

Year-End Review & Outlook

2017 – Synchronized Global Expansion Leads to Strong Markets Around the World

As we said at the beginning of last year, what matters most to the markets are economic factors and asset valuations, not politics. And even though the headlines kept us on an emotional roller coaster throughout the year, the markets stayed focused on the fundamentals.

And what a year it was! In the U.S. the economy delivered exceedingly positive results with GDP growth picking up speed in the 2nd half of the year. Unemployment, at all-time lows, energized consumer sentiment and spending, with holiday sales at record highs. Growing corporate earnings and business confidence further contributed to the health of the economy. These near-perfect conditions provided strong support to the markets.

Outside the U.S., foreign economies accelerated their recovery supported by accommodative central bank policies, coining the term “Synchronized Global Expansion” – a main theme for the past year. Every one of the world’s 45 major economies tracked by the Organization of Economic Cooperation and Development (OECD) expanded – an uncommon synchronicity. It has been a decade since the lift to the world economy was this broad.

As a result, most major asset classes around the world posted strong returns for 2017:

- U.S. large-cap stocks (S&P 500 Index)¹ = 21.83%
- U.S. small-cap stocks (S&P 600 Index)² = 13.23%
- Foreign market stocks (MSCI ACWI ex-U.S. Index)³ = 28.38%
- U.S. corporate bonds (Citigroup USBIG CORP. 3-7Y)⁴ = 3.89%

A Look Back

What We Expected

We expected the U.S. economy to grow in the 2% - 2.5% range as we maintained “full” employment and as consumers remained resilient.

¹ S&P Dow Jones Indices, factsheet a/o 12/29/2017 (total return)

² S&P Dow Jones Indices, factsheet a/o 12/29/2017 (total return)

³ MSCI, factsheet a/o 12/29/2017 (total return)

⁴ Tamarac/Envestnet, Citigroup Yieldbook a/o 12/29/2017 (total return)

- Based on the Federal Open Market Committee projections, the U.S. economy grew at 2.5% in 2017. The improvement in GDP in Q2 and Q3 is notable as it was the first time since mid-2014 that the U.S. economy sustained a 3% growth for two consecutive quarters.
- The unemployment rate declined to a 10-year low of 4.1% in November 2017.
- Consumer confidence reached a 17-year high in November 2017.

We believed that foreign markets presented increased investment opportunities, and potentially higher returns – especially relative to U.S. That was certainly the case in 2017. Look no further than the nearly 30% rise in foreign market stocks compared to less than 22% for U.S. large-cap stocks.

We even went out on a limb and said that we expected some version of the Trump Tax plan to pass – and that lower tax rates should increase corporate profits (which is positive for the markets). And both came to fruition. On December 22, 2017, after a series of compromises and controversies, the *Tax Cuts and Jobs Act of 2017* was signed into law. Passage of the law has increased the expectations for higher corporate profits (due to lower taxes) and increased business confidence.

What We Didn't Expect

We believed that U.S. stock prices would be constrained. In 2017, U.S. equities were anything but constrained, with small-caps up more than 13% and large-caps up nearly 22%.

A Look Ahead – 2018 and Beyond

Looking ahead, we believe the synchronized global expansion will continue. In the U.S., we expect GDP growth to be stronger in 2018 than it was in 2017 – based on the strength of the global expansion, a near 4% unemployment rate, and the rise in both business confidence and productivity.

Part of the increase in business confidence can be attributed to the cut in the corporate tax rate of the *Tax Cut and Jobs Act of 2017*. The new corporate rates are the lowest in decades. By one estimate, moving the tax rate from 35% to 21% will result in a 22% increase in corporate earnings. In addition to lifting business sentiment, it provides incentives to repatriate accumulated profits from overseas, which are estimated at more than \$2.5 trillion dollars.

We think the benefits of this fiscal reform have already been priced into the U.S. markets. Pullbacks should be expected if corporations fail to translate tax cuts into sustainable growth and profitability.

