The Ten Themes of 4Q 2017

Global stocks posted another solid quarter of gains from October 1, 2017 to December 29, 2017. When you go back to the March 2009 lows, stocks are in one of the longest bull runs in history. Specifically, in the 4Q 2017 period, small cap U.S. stocks rose another +2.99%[i] and large U.S. cap stocks rose +6.12%[ii]. Foreign markets also fared well during the quarter as indicated by the gains posted in Developed International Markets +2.67%[iii], and Emerging Markets +6.12%[iv]. Strong corporate earnings, easy global monetary policies, and fiscal stimulus, in the form of lower taxes, continue to be the major reasons why stocks prices breach all-time highs.

While stock markets indicated full steam ahead for the economy, bond markets remained cautious. The yield on a 10-year U.S. treasury opened 2017 at 2.45%. Wall Street widely expected that yield to rise to above 3%. Instead, the yield on a 10-year U.S. note closed 2017 at 2.40%.[v] What did rise though were the rates on shorter-term 2-year U.S. notes. The 2-year yield opened 2017 at 1.20% and closed the year at 1.89%. So, short-term interest rates rose last year, while longer-term yields fell. This narrowing of the spread between the rates on 2 and 10-year bonds is referred to as the "yield curve." When the curve narrows it typically indicates economic growth is set to decelerate. The rise in stock prices last year though suggested otherwise.

Overall, the 4Q 2017 period was extraordinarily quiet with very low volatility. In fact, the entire year was one of the least volatile on record, lulling many investors to sleep. Our research indicates stocks are modestly expensive, but they are not in a bubble yet. Therefore, more stock gains are likely in 2018.

While hope ran high last year in the markets on the new administration's pro-business agenda, however, as time passed that hope faded. It was rekindled in the 4Q 2017 period when lower taxes become a reality. Given that hope is not a sound investment strategy, the best course of action to us last year was to be slightly cautious. As we embark on 2018, we have more facts on fiscal policy. Our research now indicates that corporations are likely to spend more and give back more to their employees in the form of bonuses. This should help sustain top-line revenue growth over the next 12-18 months. As such, we are lifting our cautious stance on equities and moving back to a normal strategic allocation to the asset class.

Stay tuned throughout the year though as we objectively measure and analyze the data for any changes that could alter our opinion(s). In the meantime, **here are the ten themes** that we believe **were the most relevant for financial markets over the past three months.** FYI…they are the exact same as they were in the 3Q 2017 period! We are not kidding when we say it was a relatively quiet year for global financial markets in 2017.

1. Global stock rally continues
2. Low volatility
3. Growth decelerated
4. Fed wants to hike rates
5. Flattening yield curve
6. Commodity price rebound
7. Tax reform
8. Pent up demand from hurricanes
9. Paying even more for less
10. Global stock market performance

Global stock rally continues

During 4Q 2017 and the entire year, stocks climbed higher across the world. In the U.S., the most widely used stock benchmark for large corporations, the S&P 500 index gained +19.42% in 2017. Technology stocks were big winners last year with the sector gaining +36.91%. Only two of the eleven sectors in the S&P 500 posted losses in 2017. They were Energy and Telecom, declining -3.80% and -5.97% respectively.

Shares of smaller U.S. companies lagged the returns of larger companies last year as hopes faded on the passage of tax stimulus after health care reform was voted down. The Russell 2000 index, the most widely used proxy for small U.S. corporations, still gained +13.14% in 2017. However, you will see below how those returns lagged international markets and large cap U.S. stocks.

In our opinion, the new administration's plans to reduce regulations, lower corporate taxes and increase infrastructure spending extended the stock rally. However, that alone was not solely responsible for higher stock prices. Do not overlook the fact that global central banks such as the European Central Bank and the Bank of Japan are still pumping in record amounts of stimulus and that is fueling corporate earnings and stock prices higher.

Check out how financial markets are voting. You will see lagging U.S. stock returns compared to the MSCI Emerging Markets index, which collectively is made of countries such as Brazil, China, India and Turkey, and the MSCI Developed International index, which is mostly Europe and Japan.

