Q4 2017
Investment Perspectives

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- **EQUITY MARKETS FINISH ON A HIGH NOTE**: Major stock indices around the world closed 2017 with broad gains in Q4 as investors responded positively to an extended period of synchronized global growth and supportive financial conditions.
- **U.S. TAX REFORM BUOYS 2018 STOCK MARKET FORECASTS:** The GOP-controlled Congress passed a sweeping tax reform package in the fourth quarter, centered on lowering corporate tax rates. With more earnings available to distribute to shareholders or deploy for growth, investors and analysts alike placed their bets on stocks to rise in 2018.
- **FED HIKES RATES; ECB STILL ON HOLD:** The Fed's likely new chairperson, Jerome Powell, reiterated a commitment to gradual monetary policy normalization, and the Fed hiked interest rates 25 basis points in December. The European Central Bank (ECB) signaled that it had no intentions of raising rates in the near-term, but it did announce that it would be tapering the growth of its balance sheet in January 2018.

Market Recap

Global markets closed the year on a high note, as stock indices around the world capped 2017 with a fourth consecutive quarter of gains. Accommodative financial conditions and buoyant corporate earnings once again provided the impetus for investors to bid asset prices higher across the globe.

U.S. TAX REFORM TAKES CENTER STAGE

Front and center during Q4 2017 were the GOP-led efforts to reform the U.S. tax code and slash rates across the board—particularly for corporations. While markets were initially skeptical about Congress' ability to pass a bill offering material changes to the system, ultimately Republicans were able to garner the necessary votes to pass the Tax Cuts and Jobs Act of 2017, and President Trump signed the bill into law on December 22, 2017.

FIXED INCOME

	USD Total Return (%)	
INDEX	**Q4**	**YTD**
Barclays 1-10 Yr Muni	-0.2%	3.5%
Barclays US Agg. Bond	0.4%	3.5%
BofA/ML HY Master II	0.4%	7.5%

EQUITIES

	USD Total Return (%)	
INDEX	**Q4**	**YTD**
Russell 3000	6.3%	21.1%
S&P 500	6.6%	21.8%
Russell 2000	3.3%	14.7%
MSCI All Country World	5.7%	24.0%
MSCI EAFE	4.2%	25.0%
MSCI Emerging Mkts	7.4%	37.3%

Source: Morningstar (Data as of 12/31/17)

The early winners from the tax reform efforts appear to be industrials and materials (new rules around depreciation are expected to jump-start business capex), financials and energy due to their high tax rates and cyclical characteristics, and small caps more generally—owing to their higher effective tax rates. With the first-order effects likely priced in by markets at this point, investors are trying to anticipate the second- and third-order effects coming down the road—for instance, a possible pick-up in retail sales as Americans see bigger paychecks thanks to lower withholding rates.

NON-U.S. STOCKS CLOSE THE YEAR ON TOP

Despite the tailwind from corporate tax cuts in the U.S., for the first time since 2012, non-U.S. stocks outperformed U.S. stocks for the calendar year. Compared to the S&P 500's returns of 21.8%—very strong in its own right—the MSCI EAFE Index, a broad index of developed international equities, modestly outperformed with gains of 25.0%, and the MSCI Emerging Markets Index handily outperformed with gains of 37.3%.

In our experience, allocators and investment committees often reward the best performing asset classes by investing additional dollars in recent winners. While optimism about the domestic effects of tax reform may blunt this phenomenon to a degree, we would expect asset flows to continue to favor non-U.S. asset classes—particularly if global central banks remain supportive.

THE S&P 500 "BATS 1,000" IN 2017

With volatility depressed and investors consistently adding money to equities in 2017, the benchmark index of U.S. large cap stocks went 12 for 12, posting gains in every month during the year. In fact, the index has recorded 14 consecutive months of positive returns going back to November 2016 and has been positive in 21 of the past 22 months. Only a streak of 15 consecutive monthly gains ending in May 1959 tops the market's current run, but the market looks poised to tie the longstanding record thanks to a fast start in 2018.

INTEREST RATES GRIND HIGHER

The widely-followed 10-year Treasury rate moved modestly higher during the quarter, closing the year at 2.40%—just slightly lower than where it started 2017. Inflation continues to be of little concern to long-term fixed income investors, but a number of analysts have speculated that the tax reform bill may require meaningful debt issuance to fill near-term funding gaps. Just like any other market governed by supply and demand dynamics, if a flood of Treasuries were to hit the market over the coming months and years, there is a strong chance that investors will require higher yields in order to buy the government's debt. Given the low starting yield and high degree of interest rate sensitivity—a recipe for negative returns in a rising rate environment—core fixed income investors will want to be on alert in 2018.

