2017 Fourth Quarter Review of the Markets

Index	4th Qtr Return	YTD Return
S&P 500	6.64%	21.83%
MSCI ACWI Ex USA	5.00%	27.19%
Barclay's Bond Index	0.39%	3.54%
Consumer Price Index	0.65%	2.12%

Investment Commentary

2017 was another stellar year for stocks as prices around the world increased. The media seemed to constantly report record highs domestically with the S&P 500 index increasing 21.8% for the year. Internationally, stocks also performed well, gaining 27.2%. Ultimately, 2017 will go down as a year of strong returns and exceptionally low volatility. Global stocks for the first time in modern history did not have a single down month in the calendar year. Furthermore, throughout 2017 global stock market volatility (as measured by standard deviation of the MSCI All Country World Indices Investable Market Index) was just 2.7% with a return of 24%. Over the last 15 years the volatility of the same index has been over 15% with an annualized return of about 9.4%.

Bonds also had positive results in 2017 with the Bloomberg Barclays Aggregate Bond index returning 3.5%. Given strong equity markets and growth in every developed market economy worldwide, this was not a foregone conclusion. Working further against bonds, they did not experience a rally as a result of a drawdown in equity markets during the year given the lack of a pullback mentioned above.

Economic Outlook

Strong stock market performance has led many clients to ask, "is the market too high?" The answer is, of course, we can't know for sure. The numerical index values (i.e., 2,674 on the S&P 500, 24,919 on the Dow at the end of the year) are completely irrelevant in and of themselves. Index values only become useful when compared to things like earnings, assets, or cash flow. However, there is some justification for current valuations.

The labor picture in the United States is extraordinary. Unemployment has been below 5% for more than two years, and small businesses are reporting in surveys that skilled labor is difficult to find. This provides the income and confidence needed to drive the consumer.

Also, increased valuations have come amid increased earnings forecasts. Analysts across Wall Street spent most of 2017 increasing their estimate of how much companies in the S&P 500 would earn over the next twelve months. Often, analysts will come out with very optimistic 12 month forecasts, and then those forecasts will moderate substantially as time passes. That has not been the case this year as earnings forecasts generally continued to rise throughout the year.

Finally, as central banks continue generally accommodative monetary policy, Purchasing Managers' Indices (PMIs) across the developed world are all positive for the first time in the post-crisis period. This indicates synchronized economic expansion globally.

What could derail the current direction of equity markets? A few things top our list. First, as the Federal Reserve ("The Fed") continues to hike interest rates, there is a risk that they will do so at a pace too rapid for the economy to handle the increased cost to finance growth. This could bring the U.S. into a recession which would certainly be bad for stocks. Alternatively, should the Fed be too slow to tighten monetary policy, there is a danger that excessive risk taking behavior returns to the markets and asset price bubbles could emerge forcing the Fed to tighten too aggressively and too late.

Further, due to the very low level of unemployment in the U.S., even a small increase in unemployment could have big repercussions versus the status quo. Increasing unemployment can start a negative feedback loop that also could also point the economy towards recession.

Even if unemployment remains low, the tight labor market could result in increasing wages at a pace that accelerates inflation. If this occurs, longer term interest rates are likely to increase, making bonds more competitive with stocks which could put pressure on stock valuations.

Finally, continued increases in earnings expectations may be difficult for companies to achieve. As profit margins are quite high relative to historical levels (meaning cost cuts are unlikely to drive earnings higher from this point) companies may have to increasingly rely on growing top-line revenue to generate further earnings growth. Margins could be further pressured by any acceleration in wage growth, which has remained subdued to this point despite historically rising at such low levels of unemployment. Disappointing earnings results may cause a selloff in equity markets.

One significant positive on the earnings front comes in the form of comprehensive U.S. tax reform. Previously, the effective tax rate on corporations was closer to 25% with the highest marginal rate at 35%. Lowering the highest marginal corporate tax rate to 21% will be a significant boost to all corporations with a marginal tax rate previously in excess of 21% and is currently expected to add 7+% to S&P 500 earnings in 2018. In our opinion, the market had already largely priced in the benefits of corporate tax reform by the time it was announced.

Investment Strategy

Regular readers may be tired of hearing this, but portfolio diversification is intentionally high. While we feel that 2017 portfolio returns were strong and broadly in-line with our expectations across risk profiles, we find it increasingly difficult to justify excessive risk taking in the current environment. Investor sentiment is quite high and consumers are increasingly confident as demonstrated by the lowest savings rate in the U.S. since late 2007.

If history is a guide, these late-cycle periods often deliver strong returns with little volatility, but we are mindful that risk premiums are insufficient to justify taking higher than normal levels of risk. Economic cycles do not last forever – although it appears likely that the current one will be the longest in modern economic history. Missing out on these late-cycle periods altogether by selling early can also be quite costly to investors on an opportunity-cost basis, and we are of the opinion that the timing of market cycles is a risky endeavor.

We continue to migrate equity exposure from U.S. to international equities based upon what we consider to be a longer runway for earnings growth. Further, we maintain an allocation to intermediate term U.S. Treasury bonds which should perform well in an adverse stock market event. We have dramatically cut exposure to lower quality bonds as a result of continually increasing valuations making them much less competitive with stocks than at previous levels. Broadly speaking, client fixed income portfolios are at the highest credit quality they have been this market cycle. This may drag on fixed income performance in the short-term, but we are investing with a time horizon well beyond the short-term. We recommend that clients continue to revisit their risk profiles and reach out to us to discuss any questions or concerns they may have with their portfolios, their risk profiles, or their unique circumstances.

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