Insights: January 2018

Market Overview and Performance

Well, 2017 certainly did not lack for excitement. However, while the political and cultural conversation in the United State transformed into a day to day roller coaster throughout the year, markets remained amazingly resilient and calm. We would argue that this "consistency" was the real hallmark of 2017, not outsized stock market gains, or GDP growth, or job creation levels. In fact, many of those measures were fairly pedestrian in 2017 when compared with recent past episodes. For example, during the 11 months from January 20th to December 20th, Trump's first eleven months, the S&P 500 was up 18 percent – a significant return. However, not unusual at all as the returns under Presidents Obama and H.W. Bush were 37 percent and 20 percent respectively. Similar trends are found in GDP growth. 2017 looks to have grown at a rate of 2.2 percent, exactly in line with the previous five-year average. And job creation of just over 2 million jobs was below the levels seen over each of the last six years. Our point here is to take everything in context, and do not credit or blame Obama, or Trump, or Janet Yellen for any of it. Rather, look to what the market is saying and in 2017, the message was clearly that investors believe in the global growth narrative. And that belief was unwavering with both stock and bond volatility at historically low levels. Consider for a moment that one in every four trading days was a new all-time high for the S&P 500 in 2017. That is an amazing statistic. And for now, the global growth picture looks in tact as we head into 2018.

Wishing all of our clients and friends good fortune in 2018. As always, thank you for reading our latest Insights.

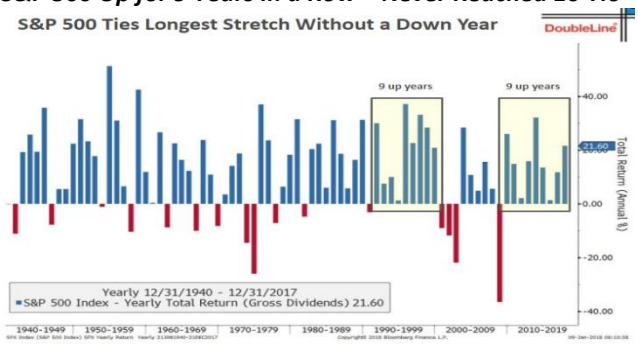
	Month to Date	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	1.11	21.83
Russell 2000 Index	-0.40	14.65
MSCI EAFE Index	1.61	**25.03**
MSCI Emerging Markets Index	**3.59**	**37.28**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.46	3.54
Barclay's U.S. Aggregate Credit Index	**2.03**	**12.21**
Barclay's U.S. Aggregate Corporate High Yield Index	0.30	7.50
Barclay's Municipal Bond Index	**1.05**	**5.45**
Macro Measures		
Gold	2.49	**12.04**
Crude Oil	**5.00**	11.09
CBOE Volatility Index	-2.17	**-27.11**
USD Dollar Index	-1.01	**-10.95**

Current Theme – Low Volatility and Consistent Positive Returns in 2017 Results in a Bullish Consensus View for 2018

While US Corporations Look to be Well Positioned for 2018, Opportunities Outside of the U.S. Are More Compelling for the Coming Year

"Relentless". "The New Money Market Fund". "The Stock Market that Never Goes Down". These were all literal labels we saw last year referring to US stocks. And it was true. The S&P 500 for example was up for 14 straight months at the close of December. That has never happened before. Perhaps even more astounding, the S&P 500 capped its ninth straight year of positive gains in 2017. That has only happened once before during the boom times of Tech Bubble in the 1990's.

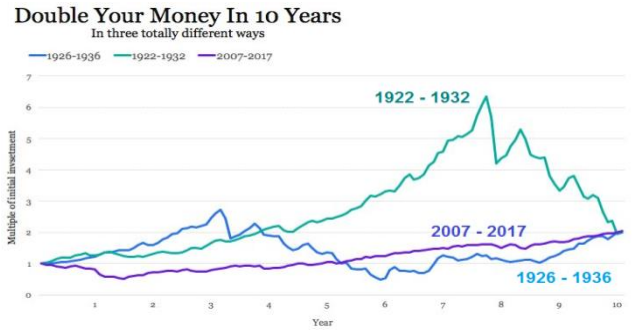
S&P 500 Up for 9 Years in a Row – Never Reached 10 Yrs



Source: Doubleline; Bloomberg, S&P Global

In fact, this past decade has been only the third period in history when the S&P 500 has doubled in value over a ten-year span, and by far with the smoothest path.