Remarkably, even as long-term U.S. interest rates have remained relatively range-bound, long-term rates across the Eurozone and in Japan have pushed lower thanks to central bank intervention. Debt from countries such as Portugal, Spain, and Italy now trades at lower yields than an equivalent U.S. Treasury. To put that in perspective, bonds from these countries yielded anywhere from 3%-5% higher than Treasuries at the end of 2012 due to their perceived risk. An even more dramatic example is Greek debt. As recently as 2015—in the wake of the country's debt crisis requiring multiple bailouts from the EU, ECB, and IMF—Greek bond yields were at a 10% premium relative to equivalent Treasuries. Now? Only a 2% premium.

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CASH FINALLY EARNS A RETURN

While the days of earning 4%-plus in money market funds remain a distant memory (see: 2007), the Fed's recent increases to short-term interest rates have finally moved U.S. money market yields off of the zero bound. In other words, investors are actually being paid to hold cash again. As of year-end, yields on 1-month Treasury Bills reached 1.29% and the average prime money market fund was yielding just over 0.90% on a net basis, according to iMoneyNet data. For investors willing to extend slightly further, 2-year Treasury yields were 1.89% as of year-end, up nearly 0.70% over the past year.

While the increase in short-term rates is a welcome development for savers, higher short-term rates can have profound effects on the economy and markets. Most obviously, companies and individuals will likely face higher borrowing costs as these benchmark interest rates increase. Further, assets like dividend paying stocks or real estate could also feel a squeeze as investors entertain swapping into risk-free Treasuries with increasingly compelling yields. That could lead to stock prices or property values adjusting lower as market participants command higher yields.

NEW FED CHAIR; SAME FED STORY

With Janet Yellen nearing the end of her term as Fed chair, much was made of the White House's selection process and whether the new chair would represent a departure from the Fed's highly accommodative monetary policy post-2008. Ultimately, the selection of Jerome (Jay) Powell to succeed Yellen represented continuity from the prior regime, with Powell confirming his commitment to gradual interest rate increases throughout the nomination process. Powell will officially succeed Yellen as chair on February 3 and is expected to oversee three interest rate hikes during 2018.

CRYPTOCURRENCY MANIA

Talk about cryptocurrencies—namely, bitcoin—reached a fever pitch during Q4 2017 as everyone from baristas to Uber drivers to 70-year-old retirees were asking "What is it?" and "How can I buy it?" Prices for bitcoin soared roughly 1,400% during 2017, which actually paled in comparison to some of its competitors—including, litecoin, ethereum, and ripple—that each gained over 5,000%. Mainstream acceptance of the online currencies has been relatively slow, but the launch of exchange-traded bitcoin futures by the CME Group in December was a big step toward legitimizing the cryptocurrency markets.

Whether this proves to be an old-fashioned bubble or a bona fide paradigm shift in how the world thinks about fiat currencies and central banks remains to be seen, but recent signs point toward the former. There is a saying that bubbles do not die from lack of demand, but rather from over-supply. As more companies add "blockchain" to their names, more "initial coin offerings" come to market, and new products are created by exchanges and fund providers, we cannot help but note a couple of key similarities to the late 90s—".com" instead of "blockchain" and "IPOs" instead of "ICOs." To paraphrase Mark Twain, history may not repeat but it often rhymes; our only advice at this point is buyer beware. ●

