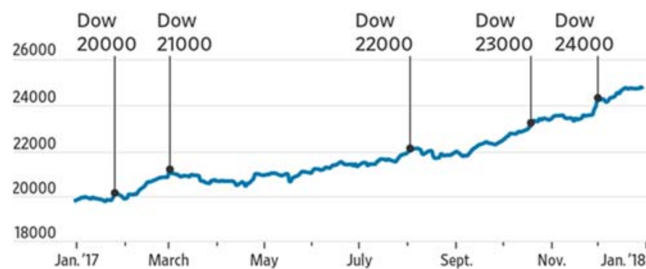
**2017 Year-End Review & Outlook**

***Equities***

The stock market climbed significantly in 2017, posting its biggest annual gain in four years and extending a bull market that began in 2009—now the second-longest in history. Powering the market's double-digit rise was a synchronized economic expansion that reached every corner of the globe. The Dow Jones Industrial Average barreled past several 1,000-point milestones during the year at the fastest pace since its creation in 1896, hitting 71 records along the way. It topped 20,000 a few days after President Trump took office in January, and eventually shot above 24,000 on November 30. (As of this publication, the Dow has now passed the 25,000 mark.)

Worldwide economic growth boosted corporate earnings, pushed consumer confidence to a 17-year high and dropped the domestic jobless rate to its lowest level since 2000. Stocks also got a year-end lift from the Trump administration's tax cut—powered through by a Republican-dominated Congress—which drastically lowers the rate U.S. companies pay, hence should make their businesses more competitive and profitable.

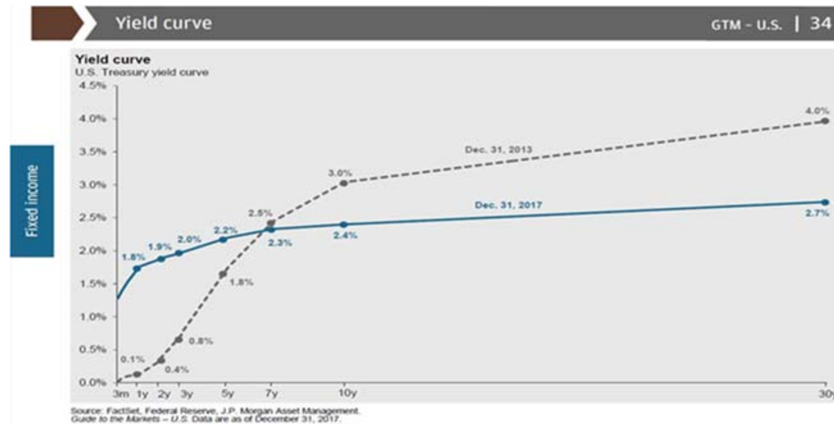
Surprisingly there was very little turbulence during the year's dramatic stock market upsurge. Nothing seemed to halt markets from advancing. Investors shrugged off one jarring headline after another: From escalating nuclear tensions with North Korea, multiple terrorist and natural disaster strikes, Trump tweetstorms and alleged Russian election collusion, high-profile men admitting to or accused of sexual improprieties, to other 24/7 media-promoted intrigue. With these damaging headlines constantly bombarding investors' psyches it was astounding that there were only eight days during the year that the broad S&P 500 Index moved more than one percent. This made 2017 the tamest trading year since 1964, according to S&P Dow Jones Indices.




***Fixed Income***

In a year when fixed income analysts predicted a 2017 where bonds yields would climb higher and prices fall, the fixed income market was also remarkably calm. In fact it was the most tranquil year for the benchmark 10-year U.S. Treasury note in almost four decades despite the Federal Reserve hiking interest rates three times amid a surging stock market. The 10-year Treasury yield spent much of the year within a narrow trading range as investors were assured by the predicable path of Fed rate increases and benign inflation.