Name	Index	4Q 2017 Return	2017 Return
Emerging Markets	MSCI EM	5.18%	34.59%
Developed International	MSCI EAFE	2.67%	21.79%
Large Cap U.S.	S&P 500	6.12%	19.42%
Small Cap U.S.	Russell 2000	2.99%	13.14%

Source: Bloomberg

Low volatility

According to the WSJ Market Data Group, the absolute daily percentage change for the Dow Jones Industrial Average was 0.31% in 2017. It was 0.30% for the S&P 500. In both instances, this represents the smallest absolute daily percentage since 1964. For the Nasdaq Composite Index, the absolute daily percentage change was 0.44%, the smallest since 1989. The average observed one-month volatility in the S&P 500 was lower than any other year since 1970. To sum up, it was a very quiet 2017.

Many investors use the Chicago Board Options Exchange (CBOE) Volatility Index, or VIX, as a gauge of fear in the market. During times of great economic uncertainty, the readings on the VIX will be at high levels, while calmer times will correspond with lower values. The average level of the VIX since it was created is 20. In the first few trading days of 2018, it fell below 9 for only the fifth time in its history. In fact, since 1990, 47 of the 56 lowest readings in the history of the VIX occurred in 2017!

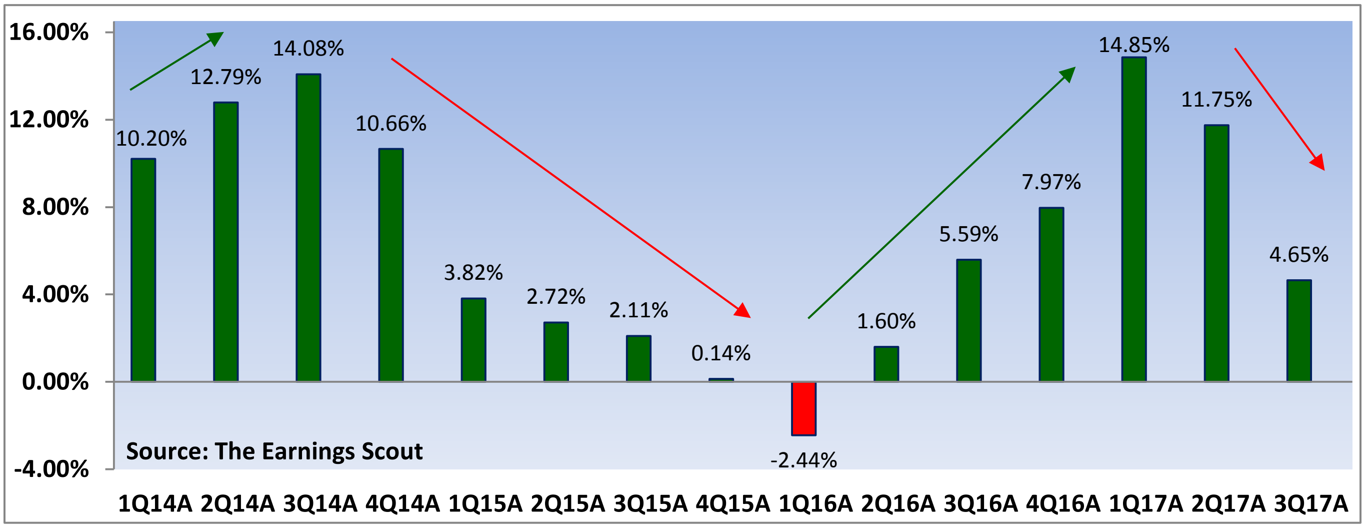
Historically calm markets make investing boring for most traders. We caution against ever getting too complacent when it comes to stock investing. Every day we are monitoring incoming market data and price movements for any signs of turbulence ahead. The bottom line is that we will be monitoring market prices and data even closer in 2018 given the historical run-up in prices.