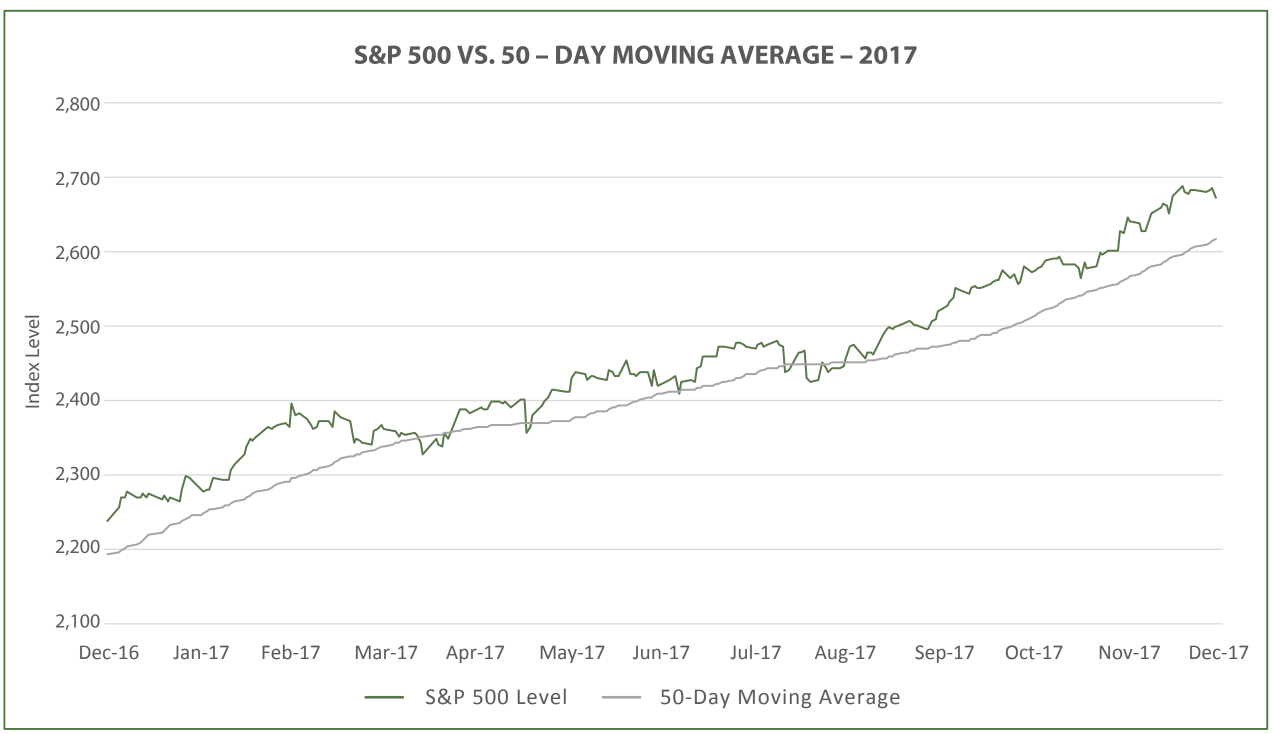
Three Key Takeaways From 2017

As you conduct your 2017 investment "post-mortem" and review portfolio returns, here are three key themes that defined global markets during the year:

1. **Markets generally ignored politics.** Much was made about the potential for Donald Trump to roil markets with a single tweet or proclamation after his election at the end of 2016, but 2017 once again showed that the market often ignores the political noise coming out of Washington on a day-to-day basis, instead focusing on corporate earnings and underlying economic trends. The same could be said for global markets vis-à-vis geopolitical tensions in the Middle East and East Asia, corruption scandals in South America, and political uncertainty in the United Kingdom and Europe. While these issues were occasionally a source of headline risk, investors largely ignored the noise and continued buying in 2017.

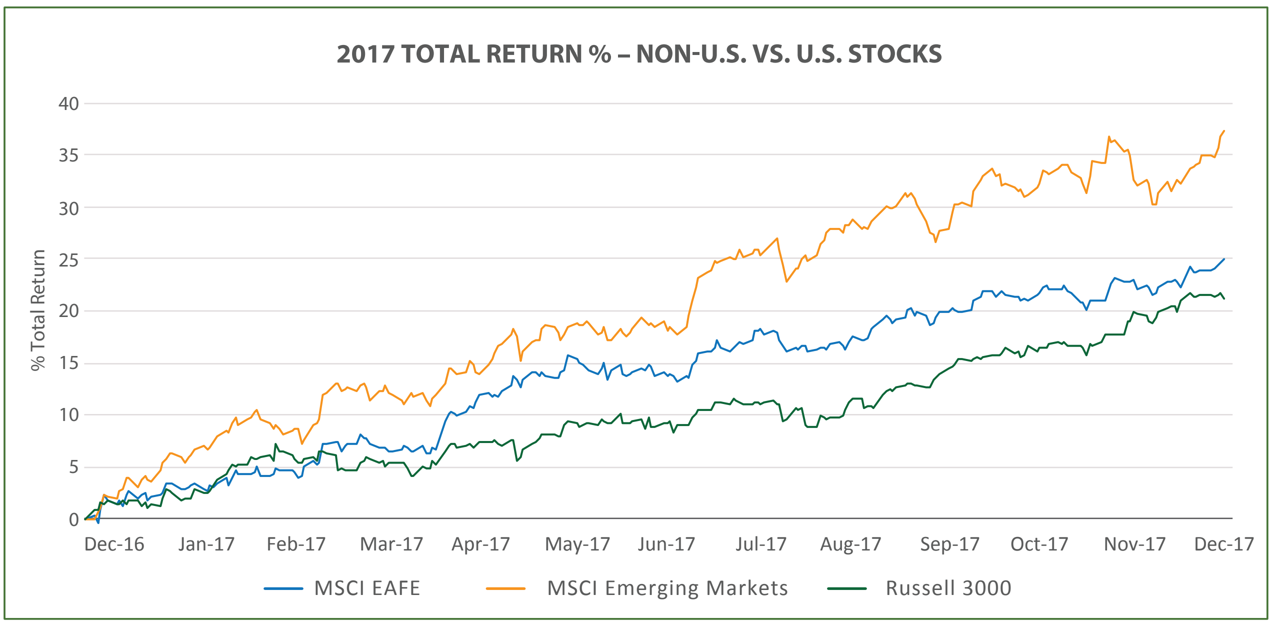
2. **Volatility was nonexistent as global risk appetite remained very strong.** As a corollary to the point above, perhaps the most defining aspect of market performance in 2017 was the utter lack of volatility across asset classes and geographies. Volatility benchmarks made multi-year lows, and as indicated by the orderly advances of stock and high yield bond indices, investors in risk assets hardly broke a sweat in 2017.