Still, notably for 2017, the short end of the bond yield curve (typically two-year Treasury notes) rose much steeper than the long end (30-year Treasurys), which pushed the full yield curve toward flattening out. An "inversion" of the Treasury yield curve (where 30-year Treasury yields are lower than two-year Treasurys) typically signals the coming of an economic recession and a declining stock market. However, very few bond analysts and economists foresee a complete yield inversion or a recession in 2018.




***Global Market Performance***

Soaring stock prices across the globe added more than $9 trillion in market value to investors' accounts in 2017, the biggest one-year dollar haul since the Great Recession. Almost every major benchmark for global stock prices ended the year with double-digit percentage gains as improving economic growth and sturdy corporate profits coaxed investors to buy. Even as equity valuations and prices ticked higher during the year therefore making it more expensive to buy stocks. Assisting equity markets, central bankers across the globe mostly kept their economic stimulus measures in place. These efforts have preserved low borrowing rates and suppressed the returns available for relatively safe government bonds, encouraging investors to own more stocks for expected higher returns.

All major U.S. stock indexes ended the year at record highs. The broad large stock S&P 500 Index advanced by 19.4% for 2017. The Russell 2000 Index of small-company stocks gained 13.1% for the past 12 months underperforming large-caps. Still, year-end tax reform enacted by Congress and the White House led to small company stock outpacing large companies in the last quarter as investors began betting that small company revenues will increase the most with 2018 lower corporate tax rates. The tech-heavy Nasdaq Composite outshone all U.S. major indexes by vaulting 28.2% by year end.

For 2017 the technology sector was the clear standout, surging 39% thanks in large part to huge advances in well-known technology stocks like Facebook, Apple, Amazon, Google-parent Alphabet and Microsoft. In fact, about one-quarter of the

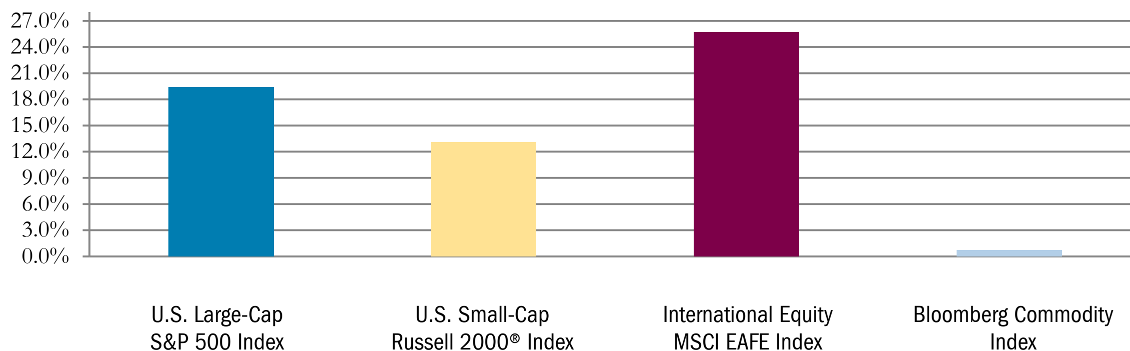
S&P 500 Index market-value creation ($3.9 trillion) came from just these five U.S. companies! Despite a December rally, the telecom and energy sectors still posted the worst sector returns on the year, down 1.3% and 1.0%, respectively.

Growth stocks of all company sizes (such as technology) vastly outperformed value stocks (such as consumer staples) in 2017 as investors focused on firms with above-average earnings during an accelerating economy rather than "safer" slower-growth/higher dividend-paying companies.

Developed international stocks jumped 25.7% in the past 12 months as measured by the MSCI EAFE Index (in U.S. dollars), outperforming U.S. stocks as signs of steady economic growth and political stability in Europe and Asia continued to be evident. The 19-nation Eurozone economy was on course to expand at the fastest clip in a decade. In Japan, companies' earnings improved and investors became increasingly encouraged that steps to strengthen corporate governance were taking hold. It was a banner year for emerging-market stocks, with the S&P Emerging Broad Market Index climbing nearly 32% in dollar terms, the best gain since 2009.