Growth decelerated

From 1Q 2016 to 1Q 2017, the majority of corporations in the S&P 500 were recording accelerating rates of sales and earnings growth. That acceleration stopped though during the 2Q 2017 period. It carried over into the 3Q 2017

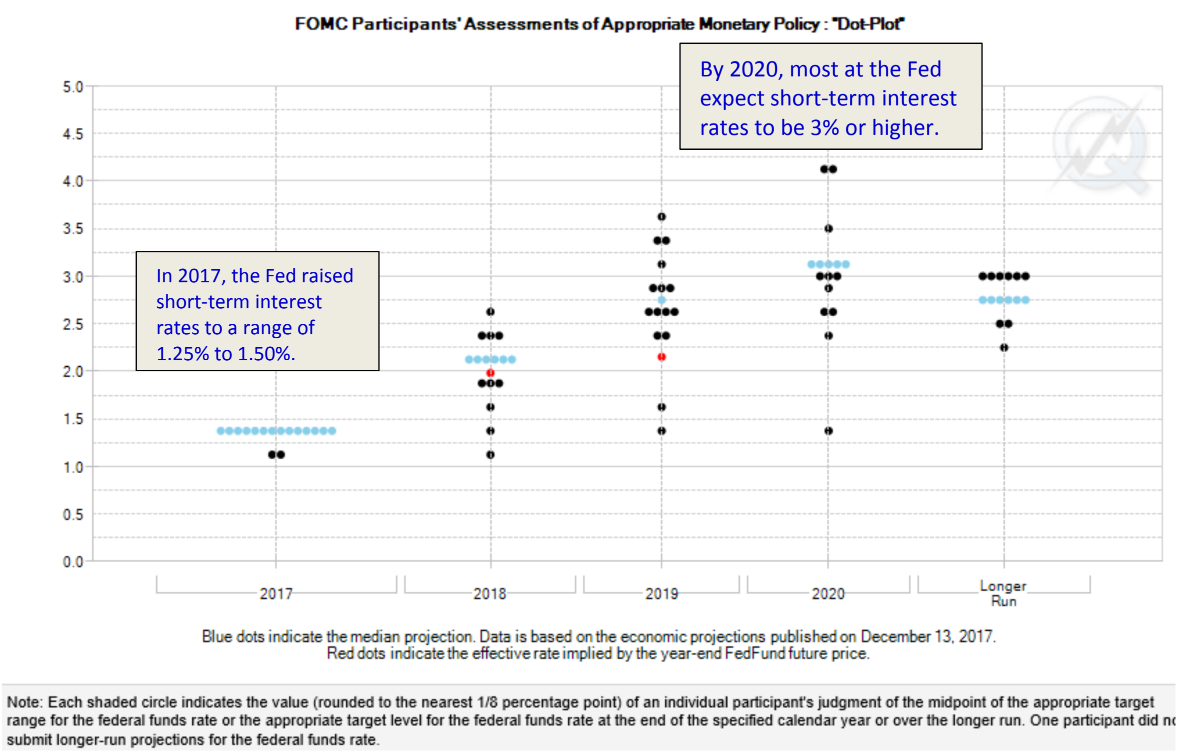
S&P 500 EPS Growth over the past three years

period when the rate of S&P 500 earnings growth dropped to 4.65%. A big reason for the drop in the earnings growth rate was because of massive losses taken by insurers for hurricane related losses.



Fed wants to hike rates

The Fed hiked interest rates in 2017. It wants to hike rates more in 2018. As of January 12, 2018, there is a 63% chance the Fed will hike short-term interest rates by +0.25% to a range of 1.50% to 1.75% at its March 21, 2018 meeting. By the end of this year, short-term interest rates should be above 2.00%. As the Fed raises rates, expect slightly more from your savings account, but also to pay more in interest on mortgages, auto loans, credit cards, etc. The key for stocks is how will higher rates impact corporate profits?



Flattening Yield Curve

The U.S. yield curve is often referred to as the spread between the rate on a 2-year note and a 10-year U.S. treasury bond. This spread narrowed more during the 4Q 2017 period by 35 basis points to 0.51%. What does this mean?

