Investment Review and Outlook

January 2018

Introduction

A global economic rebound, strong growth in corporate earnings, and the anticipation of positive outcomes from a US tax overhaul resulted in stellar returns for most major stock indices in 2017.

The S&P 500 Index of large-cap US stocks appreciated 6.6% this quarter, for a substantial rise of 21.8% for the year, in one of the lowest-volatility periods in history. The continued strength of technology stocks, which comprise the biggest sector of the market, contributed significantly to the market's performance, with a 38.8% gain during the year. Energy stocks remained one of the worst-performing sectors, dropping 1%, despite the fact that oil finally topped $60 on the last trading day of the year, gaining 16.9% in the last 3 months alone as oversupply concerns abated. Stocks in overseas markets were the stars for the first time in 5 years, outpacing US returns, as stronger-than-expected economic growth in Europe and other regions combined with a soft US dollar. Developed international markets were higher by more than 25%, and emerging market stocks increased 37.8%. The Bloomberg Barclays US Aggregate Index of bonds added slightly to earlier gains, ending the year up 3.5%, as low inflationary pressure offset the Federal Reserve's rate increases.

Entering the 9th year of a bull market in stocks, it is easy to see why investors are optimistic and maybe somewhat complacent, when even the most moderate dips have been met with strong demand by buyers. Throughout 2017, investors ignored rich valuations, contentious politics, and heightened geopolitical risk and instead focused on the prospects of fiscal stimulus, corporate earnings strength, and less regulation. As 2018 begins, the Goldilocks environment of benign inflation, strong employment, and still-low interest rates remains in place; with a potential boost from new tax laws, the economic outlook seems solid. However, we remain wary of asset valuations and the fact that the markets seem to be pricing in a very low probability of any kind of negative economic surprise or slowdown. As monetary accommodation by global central banks begins to taper off, we are watching for signs that the markets have become addicted to easy money policies. Additionally, the onset of fiscal stimulus at a time of near full employment subsequent to 8 years of asset price growth could bring about an unwelcome spike in inflation, with the potential to spook investors and change the positive outlook.

4th Quarter Review

Performance Summary
Total Returns & Values for Selected Assets as of 12/31/17

	4Q 2017	YTD Return	Price / Value
Dow Jones Industrial Average	11.0%	28.1%	24,719
S&P 500 Index	6.6	21.8	2,674
Russell 2000 Index	3.3	14.6	1,536
MSCI EAFE Index	4.3	25.6	8,135
MSCI EM (Emerging Markets)	7.5	37.8	2,522
Bloomberg Barclay's US Aggregate	0.4	3.5	103
Bloomberg Barclay's Municipal Bond	0.7	5.4	109
Gold – Continuous Contract	1.9	13.7	$1,309
Light Crude Oil – Continuous Contract	16.9	12.5	$60

Source: Factset

Economy

The US economy marched ahead in the fourth quarter, buoyed by optimism related to the passage of a business-friendly tax cut as well as solid advances abroad. The annual pace of GDP growth likely approached the low-3% pace that has prevailed since the second quarter, with numerous sectors operating at multi-year highs, most notably within manufacturing. For example, the Institute of Supply Management's manufacturing survey averaged 57.6 in 2017, the highest annual reading since 2004. While hurricane rebuilding played a role, forward-looking measures such as new orders suggest further gains are likely in 2018. Also, inventories are quite low, while export orders continue to trend higher. Since measures of CEO confidence surged with the tax bill's passage, capital spending could see a long-awaited upswing in coming quarters, further bolstering the manufacturing sector.

The industrial space was not the only area to see gains. While traditional brick and mortar retailers continue to struggle as the online paradigm takes hold, overall holiday sales are expected to be the strongest in over a decade. Even prior to December, data for retail sales consistently exceeded expectations, and auto sales likewise finished the year on firm footing. In hindsight it is not surprising that discretionary spending remained sound. The economy continued to create jobs, with October and November advances in non-farm payrolls being the strongest of the year. Also, as evidenced by the low readings in unemployment claims, firms appeared reluctant to part with labor. As a result, the unemployment rate stood at 4.1% as of the end of November, the lowest level since December 2000, and down from 4.8% as recently as January 2017. The healthy labor market nurtured strong readings in consumer confidence, and the surge in personal consumption that took hold in September remained intact.

