Market Commentary
January 2018

Introduction

2017 was a year of surprising global growth and a resurgence in investor confidence which pushed stocks higher globally. Economic data continues to be overwhelmingly positive with few negative signals. The labor market remains healthy with the unemployment rate at 4.1%, inflation has been muted with CPI at 2.2% and third quarter GDP has shown its fastest growth in more than two years coming in at an annual rate of 3.2%. The Federal Reserve acted as expected in their December 13th meeting by raising short term rates for the third time this year by 25 basis points, bringing the overall Fed Funds rate to a range of 1.25 - 1.50%. The newly approved tax reform bill has fueled market optimism heading into 2018 which should reaffirm the Feds plan to hike rates next year. With strong momentum going into the New Year and a supportive tax bill for US corporations, we believe the environment is still conducive for taking equity risk, but not without a watchful eye, as interest rates move higher and the economy heats up.

Domestic Equities

U.S. stocks posted their best quarter of the year as tax reform came to the forefront of political discussions, with the S&P 500 returning **6.64%** in Q4 and **21.83%** year-to-date. The overall drop in the corporate tax rate to 21% and opportunity for companies to repatriate cash at a lower 15.5% rate renewed investor confidence in U.S. equities and helped performance throughout the quarter. Along with help from the new tax bill, companies within the S&P 500 experienced robust earnings and sales growth up 7.10% and 5.33% respectively. Although smaller sized stocks posted positive absolute performance for the quarter, they underperformed larger sized stocks due to valuation concerns as the Russell Midcap index returned **6.07%** and the Russell 2000 index returned **3.34%**. Even as investors continue to question whether stocks can move higher (especially smaller sized stocks), in our view, companies appear to be earning enough to offset their lofty valuations.

International Equities

International equities ended the year up **25.03%,** beating the S&P 500 by a margin of **3.2%.** International equities were supported by parting political clouds and macro tailwinds, including a robust labor market recovery, growing export markets, and improving lending conditions. The Eurozone's annual economic growth rate increased 0.6% in the third quarter, representing a gain of 2.5% year on year, outpacing that of the United States. Japan's economy also surprised to the upside to grow at an annualized rate of 2.5% in the third quarter, representing the seventh straight quarter of growth, which registers as its longest expansion since the mid-1990s. While uncertainty remains, we believe the developed international economies are still early on in their economic cycle and have ample room to grow.

Emerging markets (EM) had a strong year with the MSCI EM index returning **37.28%**. EM equities benefitted from improving EM fundamentals, synchronized global economic growth, a benign U.S. dollar, range bound commodity prices, and cheaper valuations. In the near term, one of the most pertinent downside risks is a stronger dollar from a tightening Fed and expansionary fiscal policy, but we believe EM exports will benefit from a stronger U.S. as well as global economy. In addition, improving fundamentals and cheap valuations will continue to make the space attractive. From a long-term perspective, many EM countries, especially those in Asia, are experiencing a growing middle class and stronger domestic consumption, which will enable them to be more independent from other countries, allowing them to be more stable that their oil producing counterparts. We continue to have an optimistic outlook in the EM space in 2018.

Fixed Income

In 2017, fixed income markets performed the opposite of consensus expectations. Despite three Fed rate hikes, the 10-year U.S. Treasury yield ended the year at **2.4%**, which was basically where it started the year due to modest growth and inflation. The ECB announced its decision to start weaning off its quantitative easing program in early 2018 by halving the amount of bond buying while promising to keep stimulus for more years. Government intervention imposes upside forces to interest rates via monetary and fiscal policies, but natural economic forces such as demand for yield from both retirees and foreign investors from lower yielding countries help keep rates capped. For instance, when the Austrian government issued an 100-year bond that will yield just 2.1%, 3.5 billion euros of the bond was sold but more than 11 billion euros of the bond was ordered. We believe the projected path for interest rates has shifted upward, but will stay range bound. In terms of sectors, low credit quality bonds continue to outperform high credit quality bonds, benefitting from global economic recovery. As government and municipal bonds offer limited upside, investors continue to search returns in corporate bond, including high yield bonds. We believe fixed income securities will continue to benefit portfolios from a diversification perspective despite low returns.

Alternatives

Alternative asset classes lagged during a positive environment for global equities in 2017. Oil prices rebounded following Hurricane Harvey and Irma, with WTI crude ending the quarter at **$60.42** per barrel, rising from $51.67 per barrel at the end of the third quarter. The Morningstar Diversified Alternative index was up **0.63%** on the quarter and 2.70% on the year, as risk-reducing alternatives were unable to provide the same upside as global equities and fixed income, though they continued to provide valuable downside protection during a year that saw rising asset prices to new highs as well as an increasing level of volatility due to geopolitical tension. Hedge fund-like alternatives will continue to play a key role in downside protection and reducing volatility within a portfolio by maintaining low correlation to equity and fixed income markets as we approach a late stage U.S. economy.

Real Estate

Real estate has continued to be a positive contributor to the economy in 2017, and should continue to grow as Millennials buy homes, as buyers aged 36 and below have become the largest share of home buyers, according to the National Association of Realtors. Recent data has been positive, with new home sales increasing 17.5% in November, and up 26.6% from a year ago. The NAHB index, a measure of homebuilder optimism and a leading indicator for the housing market, rose to 74 in December, the highest level since the 1990s. Though the data has been positive in nature, tight supply, rising home prices, and the rising cost of borrowing remain headwinds for housing in 2018.

Conclusion

2017 was a surprisingly enjoyable year for investors everywhere and while a feeling of nostalgia hovers over the investment community in 2018, we remind ourselves to continue to invest with caution. There are some key happenings to take place in 2018 which could have a profound impact on financial markets globally such as the decisions of foreign central banks, the effects of the new tax bill and the transition to the new Fed Chair Jerome Powell here at home, to name a few. Despite our view that the economy is in a good place, there are still unknowns that lie ahead, which is why we will continue to stay true to our philosophy and manage our clients' portfolios with a sense of prudence and care.