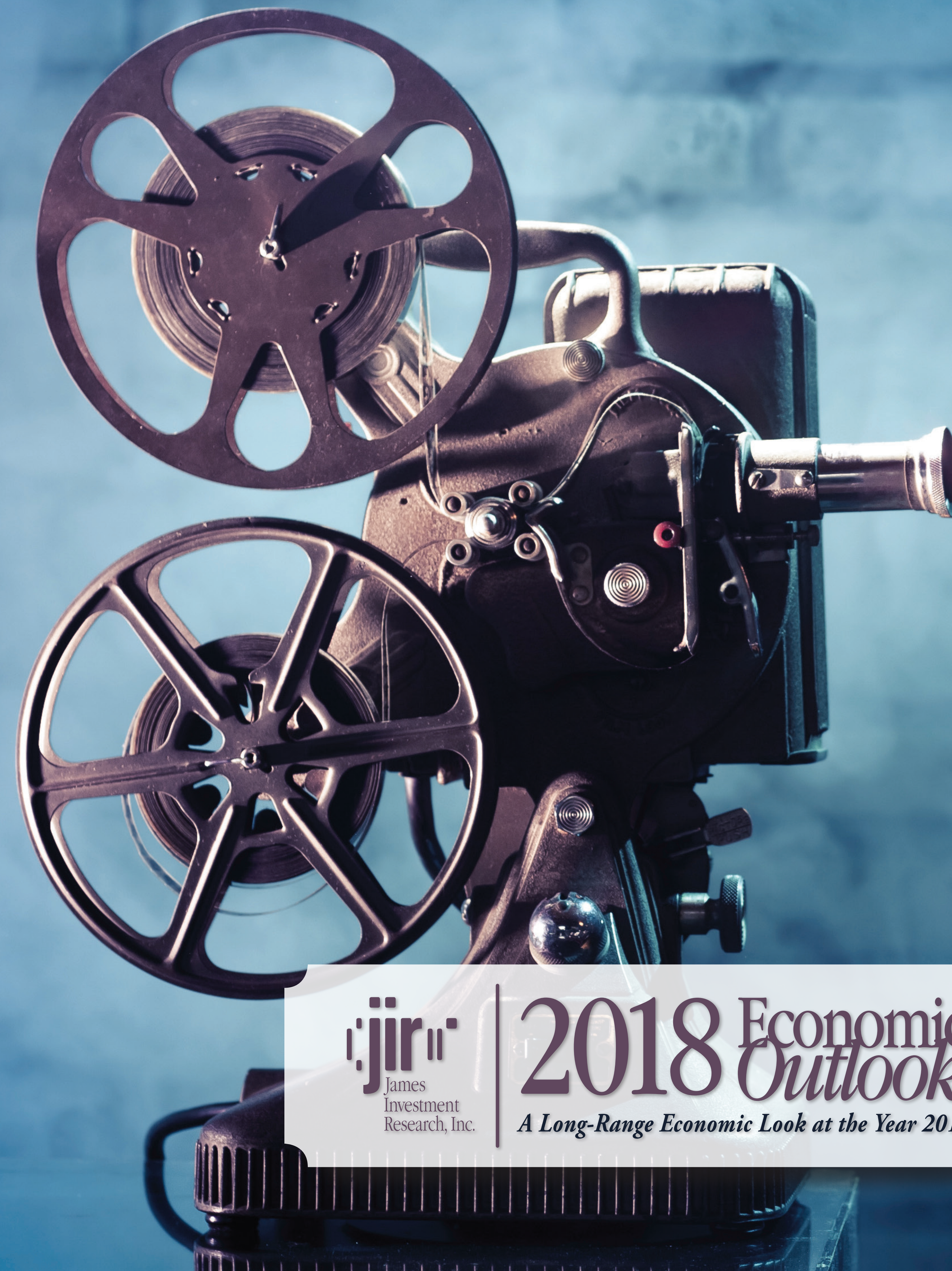
James Investment Research, Inc.
P.O. Box 8
Alpha, Ohio 45301
937.426.7640 Phone
937.426.7097 Fax



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2018 Economic Outlook

A Long-Range Economic Look at the Year 2018

Economic Outlook

Economy

POSITIVES

- No recession tripwires triggered
- James macro indicators are favorable
- Tax cuts historically boost economy
- Regulatory environment improved

NEGATIVES

- Record federal and consumer debt
- Multiple asset bubbles
- Trade agreements in peril
- Optimism too high

The economy has been on a roll and our early warning tripwires for a recession are all quiet. For example, the yield curve spread* while flattening, is still positive. Furthermore, banks are not tightening corporate lending standards and industrial production expanded in the last year. Lastly, jobless claims have not started an upward trend.

Once fully implemented, tax cuts have historically been associated with improved long-term economic growth. When compared with the prior three years, the following three year period showed sizable improvements. Working-class wage growth accelerated and the unemployment rate fell. Surprisingly, even Federal Income tax receipts showed accelerated growth.

The regulatory environment has also improved. The Federal Registry, a compilation of federal rules, has been trimmed by 32 percent or over 30,000 pages. Regulatory burdens have been recognized as a top problem for smaller businesses and this change should promote future growth.

Potential problems could include bursting market bubbles, trade wars, unexpected global conflicts and a sharp slow-down in China. In addition, U.S. government and consumer debt levels are high. A significant rise in interest rates could put a major stress on both.

