

Up, Up and away for Markets as Tax Bill Passes January 2018

Dear Client:

Fourth Quarter Review

For the year... Stocks were up. Bonds were up (rates were down). Most commodities, including gold, were up. Developed markets and emerging markets mostly headed higher. The United States passed a new tax bill providing a massive rate reduction to corporations and the highest individual income earners too. Simply stated, 2017 was an excellent year for capital markets across the globe. Only the broad U.S. dollar and several smaller emerging markets experienced losses. Markets outperformed most consensus projections for the year.



Also, in 2017, the markets posted some of the lowest volatility measures ever recorded. The S&P 500 nearly set an unprecedented record of having gains in all 12 months of the calendar year, missing this milestone only because of a 0.50% loss in December. The S&P 500 moved up or down by 1.0% or more (which constitutes a significant fluctuation) on only eight occasions during the year, with the most recent significant fluctuation occurring on Sept. 11. In comparison, the index had 48 such days in 2016 and 71 in 2015. It is important to note that stocks were not the only asset classes that experienced minimal volatility; bonds and other securities fluctuated mildly too. Low volatility is primarily a reflection of stable trends in overall developed market output; however, in 2017, these trends were reinforced by stimulus efforts around the world by Central Banks. ***If economies continue to appear stable, and concerns about rising interest rates and debt are muted, I think markets will likely continue to enjoy relatively low volatility.***

U.S. Equity Market



In the fourth quarter of 2017, the broad U.S. equity market (as measured by the MSCI USA IMI Index) rose 6.3%, and the large-cap focused S&P 500® Index rose 6.6%. Larger-capitalization stocks fared better than smaller cap stocks, and growth-oriented stocks outpaced their value-oriented brethren across the market capitalization spectrum. For the full-year, the broad U.S. equity market (MSCI USA IMI Index) and the S&P 500 Index rose 21.3% and 21.8%, respectively. Like results posted in the fourth quarter, growth stocks outpaced value stocks across all market capitalizations for the year. Of the 11 economic sectors within the S&P 500 Index (which serves as another proxy for the equity market), the Consumer Discretionary and Information

Technology sectors were the top performers in the fourth quarter of 2017, while the Information Technology and Materials sectors were the best performing sectors for the full year. Conversely, the Utilities and Health Care sectors were the worst performing sectors in the fourth quarter, and the



Telecommunication Services and Energy sectors were the worst performing sectors for the full-year. As the quarter closed, indexes achieved some historic results:

- The NASDAQ composite, for the first time, posted gains in 11 of 12 months in 2017.
- The Dow rose 1.8% for December – the first time it recorded nine straight months of gains since 1959.
- The Dow reached 25,000 and then 26,000 (on January 18) -- each thousand-point milestone was achieved in the shortest period to date at five weeks and seven trading days, respectively.

Emerging Markets

International equity markets had a strong fourth quarter and an even stronger full year 2017. The developed equity markets, as measured by the MSCI EAFE Index (net of taxes), rose 4.3% and 25.0% in the fourth quarter and full year, respectively. Emerging markets, as measured by the MSCI Emerging Markets Index (net of taxes), climbed 7.4% and 37.3% in the fourth quarter and full-year, respectively. Even after their meteoric rise, markets abroad continue to have far lower valuations than those in the U.S., based on the Shiller price to earnings ratio and Buffet's total market vs. U.S GNP metric. While lower value is not the only, or the best, reason to buy a specific stock or group of stocks, history shows that **cheaper values plus higher growth expectations can signal that it is a good time to buy.**

U.S. Bonds

Bond markets posted mixed results in the fourth quarter, with some major indices and sectors posting gains, while others were posting losses. In contrast, for the full-year 2017, most major fixed income indices and sectors posted positive results. The broad U.S. bond market, as measured by the Bloomberg Barclays U.S. Aggregate Bond Index, rose 0.4% and 3.5% for the fourth quarter and full year, respectively. For both the quarter and full year, longer-duration maturities fared better than shorter-duration maturities did. The yield on the 10-year U.S. Treasury note ended the fourth quarter at 2.40%, compared to 2.33% at the end of the third quarter and 2.45% posted at the end of the fourth quarter of 2016.



The market gift wrapped returns for investors in 2017, as GDP rose, and the anticipated tax cuts were delivered. The market concluded 2017 with an enormous amount of momentum, both in prices and in economic terms. The global recovery seems “synchronized” as all major and most less developed countries are in expansion. I would expect the tax cut will undoubtedly help corporate profits now and in the future. However, I believe 2018 looks like a more sobering year. If citizens experience higher take-home pay, then partisan rancor over the new tax bill could dissipate in the near term. However, longer term, the math indicates that of the changes created by tax bill will be irrefutable contributors to the country's mounting deficits. In my view, geopolitical risks still abound, but forming an investment strategy around uncertain political risks is next to impossible and may be a pointless exercise. Thus, I may have comments next quarter about the impacts of a Federal Government shut-down, but my thoughts now or then will not center on devising our investment strategy based on politics.