While we expect the economy to deliver above-trend growth in the coming months, there are concerns we are monitoring. First, the aforementioned increase in consumption is increasingly coming from a drawdown in savings. This likely stems from disappointments regarding income growth despite the seemingly tight labor market. For example, year-over-year increases in average hourly earnings remain stuck in the mid-2% range that has prevailed since early 2015. Meanwhile, November data showed the personal savings rate dropped to 2.9%, the lowest in ten years, as consumers seem willing to incur debt to finance their spending behavior. While we are far from the levels of debt associated with the pre-crisis refinancing boom, we would prefer to see steady gains in personal income fuel further advances in the consumer space.

Additional concerns relate to limitations on mortgage interest and property tax deductibility within the new tax bill, and the likely negative impact on the housing sector. The National Association of Realtors predicts the bill's passage will result in an aggregate 10% drop in national home prices (with New Jersey suffering the most, with a 21% loss). While we doubt the impact will be as extreme as NAR's forecast, on the margin tax reform will directly impact what is a meaningful sector of the US economy. Indirectly, the possibility exists that home depreciation disrupts the more-impactful consumer sector should the psychology of paper losses on an individual's largest asset cause a re-evaluation of future spending habits. However, as with our concerns regarding leverage, we believe employment trends will be more important, and the "wealth effect" generated by equity gains will more than offset housing's detraction from economic growth.

As we move further into 2018, we see the economy downshifting to a more trend-like pace of growth, most likely settling in the low 2% range. The reduction of the corporate tax rate to 21% from 35% should support the labor market and foster increases in capital investment. Traditionally, downturns in industrial production, an increase in the unemployment rate, and an inverted yield curve are among the necessary ingredients for a recession to take hold. While the yield curve has flattened meaningfully of late, we do not think these other benchmarks are in danger of being breeched any time soon. However, the Fed, even under new leadership, likely will continue raising borrowing costs via increases in the federal funds rate while concurrently trimming its hefty bond holdings, offsetting some of the tax cut's fiscal stimulus with slightly tighter monetary policy. At this point, the handoff from the Fed to a more traditional growth engine is healthy, since its unprecedented (but necessary, in our opinion) policies clearly distort pricing in the capital markets, which in time will create imbalances. That being said, should inflation surprise on the upside (most likely due to wage pressures), the Fed will be forced to respond more aggressively, and growth will suffer accordingly. We think that is a 2019 issue at the earliest and remain constructive for the 2018 outlook.

Equities

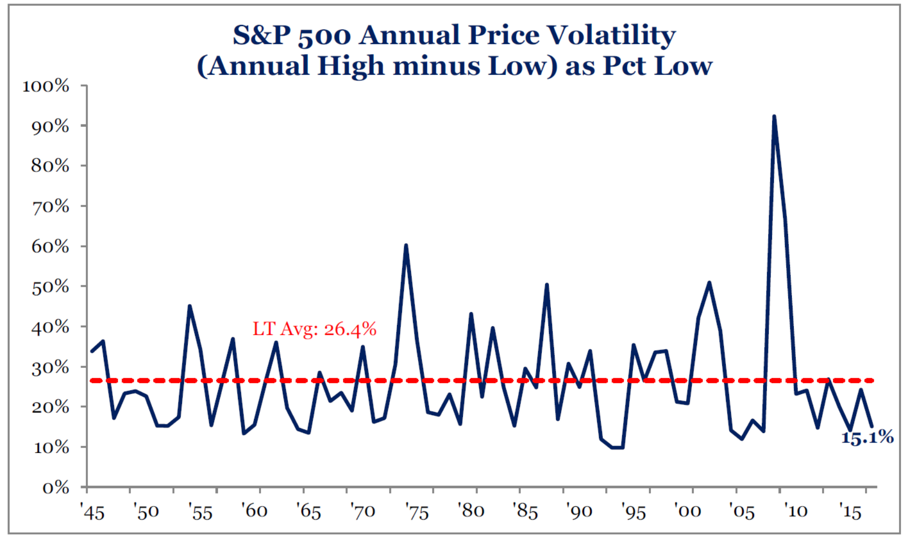
Equity markets around the world ended the year on a strong note as the synchronized global economic expansion and resulting growth in corporate profits continued. The passage of tax reform in the US only added to the optimism generated by the worldwide expansion. The Goldilocks combination of steady global economic growth with persistent low inflation made for a remarkable year in many ways as the following statistics bear out:

- S&P 500 had positive returns for all months, the first time in its history
- 282 trading days without a 3% market correction, which is the longest period on record
- Dow Jones Industrial Average had 71 record highs, beating the old record of 69 from 1995
- Technology companies comprised 24% of the S&P 500 at year end, the third highest historical sector weight behind Technology in 2000 (34%) and Energy (30%) in 1981
- Bitcoin's bubble-like price surge of 1403% rivaled silver's ascent in 1979-80 of 713%

During the quarter, the S&P 500 index returned 6.6%, led by the Amazon-dominated Consumer Discretionary sector (+9.9%), Technology (+9%), and Financials (+8.6%). Developed markets outside the US as measured by EAFE rose 4.3% as the dollar weakened during the quarter. Asian markets' 8.4% led the Emerging Equity complex, which returned 7.5%. For the year, the S&P 500 index returned 21.8% while equity markets in non-US developed countries returned 25.6% due to the dollar's decline during the year. Driven by robust returns in Asia, markets in emerging countries led the way for the year with a 37.8% return.

For quite some time, we have expressed our view of favoring stocks over bonds, which can be summarized by the acronym, TINA. It represents the famous slogan, "There Is No Alternative", originated by Victorian philosopher Herbert Spencer and used frequently by Margaret Thatcher in the 1980s in her arguments for free-market capitalism. In recent years, dominated by global central banks' quantitative easing and the resulting artificially low interest rates, TINA expresses the sentiment that there is no alternative offering attractive returns other than equity investments. This sentiment, supported by record-low volatility (see Chart 1) and a broad but moderate economic expansion, drove investors' enthusiasm for stocks even as valuations rose to historically lofty levels.

Chart 1



Source: Strategas Research Partners

As we enter 2018, a new acronym, MOTS , "More Of The Same", enters the lexicon. With the help of continued global growth, low inflation and recent US corporate tax rate cuts, we believe S&P 500 companies can deliver 10% EPS growth. The capital expenditure recovery will continue, and investors will reward companies that invest in growth investments along with R&D. As interest rates increase modestly around the world, investors will be less willing to use higher valuation multiples, and prices may not rise at the same rate as earnings.

On the topic of recession risk, we reiterate our sentiment from the last quarter. While the economic expansion is protracted and indicators such as yield curve flattening begin to raise recession chatter, barring cataclysmic geopolitical events, recession risk in the US and globally is very low by most indicators. We are aware of and increasingly concerned about the elevated market valuation and acknowledge that prolonged periods of low rates and volatility can result in excessive risk taking; we are watchful for signs of retail investor euphoria, which would be a clear warning signal of an impending significant correction. Based on the current conditions, we continue to believe US and global equities offer better returns than fixed income or cash but expect there will be a material increase in volatility.

Economic and Market Drivers

Tailwinds	Headwinds
Low interest rates	Fed Policy – rising rates and balance sheet runoff
Fiscal Stimulus Package	High U.S. Equity Valuations
Improving Real Household Income	Tight U.S. labor market – rising labor costs
Low Inflation	Political confusion – debt ceiling
Animal Spirits rising - Business Optimism	Protectionist Trade Policies
Household Formation Increasing	Aging Demographics in Developed Markets
Lack of Investor Euphoria	China Slowdown / Deleveraging

Bonds

After an unimpressive, but again positive, 0.4% quarterly gain for the Bloomberg Barclay's Aggregate Bond Index, the annual return amounted to a respectable 3.5%. An ongoing reach for yield drove performance, as duration and credit risk generated the highest returns by a wide margin. Maturities greater than 10 years posted a 10.5% gain, and lower-rated credits produced 7.5% for the full year. In contrast, anything maturing in under 5 years increased less than 2%. As we expected rates to rise along the curve, we believed the best strategy was to be positioned defensively with duration shorter than the benchmark and underweights in the longest maturities.

Given the insatiable investor appetite for yield, corporate issuers took advantage of the low rate environment and sold $1.4 trillion in investment grade bonds, setting another record for the fourth consecutive year. Spreads tightened to 95 basis points, a historically tight level. Even with limited room for further spread compression, we continue to favor spread product and, in particular, corporates. With the passing of the tax bill and our expectation for positive GDP growth over the foreseeable future, we believe credit fundamentals should remain stable and prefer the higher yields relative to Treasuries. Additionally, there may be less supply following tax reform, as companies should have decreased need to issue bonds subsequent to the significant tax savings or repatriation cash from overseas. As we already are quite overweight the corporate sector and wary of the diminishing compensation for risk, our bias is not to add to the overweight but to be selective regarding future purchases and strategically sell overly rich positions in order to maintain our current exposure.