Investors added new money into overseas stocks in 2017, which were less expensive than their U.S. counterparts by conventional measures. The price of S&P 500 stocks compared with trailing earnings (price/earnings ratio or P/E) over the past year was 23. The price/earnings ratio for the Stoxx Europe 600 Index was 19, while the Nikkei Stock Average was 18, according to FactSet. And despite emerging markets' huge advance in 2017, they still have the lowest P/E (so the best value) of any major index at 16.

Natural resources and other commodities were essentially flat (up 0.7%) for 2017 as measured by the Bloomberg Commodity Index. A 20.8% jump in metals including gold (up 13.5%) along with a declining dollar helped the commodity index price. Detractors from the index included energy (-4.3%) and agriculture and livestock products (-8.1%). The Bloomberg Commodity Index measures the collective returns of a basket of 23 commodity futures contracts representing the energy, precious and industrial metals, grains and livestock industries.



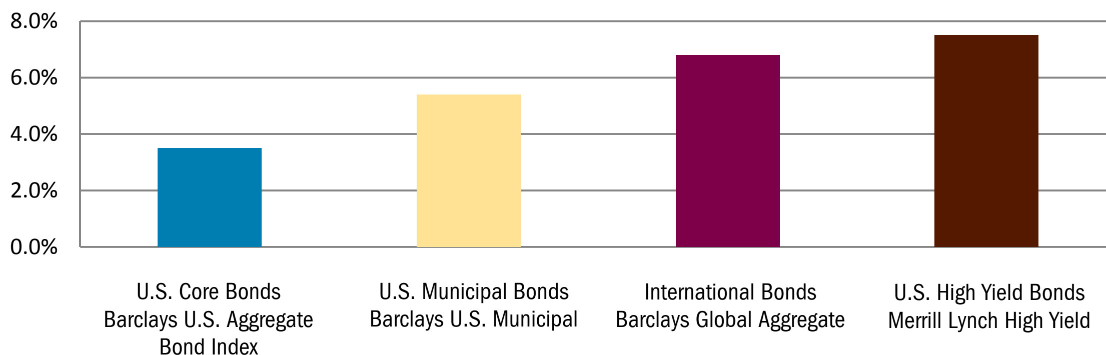
For most of 2017, the yield on the benchmark 10-year Treasury note fluctuated in a narrow band between 2.2% and 2.4%. One of the few times it broke through the upper end of that range was in late December, as Congress passed the major tax cut package.

A growing economy typically leads to lower unemployment, higher wages for workers and broader inflation. Rising inflation leads to even higher Treasury yields as the Federal Reserve aggressively hikes borrowing rates in an attempt to cool escalating consumer prices. However, despite a growing economy and lower unemployment with higher wages, there has been no evidence of out-of-control inflation. Perhaps improved technology at the work place and a more global competition for goods and services has kept a lid on inflationary pressures.

If tax cuts stoke inflation in 2018, many investors believe the Fed will try to stamp it out by taking an even harder line on rate increases. That expectation has helped push up yields on short-term bonds (like the two-year Treasury note), which are especially sensitive to changes in monetary policy, but kept a lid on long-term Treasury yields that are more reactive to inflation expectations (which is expected to be moderate for the year).

For 2017 the Bloomberg Barclays U.S. Aggregate Bond Index of high-quality government, mortgage and corporate bonds ended up 3.5%. Non-investment grade or high-yield bonds rose 7.5%, as measured by the Bank of America/Merrill Lynch High Yield Master Index. A continued positive economic and stock market outlook kept high-yield bond's prices rising for the year with "spreads" very low (the difference in yield between investment-grade and high-yield bonds). State government municipal bonds gained 5.4% for the 2017 as measured by the Bloomberg Barclays Capital Municipal Bond Index; surprisingly outperforming taxable high-quality bonds despite anticipated tax cuts for the high-tax-bracket earners who mainly invest in these tax-free debt securities. The Bloomberg Barclays Capital Global Bond Index was up 6.8% for the past 12 months, due mainly to continuing stable foreign developed country and emerging market growth, along with favorable local currency values versus a weakened U.S. dollar.