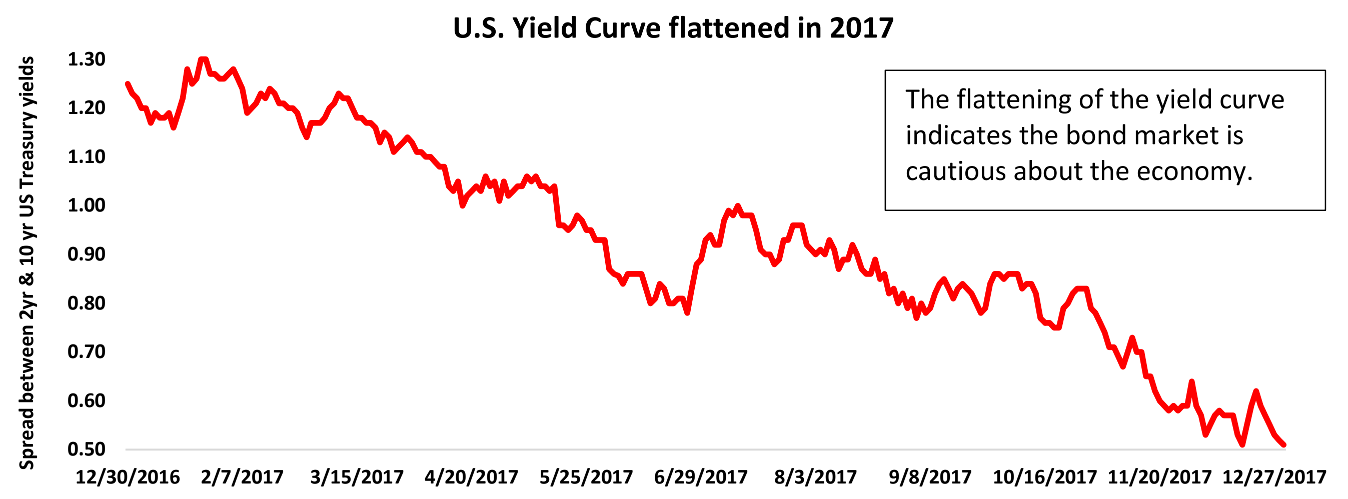
When the spread narrows between the rates on 2 and 10-year notes, it usually indicates less robust economic growth on the horizon. When it inverts (i.e. the rate on a 2-year note becomes higher than that on a 10-year bond), it indicates a pending recession. In the last 20 years, the yield curve has inverted twice. Once in 2000 before the dot.com collapse and again in 2007 before the financial crisis of 2008.

With the rate on a 2-year note closing 2017 at 1.89% and the 10-year bond at 2.40%, the curve is far from inverted. However, the narrowing of the spread to just 51 basis points has the bond market signaling caution.

Check out how interest rates moved during the fourth quarter and throughout 2017. The real question is why has the bond market been more cautious while the stock market is at or near all-time highs?

Date	2 Year U.S. Treasury yield	10 Year U.S. Treasury yield	Spread between 2 Year and 10 Year (Yield Curve)
December 30, 2016	1.20%	2.45%	1.25%
March 31, 2017	1.27%	2.40%	1.13%
June 30, 2017	1.38%	2.31%	0.93%
September 29, 2017	1.47%	2.33%	0.86%
December 29, 2017	1.89%	2.40%	0.51%