While we anticipated higher rates and some narrowing between the 2-year and 10-year Treasury yields, the magnitude of the flattening has been impressive. Heading into 2018, we are watching carefully for the prospect of an inverted yield curve and the potential for a subsequent recession which cannot be ruled out. However, our forecast does not include such an outcome and instead calls for continued positive growth. Going into the new year, we will look for opportunities to purchase bonds in the intermediate part of the curve to lessen the underweight and extend on any material backups in rates, which could occur if inflation picks up domestically or the European Central Bank (ECB) ceases their bond buying program. Should the ECB let the program run out in September of 2018, more bonds would be available to foreign investors, pressuring extremely low European yields higher and diverting the demand for US securities.

Municipal bonds were an unexpected casualty of the tax reform debate, resulting in wild price swings as investors snapped up the bonds of municipalities rushing to sell a record number of bonds in December. Overall, the market's performance for the quarter and year were solid, with the Barclay's Municipal Bond Index advancing 0.8% and 5.5%, respectively, masking a sharp increase in volatility during the last two months of the year. Meanwhile, yields on the shortest maturities grinded higher in sympathy with the Fed's tightening, resulting in a much flatter yield curve than we have seen post-crisis, as the difference in yield between the shortest and longest maturities narrowed. Overall, yields on all maturities finished well above the near-record lows seen this summer, restoring a degree of value in the market absent for some time.

As noted in prior communications, we expected yields to move higher from mid-year as the economy continued to perform well and inflation, particularly on the wage front, slowly advanced, forcing the Fed to continue tightening monetary policy. This scenario became mere background noise compared to the gyrations caused by tax reform proposals. The most damaging to the muni market would have been the House version of the bill, which threatened to eliminate traditional heavyweight borrowers such as hospitals, higher education and housing authorities from utilizing the market starting calendar year 2018. Yields started to rise as investors correctly assumed that those entities would rush to the market to beat the year-end deadline. In addition, both the House and Senate bills proposed elimination of advance refunding deals which are used to defease outstanding, higher-yielding debt with new bonds paying lower coupons after a drop in interest rates. As a result, advance refunding deals flooded the new issue calendar heading into year-end as well. All told, December issuance was a single-month record of $62.5 billion.

Thankfully, the final bill still provided not-for-profit issuers access to the market. While the elimination of advance refundings negatively impacts borrowing costs for issuers, we are not overly concerned. Our expectation for a continued rise in interest rates means fewer coupons would be candidates for refunding moving forward.

Our largest concern post-reform is the change of behavior within the corporate sector, particularly bank and insurance companies that traditionally have been large players in the municipal bond market. The reduced corporate tax rate likely diminishes corporate demand for tax-free bonds since lower rates reduce the value of a tax-free income stream. However, households and mutual funds remain the largest buyer base, and while the top bracket for individuals is lower (now at 37% versus 39.6%), it still resides at a level where municipal bonds will be competitive on an after-tax basis. Also, the 3.8% surcharge on investment income to fund the Affordable Care Act shockingly survived the final tax bill. The tax does not apply to municipal income, which further adds to the market's appeal.

We continue to believe a conservative maturity profile is most appropriate given the risk of higher interest rates. In times of disruption (such as late November/early December) or periods of heavy new issue supply, we will look to extend into longer maturities to lock in attractive income streams should pricing become compelling. Over time, we expect intermediate maturities to cheapen as the Fed's rate increases advance, and we likely will add to these maturities. We have shunned this part of the yield curve of late given such low absolute yields that investors are not generating positive real returns net of inflation.

Conclusion

The environment that resulted in the generous market returns of 2017 remains in place: relatively low inflation and interest rates, healthy employment levels and modest but positive economic growth. Now added to this mix is the start of a new tax package for both corporations and individuals. We do not see factors that would indicate the onset of a recession, although we expect to experience more garden-variety pullbacks of >5%, which happen, on average, every 3 months. It has been 14 months since the last one.

At the same time, we are well aware that valuations of many assets are rich, central banks are becoming less accommodative, and that exceptionally low market volatility is an indication of complacency that assigns a very low probability of any unexpected negative surprise or shocks. We also note that the new stimulus may be overkill at a time when economic growth already has picked up, asset prices have steadily risen and employment is strong. Down the road, it adds to the deficit with the risk that there is little room for additional stimulus in the next downturn. But for now, Happy New Year.