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Fourth Quarter 2017 Investment Review & Outlook

EXECUTIVE SUMMARY

2017 Recap:

- 2017 was the least volatile year for U.S. stocks on record; the S&P 500 was positive in every month of the year for the first time in history
- The combination of improving growth, central bank accommodation, and tax reform paved the way for the biggest stock market return since 2013. Gains were broad-based across U.S. and international markets
- Bonds rebounded from a challenging Q4 2016 to deliver modestly positive returns in 2017 as inflation and interest rates remained low

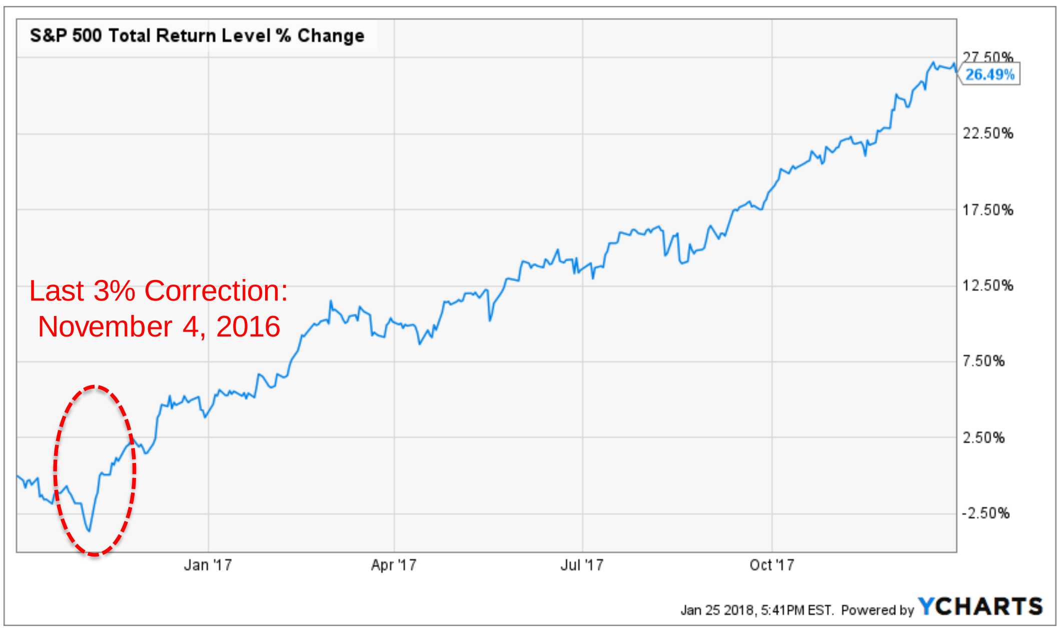
NEXT Outlook:

- Equity risk factors have increased – namely elevated valuations and an historically extended period of low volatility - but much of the backdrop remains supportive of risk assets in the near term
- Given the unusual persistence of market gains, we believe a correction in the next 6-12 months is likely. However, we advocate rebalancing to equity target weights rather than outright underweighting equities at this time
- We believe that incorporating alternative investments that are less dependent on equity and bond returns makes sense in an environment where market risks have increased

To Our Clients and Friends,

The history books will largely remember 2017 as the first year of Donald Trump's presidency, a period of political chaos that's redefined expectations for the executive office. Whether it was the unprecedented number of staff changes at the White House, open taunting of a nuclearized North Korea, or Robert Mueller's investigation into the campaign's potential collusion with Russian authorities, a barrage of daily headlines about the President seemingly consumed all other news.

It is more than a bit surprising, then, that 2017 will also go down as the least volatile year on record for financial markets[1]. The S&P 500 index finished every calendar month of 2017 in positive territory – the first time that's happened since the index was created nearly 100 years ago. Even more instructive: since November 4, 2016, four days prior to the election, the S&P 500 has failed to register so much as a 3% decline, the longest such stretch in recorded history.



At first glance, it is difficult to reconcile this narrative of political turmoil with such benign market behavior. Many of our clients have expressed amazement (and apprehension) at the relentless climb in equity prices. Yet, there are also several clear factors that explain 2017's market performance:

1. **A coordinated, global cyclical recovery took root:** The industrial slowdown that occurred in 2015 and 2016 reversed last year, leading to a synchronized upswing in manufacturing data around the globe. U.S. GDP topped 3.0% in consecutive quarters, while European GDP moved above 2.5%. Developing economies also emerged from a multi-year slump.

2. **Earnings growth rebounded and kept valuations in check:** Similar to economic data, the earnings recession that occurred between 2015 and 2016 rebounded in 2017, such that year-over-year EPS growth topped double digits for the year. This rise in earnings kept price-to-earnings multiples somewhat restrained, as they rose from 16.9x to 18.2x during the year. While that

[1] As measured by the CBOE Volatility Index, or "VIX"

represented an 8% increase, it was well below the 22% market gain (i.e., this year's gains were not solely due to multiple expansion).