U.S. Department of Treasury

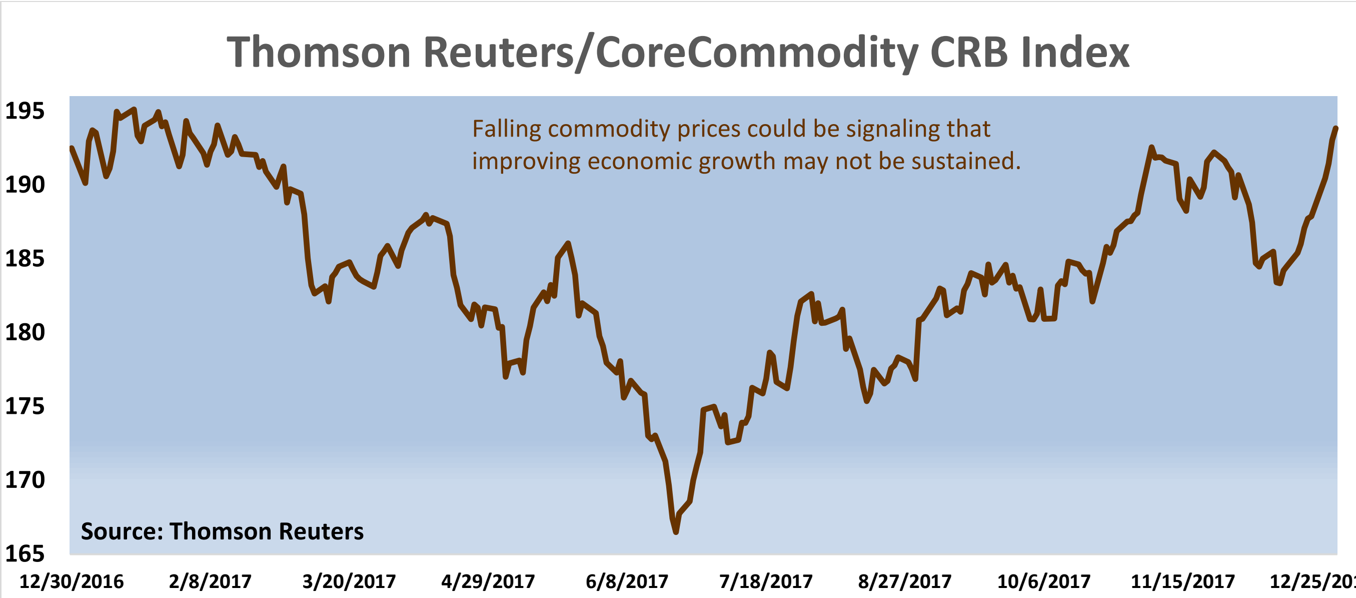


Source: U.S. Treasury Department, The Earnings Scout

Commodity price rebound

In addition to the U.S. bond market signaling caution, commodity markets were signaling caution early in 2017. However, that changed significantly in the second half of the year when commodity prices rose sharply. Specifically, commodity prices, as measured by the Thomson Reuters Core Commodity CRB index, which tracks 19 different commodities, from crude oil to orange juice, rose +16.43% from June 22, 2017 to the end of the year. Even with that bounce, the commodity index only gained +0.70% in 2017.

It should be noted that falling commodity prices are usually a sign of slowing economic activity. Therefore, as stocks are suggesting full steam ahead, commodity markets began to indicate better growth on the horizon too. When will the bond market join the party?



Tax reform

"We believe every-day Americans know better how to spend their own money than the federal bureaucracy, and we want to help them keep as much of that hard-earned money as we can."
President Donald J. Trump

Ever since President Trump was elected, the stock market has been expecting his pro-business agenda of lower taxes, less regulation and increased infrastructure spending to boost corporate profits and lift the economy. This is one of, but certainly not the only reasons stock prices are at all-highs. In our opinion, this is the year that the baton is to be passed from the Fed, with its easy prior U.S. monetary policy of near zero interest rates, to easy fiscal policy initiatives. By raising interest rates three times in the last year, Janet Yellen, head of the Fed, is handing over the baton to Donald Trump.

During the 4Q 2017, tax reform stimulus was back on the table and that triggered much excitement across financial markets. Just before Christmas, tax reform stimulus became a reality and will send corporate tax rates down from 35% to 21%. What companies do with those tax savings will ultimately determine the direction of the economy and financial markets.

Should markets be excited by tax reform? We say yes, but certain companies will benefit more from a corporate tax rate cut from 35% to 21%. In particular, the average S&P 500 company, which represents very large multinational corporations, on average, pay an effective corporate tax rate of around 27% according to our research over the past four quarters. This compares to the average Russell 2000 company, which represents smaller more domestically focused companies that pay an effective tax rate of 38%. Because smaller companies stand to benefit more from tax reform in general, this is a major reason we are entering 2018 with a more favorable outlook for shares of smaller U.S. based companies.

