Trumbower Financial Advisors, LLC
4th Quarter 2017
Investment Market Commentary

An Affair to Remember

Undaunted by twitter wars, buoyed by tax reform, comforted by docile volatility readings, validated by global earnings growth or lacking attractive alternatives, investors continued their unfaltering love affair with stocks.

All the major equity market indices bestowed lavish double-digit rewards on their adoring fans last year. Emerging Market equities bejeweled us with gains of over 37%. Large Cap US and Developed Internationals showered over 21% on devotees. Smaller US equities were less generous but handed out respectable carat weight nonetheless.

Asian stocks haven't shown this much passion since 1993. The bountiful MSCI Asia ex-Japan Index rose 47%, led by a 58% revival in Chinese stocks. Hong Kong's Hang Seng and India's Sensex indices pampered participants with advances of 37% and 29.5%. The bashful Nikkei blushed its way up 19%.

In spite of a few jilted losers (Pakistan for one), Asia's GDP surged on the wings of booming trade. Brawny currencies contributed to an enticing 23% increase in corporate earnings. The spike in stock prices has been supported by the effects of synchronized global recovery such that the average P/E in the region is reasonable at just 13.5 times forward earnings. More steamy romance in the orient may be on its way.

The US dollar finally lost some of its allure. The US Dollar index slumped -9.15% to its lowest level since 2003. The euro, pound, yuan and yen rose 14.1%, 9.5%, 6.8% and 3.8% against the dollar further sweetening US

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4th Quarter Equity Market Results

	4th Qtr. % Chg.	12-mo. % Chg.
S&P 500	6.64	21.83
S&P 400	6.25	16.24
Nasdaq	6.56	29.65
Russ 2000	3.34	14.65
MSCI EAFE	3.90	21.78
MSCI Emg	7.44	37.28

Selected Benchmark and Category Average Returns

Large Cap Equity

Benchmark Indx & Category Average*	(Total Return) **4th Q 2017**	**12 Mos.**
Russell 1000 Growth	7.86	30.21
Large Cap Gr Avg	6.37	28.56
Russell 1000 Value	5.33	13.66
Large Cap Val Avg	5.73	15.57
S&P 500 Index	6.64	21.83
Large Cap Blnd Avg	6.18	20.05

Mid Cap Equity

Benchmark Indx & Category Average*	(Total Return) **4th Q 2017**	**12 Mos.**
S&P MC 400 Growth	7.08	19.92
Mid Cap Gr Avg	5.92	25.15
S&P MC 400 Value	5.36	12.32
Mid Cap Val Avg	5.15	13.17
S & P 400 Index	6.25	16.24
Mid Cap Blnd Avg	4.99	15.34

Small Cap Equity

Benchmark Indx & Category Average*	(Total Return) **4th Q 2017**	**12 Mos.**
Russell 2000 Growth	4.59	22.17
Small Cap Gr Avg	5.01	22.21
Russell 2000 Value	2.05	7.84
Small Cap Val Avg	3.48	8.50
Russell 2000	3.34	14.65
Small Cap Blnd Avg	3.47	11.68

International Equity

Benchmark Indx & Category Average*	(Total Return) **4th Q 2017**	**12 Mos.**
MSCI EAFE	3.90	21.78
Intl Equity Avg	3.88	25.63

* **Category average** calculated using *Morningstar Direct*. Fund universe screened to include funds that meet the following criteria:

- **A.** M-Star Category consistent with designated asset class and management style.
- **B.** M-Star Style Box consistent with designated management style.
- **C.** Fund's Objective consistent with asset class.
- **D.** Excludes Index Funds.

We have not independently verified *Morningstar* data.

Congratulations, Heath Brewer, Karen Hunt and Kim Davis! In recognition of their ongoing efforts and achievements, Heath, Karen and Kim were promoted to Senior Portfolio Manager, Operations Manager and Associate Office Manager effective January 1st.