Global debt rose to a record \$233 trillion in the third quarter of 2017, more than \$16 trillion higher than recorded at year-end 2016, according to the just completed analysis released by the Institute of International Finance (IIF). Private non-financial sector debt hit all-time highs in Canada, France, Hong Kong, South Korea, Switzerland, and Turkey. At the same time, though, the ratio of debt-to-gross domestic product fell for the fourth consecutive quarter as economic growth accelerated. The ratio is now around 318 percent, three percentage points below a high set in the third quarter of 2016, according to the IIF. "A combination of factors, including synchronized above-potential global growth, rising inflation (China, Turkey), and efforts to prevent a destabilizing build-up of debt (China, Canada) have all contributed to the decline," IIF analysts noted.

The United Nations calculates that the global population is now at 7.6 billion, suggesting the world's per capita debt is more than \$30,000. The debt pile could end up acting as a brake on central banks trying to raise interest rates, given worries about the debt servicing capacity of highly indebted firms and governments, the IIF analysts wrote. First, let's just allow the notion to sink in that global debt is so massive **every living person needs to chip in \$30,000 to help get rid of it all**. Then ask the question to be answered in the future... What happens if rates rise from the historic lows to near normal?

My Thoughts on Risk Management

Finally, let me close with some ideas about risk management, because managing risk will likely prove to be critical as we enter an aging bull market and economic cycle. In my view, this major tax cut could certainly help to extend the cycle. I recommend keeping a very close eye on these issues and others, such as the Federal Reserve's (Fed) quantitative tightening plans and the potential implications of the agency's personnel changes on the Fed's monetary policy setting committee (Federal Reserve Open Market Committee). The Fed is staying on the schedule it revealed last fall, and this quarter the agency is reducing its balance sheet by \$30 billion per month.

Investors need to worry about inflation. It erodes nominal returns and turns gains into smaller, real, inflation-adjusted returns. In 2018, I believe the tax plan and tight labor markets could help to move inflation a little higher. However, it is also possible the long-term demographic challenges of an aging population and the debt-creation cited above may continue to keep a lid on inflation. Given these inflation "push" and "pull" factors, I plan to keep a watchful eye on potential inflationary pressures in the months ahead.

Further, LPL Financial recently reported an interesting study that the relative strength index, an indicator of technical momentum, is at its highest level since 1995, which indicates the S&P 500 is at its most overbought level in at least 22 years. Another measure of speculation, margin debt (which is created when investors buy stock with credit), has been at elevated levels for months. According to the most recent data, the New York Stock Exchange (NYSE), was valued at \$580.95 billion at the end of November, its fifth monthly record in a row, and up 3.5% from October. Records aren't rare—according to data from Bespoke Investment Group, more than 23% of all monthly readings are records—but debt has been creeping up basically all year. The 11 highest debt readings on record all occurred in 2017. High levels of debt be it margin, bank leverage, or for home buying are often signals of irrational, manic behavior. Of course, the best evidence of speculation and mania is often anecdotal, and therefore I will say the new word we all keep hearing "Bitcoin." The very hyperbolic rollercoaster of the investment (?), currency (?), or trading instrument (?) continues to baffle and confound experts and novices alike. What I will say definitively this month about "bitcoin" is I have neither read nor heard anyone who could clearly articulate what and how its true value is calculated! The internet is now filled with new versions of it, and armies of "new experts" trying to sell it to you and me.

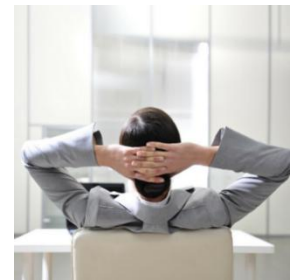


I continue to advocate that focusing on long-term goals yet staying attentive to conditions over the medium-term could prove prudent in the current market environment. Thus, my portfolio considerations remain little changed from last quarter. Consider that risk is quietly growing and keep your overall equity exposure in-line with portfolio allocation targets. I would suggest consideration of the following portfolio actions:

- 1) Continue to tilt equity holdings away from the U.S. to International (Buy emerging markets equities);
- 2) use gains in U.S. equities for liquidity needs;
- 3) rebalance portfolios from stock gains and hold some cash to increase your margin of safety;
- 4) favor small caps over large caps, be they at home or abroad;
- 5) seek out a selected niche and special illiquid private investments;
- 6) look to a mix of short duration, floating rate bonds and intermediate credit fixed income while observing central bank actions;
- 7) when choosing, consider value stocks versus growth stocks

A Look Ahead

With a new year upon us, this is an opportune time to resolve to review your financial objectives and goals. Also, I strongly recommend that you evaluate your risk tolerance, unique circumstances, and time horizon. Let's work together to determine whether the asset allocation we I have in place is still suitable for you. I wish you health, joy, prosperity, and happiness in the New Year. As always, I look forward to continuing to work with you toward achieving your investment goals.



Appreciatively,

Walid L. Petiri

Sources: Bloomberg Barclays, MSCI Barra, Russell Investments, Standard & Poor's, Federal Reserve Board