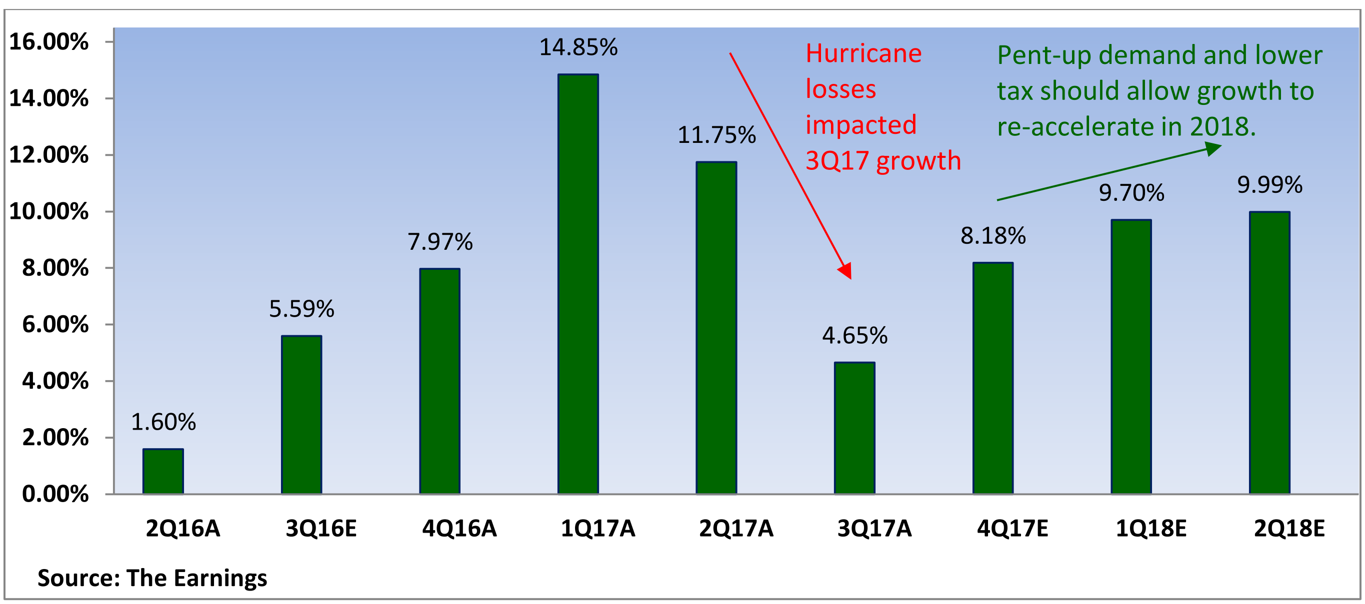
Pent-up demand from hurricanes

Four hurricanes made landfall in the U.S in 2017. Three of them hit as monster category 4 storms. While it will take years to recover in some places, especially in Puerto Rico, all things considered the damage could have been even far worse.

The overall impact to the global economy was minimal from the storms. However, islands throughout the Caribbean and parts of Texas, Florida and Louisiana may never be the same again. In addition, we saw major earnings hits to insurers and re-insurers during 3Q 2017 earnings season.

The main thing about the hurricanes as it related to the financial markets is that they really distorted economic data. S&P 500 earnings growth in the 3Q 2017 period slowed sharply. The lost economic activity and insurance losses from the hurricanes were a major reason for that. The good news is pent-up demand and rebuilding increases in 4Q 2017 and beyond also increase EPS growth expectations. When combined with tax cuts, this should help sustain very solid revenue and earnings growth for U.S. corporations in 2018.

S&P 500 Actual and Estimated EPS Growth



Paying even more for less

While corporate earnings were strong in 2017 and should continue to be strong in 2018, they have not kept pace with the rise in stock prices. This has caused P/E multiples on the market to rise. The P/E multiple is a valuation metric that represents just how much you pay for every dollar of expected earnings.

