, the demand for long-term bonds was marginal. Yields on 10-year Treasuries were volatile for the second straight year, ultimately falling below their 2016 year-end totals. The yield on the benchmark 10-year Treasuries closed 2017 at 2.41%, down from the 2016 yield of 2.44%. During the early part of the year, bond prices rose as yields sunk below 2.30%. However, as investors saw a strengthening economy and rising interest rates, a period of bond sales occurred, which peaked during the last quarter, ultimately pushing yields closer to last year's final value.
- **Oil:** It took almost the entire year, but oil prices began to surge at the end of 2017, reaching over \$60.00 per barrel. Oil prices dipped below \$45.00 per barrel, eventually hovering around \$51.00 per barrel for much of the early part of the year. However, U.S. oil prices soared nearly 27% since September as OPEC limited supplies while demand increased. Retail regular gasoline prices closed the year around \$2.472 per gallon on December 25, about \$0.163 more than a year ago.
- **FOMC/interest rates:** The Federal Open Market Committee raised interest rates three times during 2017. The first increase occurred in March, followed by a rate increase in June and another in December. Each rate increase was 25 basis points for a total rate increase of 75 basis points. Following each rate increase, the Committee expressed the expectation that the labor market would remain strong and the economy would continue to expand, while noting that inflation has not risen as quickly as anticipated. The Committee forecasts three 25 basis point rate increases in 2018.
- **Currencies:** The dollar weakened in 2017, particularly against its performance for much of 2016. The Wall Street Journal Dollar Index, which measures the U.S. currency against the currencies of 16 other countries, closed 2017 at \$85.98, down from its 2016 year-end mark of \$93.26 — a decrease of almost 9%. This marks the first annual decline in the value of the dollar in five years. Stagnant inflation and positive economic strengthening in other parts of the world weighed on the U.S. currency. A weakening dollar could help exports, particularly if this trend continues into 2018. However, consumers may not be so happy because the cost of imports should rise with the dwindling value of the dollar.
- **Gold:** Gold rose roughly 15% on the year, closing 2017 at \$1,305.10. A weakening U.S. dollar, political unrest, and minimal impact of the Fed's interest rate hikes contributed to the surge in gold prices.

The Economy (through November 2017)

- **Employment:** Overall, the U.S. labor market endured a few bumps during the year, but closed 2017 in relatively good shape. Despite destructive hurricanes that likely impacted new hires over the latter part of the summer into the fall, employment growth averaged 174,000 new jobs per month in 2017, compared with an average monthly increase of 187,000 new jobs in 2016. The unemployment rate ended the year (as of November 2017) at 4.1% — lower than the 4.6% rate at the close of 2016. According to the Bureau of Labor Statistics, there were 6.6 million unemployed persons in November 2017, down from 7.4 million unemployed in November 2016. The employment participation rate remained the same in 2017 as it was in 2016 — 62.7%. The employment to population ratio was 60.1% in 2017, up slightly from 59.7% in 2016. In 2017, the average workweek was 34.5 hours (34.3 hours in 2016). Average hourly earnings in 2017 increased 2.5%, or \$0.64, to \$26.55 (the same percentage gain as occurred between 2015 and 2016).
- **GDP:** Economic growth, as measured by the gross domestic product, expanded throughout the year, increasing at an annual rate of 3.2% in the third quarter of 2017. The third-quarter annual rate of growth is the highest since the first quarter of 2015. The first-quarter GDP rose 1.2%, followed by a 3.1% gain in the second quarter. Gross domestic product essentially measures what the economy produces, such as goods and services. On the other hand, gross domestic income measures all income earned from the production of goods and services, such as wages, profits, and taxes. GDI rose 2.0% in the third quarter of 2017, compared to a 4.1% increase in the third quarter of 2016. The average of gross domestic product and gross domestic income, a supplemental measure of U.S. economic activity that equally weights GDP and GDI, increased 2.6% in the third quarter, compared with an average annual increase of 1.2% in 2016.
- **Inflation/consumer spending:** Inflationary trends did not keep up with economic growth in 2017. Inflation, as it relates to the consumer, remained below the Federal Reserve's stated target rate of 2.0%. Indications are that inflation is expanding, albeit at a deliberate pace. The personal consumption expenditures (PCE) price index is the measure of the increase in the prices of goods and services purchased by consumers. The PCE price index was 1.8% higher in November 2017 compared to November 2016. Core PCE, which excludes the volatile food and energy components, expanded at an annual rate of 1.5%. Personal (pre-tax) income increased 2.8% in the third quarter of 2017 compared to a rate of 3.0% for the third quarter of 2016. After-tax income (disposable personal income) increased 2.1% in the third quarter of 2017 after expanding at an annual rate of 2.5% in the third quarter of 2016.

Another measure of inflation, the Consumer Price Index, measures the price level of a basket of consumer goods and services purchased by individuals. Over the 12 months ended November 2017, the CPI rose 2.2%.

