Investment Perspective

Financial market conditions were exceptionally favorable in 2017 as global stock markets advanced with little turbulence. The combination of double-digit earnings growth, low volatility and below-average inflation produced "nirvana" — a wonderful investment environment. Nine years ago, this situation was merely a dream, but is now reality. In fact, this past year was the first time in 90 years that the S&P 500 produced a positive return for 12 consecutive months. Remarkable! The data further shows that there were only four other years with 11 positive months: 1936, 1958, 1995 and 2006. Clearly, 2017 was a special year. Moreover, the S&P 500 has already increased over 7% in January for its strongest start in 30 years. It also hit 14 record highs — the most in any month since 1955!

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Today, the investment outlook is favorable with solid growth, low inflation, healthy consumer confidence and positive investor sentiment. The odds favor another year of double-digit returns for U.S. stock markets. However, there is concern that current conditions may weaken based upon "it can't last forever" logic. Historically, we have one or two minor annual corrections, but 2017 marked the first time since 1995 that we did not experience a correction greater than 5%. In fact, we just reached the longest period without a 5% correction in history, lasting 400 trading days and counting. It is reasonable to expect a modest correction to cleanse the market of excesses. We are unlikely to have another year with such low volatility. Today, there is fear on Wall Street — the fear of missing out. FOMO! We remain committed to "time in the market" as opposed to "timing the market." The challenge is to remain alert to over-exuberance with equities amidst these positive trends. A summary of last year's index returns through December 31, 2017 is as follows:

Dow Jones Industrials	+28.1%	Russell 2500	+16.8%
MSCI EAFE	+25.0%	S&P 500	+21.8%
NASDAQ Composite	+29.6%	Wilshire 5000	+21.0%

GLOBAL ECONOMY

The overall economic tone has significantly improved with fewer worries about soft patches from peripheral Europe and commodity-linked emerging markets

Global GDP (ex. U.S.) is expected to increase 4.1% in 2018 after a surprisingly strong 2017. This is the broadest and strongest period of global growth since the mid 1990's. Last year, the investment community expected world economic growth of 3.3%, but gradual improvements in every region resulted in growth of 4%. The overall economic tone has significantly improved with fewer worries about soft patches from peripheral Europe and commodity-linked emerging markets. Massive stimulus measures conducted by the major central banks have effectively boosted confidence and growth. Expectations for policy normalization are increasing and will likely be viewed favorably after 10 years of massive stimulus. The European region is strengthening with a 2.0% growth forecast.

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Japan is steadily improving with 1.7% growth expected. Chinese growth is stabilizing around 6.5% as the country pushes reforms to create a more balanced economy. The global outlook is healthy and more resilient to adversity, but geopolitical tensions and terrorism remain sizeable risks.

Further, the expansion is broad-based, which lessens the risk of an unexpected downturn

The U.S. economy is expected to grow 2.7% this year following 2.3% in 2017. This uplift is a positive development from several stall-speed quarters where growth remained under 2%. Further, the expansion is broad-based, which lessens the risk of an unexpected downturn. The economy will also benefit from tax reform which lowered the corporate tax rate from 35% to 21%. This tax reform will also increase business spending and allow the expensing of new investments for up to five years. Consumer spending, which accounts for over 65% of total GDP, is strong with 2.9% growth. Employment is healthy, disposable income is rising, business and consumer confidence are at record levels and household balance sheets are the strongest in decades. In addition, manufacturing is primed for growth because of increasing business investment, inventory rebuilding and an improving housing market. Other major sectors, such as residential and non-residential investment spending, are expected to expand at healthy rates. Non-residential investment aided by higher corporate profits and tax reform should grow greater than 6%. Residential investment will increase 2% from the lumpy activity experienced mid 2017. Housing fundamentals are solid with existing home sales reaching 5.5 million despite inventory at historic lows. The S&P/Case-Shiller Home Price Index has increased 6.2% y/y and home values are above their 2006 peaks helping to strengthen household balance sheets. The aggregate value of mortgage debt is 30% lower than 12 years ago and home values are higher — a good combination. In addition, single-family housing starts are projected to grow 5%, but remain below both historic levels and the pace of household formation. The recent 13% growth in starts is helping to get home construction back to trend. Demand is strong with low borrowing costs. We have entered the ninth year of expansion, and it is important to note that economic recoveries do not die of old age.