Additional catalysts that could trigger a pullback include:

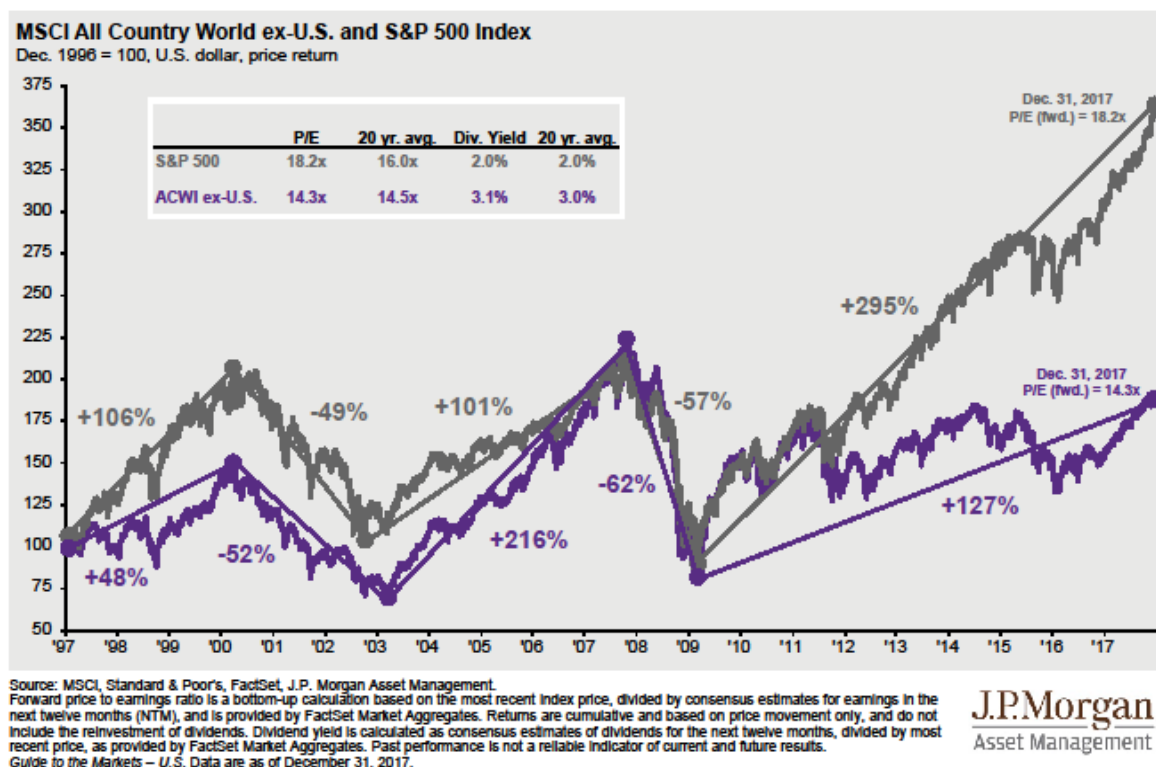
- **Tightening Monetary Policy that Surprises the Market:** It's important to remember that after the 2007 Financial Crisis/Great Recession, the Fed cut interest rates to an historic low. In January 2009, the short-term federal funds rate hit 0.15% and stayed there until the end of 2015. The rate reductions were designed to increase consumer spending and strengthen the economic recovery. And it worked! But the time has come to increase those very low interest rates. In 2017, the Fed moved to normalize rates, but the current target rate is set at only 1.25% - 1.5%. The new Fed chair, Jerome Powell, may need to pick up the pace of rate increases in 2018, especially if the economy overheats. If interest rates rise faster than the markets anticipate, there could be a decline in equities as investors shift into the safety of bonds and cash.
- **A Global Trade War:** If there are negative developments in NAFTA negotiations and/or stress on U.S.-China trade relationships (especially as it relates to North Korea), the current strength in global trade could suffer. For example, if the U. S., European Union, and China all push up prices of imports by 10%, then GDP would drop by 2% - 3% in all three economies. We believe this is a very real possibility given the many anti-trade policies proposed by the current Administration.
- **Overheated U.S. Markets:** The more troubling question for us centers on asset valuations and the lack of volatility in U.S. equities markets. After a 9-year bull market, stocks continue to be valued at the upper range of historical price-to-earnings (P/E) ratios. Not only did we see a rapid rise of stock prices in 2017, but certain sectors had hyperbolic increases that contributed heavily to the market's gains. For example, the technology sector soared by 38%⁵ in 2017. And just 5 stocks (Facebook, Amazon, Apple, Microsoft, and Google) accounted for 25% of the S&P 500 index's return in 2017. The S&P 500 is now in its longest-ever stretch without a 3% decline, a drop that is historically common and very healthy. Last but not least, "enthusiasm to own stocks" has clearly moved from pessimism to optimism, which in-and-of-itself can cause markets to overheat. Now, more than ever, we believe that there is an increased probability that U.S. equities will either move sideways or experience a decline.