   The chart below shows the S&P 500 Index relative to its 50-day moving average—a commonly-used technical indicator that plots the average index value over the prior 50 days. Not only was the moving average almost a straight line from the bottom left of the chart to the top right, but the S&P 500 hardly broke through the moving average during the year—both signs of strong market momentum and investor risk appetite.



Source: YCharts (Data as of 12/31/17)

3. Diversification works again. After being a drag on portfolio returns for the past few years, investors were finally rewarded for having allocations to non-U.S. stocks in 2017. With emerging markets indices handily outpacing the S&P 500 and developed international stocks (MSCI EAFE Index) generating outperformance, 2017 was a good reminder that diversification still works. In fact, research shows that periods of geographical outperformance/underperformance tend to be cyclical; 2017 may be the beginning of a new relative performance cycle as non-U.S. stocks catch up to U.S. gains over the past five years. ●



Source: YCharts (Data as of 12/31/17)

Three Key Questions for 2018

While looking in the rear-view mirror is a useful and necessary exercise, looking out the windshield is the more relevant way to assess your portfolio's current exposures and allocations.

1. **Will the Fed stick to its plan?** At its December meeting, the Fed's Open Market Committee (FOMC) signaled its intention to raise short-term interest rates three times in 2018 in response to strong unemployment data and improving inflation data. Probabilities derived from market data as of year-end suggest that investors are skeptical, with the average expectation being roughly 2.5 rate hikes for 2018—implying that the Fed may surprise to the upside. Given that short-term rates have such a broad impact on economic activity, a more aggressive rate hike trajectory could risk triggering a recession.

   Potentially complicating matters is that there is expected to be significant turnover at the Fed in 2018, with four positions likely to be filled by the Trump administration (Marvin Goodfriend is awaiting confirmation for one of the four board seats). While most prognosticators believe that Trump is unlikely to shepherd the Fed in a more hawkish direction given the potential for economic harm, there remains a chance that the overall philosophical leaning of the Fed might materially shift by year-end, marking an end to the era of ultra-accommodative monetary policy.

2. **Will global growth continue to surprise to the upside?** The biggest question that appears to be facing stocks in 2018 is how long the recent phase of synchronized global growth will continue, underpinning increasingly optimistic earnings growth expectations and expanding valuation multiples. The U.S. appears to have successfully navigated its hand-off from a liquidity-driven market to a growth-driven market in the face of Fed rate hikes and balance sheet tapering, but the rest of the world continues to operate in an accommodative monetary environment thanks to the extraordinary measures being pursued by the European Central Bank and the Bank of Japan. Keep a close eye on market reaction as these global central banks mull tapering activities of their own.