- **Housing:** The housing market had been relatively strong for much of the year, although a lack of inventory may have impacted sales and prices. Through November, existing home sales are up 3.8% over a year ago. The November annual sales rate of 5.81 million is the highest since December 2006. The median existing-home price for all housing types in November was \$248,900, up 5.8% from November 2016 (\$234,400). November's price increase marks the 69th consecutive month of year-over-year gains. Total housing inventory was 1.67 million existing homes for sale — 9.7% lower than last November (1.85 million). According to the National Association of Realtors®, the expected increase in mortgage rates in 2018 could cut into the affordability of new homes in many markets if inventory remains low. New home sales jumped 26.6% above the November 2016 annual rate of sales. The median sales price of new houses sold in November 2017 was \$318,700 (\$305,400 in 2016); the average sales price was \$377,100 (\$359,900 in 2016). The seasonally adjusted estimate of new houses for sale at the end of November was 283,000, representing a supply of 4.6 months at that sales rate. Over the same period in 2016, there were 250,000 homes for sale for a supply of 5.1 months.
- **Manufacturing:** Manufacturing and industrial production performed better in 2017 than the prior year. The Federal Reserve's index of industrial production revealed that total industrial production rose 3.4% over the 12 months ended in November. Over the same period, the output of consumer goods increased 2.2% and production of business equipment expanded 5.2%. Capacity utilization for manufacturing increased 1.1% over the past year. New orders for manufactured durable goods (expected to last at least three years) increased by 5.4% from 2016. Shipments were up 4.1%. Capital goods — tangible assets used by manufacturers to produce consumer goods — also expanded in 2017. New orders for capital goods increased by 6.9% and shipments of capital goods expanded by 4.5%.
- **Imports and exports:** Through October, the goods and services trade deficit had increased \$49.1 billion, or 11.9%, compared to the same period in 2016. Exports increased \$97.5 billion, or 5.3%. Imports increased \$146.6 billion, or 6.5%. The prices of both import and export goods and services expanded by 3.1% over the 12 months ended November 2017. However, excluding energy, import prices were up only 1.4%.
- **International markets:** The global economy was relatively stable in 2017 amid low inflation and easing of accommodative monetary policies. In Europe, negotiations continued to progress, leading to Britain's exit from the European Union. Possibly impacted by the impending Brexit, Britain's economy expanded at a subdued 1.5% rate, effectively pushing its economy behind that of France in the world rankings. Eurozone inflation increased by 1.5% over a year earlier, prompting a reduction in stimulus measures including an interest rate hike. Germany, Italy, and Finland saw their third-quarter GDPs expand at a rate exceeding expectations, while economic growth slowed in France, Spain, and the Netherlands. The Japanese economy also pushed toward its 2.0% target inflation goal. A jump in capital spending helped propel Japan's third-quarter GDP to an annualized 2.5% growth rate. The world's second-largest economy continued to expand as China's GDP enjoyed a 6.5% annualized growth rate. The Chinese government continued to maintain its grip on economic activity, particularly considering President Trump's tough anti-China trade rhetoric.

Eye on the Year Ahead

The year 2018 is off to a rousing start, with the passage of major tax overhaul legislation that could impact consumer and business income and equities. The U.S. economy, which got off to a slow start in 2017, picked up steam throughout the year and enters 2018 in pretty good shape. The U.S. economy as well as major world economies are expected to continue to grow this year. The Fed has indicated that it expects to raise interest rates three times this year despite stubborn inflationary expansion. The housing market should continue to grow, especially if builders pick up the pace of new residential construction to add to dwindling inventory. However, political unrest continues to plague Washington, with the cloud of the Russian investigation hanging overhead as we begin 2018.

Data sources: Economic: Based on data from U.S. Bureau of Labor Statistics (unemployment, inflation); U.S. Department of Commerce (GDP, corporate profits, retail sales, housing); S&P/Case-Shiller 20-City Composite Index (home prices); Institute for Supply Management (manufacturing/services). Performance: Based on data reported in WSJ Market Data Center (indexes); U.S. Treasury (Treasury yields); U.S. Energy Information Administration/Bloomberg.com Market Data (oil spot price, WTI Cushing, OK); www.goldprice.org (spot gold/silver); Oanda/FX Street (currency exchange rates). News items are based on reports from multiple commonly available international news sources (i.e. wire services) and are independently verified when necessary with secondary sources such as government agencies, corporate press releases, or trade organizations. All information is based on sources deemed reliable, but no warranty or guarantee is made as to its accuracy or completeness. Neither the information nor any opinion

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The Dow Jones Industrial Average (DJIA) is a price-weighted index composed of 30 widely traded blue-chip U.S. common stocks. The S&P 500 is a market-cap weighted index composed of the common stocks of 500 leading companies in leading industries of the U.S. economy. The NASDAQ Composite Index is a market-value weighted index of all common stocks listed on the NASDAQ stock exchange. The Russell 2000 is a market-cap weighted index composed of 2,000 U.S. small-cap common stocks. The Global Dow is an equally weighted index of 150 widely traded blue-chip common stocks worldwide. The U.S. Dollar Index is a geometrically weighted index of the value of the U.S. dollar relative to six foreign currencies. Market indices listed are unmanaged and are not available for direct investment.

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