SIGNATUREFD

WINTER 2018

MARKET SENSE:
Looking Back at 2017

OVERVIEW

The year 2017 will likely go down as one of the best years ever for equity markets. It is true that other years have seen much bigger gains than the 20% +/- gains experienced last year, but the combination of persistent moves higher and virtually no negative events is almost without comparison. Consider the following:

- The market has gone 391 days without a 5% correction, nearing its record that was set in the 1950s and has gone more than 300 days without even a 3% correction, a new record.
- The Dow Jones achieved 71 record highs in 2017, breaking a 113-year record and hitting a new high on average every 3.5 days.
- The S&P 500 was up each month of 2017, its first time ever meeting that mark each month in a calendar year.
- The VIX (Volatility Index and so-called market fear indicator) registered its lowest levels ever during 2017. In fact, 16 of the 20 lowest levels ever achieved occurred during 2017.
- The market only moved by 1% eight days during 2017, the fewest moves of that magnitude except for 1964

The above statistics occur for good reason. The combination of progressively improving global growth, corporate earnings, and still low interest rates provided the fuel for the strong gains and low volatility. In our outlook from a year ago, we were mostly in line with this outcome as summarized in our newsletter at the start of 2017:

> **"We have been more optimistic on the economy and the markets than the majority of investors over the past 18 months (…) We suspect there are a few points of GDP worth of pent-up demand by consumers and businesses that will be unleashed by the current optimism. This, along with improving situations in Japan, Europe, and China, is likely to usher in a period of globally synchronized growth. Clearly the markets had not been prepared for this breakout of good news. Even though optimism has returned, expectations still seem modest. (…) Thus, the first half of 2017 should see a continuation of recent trends."**

But the overall mood has turned dramatically from a year ago. Expectations were reasonable, and now seem closer to exuberant. At a conference with several hundred other investors last March, I turned in a survey that the S&P 500 would hit 2800 by March 2018 (the market was under 2,400 at the time). This wasn't a forecast, mind you, but was meant to point out that the biggest surprise at

the time would have been a sharp move higher. That level is now less than 25 points away (and could be achieved by the time you read this). As we enter 2018, any market forecaster that doesn't want to be called into question has a year-end 2018 target of at least 3,000, and many higher than that. We would submit to our readers that the markets have improved substantially, but even this has been outdone by the change in expectations.

We recognize that these conditions can last for a while longer and we retain our optimistic outlook for early 2018. We will touch more on our outlook for the year ahead, but first let's look at the quarterly and full-year performances of some major benchmarks in the table below.

	4th Quarter	52 Weeks
S&P 500	6.64	21.83
Dow Jones Industrial Average	10.96	28.11
MSCI EAFE (Developed International)	4.23	25.03
MSCI EM (Emerging Markets)	7.44	37.28
Bloomberg Commodity Index	4.71	1.70
Barclays Global Aggregate Bond Index (Global Bonds)	1.08	7.39
Barclays U.S. Aggregate Bond Index (Taxable Bonds)	0.39	3.54
Barclays Municipal 5 Yr Index (Tax-Free Bonds)	-0.70	3.14
HFRI Fund of Funds Composite Index	2.02	7.74

WHAT WORKED AND DIDN'T WORK IN 2017

We suspect that if we polled investors that held balanced portfolios a year ago and told them theywouldearn returns of generally between 10-15% during 2017, that they would have been largely enthusiastic. However, this high-level review masks some important subtleties and it is worth a deeper review to identify the significant influences on our portfolio performance in 2017. First and foremost, portfolio results were impacted significantly by one's exposure to 'growth' vs. 'value' stocks. The former produced returns of nearly 30% while the latter about half this amount. A similar story existed for large vs. small stocks, with the largest companies producing the best results. The SignatureFD investment philosophy tends to overweight value and small-cap oriented stocks, and 2017 was no exception.