A Positive Note – Global Expansion

The strength and momentum of the synchronized global expansion should not be underestimated. As we're writing this outlook, 96% of major economies have a Purchasing Managers Index (PMI) figure of about 50, indicating acceleration. This has created a virtuous cycle of consumption, earnings growth, and investment around the world. This expansion provides a strong economic underpinning that is very positive for the markets in the U.S. and around the world.

⁵ Goldman Sachs Global Investment Research, 1/2/2018

So, we expect any weakness in the U.S. markets to be balanced by continued strength in the international markets. The JP Morgan chart below shows that the S&P 500 Index (which represents the U.S. markets) is trading at 18.2x-forward-earnings vs. its 16x historical average, while MSCI ACWI ex-U.S. (which represents the foreign markets) is trading at 14.3x vs. its 14.5x historical average. This indicates that markets outside the U.S. still have more room to go. Fundamentals of foreign economies, especially in emerging markets, have improved and are less vulnerable to changes in the Fed policy and the strength of the U.S. dollar.



Additionally, we believe allocations to U.S. value-stocks, bonds, and alternative investments will continue to be important in 2018 and beyond. Although our allocations to these assets detracted from returns in 2017, they continue to provide balance to portfolios, which becomes especially important during market weakness. The net effect is that portfolios should produce solid returns in 2018 – but with greater volatility along the way.

Stay the Course

Some of our clients have understandably expressed concerns about the rapid rise of the markets – asking whether they should “go to cash” to wait it out. And since the frequency and intensity of these types of questions has been picking up, as we head into 2018 we want to return to the time-tested principles for successful long-term investing:

- Market Timing Has Never Worked. Why? Because you have to be right twice! First you need to perfectly time the highest point to sell, and then you need to perfectly time the lowest point to buy back in. Correctly timing both is virtually impossible.
- Being Diversified is Critical. A diversified portfolio is never the best or the worst performer in any single year (when compared to the returns of individual asset classes or sectors). The benefits of diversification truly show over the long run. Often diversification gets a bad rap for not “working” – especially when one part of the market is roaring ahead, leaving a diversified portfolio lagging behind. But overall, and over time, diversification works and is a winning strategy for long-run investors.
- Volatility and Rebalancing is Your Friend. While we don’t know what events will occur in 2018, the tide of volatility that has been absent may very well come roaring back. Volatility is normal and you should not let it derail your asset allocation. The key is to use volatility to your advantage by rebalancing your portfolio. And that’s what we do based on your specific needs and risk tolerance. This disciplined approach helps pair back on higher valued asset classes and buys into those out-of-favor asset classes that have more reasonable valuations. Over time, you’re not going “in and out” of the “stock market”; instead you’re staying invested in the right mix of asset classes.

All of this leads to the essence of being a successful long-term investor – compounding! But don’t just take our word for it. Listen to the wise counsel from Albert Einstein who said, “Compound interest is the eighth wonder of the world. He who understands it, earns it... he who doesn’t, pays it.” The only way to have the power of compounding on your side is to be invested.

We understand that market volatility and pullbacks can be unsettling. But as history shows, all market declines are followed by market recoveries. To be successful, you need a well-diversified portfolio to ride out the inevitable ups and downs of the markets. That way you’ll stay invested, compound your earnings, and reach your long-term goals.

Please let us know if you have any questions about our outlook or your specific situation. As always, we appreciate the trust you’ve placed in us.