PENNIALL PERSPECTIVE

January, 2018

"The positive near-term economic outlook, lowness of interest rates, need of most investors for return and moderate psychology all seem to suggest it would be a mistake to get out. On the other hand, the extremely high asset prices, macro-fragility and risky behavior going on all around us argue for considerable caution."

-Howard Marks, Oaktree Capital

Economic & Market Summary

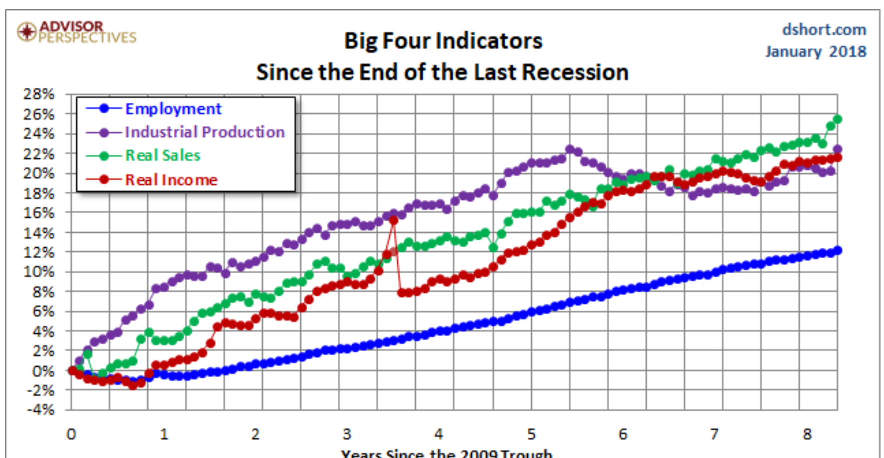
With improving economic data, especially in Europe and other international regions, markets went on a tear pushing several major indexes further into record territory. Emerging markets were, once again, top performers, but the US and Japan also posted strong returns. Natural resources, precious metals, and real estate also had a good quarter. In the US, third quarter earnings jumpstarted the rally and low unemployment, manufacturing data, and housing reports kept sentiment high. Improved business conditions in Europe and impressive demand in Japan added to the string of favorable economic reports, encouraging investors to pour into riskier assets.

Bonds were modestly positive for the quarter. The US Federal Reserve raised short-term interest rates once again in December, but intermediate and longer-term rates stayed low. This resulted in a flattening of the yield curve, a phenomena we delve deeper into below.

Bull Case

For the first time in almost a decade, all major economies grew simultaneously during 2017. Across Europe, a broad-based recovery fueled by low interest rates, strong corporate earnings, and central bank stimulus boosted markets. Japan, who also benefited from central bank accommodation, reported unemployment at a 23-year low, workers shifting into higher-paid positions, and increased consumer demand. While data suggests China's economy has likely started to moderate, 2017 GDP growth increased to 6.9%, the first annual uptick since 2010. Economic conditions in the US were also largely positive:

- Strong earnings growth
- Q3 GDP revised to 3.2%
- Manufacturing data continuing to improve; ISM PMI highest since 2005
- Low unemployment; currently at 4.1%
- Inflation remains low



Big Four Indicators Month-over-Month

Indicator	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Employment	0.15%	0.16%	0.03%	0.14%	0.10%	0.14%	0.09%	0.14%	0.03%	0.14%	0.17%	0.10%
Industrial Production	-0.30%	0.24%	0.20%	1.09%	0.02%	0.18%	-0.23%	-0.41%	0.18%	1.79%	-0.12%	0.89%
Real Sales	0.23%	-0.32%	0.39%	0.16%	0.17%	-0.03%	0.37%	-0.45%	1.48%	0.56%	0.47%	0.20%
Real Income	0.46%	0.50%	0.53%	-0.12%	0.35%	-0.10%	0.25%	-0.03%	0.06%	0.21%	0.20%	0.31%

Employment is released the first week of the month, Income the last week, Industrial Production and Sales mid-month.