**FIXED INCOME MARKETS**
**2017**




## Portfolio Review

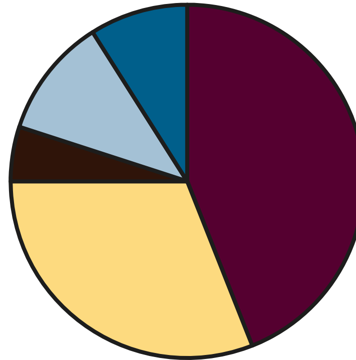
> *U.S. stocks' headlong advance in 2017 is stoking bullish sentiment going into 2018 but has some market watchers questioning how much further the rally can go.*
> — Ben Eisen; The Wall Street Journal

SFC Tactical Investment Strategies (TIS) portfolios overall registered very positive returns for 2017 that were above expectations going into the year. Still, our model portfolios somewhat underperformed the benchmark indexes by being conservatively positioned with underweighted equities in the midst of a rapidly rising stock market. We do not expect to outperform the benchmarks in times when the stock market is "running hot," as it has for nine straight quarters. We do anticipate, nevertheless, that our balanced model portfolios will perform well over the long term—after good and bad stock market periods. SFC TIS's performance track record for over 15 years in balanced portfolios demonstrates that our tactical

asset allocations decisions and investment selections have worked well for financial advisors and their clients. And, most importantly, with less risk than the benchmarks.*

**SFC TIS Moderate Portfolio Model Allocations**
**Accounts Over $100,000**

Equity | Fixed Income | Nat. Resource | Alternative | Cash



History indicates that there's likely to be a pullback in the stock market of over five percent in any given calendar year, which did not happened in 2017. When the market does decline (and it will), we anticipate using our excess portfolio cash to invest mainly in beaten-down stock holdings to increase our equity positions in all model portfolios.

As there was extremely low volatility in the stock and bond markets, few trades were made last year to capture lower securities prices. Nevertheless, starting in late December some trades were executed to either sell holdings to lock in capital losses (benefiting clients' tax returns in taxable/non-qualified accounts), and either purchase similar or potentially better performing securities. Specifically, "swap" trades were made in some bank loan/floating rate and natural resource funds/ETFs.

Financial advisors' client accounts were not rebalanced to model portfolio percentage positions at year-end, not only to avoid high realized capital gains in stock holdings during the bull market run, but more significantly to keep accounts in a over weighted equity positions (relative to their current model portfolios). This is in anticipation that at least the start of this year and perhaps all of 2018 will continue to see further momentum in higher stock prices. Though very early in the New Year, with global equity markets continuing to accelerate, this strategy is paying off for advisors and clients.

This "running with the bulls" strategy may add some further risk to client accounts, but keep in mind stock positions still remain underweighted to higher "neutral" model portfolio stock percentages, and there are "alternative" holdings to steady portfolio turbulence (discussed in the Market Outlook section). Also, additional cash is available to purchase securities at lower prices when a stock market correction occurs.

## Market Outlook

*… bad news for the three bears as Goldilocks has been putting miles on her Peloton and she is hungry.*
—Blaine Rollins, CFA, Managing Director, Portfolio Manager; 361 Capital

Our market outlook is little changed from last quarter … perhaps even more optimistic for stocks in the near term. As mentioned in our Third Quarter *Investment Insights*, the "Trump Trade" is back. This is in reference to the early days after President Trump's election and investor sentiment for the new administration's pro-business policies was exuberant. After a series of what have been judged as newbie political/public relations missteps and failed legislative attempts (think repealing and replacing Obamacare) during the year, the Trump administration regained their mojo by passing historic tax reform at year end. And to the surprise of many pundits, the sprouts of peace dialogue have recently begun between North and South Korea. (With visions of the "big and bigger" nuclear buttons being pulled from Leader Kim Jong-un's and President Trump's desks.)

