2018: Dow 28,500, S&P 3100

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Last December we wrote "we finally have more than just hope to believe that this year, 2017, is the year the Plow Horse Economy finally gets a spring in its step." We expected real GDP growth to accelerate from 2.0% in 2016 to "about 2.6%" in 2017. Our optimism was, in large part, based on our belief that the incoming Trump Administration would wield a lighter regulatory touch and move toward lower tax rates.

So far, so good. Right now, we're tracking fourth quarter real GDP growth at a 3.0% annual rate, which would mean 2.7% growth for 2017 and we expect some more acceleration in 2018.

The only question is: how much? Yes, a major corporate tax cut (which should have happened 20 years ago) is finally taking place. And, yes, the Trump Administration is cutting regulation. But, it has not reigned in government spending. As a result, we're forecasting real GDP growth at a 3.0% rate in 2018, the fastest annual growth since 2005.

The only caveat to this forecast is that it seems as if the velocity of money is picking up. With $2 trillion of excess reserves in the banking system, the risk is highly tilted toward an upside surprise for growth, with little risk to the downside. Meanwhile, this easy monetary policy suggests inflation should pick up, as well. The consumer price index should be up about 2.5% in 2018, which would be the largest increase since 2011.

Unemployment already surprised to the downside in 2017. We forecast 4.4%; instead, it's already dropped to 4.1% and looks poised to move even lower in the year ahead. Our best guess is that the jobless rate falls to 3.7%, which would be the lowest unemployment rate since the late 1960s.

A year ago, we expected the Fed to finally deliver multiple rate hikes in 2017. It did, and we expect that pattern will continue in 2018, with the Fed signaling three rate hikes and delivering at least that number, maybe four. Longer-term interest rates are heading up as well. Look for the 10-year Treasury yield to finish 2018 at 3.00%.

For the stock market, get ready for a continued bull market in 2018. Stocks will probably not climb as much as this year, and a correction is always possible, but we think investors would be wise to stay invested in equities throughout the year.

We use a Capitalized Profits Model (the government's measure of profits from the GDP reports divided by interest rates) to measure fair value for stocks. Our traditional measure, using a current 10-year Treasury yield of 2.35% suggests the S&P 500 is still massively undervalued.

If we use our 2018 forecast of 3.0% for the 10-year yield, the model says fair value for the S&P 500 is 3351, which is 25% higher than Friday's close. The model needs a 10-year yield of about 3.75% to conclude that the S&P 500 is already at fair value, with current profits.

As a result, we're calling for the S&P 500 to finish at 3,100 next year, up almost 16% fromFriday's close. The Dow Jones Industrial Average should finish at 28,500.

Yes, this is optimistic, but a year ago we were forecasting the Dow would finish this year at 23,750 with the S&P 500 at 2,700. This was a much more bullish call than anyone else we've seen, but we stuck with the fundamentals over the relatively pessimistic calls of "conventional wisdom," and we believe the same course is warranted for 2018. Those who have faith in free markets should continue to be richly rewarded in the year ahead.

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