Demand is strong with low borrowing costs

ENHANCING PRODUCTIVITY

We anticipate that a lower corporate tax structure, expensing of new equipment and a more relaxed regulatory environment will encourage business investment

Stronger productivity growth in the U.S. is the best way to achieve growth above 3% during this period of slow labor force growth. Firms need to strengthen capital investment to boost labor productivity, especially as business confidence improves. The CEO Economic Outlook index compiled by the Business Roundtable rose 30% over the past year. This index is highly correlated with the growth rate in capital spending in real GDP on a y/y basis, which rose 4.6% after contracting in early 2016. To improve productivity, companies will need to increase their capital expenditures over time — particularly with regards to technology. Technological progress has provided enormous cost-saving benefits to businesses and consumers. Consider the price of a long-distance phone call compared to 30 years ago, or the fact that the U.S. produces over 10 million barrels of oil per day — surpassing the record set in 1970! Additionally, regulatory relief and tax reform will unleash greater investment in the economy. We anticipate that a lower corporate tax structure, expensing of new equipment and a more relaxed regulatory environment will encourage business investment. As a result, business spending may grow twice the rate of GDP over the next few years. Faster real growth supported by capital spending and rising productivity will help sustain a favorable environment for equities.

INFLATION & INTEREST RATES

We remain in the early to middle stages of the Fed tightening process, which typically has a positive effect on equities

The Federal Reserve has raised interest rates five times since December 2015 and forecasters predict three more hikes this year. In addition, the Fed would like to normalize interest rate policy to replenish its monetary policy tools. This tightening is occurring because inflation is nearing its 2% target and employment levels are healthy Overall inflation is 2.1% and core inflation (excluding food and energy) is 1.8%. The Fed's preferred inflation gauge, the core personal consumption expenditures price index, is up 1.5%. All domestic inflation measures indicate inflation is rising moderately while the fear of deflation has significantly declined. Specifically, the 10-year breakeven inflation rate is 2.07% — up from the 1.23% low in February 2016. Globally, the threat of deflation remains a big risk, which explains the ongoing massive stimulus undertaken by the Bank of Japan and European Central Bank. However, their large quantitative easing programs should taper over the next 12-24 months. In America, the federal funds rate should gradually increase, but not reach prior peaks of 4% to 6%. At the same time, the long end of the yield curve should drift higher due to the combination of higher short-term rates, better growth and more tapering. The 10-year Treasury note recently closed at 2.66% — its highest level in three years. We remain in the early to middle stages of the Fed tightening process, which typically has a positive effect on equities. In fact, when the 10-year Treasury yield is below 5%, rising rates tend to produce rising stock prices.

INVESTMENT OUTLOOK

The stock market appears attractive at 18.7x this year's estimated S&P operating earnings considering the outlook for growth, inflation and interest rates

Economic fundamentals have improved significantly and the investment outlook is favorable. Earnings grew 11% last year and revenue growth accelerated. Business confidence and investor sentiment have improved dramatically and the stock market is hitting new highs. The outlook for equities continues to be positive with 16% earnings growth likely in 2018. Half of this growth is related to fundamentals with the remainder attributed to corporate tax rates. We expect S&P 500 operating earnings to increase 16% to $153 per share in 2018 versus $132 last year. The stock market appears attractive at 18.7x this year's estimated S&P operating earnings considering the outlook for growth, inflation and interest rates. During the 2014-2016 period, the S&P 500 index performed well, but earnings remained at $119 for three years. Now, the trajectory of earnings growth is improving and the markets are responding. For example, earnings bottomed near $60 in 2009 and might surpass $160 in 2019 — an increase of 167% in 10 years. This earnings improvement stems from better revenue growth, a modestly weakening dollar and rebounding energy sector profits. The combination of margin improvement, share repurchases and tax rate reductions will help generate above-average earnings growth. Additionally, the repatriation of substantial offshore cash due to tax law changes will likely boost dividends, domestic acquisitions and stock buybacks.