After a decade of subpar economic growth, we believe the trend has turned and gains are likely in 2018.

Stocks

POSITIVES

- Momentum remains strong
- Solid earnings growth
- Long-term benefit of lower taxes

NEGATIVES

- Valuations near extremes
- Too much optimism
- Tax cuts initially disappointment
- E-commerce mania

The stock market is in a topping phase as evidenced by extreme valuations and too much optimism. We find the typical large-capitalization stock is at record highs according to Price-to-Sales* ratios. Likewise, euphoria reigns. Investors Intelligence recently reported the highest level of net bullishness in decades.

The e-commerce area has seen explosive growth in the last five years. It rivals many previous bubbles, all of which saw significant downturns after their peak.

While economic conditions look favorable, we found 6 of the last 13 significant market corrections (over 15% declines) took place outside of a recessionary environment.

Tax cuts will affect stocks. Our research finds stock returns are usually stronger in the 12 months prior to the tax cut signing than in the following 12 months. However, the long-term impact is quite positive and we believe certain sectors of the market will especially be rewarded.

We do find some favorable factors. Stocks often move in long-term trends and the current one has been for higher prices. Also, corporate earnings are growing at a faster pace than their 5-year average.

Overall, risks of a significant correction are high. It would be prudent to take a more conservative approach to stocks until risk levels fall.

Bonds

POSITIVES

- Accommodating future Fed leadership
- Moderate inflation
- Lower interest rate trend intact
- Worldwide demand strong

NEGATIVES

- Quantitative Tightening
- Lower quality at risk
- Extreme low unemployment

The Federal Reserve Bank (Fed) will look different in 2018 with four empty seats and a new Chair, Jerome Powell. He has voted in line with Chairwoman Yellen and is likely to maintain his dovish stance while returning rates to a more “normal” position. Quantitative Tightening* could push rates higher, however if the economy slows, this would be put on hold.

Eight years of low rates have encouraged more risk taking, even in the bond market. As a result, investors are no longer being adequately compensated for investment in lower quality bonds. The recent high-yield bond sell-off suggests focusing more on higher quality bonds.

Tax law changes may impact municipal bonds. Supply may be diminished as Congress looks to disallow some previous issuers from offering new tax-exempt bonds. Furthermore, tax rate changes for the top bracket are not significant enough to warrant a sell-off in municipal bonds. In fact, we believe any pull back could represent a buying opportunity.

We will continue to watch inflation as it has remained low. Unemployment is also approaching cyclical lows and a further dip could trigger higher wage inflation. Our research indicates the historic bond bull market is intact and historically tax cuts have been positive for bonds the year after the law is signed. Still, we will watch for any break in the trend and prepare to take action if needed.

International

POSITIVES

- Global economy growing with little inflation
- Euro-zone leadership increasingly pro-business
- Manufacturing nations experiencing growth
- Improved outlook for pro-business commodity exporters

NEGATIVES

- China’s huge debt problems may hurt growth
- Middle East risks heating up
- Bitcoin bubble may impact economies

Many pundits are raising their global Gross Domestic Product (GDP) growth forecasts for 2018. Inflation is currently benign. Deflation seems vanquished in Japan which may lead to better growth.

Stronger growth should bode well for economies with a strong manufacturing base, including South Korea and Vietnam. Commodity exporting countries with new reform-minded and pro-business leadership should likely do well. These include Chile and Peru.

We have some areas of concern. First, a leadership change in Saudi Arabia could send oil prices skyrocketing; disrupting the global economy. China’s huge debt burden will weigh on their economy and, if not expertly managed, could weaken its import appetite which would harm world growth.

While not a currency and not a security, the current cryptocurrency* bubbles are draining hundreds of billions of dollars out of the global economy. A bursting of that bubble could send financial shock waves around the globe. Governments worldwide will likely take some action in 2018 to help protect their domestic currencies.

Conclusions for 2018

We believe we are in a Topping Market and prepared a special study to explain why. We wanted to give some ideas of what we will try to do.

Hold high quality bonds where appropriate

- Since 1926, Government bonds have advanced 5% annually in the years stock prices fell.

Lower equity levels

- Asset class diversification historically provides better capital preservation in down markets.
- Active risk management is often beneficial.

Lower holdings in e-commerce and other high-flying, expensive stocks

- E-commerce stocks show signs of being in a bubble. Historically, the aftermath of bubbles has been unpleasant.
- Valuation measures have been ignored for a long period of time. We believe a change is likely and may last for years.

Focus equity holdings on bargain securities – measured by valuation, earnings and price momentum

- Bargain stocks had been lagging expensive stocks; this appears to be reversing.
- Historically, bargain stocks have held up better in challenging markets than expensive stocks.

International investing holds some opportunities

- While international stocks often move in correlation to U.S. equities, valuation levels and the economic cycle favor some international markets.
- We see reasonable opportunities in some Euro-zone countries: India, South Korea, Vietnam, Peru and Chile.

**Quantitative Tightening* *is a course of action undertaken by the Federal Reserve to constrict spending in an economy that is seen to be growing too quickly or to curb inflation when it is rising too fast.*

**Yield Curve Spread* *is a metric bond investors use when gauging the level of expense for a bond or group of bonds.*

**Price-to-Sales* *ratio is an indicator of the value placed on each dollar of a company's sales or revenue.*

**Cryptocurrency* *is a digital or virtual currency that uses cryptography for security.*

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