Since price has risen as EPS estimates have fallen in every quarter over the past six years, by the end of 2017 you had to pay 18.09x for every dollar of future earnings among S&P 500 companies. One year ago, you had to pay a multiple of 17.05x for every dollar of future earnings. Five years ago, you only had to pay 12.58x for every dollar of S&P 500 earnings. As such, stocks have become even expensive as investors have been willing to pay increasingly more for less.

Date	*S&P 500P/E ratio based on EPS Estimate over the next 12 months
12/31/2012	12.58x
12/31/2016	17.05x
12/31/2017	18.09x

As a rule of thumb, the higher the P/E ratio, the more expensive the overall stock market. The long-term historical P/E ratio for the S&P 500 (i.e. the market) is 15x.

Source: The Earnings Scout

Global Stock Market Performance

Country	Stock Index	4Q 2017 Return	2017 Return
Turkey	BIST 30	12.69%	48.81%
Hong Kong	Hang Seng	8.58%	35.99%
India	SENSEX	8.86%	27.91%
Brazil	Ibovespa	2.84%	26.86%
Philippines	PSEi	4.74%	25.11%
Greece	ASE	6.19%	24.66%
South Korea	KOSPI	3.05%	21.76%
Indonesia	JSE Composite	7.71%	19.99%
U.S. Large Cap	S&P 500	6.12%	19.42%
Japan	Nikkei 225	11.83%	19.10%
Portugal	PSI	-0.39%	15.15%
Taiwan	TSE	3.03%	15.01%
Thailand	SET Index	4.81%	13.66%
Italy	MIB	-3.71%	13.61%
U.S. Small Cap	Russell 2000 Index	2.99%	13.14%
Germany	DAX	0.69%	12.51%
France	CAC	-0.32%	9.26%
Mexico	Bolsa IPC	-1.97%	8.13%
Ireland	ISE	2.27%	7.99%
U.K.	FTSE	4.27%	7.63%
Spain	IBEX	-3.25%	7.40%
Australia	S&P/ASX 200	6.82%	7.12%
China	Shanghai Composite	-1.25%	6.56%
Canada	TSX Composite	3.67%	6.03%
Russia	MICEX	1.57%	-5.51%

Source: Bloomberg

Conclusion

Last year's global stock rally was built on hope and speculation that easy fiscal policy would lead to increased profits and higher stock prices. Mr. Market speculated and got it right. We do not guess or speculate. At a slight underweight to equities we participated in the rally but were not greedy. Keep in mind that if one or two votes in the Senate went the other way, corporate tax rates would still be at 35% and 2018 markets would likely be opening very differently.

Because of the reality of lower taxes, we are now more optimistic that CEO's will go out and spend those savings on property, plants and equipment. This should support further revenue growth for S&P 500 companies in 2018. As such, we now have a more favorable view on U.S. stocks, especially since they lagged the returns of most international markets last year. With small cap U.S. based companies standing to benefit more from the tax cuts than large cap companies, and given the fact small caps underperformed last year, we are also favoring smaller U.S. companies over larger ones this year.

As always, we will be paying close attention to the U.S. Fed in 2018. It has taken steps to raise interest rates and reduce the size of its balance sheet. These moves are the opposite of the stimulus the central bank has provided markets for almost a decade. Will they derail the improving growth? Maybe, but our research indicates that it is not likely at this point.

While we take great pride in our measurement and understanding of all the economic and earnings data, it is impossible for us to know every major market factor in advance. Because of this we continue to apply our fundamental beliefs that risk and return are related, markets are efficient over time, profitability matters and diversification is key. These fundamental beliefs continue to be the core of our short term and long-term investment approach.

We hope you found this information useful, and encourage you to approach us with any questions you may have. We look forward to our next conversation.

Strategic Investment Advisors Investment Committee,

Mark Klopfenstein, AIF® **Nick Raich, CFA®**

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[i] Small cap stocks are measured by the Russell 2000 Index
[ii] Large cap stocks are measured by the S&P 500 Index
[iii] Developed International Markets are measured by the iShares MSCI EAFE Index Fund
[iv] Emerging Markets are measured by the iShares MSCI Emerging Markets Index Fund
[v] Interest rate data related to U.S. Treasuries obtained from the U.S. Treasury Department