Why do our portfolios tend to hold overweight positions to these styles of equities? Simply, most fundamental research shows that these stocks tend to provide better results over the long term with less risk. Of course, over shorter periods of time, other forces can be at work. In 2017 markets were dominated by momentum, which is typical in the late stages of a cycle. Our simple explanation for this is that investors came into last year under exposed to stocks, and to not be left behind, they purchased the largest and easiest to access parts of the market. This momentum tendency has been amplified by the growth in importance of Exchange Traded Funds (ETFs) within the market.
On a more nuanced basis, the performance of portfolios was driven by sector weights. During most of 2017, our target portfolios were overweight energy, financials, and industrials and underweight consumer, healthcare, utilities, and technology. Most of these allocations helped portfolios, but the positions in energy and technology more than offset this on the downside. Technology was the dominant sector in 2017, rising by nearly 40%, while energy was the second worst sector with slight losses in the year.

Finally, in portfolios where we hold active managers, the selections largely added value with most of these managers exceeding their most appropriate benchmarks. The most impressive of these performances came from Primecap, which is a decade-plus holding of our firm. Even with limited exposure to the FAANG (Facebook, Amazon, Apple, Netflix, Google) stocks, they were able to best the mid-cap growth benchmark by almost 6%. The other two core US managers in many client portfolios (DFA Large Cap Value and Vanguard Dividend Growth) also exceeded benchmarks by similar amounts.

In summary, when we review the past year, we find that our macro-positioning of being fully allocated to stocks and cautious on bonds was largely non-consensus to start 2017 and rewarded clients. In addition, most of our sector weightings helped, while on-average, active management helped when present. The two primary components that detracted from the portfolio were the overweight to small and mid-cap companies and high exposure to energy stocks and underweight exposure to technology. Below we will discuss how we think about this positioning as we head into 2018.

GLOBAL CAPITAL SPENDING IS SET TO HIT ITS HIGHEST LEVEL IN MORE THAN SIX YEARS OVER THE NEXT 12 MONTHS.

2018 OUTLOOK AND PORTFOLIO POSITIONING

Current conventional wisdom seems to encompass five basic points. First, we are in a period of globally synchronized growth that is running above trend and likely to moderate in 2018. Second, that central banks are largely moving toward normalizing policy, but this shift will be benign. Third, inflation is trending higher, but in a controlled fashion. Fourth, risks in China are contained. Finally, geopolitics are always a risk, but seem secondary to the markets currently. We are largely in line with this, but continually question our thinking as we find agreement with the predominant view an uncomfortable position. It is a mathematical certainty that when investors largely agree, that reality is priced into markets and a material shift from that narrative creates surprise. Valuations of many financial assets are higher than normal, but those investors choosing to take a contrary view have likely underperformed. Many of the typical signs of a bull market top are not yet present, and investors should recall that bull markets often actually accelerate as they move into the last 10-15%.

So, by judging market behavior and investor attitudes, we would project that markets could remain in a bull trend for another year or two. However, as events unfold the possibility always exists that the plan needs to be adjusted. As we go through our scenario planning, we find four primary outcomes that could upset this current equilibrium. Of these, three are negative changes while one is positive. The first two of these risks we would put in the category of policy mistake. History tells us that policymakers typically push until something breaks. Of course, that is not intentional, but it is uncertain with foresight when policy direction will move from bending markets to breaking them. The first of these policy mistake potentials is a Fed that becomes too aggressive. The Fed has raised rates 5 times since commencing normalization in December 2015. Even with these moves, the financial =conditions have largely eased over the past year, likely a surprise to Fed officials. The market is now

largely pricing in 3 more rate hikes in 2018. If inflation were to surprise on the upside, investors could start to feel that the Fed even - at that pace - is falling behind, causing them to tighten further. At this point the risk becomes that the cumulative effect of tightening acts as a sudden brake on the economy and the next downturn is triggered.

The second policy mistake potential comes from China. With the conclusion of President Xi's consolidation of power in late 2017, he now has political capital to expend. One of the stated priorities of the Chinese leadership is to reform the financial system, which largely means reduce the pace of debt growth and restructure many of the inefficient state-owned companies. Both are positive long-term, but can create unintended negative consequences in the near-term. Based on his previous statements, Xi wants to show Chinese strength at the 100th anniversary of the communist Party in China (2021), as well as when he would be up for reelection (2022), becoming the first leader in decades to serve beyond the conventional 10-year term limit. This political calendar means that China would be willing to show disappointing results in 2018 and 2019 to begin an upswing that is in full force in 2021 and 2022.

