Ginsburg Financial Advisors, Inc.
Personal Financial Planning & Investment Management
Larry P. Ginsburg, CFP®

phone: **(510) 339-3933**
fax: (510) 339-1611
LGinsburg@GinsburgAdvisors.com

Good Stock Market Results in 2018?
Possible in 2018?
Potential for Increased Volatility Likely

"Normally I don't care for abstract art, but I always feel better when I look at this one."

We Remain Optimistic but More Cautious

Will the Financial Markets not be Deterred?

Despite all of the negative rhetoric within U.S. politics and heightened geopolitical volatility (namely tensions with North Korea and seemingly daily terrorist acts around the globe), the financial markets have delivered strong returns year-to-date through market close 12/21/17. We expect 2018 to present another strong year of results for equities ("stocks") with foreign stocks, both developed international markets and emerging markets, once again outpacing U.S. stocks. Next year should be a challenging time for fixed income ("bonds") as rising interest rates in the U.S. will present a headwind to bond results.

2017, What a Year! Almost Everything Went up in Value

2017 represented a very strong year in the financial markets with both stocks and bonds posting positive gains year-to-date. Stock performance was especially strong driven by improving global economic growth and continued low interest rates. Large capitalization U.S. stocks returned +22.3% outpacing U.S. small cap and mid cap stocks, which were up 16.5% and 15.4% respectively. Developed International (aka Foreign) market stocks delivered even better results with large cap stocks generating a +23.9% return and small-to-mid cap stocks returning +30.8%. Emerging market stocks, however, led all asset classes posting a 34.2% return year-to-date. In addition to improving economic trends and moderating political events, foreign stocks benefited from an 8.7% decline in the U.S. dollar.

U.S. investment grade bonds of all types managed to post a 3.0% gain through market close 12/21/17 driven by a 5.8% gain in investment grade corporate bonds. In the face of rising U.S. interest rates, U.S. Treasuries managed to post a positive 1.8% return reflecting continued strong demand for relatively high yielding investment grade debt from international investors. International bonds returned +9.3% year-to-date driven by strong international corporate bond performance and emerging market bonds, which returned +10.7% for the period.

Even though Brent crude oil is up 14.2% as a result of reduced production activity out of OPEC, commodities is one of a few asset classes that is down year-to-date, posting a negative 1.7% return. Another asset class that is down through 12/21/17 is mid-stream energy, multi-limited partnerships (“MLPs”), which have returned -7.6%. The weakness in MLPs in the face of positive underlying fundamentals has been largely driven by retail investor outflows as these investors have exited MLPs in pursuit of higher returns in other areas of the market.

2018 Outlook for Stocks – Another Positive Year, Especially for Foreign Stocks

We expect stocks to generate another year of positive returns driven by increasing global economic momentum, lower politically-induced event risk, and a relatively low interest rate environment. The U.S. economy, which is in the midst of its second longest expansion since World War II, is entering the late phase of its business cycle. This phase of the business cycle is typically characterized by accelerating GDP growth, low unemployment, rising wages, and increasing inflation expectations. Such an environment provides a positive backdrop for U.S. stock performance, which should generate a high single-digit-to-low double-digit return for 2018. Since valuations have surpassed historical levels, we expect U.S. stock volatility to pick-up especially as the U.S. Federal Reserve (“Fed”) continues to tighten its monetary policy. The tightening of monetary policy ultimately slows economic activity, via suppressing personal and corporate borrowing, thereby increasing the perceived risk of a recession. However, we view the risk of a U.S. recession in 2018 as low, especially given the recent tax reform bill passed by Congress that is expected to stimulate consumer spending and corporate capital expenditures thus accelerate economic growth.

We continue to look for opportunities to reduce large U.S. companies' stock exposure in favor of increasing weightings to foreign stocks given their more favorable return profile. Foreign stocks are not only cheaper relative to U.S. stocks, but improving economic conditions and more accommodative central bank activity, particularly within developed international economies, provides the potential for lower volatility return streams. We expect 2018 to emulate current year returns with developed international market stocks outpacing U.S. stocks and emerging market stocks outperforming U.S. and developed international market stocks.

