PROVIDENCE FIRST
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KeyBank

INVESTMENT REVIEW

As was the case all year the equity markets continued to advance during the quarter. It was the fourth consecutive quarter that all of the major equity market indexes recorded gains. Domestic equities, as represented by the Russell 3000® Index, recorded their ninth consecutive quarter of positive returns, advancing 6.3%. Large-cap stocks were the best domestic performers followed closely by mid–cap issues. Full year returns were very solid as the Russell 3000® Index advanced 21.1%.

As expected, the Federal Open Market Committee increased the Federal Funds rate 25 basis points (one quarter of one percent) at its December meeting. Interest rates rose modestly during the quarter with the 2-year note rising 40 basis points to 1.88% and the yield on the 5-year note increasing 28 basis points to 2.21%. Further out the curve, the 30-year bond yield declined 13 basis points to 2.74%. As a result, fixed income returns were mixed in the quarter. The longer maturity Bloomberg Barclays US Aggregate Index returned 0.39% while the shorter US Intermediate Government/Credit Index was down 0.20%.

The markets sharp advance reflects a continuation of the gradual improvement in global economic growth combined with little or no indication of a near term recession. Solid corporate earnings also aided returns as did the passage of the tax bill late in the year. In addition to improving economic fundamentals, international market performance was aided by the weak U.S. dollar as the dollar's weakness enhances the return on foreign securities for dollar-based investors. Both domestically and abroad, earnings growth has been better than expected, job growth is solid, consumer confidence is high, inflation is subdued and interest rates remain low.

ECONOMIC OVERVIEW

U.S. economic growth strengthened during 2017 although advanced estimates suggest growth may have cooled during the fourth quarter. GDP (gross domestic product) grew 2.3% during 2017, a meaningful increase over the 1.5% growth recorded in 2016. Business activity demonstrated clear signs of improvement. Manufacturing rose 2.8% in 2017 after having been essentially flat in 2015 and 2016. Factory orders rose 4.9% in 2017, compared with an annualized decline of 0.5% during 2015 and 2016. Part of the manufacturing improvement reflects the rebound of oil production: The crude oil portion of industrial production rose 6.3% in 2017, compared with a decline of 4.8% in the prior year. Consumer spending also solidified in 2017. Personal consumption rose in 2017, driven by personal income growth of 4.1% last year compared to only 1.6% the prior year. Wage and salary growth was particularly strong, rising at an annualized rate of 4.9% through the first ten months of the year. Business and consumer confidence also rose nicely during the year.

International economic growth continued to strengthen. While Europe appears to be stronger than other parts of the world the improvement is very broad and encompasses both developed and emerging markets. As we noted last quarter, strategists are again talking about a period of synchronized global growth. Foreign countries appear to be much earlier in their economic cycles suggesting that U.S. economic growth could stay stronger for longer. We remain positive on the economy and believe that modest growth will continue well into 2018.

INVESTMENT OUTLOOK

We continue to find stocks attractive relative to fixed income securities and are keeping equity weightings modestly higher than long-term targets. Valuations are above long-term averages but are reasonable when interest rate levels are taken into consideration. Our positive outlook on the economy further fuels our appetite for equities as does the recently passed tax bill which should result in a nice boost to corporate earnings. While growth in the U.S. continues to be relatively modest, growth in many overseas markets has accelerated. This, coupled with the possibility of continued weakness in the U.S. dollar, has led us to shift toward an overweight in international equities. In the U.S. market we are benchmark weighted in large-, mid- and small –cap stocks. In the fixed income markets we expect volatility to continue as participants adjust to a less accommodative Federal Reserve. We expect the FOMC to raise rates three times during 2018 as the Committee continues to 'normalize' rates. While optimistic about the investment outlook, we view geopolitical risk and higher than expected inflation as the primary risks to our outlook.

EARNING INTEREST

In previous issues, we reviewed that credit cards, auto loans, and home mortgages all had different interest rates. This is the percentage that is used or charged for the use of money. In those examples, you were the person ***paying*** interest because you were receiving the loan. When you put your money into a savings account, you are the person ***earning*** interest on the money that is being saved.
You will earn about 1% interest on your money in a savings account, which is a much lower percentage than the interest rates that are charged when you receive a loan. Savings accounts pay relatively low interest rates because there is little to no risk of losing your money. Other investments—such as bonds and stocks—can earn more interest and gains, but there is more risk and a possibility of losing some money. These types of investments will be further discussed in a later session.

To show how this interest works, let's assume that a person puts $20,000 into a savings account. What will be the balance after one year?

$20,000 initial balance	x	1% interest rate	=	$200 interest earned
$20,000 initial balance	+	$200 interest earned	=	$20,200 new balance

What would happen after Year Two? Remember that the initial balance will now be different.

$20,200 initial balance	x	1% interest rate	=	$202 interest earned
$20,200 initial balance	+	$202 interest earned	=	$20,402 new balance

The Year One gains were added to the initial balance, so that the Year Two gains were larger than the first time (even if only by $2). This is an example of **compound interest** because the initial balance and gains are combined, resulting in the following years generating even larger gains. "Compound interest is the eighth wonder of the world," Albert Einstein said. He called it "the greatest mathematical discovery of all time." The power of compound interest is shown when multiple years of growth can build upon itself.

To show the power of compound interest, let's see what happens to the same $20,000 initial balance at a 6% of interest rate. In just 12 years, the yearly interest nearly doubles from initially being $1,200 in Year 1 to over $2,200 in Year 12. Also, the total balance doubles from $20,000 to now over $40,000. The power of compound interest – coupled with the principle of saving – will help you achieve your financial goals.

If you need any assistance with your trust fund, please contact Providence First Trust Company at 602-952-2300 or toll-free at 1-800-350-0208.