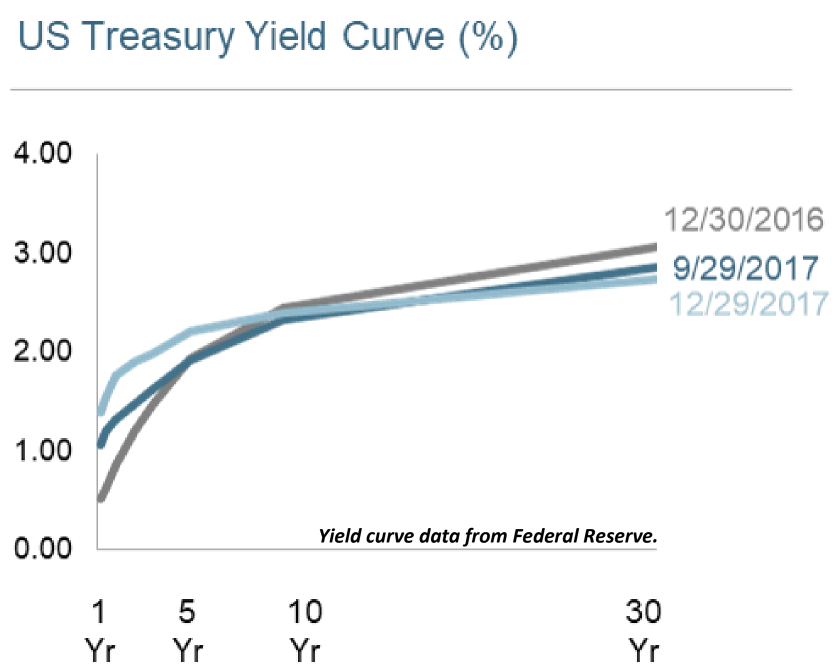
Synchronized global growth certainly benefited markets during 2017, but the real question is whether or not this growth can persist. Interest rates remain very low, continuing to give companies access to inexpensive credit. In some areas of the world, including the US and UK, central banks have started raising interest rates, but in other areas, including Europe and Japan, short-term rates are negative. Additionally, historical comparison for global interest rates show we are in an ultra-low rate environment and even a modest uptick would still result in uncommonly low yields. Without a major rise in rates, this low yield environment will remain intact and continue to support global growth.

The US has another notable tailwind – tax reform. While estimates regarding tangible economic results from the tax law change are wide-ranging and downright confusing, it is generally agreed that corporations will benefit in the near term. Many individuals are also likely to see meaningful tax relief, which may provide a boost to economic growth in the form of increased demand. Perhaps most importantly, however, is that through the tax bill, Washington has firmly aligned itself in the pro-business camp encouraging a boost in capital expenditures and increased business sentiment.

Turning to markets specifically, price momentum is tremendously positive. Momentum refers to the direction and the rate of change in a security's price. There is empirical evidence to suggest that increasing prices have a higher probability to continue increasing and decreasing prices have a higher probability to continue decreasing. With strong returns across most sectors and regions last year, technical indicators largely point towards further price appreciation.

Bear Case

There is another side to review when considering whether economic growth will continue its expansion. Consumer spending was the heavy lifter of US economic growth last year at 2.9%. This increase occurred by stealing from the savings rate and borrowing rather than a sustainable increase in personal income. The savings rate registered at 1.9%, down from 5.9% as recently as 2015. In addition, consumer loans have accelerated while real disposable personal income has dropped dramatically over the same time period. History shows periods of low savings are usually followed by periods of decreased consumption and reduced demand. And while the tax bill may provide a near-term boost for growth, this comes at the expense of increasing an already massive debt balance. Many of you have heard the thesis: when too much debt exists in an economy, sustainable economic growth diminishes. Historically speaking, the over-indebtedness threshold of 90% of GDP (current government debt exceeds 106%) translates to a reduction in economic growth by one-third or more.



Yield curve data from Federal Reserve.

Despite improvement in worldwide growth, asset prices have continued to grow at a faster clip than underlying growth. This has resulted in prices that are unsubstantiated and vulnerable to downside revision. Overvaluations do not necessarily correct over the short-term, but they have historically reverted to the mean for the long haul. Based on current valuation metrics using earnings, revenues, and market capitalization data, US stock market returns for the next 7-10 years are projected to be meager at best.

A basic tenant of economics states that an inverted yield curve signals a recession. While we are not currently experiencing an inversion in the US, we are in a period of the yield curve flattening (a stage before inverting). The yield curve plots the yields for various bond maturities, in this case we are referring to US Treasury bonds (see chart). As the chart illustrates, short-term rates are rising while long-term rates are staying relatively the same. This bearish sign is worth monitoring closely.

Finally, let us not forget the old adage "don't fight the Fed." Since December 2015, the Fed has raised rates five times. Guidance suggests three more rate hikes are coming this year. Simultaneously, the Fed is now reducing its balance sheet (known as Quantitative Tightening). The impact of Fed rate hikes and QT may impact the economy and stock valuations sooner rather than later. There is evidence to support that the brunt of these past and current policy moves will be felt in 2018. This is not a positive omen for the economy or markets.

Conclusion

Fundamentals have improved and worldwide growth is taking hold, but can this growth overcome high prices and gain the momentum necessary to overcome impending headwinds? Additionally, projected returns for virtually all asset classes are below their long-term averages which equates to potential risks overpowering potential returns. Ultimately, data has been and continues to be mixed, encouraging our team to focus on portfolio risk management and staying true to the investment philosophy that aligns with your long-term plan.