2018 Will Be Different

In the wake of the unusual market performance of 2017, one can be certain that what lies ahead will not be more of the same. For one thing, the most recent 12 months was exceptional both in terms of the rate of gain and the absence of volatility. The advance of about 18% already registered through the next to last week of the year is nearly double the typical annual rate of gain logged over the last 90 years. What's more, although there's been a pullback of 10% or so during the course of most years, the few periods of price weakness over the last four quarters never exceeded the low single digits.

Undoubtedly, most investors will be pleased with this kind of performance, but it would be naïve to expect that "steady as she goes" will be the market's theme in the new year. Indeed, as most folks will recall, January often brings with it a marked change of pace, not always one that is encouraging. The most recent example of this was in the opening weeks of 2016, when it seemed as prices were going off a cliff. Tensions were high for several weeks and then prices began to stabilize, followed by a few months of marking time and growing strength toward yearend.

There will be a number of constraints against a repeat of this year's performance. One is the relatively rich valuation of the U.S. market. Even with a bump up in corporate earnings from changes in the tax law, the leading indexes are still selling at the upper end of traditional valuations. Further gains can be justified only by improvement in underlying profitability. Given recent valuations, it is hard to expect a year-ahead advance much greater than 3-5%.

What's more, it's likely that there will be a rotation from groups such as tech that have had unusually broad gains to some of the industry areas that have been overlooked. So even though overall prospects will be dimmer, careful selection of portfolio holdings may reap above average rewards.

With that said, international markets continue to be priced much more reasonably, which in turn suggests better potential for gain. That's especially the case for the emerging markets, which are available at considerable discount from those domestically.

In view of the likelihood of continuing increases in U.S. interest rates, prospecting for worthy fixed-income candidates will be difficult. Even so, short-duration high yield bonds as well as deep discounted closed-end bond funds offer opportunities to be considered.