Do not Expect Much out of Bonds in 2018

Global bond prices remain elevated due to the continued low interest rate environment created by the U.S. Federal Reserve ("Fed") and other central banks since the Great Recession. U.S. bond prices remain at historically high levels even though the Fed continues to tighten monetary policy by raising the Federal Funds Rate, which is the interest rate banks and credit unions lend excess reserves overnight to each other. The Fed is also liquidating its holdings of Treasury bonds and agency mortgage backed securities ("MBS"), which increases the supply of these bonds thus pressuring yields higher (bond yields and bond prices are inversely correlated). We expect investment grade bonds to generate another year of "coupon-like" returns with income payments more than offsetting the decline in nominal values due to rising interest rates. This view may change, however, should inflation expectations rise above the prevailing view of a gradual rise in the government's inflation measures over the course of 2018. Should such a situation occur, we would consider shifting client bond exposures towards assets with less inflation sensitivity, such as Treasury Inflation Protected Securities (TIPS) and commodities.

Foreign bonds continue to provide return enhancing opportunities compared to U.S. investment grade bonds while lowering overall bond volatility through lower sensitivity to U.S. interest rates and more diversified credit exposure. As a means to lower bond-related volatility and increase the return potential of fixed income assets, we continue to advocate diverting a portion of client bond holdings to real estate sector investments. It is important to note that given the level of U.S. stock and global bond prices, we continue to recommend holding a diversified mix of investment grade bonds to stabilize the returns generated on our clients' fixed income holdings. We continue to avoid direct ownership of non-investment grade bonds such as high yield and floating rate debt in client portfolios given where the U.S. is in its business cycle and the high correlation of returns between these assets and traditional stocks. While we are not anticipating generating meaningful returns from our clients' bond holdings, their inherently lower volatility characteristics provide ballast to portfolios during periods of heightened stress within the global financial markets. (We do not recommend seeking the highest possible income from bonds and accepting the accompanying risk. Our view is that if investors want to accept risk, owning stocks is preferable.)

Tactical Opportunities for 2018

We expect sector-specific investments in financials, healthcare, and technology to outperform the broad U.S. stock market throughout the course of 2018. Financials are attractively valued and will benefit from rising U.S. interest rates, a lower corporate tax rate, and deregulation within the U.S. banking sector. Both healthcare and technology should disproportionately benefit from the change in tax rates on repatriated foreign cash and earnings ultimately leading to increased shareholder-friendly capital deployment, such as share buybacks and higher dividends. A potential increase in merger and acquisition ("M&A") activity could also push valuation multiples higher in each of these sectors.

Alternative Assets Increase the Efficiency of Portfolios

Given the likelihood of increased volatility within U.S. stocks and the dearth of return opportunities within fixed income, alternative assets provide the opportunity to lower portfolio volatility while enhancing the return potential of client portfolios. Alternative assets are assets and strategies with a low correlation to traditional stocks and bonds. These assets tend to enhance portfolio diversification via their low relationship with stocks and bonds while stabilizing performance due to their lower correlated return streams. Adding alternative assets to a portfolio can also reduce drawdowns (i.e. the maximum peak-to-trough decline in portfolio value each year) thereby allowing portfolios to compound returns more efficiently over time.

We are particularly optimistic over the prospects for energy sector MLPs in 2018. Not only does this asset class directly benefit from favorable U.S. shale oil and gas production trends, but they are direct beneficiaries of the reduction of the corporate tax rate since not only do these pass-through entities experience a lower tax rate but C corporation structured MLP mutual funds will also experience a reduction in their effective tax rates. There has also been increased ownership of these assets over the course of 2017 among institutional investors, such as pension funds, endowments, and private equity. Since institutional investors predominantly have large research budgets to support sophisticated research and outside consultants, they tend to identify and move into undervalued asset classes well ahead of retail investors.

Prudent Asset Allocation Minimizes Risk

At this point in the market cycle, where both bond and stock prices trade near historical highs, it is prudent for our clients' fixed income holdings to serve as a "shock absorber" to potential downdrafts in the financial markets. We prefer to assume higher levels of risk, thus the potential for higher levels of returns, within the stocks portion of your portfolio rather than with bonds. Not only do equities generally deliver higher returns over time, but minimizing the volatility within your fixed income holdings helps moderate overall return fluctuations enabling your portfolio to compound returns more efficiently.

As always, please contact us if you have any questions or concerns about your investment portfolio. We welcome the opportunity to discuss your goals and the most appropriate strategy to attain them. We are also honored to speak to any of your friends, associates, or relatives should they have an interest in our financial planning or investment management services.

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