The final two scenarios are largely off most investors' radars, which makes them interesting to ponder. One of these scenarios would be that the accelerated pace of global growth, strong markets, and rising interest rates of the past 18 months is another head fake. In this scenario, growth and inflation would disappoint likely from the result of tightening financial conditions, high global debt levels, and very low savings and investment rates. The result would be disappointing economic data and corporate earnings, leading to weaker equity markets and interest rates that defy expectations and trend lower. Though this appears to be a lower probability outcome, it is helpful to remember it has been the tendency for the past decade.

THE MARKET IS CURRENTLY FORECASTING ONLY TWO RATE INCREASES FROM NOW THROUGH YEAR-END 2019.

The final unexpected scenario is also the most positive for investors. While it appears that the tax cut package passed by Congress in December is adding fiscal stimulus at a time that it is not needed (i.e. growth is already above economists' predictions of potential), inflation is not the only possibility. There could be significant pent-up productivity potential in the economy that could allow a goldilocks environment of continuing accelerating growth without imminent inflation. In this view interest rates would stay low, earnings would continue to exceed expectations, and wage growth would aid consumers without the negative offset of inflation.

To assess the path that 2018 starts taking, we will monitor several things. First, given the likelihood that the effects of the tax stimulus are likely to boost inflation or productivity, watching these two items is important. Second, monitoring the condition of credit markets is important as these often begin to deteriorate ahead of actual economic data. We will focus on the cost of corporate debt and the way equity markets respond to rising or lowering yields on long-term treasuries. Finally, we will monitor news out of China about reform and stresses that may arise in the credit markets.

When we take all the above into account, we view the most likely outcome for 2018 to be positive for equities over fixed income, though probably lower returns than 2017 and more volatility, especially later in the year. Risks continue to rise as the economy enters the later stages and valuations continue to rise. But history shows little predictive value from these observations over a one-year period.

Our portfolios enter 2018 positioned for our views of this base case and alternative scenarios. We continue to find investments in financials, industrials, and energy the most compelling, largely based on near-term earnings potential and valuations. Thus, portfolios remain with the bias toward small-cap and value styles. From a geographic perspective, our portfolios remain widely diversified, with allocations to the US and Europe largely in line with global indexes. We have mild overweight exposure to emerging economies and Japan with underweight exposure to Australia and the U.K. If downside scenarios start to appear, we will review exposures as the relatively high non-U.S. exposures and the cyclical parts of the portfolio would need to be adjusted for the changing landscape.

Within fixed income markets, we continue to believe that longer-term interest rates are set to rise. Our portfolios continue to hold significant positions in shorter-term bonds that have more exposure to credit risks. If inflation becomes the outlet for the accelerating pace of economic activity, then this could move interest rates sharply higher in a short time frame. As such, we view the risk that the Fed moves more than expected to be higher than the alternative. Watching the yield curve (i.e. the spread between long-term vs. short-term bonds) will be key. We expect continued discussion about the implications of an inverted yield curve (when long rates drop below short rates). Our reading of history shows that this does typically indicate a recessionary environment, but it does so with some advanced notice – typically 2-12 months.

CONCLUSION

Even though our current game plan for 2018 is roughly in line with the conventional view, we understand this narrative seems a little too basic for the complexity of today's globally linked economy and markets. As Yogi Berra famously said, "It's tough to make predictions, especially about the future." To compensate we will be looking for information that diverges from this popular view and for signs that one of the four alternative scenarios that we discussed is becoming likely. Chief among these will be the interaction of interest rates and equity valuations, changes in the strength of credit markets, and market reactions to any unexpected economic data – either positive or negative.

We remain appreciative of the confidence you have placed in our firm and we remain available to discuss any of our views or answer questions at your request.