Add front-page headlines on an improving U.S. economy (synced with a worldwide expansion) and a stock market hitting new highs—coupled with business-page news on tame inflation, continuing positive manufacturing/construction/housing sales/consumer confidence and low unemployment numbers—results in investors ostensibly being downright giddy again. And to many, not only is the once couch-potato economy being transformed into a Goldilocks-Peloton economy, but the market bears appear to have gone into hibernation!

Reviewing tax reform, the short-term implications are mixed while the long-term are more favorable (not including the unknown affected to the ever-ballooning Federal deficit). Tax cuts can raise U.S. GDP by as much as 0.4 percentage points a year for the next two years, according to analysts at Bank of America Merrill Lynch. While the corporate tax rate was significantly lowered from 35% to 21%, which is beneficial to most company earnings, large U.S. firms wanting to repatriate cash held in foreign banks will have a one-time tax hit. Although analysts' consensus forecasts still expect solid 2018 corporate profits compared to 2017, a repatriation tax will impede reported earnings in the coming quarters. Bank of America Merrill Lynch estimates that corporate tax reform will prompt U.S. companies to repatriate cash reserves between $200 billion and $400 billion of the $1 trillion funds held in foreign banks. Repatriating so much foreign cash to U.S. dollars should lift the dollar (perhaps only temporarily) versus other major currencies.

Not meaning to be the "Debbie Downer" at this swinging investor sentiment party, although our stock market outlook for the short term is positive, there are still issues that cause us some concerns over the mid- to long term. Issues such as high stock valuations, the long length of this bull market, constant domestic political/social divisiveness and geopolitical risks.

Also, given our apprehensions about rising yields and lower prices on government bonds, other "alternative" investment strategies to both stocks and bonds make sense, and have been implemented as a higher portion of clients' portfolios than in prior years. Such alternative investments include long/short equity (investments that can bet for and against individual stocks), hedged equity (protecting some of the downside risk of stocks), equity options writing (selling stock puts and calls), multi-strategy stock and bond funds, and natural resources.

Historically, equity alternative strategies have had similar returns to stocks in periods of positive but lower-than-historical returns, with less than half the volatility (or "downside" risk). During periods when equity market returns are in negative territory, alternative strategies for stocks overall outperformed the S&P 500 Index. Fixed income alternative strategies typically add gains as interest rates rise (and traditional bond prices fall).

So in summary, while we are "running with the bulls" for now, we are still somewhat cautious compared to other upbeat money managers as we don't want clients' accounts to be mauled by the hungry bear after it wakes from a very long hibernation. This is in light of high stock valuations and the potential for lower returns going forward, along with rising interest rates and possible declining bond prices. As such, we believe we are in a favorable environment for alternative investment strategies as a portion of client accounts.

We appreciate your continued confidence in our services, and wish you and your family a happy, healthy and prosperous New Year! Your inquiries are welcomed.

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* For financial advisors, please contact our firm for performance information on SFC's model portfolios

**Sources:** 361 Capital, *Weekly Briefing*, January 8, 2018; Bloomberg Commodity Index, Tables & Charts – December 2017 Edition; Marketfield Asset Management, *The Weekly Speculator* (multiple publications); Janus Capital Group, *Investment Outlook* by Bill Gross, December 2017; JP Morgan Asset Management; *Guide to the Markets*, December 2017; Nottingham Advisors, *2018 Outlook for Equity, Fixed Income & Alt Investors*, January 8, 2018; State Street Global Advisors SPDR ETFs Chart Pack, *2018 Outlook Edition*; USA Today (multiple publications); The Wall Street Journal (multiple publications).

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