3. **Inflation was tame and allowed central banks to remain accommodative:** Tepid inflation in the U.S. allowed the Federal Reserve to proceed with a slow, deliberate unwind of crisis-era monetary policies. This provided investors comfort that the central bank would not tighten policy at a pace that would disrupt growth. The European Central Bank and Bank of Japan also maintained their asset purchasing programs, providing a backing to market prices.

4. **Republicans succeeded in cutting corporate tax rates:** Despite an otherwise ineffective year legislatively, the GOP delivered on the campaign promise most important to stock markets. The corporate tax rate was cut aggressively (and permanently) from 35% to 21%, a level that many did not expect to survive negotiations in Congress. Changes in capex deductions and repatriation of foreign cash potentially provide further stimulative effects for Corporate America in 2018 and beyond.

5. **President Trump did not meaningfully engage in a trade war as feared:** Although this could change in the future (and indeed, in recent days there have been several troubling developments on this front), to date the Trump administration's efforts have largely been rhetorical. Trump has thus far not implemented broad-based trade restrictions, currency devaluation, or withdrawn from NAFTA as some had cautioned.

The end result was a 22% gain in the S&P 500 Index in 2017, surprising even the most optimistic of market prognosticators. And although gains were uneven across markets (the energy sector, for example, finished in negative territory), it was largely a great year for investors.

The key question, of course, is whether this momentum is sustainable. There is no doubt that certain risk factors have increased, not the least of which is simply the amount of time that has passed without a correction. As we've noted here in the past, it is abnormal for stock markets to march unimpeded without periodic pull-backs, no matter how strong fundamentals are. History would suggest that we are "due" for some level of market reset in 2018, though we believe a correction feels more likely than a true bear market. A market correction is typically defined as a temporary decline of 10%, whereas bear markets exceed 20% and are more extended in time frame.

The other factor that we continue to monitor is market valuation. Based on J.P. Morgan data, the S&P 500's forward price-to-earnings multiple is about 14% higher than its historical average – elevated, but nowhere near the extremes we observed in the late 1990's. We remain cautious, but since valuations have never been a good predictor of near-term performance (indeed, high valuations can persist for years), we are primarily focused on rebalancing portfolios toward their long-term equity targets rather than underweighting equities outright. We also continue to favor international markets where we believe equities are comparatively less expensive.

For now, the potent cocktail of variables we described above remains in place. Inflation is low, growth is improving, and the biggest corporate tax cut in modern history is poised to start flowing through earnings and the economy. This backdrop, along with current economic indicators, suggest that a recession is unlikely to occur in the near future. Absent a major change in fundamentals – such as an unexpected inflation spike or an aggressive shift in Trump's trade policy – it is hard to ignore this powerful level of support for financial markets.

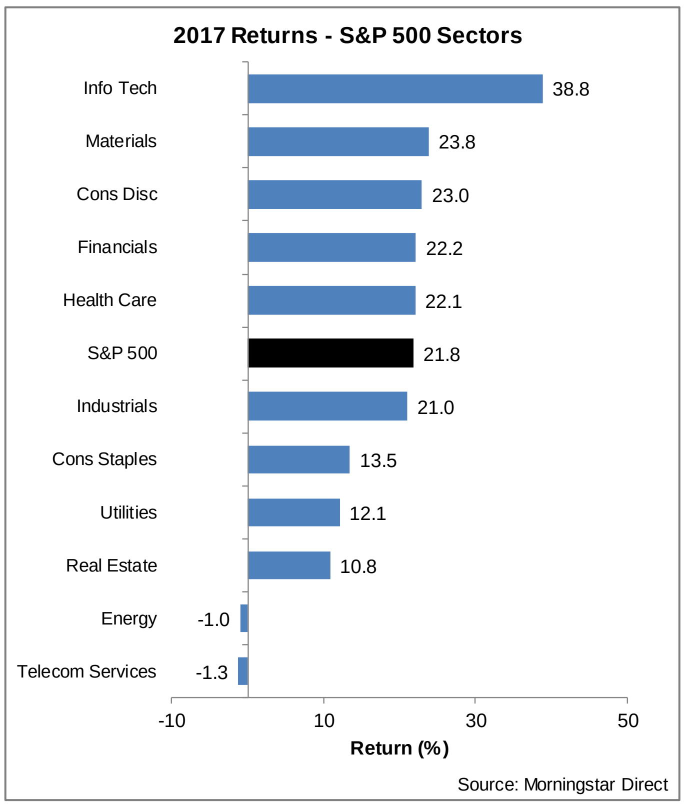
A Review of Market Performance in 2017:

The final three months of 2017 concluded much as it began, with another robust quarter of market performance. The S&P 500's 6.1% return in Q4 lifted the broad U.S. stock market to a 21.8% return for the year, the third-best calendar year return of the bull market that began in 2009.

Riskier market segments such as small and mid-cap stocks underperformed their large cap counterparts, rising 15% and 19%, respectively. Despite a general sentiment that corporate tax reform would be more additive to smaller, domestic businesses than large multinationals, it has been the latter who have performed best in 2017. The explanation for this discrepancy may partially be time frame: small cap stocks leapt nearly 20% in the few weeks after Trump's election in anticipation of more pro-growth policies. That likely had the effect of pulling some of the market's return forward out of 2017 and into 2016 (and indeed, small cap outperformed large cap by nearly 10% that year).