The U.S. equity base has been shrinking, which raises the prices of existing equities since fewer companies are available for investment. The number of stocks declined by 50% in 20 years!

Conditions in capital markets are favorable for businesses because of improving borrowing capacity and relatively low interest rates. In fact, gently rising rates may motivate prospective buyers to invest while capital is inexpensive, which could create an uptick in mergers & acquisition (M&A) activity. The combination of debt-enabled M&A, bigger buybacks and limited supply from new issuance creates a favorable demand/supply balance for equities. In fact, the U.S. equity base has been shrinking, which raises the prices of existing equities since fewer companies are available for investment. For example, the Wilshire 5000 stock index was founded in 1974 with the objective of tracking all public U.S. equities. It started with 5,000 equities and grew to a peak of 7,562 in 1998. Since then, it has subsequently declined to 3,492 stocks — with 2005 being the last year at 5,000 companies. The number of stocks declined by 50% in 20 years! This powerful trend has favored remaining equities because the total market capitalization of $29 trillion has never been higher. New supply from initial-public-offerings (IPOs) remains limited. Last year, 160 offerings raised $36 billion — up from the 105 deals that raised $19 billion in 2016 — but below the 275 IPOs in 2014 that netted $85 billion.

Don’t fight the tape!

From a technical perspective, the indicators are bullish. Don’t fight the tape! The secular bull trend remains firmly in place and it will take strong corrective action to change the secular trends. The advance-decline indicators are positive with new highs across the board. The Investor Intelligence Bull/Bear ratio reached its highest reading since March 1987 during the first week of January. The latest reading showed that 66.7% of investment advisers were bullish while only 12.7% were bearish.

What about the January trend? The old stock market adage is “so goes the first day, week and month, so goes the year.” This January, the first five days were up 2.8%. Based on 39 years of data, this leads to a positive annual return 87% of the time with an average gain of 14%. Last year, the first five days were up 1.3% and the S&P 500 return was 21.8%.

Above-average earnings growth with modest valuation expansion should support appreciation consistent with historic trends

The market may be overbought short-term and some caution and vigilance is warranted. A few key risks include: China slowdown, cyber-attacks, disappointing earnings by some companies, inflammatory Tweets, military conflicts, over-tightening by the Fed, stronger dollar and unexpected inflation. Additionally, protectionism and immigration policies present a significant wildcard for the economic outlook. The Trump administration has proposed ideas which may inhibit the flow of trade and sour relations with key trading partners. It is difficult to gauge the possibility of worsening sentiment. We believe U.S. equities, particularly small and medium-sized growth companies, remain attractive. Above-average earnings growth with modest valuation expansion should support appreciation consistent with historic trends. The pace of inflows into equities remains below historical trends suggesting there may be better flows in the future.

In closing, 2018 is the Chinese "Year of the Earth Dog." Chinese horoscope predicts this dog year will be good yet tiresome, challenging but rewarding. Careful planning should produce success. The dog is intelligent, loyal, protective and the most conservative of all Chinese zodiac signs. Historically, the S&P 500 has produced positive returns in dog years 71% of the time with an average gain of 10.7% since 1934. In addition, since 1977, we have had 18 government shutdowns and seven including furloughs (January 19-22 latest). Those seven produced an average annual return of 15.7%. We look forward to producing above-average returns in 2018.

Appendix: Summary of Key Economic and Financial Measures

	Yearend 2016	Yearend 2017	Difference/ Change
Fed Funds Rate (%)	.75	1.50	+75 bps
10 Yr. Treasury Yield (%)	2.48	2.43	-5 bps
Inflation (CPI y/y % ch.)	2.09	2.11	2 bps
Gold ($/oz.)	$1,146	$1,291	+13%
Oil ($/barrel)	$54	$60	+11%
Euro per Dollar	.95	.83	-12.6%