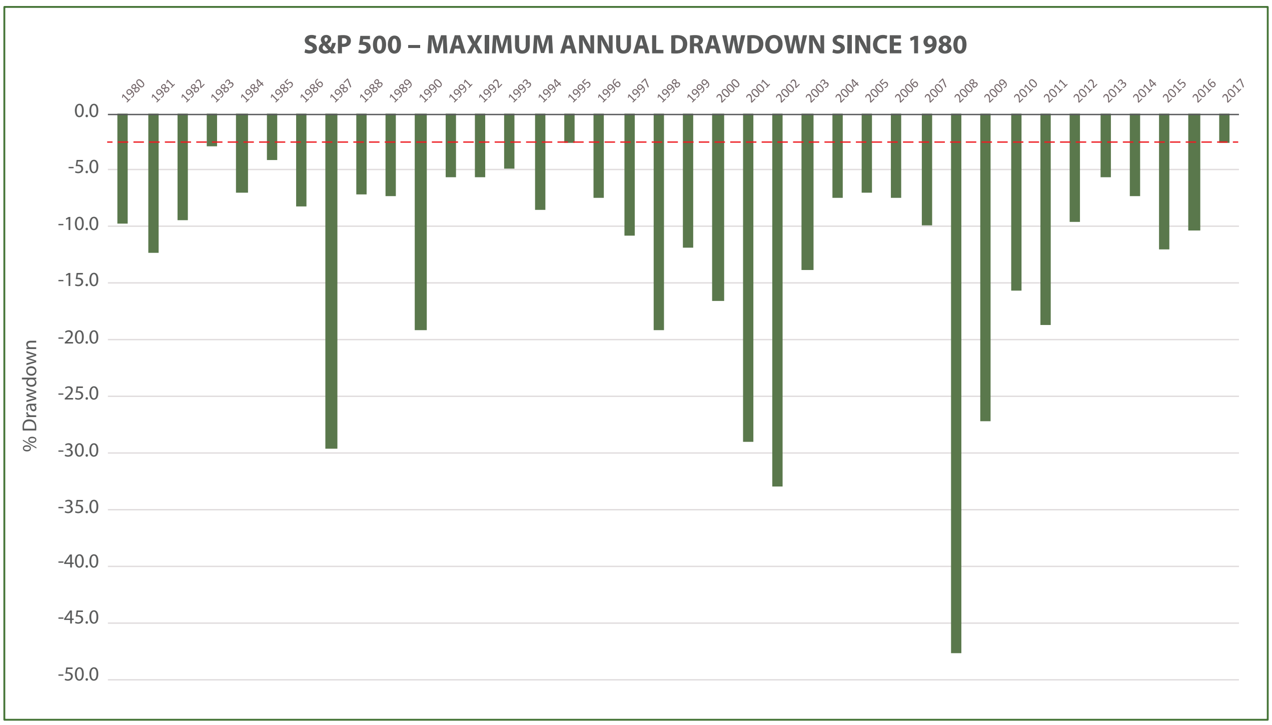
3. **Will this be the year that interest rates finally rise?** Calls for rising long-term interest rates as a result of unprecedented monetary stimulus around the world have proven premature over the last five-plus years, but some market commentators see 2018 as the year when rates finally move higher as inflationary forces take hold. At greatest risk are the billions of dollars of debt held in long duration fixed income instruments.

   Take the iShares Core U.S. Aggregate Bond ETF as an example. The Fund is nearly $54B and tracks the Bloomberg Barclays U.S. Aggregate Bond Index—a proxy for core fixed income. As of 12/31/17, the ETF yielded 2.4% and had an effective duration of 5.8 years. If interest rates were to rise 1.0% from current levels, the ETF's duration—a measure of interest rate sensitivity—suggests that the share price would fall roughly 5.8%. While investors would continue to receive income distributions, when looking at total returns (income + price change), an interest rate move of that magnitude would be expected to produce an annual total return of roughly -3.4%. Of course, the inverse scenario would produce strong gains for investors, but the consensus sees a growing asymmetry between the potential upside in long-term bonds relative to the potential downside. ●

Chart of the Quarter

A hot topic in 2017 was the lack of volatility in U.S. equity markets. The CBOE S&P 500 Volatility Index—better known as the "VIX"—made multiple historical lows, reflecting investors' subdued volatility expectations throughout the year. Stocks hardly declined as the S&P 500 made 62 new record highs (measured by daily closing levels) over the course of the year.

That brings us to our chart of the quarter. Below you will find a plot of the S&P 500's maximum annual drawdown for each calendar year dating back to 1980 on a total return basis—in other words, the worst peak-to-trough loss that the index experienced during the year, including dividend income. The red line represents 2017's biggest drawdown: -2.6%. As you can see, going through a full year without a decline of at least 3% is a rare occurrence, happening only two other times in nearly 40 years (1995 and 1983).



Source: Morningstar (Data as of 12/31/17)

Practically speaking, what can we take away from this chart? For starters, we can be thankful for a relatively low stress year of significant gains in equity markets. Second, we should recognize that this type of environment is not the norm and ensure that our expectations are calibrated accordingly. Investing in stocks involves taking some level of risk, and ultimately there will be a sell-off that will once again test investors' patience and conviction. Last, and perhaps most importantly, it is critical to avoid the complacency that this type of market can foster. It may be tempting to forego portfolio rebalancing and "let it ride," but staying disciplined and sticking to a process will always be at the heart of a successful, long-term investment strategy.

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