2017 also saw a return to dominance of growth stocks over value oriented ones, a reversal from the prior year. The so-called FAANG stocks of Facebook, Apple, Amazon, Netflix, and Google (Alphabet) accounted for roughly half of the NASDAQ return in 2017 and a fifth of the S&P 500's return. The Russell 1000 Growth's 17% outperformance over its value counterpart was the second largest of the past 18 years.

This preference for higher growth companies was reflected in sector performance, as technology companies sharply outperformed the rest of the market with a 39% return. Technology stocks have now grown to represent 24% of the S&P 500 Index, a level rivaled only by financials in 2007 and technology in the late 1990's. So-called bond proxies – stocks with low volatility and a yield component – like telecom, utilities, and consumer staples lagged. Curiously, energy also struggled despite a significant rebound in oil prices. This effect was extended to energy infrastructure MLP's; despite underperforming in 2017, we think those assets are one of the few attractively valued areas of the market.



The international markets showed continued strength in the fourth quarter and outperformed the U.S. for the year. Developed market indices – e.g., areas like Europe, Japan, and Australia - climbed just over 26% in 2017, while emerging markets finished up 38%. Currencies were part of the story here, as a weakening U.S. dollar contributed to returns for U.S. investors. In developed markets that accounted for 10% of the 26% return, while in the emerging markets it comprised 7% of the 38% return.

Fixed income markets performed well, although the large gains in credit sectors we enjoyed in 2016 were not repeated. This was not a surprise to us; as we have noted here over the past 12 months, valuations have tightened in high yield and bank loan markets such that these investments' return is now mostly predicated upon their income. That does not mean we dislike these investments – in fact, we continue to favor them over traditional, longer duration fixed income – but we have become more defensive in our exposure in recognition of current price levels.

We were surprised, on the other hand, by the performance of higher quality, longer duration fixed income (although this too was largely due to time frame bias). Immediately after the election, intermediate bonds sold off sharply due to expectations of higher growth and inflation in a Trump administration. Once it became clear that Republicans would struggle to execute its legislative agenda, however, interest rates retraced their path lower by more than 50 bps. While this resulted in a rally in intermediate bond prices for 2017, these gains simply offset the now forgotten losses from the fourth quarter of 2016. This flat performance was more in line with our expectations and a major reason why we have shortened duration in client portfolios.

Finally, we saw a respectable rebound in performance for alternative investments (defined here as hedge fund strategies) in both Q4 and full year 2017. The broad index for the asset class was up just under 7% during the year, while equity oriented long/short strategies rose more than 13%. Following a tough 2015-2016 time frame, we were encouraged to see many of the investments we follow show improved effectiveness – and often without being simply dependent on stock market exposure. In a world where fixed income's return potential is more limited and equity valuations are elevated, we continue to believe having lower beta solutions such as these make client portfolios more durable and consistent.

Final Thoughts

In recent commentaries, we have tried to lay the groundwork to reset longer-run return expectations for our clients. Stock market gains have been incredibly robust over the past several years, but we do not believe that level of performance is sustainable. To put recent performance in context, analysis by finance professor Jeremy Siegel shows that the annualized return of 15.5% over the past five years ranks in the top quartile of all five year returns since 1871.

There have been many reasons for these returns, perhaps most important of which was unprecedented central bank intervention following the global financial crisis. At some point, however, the current level of stock market valuations will have to be accounted for. Institutional investors almost universally agree: J.P.Morgan, for example, currently expects U.S. stocks to produce 5.5% per year over the next 10 years, well below the long-term average of ~9%.

For our clients, we believe this has a number of implications. For one, we believe we may have to be slightly more active in taking advantage of investment opportunities. This is a difficult mandate, but one that we believe is possible when taking a longer-term view. One recent example is shifting exposure toward what we believe to be a multi-year opportunity in international equities.

Another critical aspect of portfolio management moving forward, in our opinion, is the use of alternative investments. We know that these allocations have been a point of frustration for many of our clients recently, especially in light of the substantive gains in equity markets. Despite recent performance, however, we believe that: (1) these investments are able to achieve a mid- to high-single digit return with much lower risk and correlation than traditional equities. With fixed income returns likely remaining depressed for some time, this source of lower risk return should not be ignored; and (2) in an environment where the stock markets are moving more laterally and with more volatility than they are currently, these solutions' opportunity set and relative value versus stocks should significantly increase.

It is unclear whether the current market environment will revert anytime soon. As we noted in our first section, fundamentals are strong and the powerful safety net of the Federal Reserve remains in place. When that day does come, however, we believe our client portfolios are well prepared to navigate it.

As always, if you feel as though your individual circumstances have changed or your view of portfolio risk has shifted, we encourage you to call or stop by our office at your earliest convenience.

Kindest regards,
Your Investment Team
1/29/2018