An Affair to Remember

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investors' International relationships.

Lust for Growth Style stocks over Value remained intense. The disparity was greatest among Small Caps. The Russell 2000 Growth beat the Value index by 14.33%. Technology, Consumer Discretionary and Healthcare climbed 36.9%, 21.2% and 20% in 2017 while classic Value sweethearts Telecomm and Energy dropped -6% and -3.8%. The divergence in Style-specific performance has reached a point where a break-up is overdue.

2017 was for Tech lovers. The FANGs (Facebook, Apple, Amazon, Netflix and Google (aka Alphabet)) are credited with 20% of the S&P 500's 2017 return. The Tech sector gained over 35%. Tighter regulation of social media giants coupled with fears about overly exuberant price appreciation could put investors on the rebound back to Value stocks. The average Large Cap US Growth PE ratio is currently 4.4 points higher than its 15-year average compared to a spread of 3 for Large Cap Value. Companies with Value Style attributes also stand to gain more from lower tax rates.

A shift in the Style preference cycle could create unforeseen heartaches. Growing obsession with passive participation has propelled billions into market cap weighted indexes. The FANGS account for 13% of the S&P 500 and often a larger share of active Large Cap Growth funds. When infatuation with Big Tech ends collapsing prices of a handful of dominant constituents might trigger a much broader, deeper decline.

Wishes came true when Congress enacted tax reform at the last minute. Investors expect it to spur economic growth, inflate wages, lure cash and corporate capital to the US. Some guess that lowering the corporate rate from 35% to 21% could boost earnings growth by 5% to 10% in 2018. Buried in the legislative fine print, however, are a myriad of disallowed deductions. Federal Reserve data indicates that the **effective** tax rate for non-financial corporations has averaged 21% since 2010.

Even if lower taxes fatten company coffers there is no guarantee the windfall will have the promised expansive effect. Cash as a percent of the current assets of S&P 500 companies rose from 19% to over 30% during the last decade. Excessive liquidity has largely financed stock buy-backs not new plants or employee raises. CEO's surveyed say they will pay down debt with tax benefits. Economic theories don't come with guarantees.

The 2017 interest rate saga was less thrilling - or perhaps credit markets have secrets to tell? The short-end of the Treasury yield curve responded promptly to 2017 Fed Funds rate hikes but flattened out as money kept pouring into longer-term US debt and inflation remained at bay. The spread between 2 & 10-year Treasuries narrowed to 0.51% - approaching a decade low – while the 2-year yield edged ahead of the S&P 500 dividend yield for the first time in nearly 10 years.

Love doesn't end just because it gets old but recessions always dampen financial ardor. Investors become suspicious when flat yield curves threaten to invert - a condition where short-term interest rates exceed long. Recessions are always preceded by this phenomenon, although not every inverted curve has been followed by one. If recent inflation rates persist, the Fed's suggested 2018 rate increases will invert the curve. The Fed is more likely to back off until inflation catches up.

Stocks generally do quite well when the curve slopes gently upward. A recent study by *BCA Research* found that the S&P 500 performs best when maturity spreads range between 0% and 0.5%. Median Index returns over the past 30 years have exceeded 20% in this type of environment. Small Caps tend to fall behind, as was the case during 2017 when the curve started to stretch out.

Despite its perplexing absence, the most talked about risk facing both stocks and bonds is "unexpected" inflation. People have gotten used to benign advances in the CPI, so it may not take much of an uptick to surprise. Current PE multiples are historically reasonable in the context of inflation rates averaging under 2%. Stocks will start to look less affordable as inflation rates creep up – unless rising prices drop to the bottom line announcing the birth of true economic growth.

There are suitors capable of delivering healthy inflation: infrastructure spending, higher minimum wages, tighter labor supplies and a weaker dollar all have the capacity to jump start it. Higher prices won't be universally popular but, ultimately, they come with the growth territory.