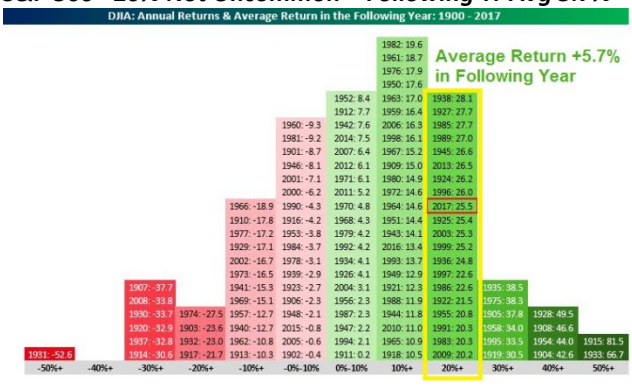
Only 3rd Time in History When S&P Doubled Over 10 Yrs



Source: Morgan Housel

With the news media cycle on hyper drive this year, many are anxious to quickly credit someone or some policy for the market gains, but as we stated in our opening comments, the market pays for what it sees as future growth potential (now viewed as robust) and as the chart below highlights, a 20+ percent return, while certainly welcome, is not an uncommon occurrence.

S&P 500 +20% Not Uncommon – Following Yr Avg 5.7%



Source: Bespoke Investment Group

Perhaps more surprisingly, a 21 percent return for US stocks places them decidedly below average in 2017. As one can see in the chart below from Morgan Stanley, every other major region of the globe did better than US equities in 2017.

US Return of 21% Below Global Average of 27% for 2017

	2017 Total Return (% in US dollars)				
	S&P 500	MSCI All Country World	MSCI Emrg. Markets	MSCI Japan	MSCI Europe
Cons. Disc.	23.0	25.7	40.4	22.0	25.5
Cons. Staples	13.5	18.5	25.8	25.8	24.5
Energy	-1.0	7.6	21.7	46.2	20.7
Financials	22.2	24.7	33.2	15.3	28.4
Health Care	22.1	20.7	32.7	19.6	17.9
Industrials	21.0	25.9	26.3	30.8	32.0
Tech	38.8	42.3	61.0	42.7	36.6
Materials	23.8	30.2	34.2	33.4	35.8
Real Estate	10.8	18.5	50.0	7.5	26.6
Telecom	-1.3	8.6	17.5	11.4	16.4
Utilities	12.1	14.8	17.1	-0.2	24.4
Total	21.8	24.6	37.8	24.5	26.2

Source: Morgan Stanley; Factset

At face value, a contrarian might look at that chart and think the US might be the best positioned for further gains since it "underperformed" the rest of the world. However, numerous factors suggest that this may not be the case.

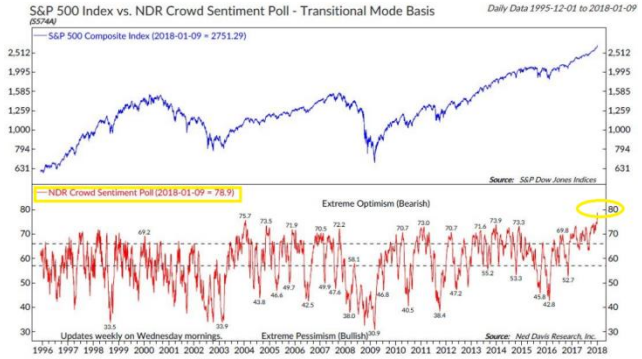
One of the indicators we have discussed in past Insights is relative strength, or a measure of market momentum. John Murphy, Chief Technical Analyst at Stockcharts.com suggested to Bloomberg that "2018 may not end as well as it started" based on the following. As Mr. Murphy highlights, the current RSI reading of 86 is "very stretched" and above the last two prior peaks (circled) which were precursors to significant pullbacks. In another parallel to the Tech Bubble, it is the highest reading since the late 1990's.

S&P 500 RSI Level Extended - Above Last Two Prior Peaks

Source: Stockcharts.com

Additionally, many have suggested that the end of a Bull market can only happen when sentiment reaches a "euphoric" stage. This is not a precise thing that can be measured of course, but Ned Davis Research compiles a composite of seven different indicators of sentiment and have found that investor sentiment is at the *highest level ever recorded* in their data history.

NDR Crowd Sentiment Highest Ever Recorded, "Euphoric"



Source: Bloomberg; TCW; ZeroHedge

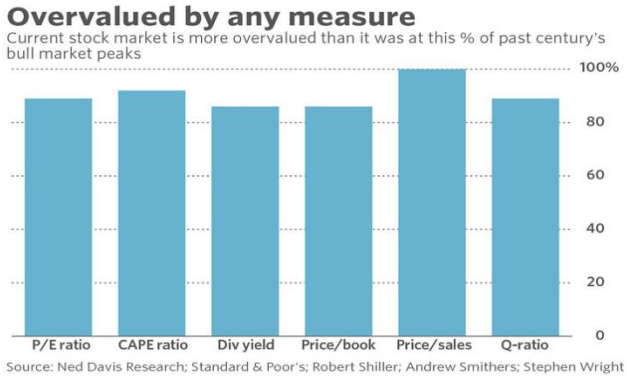
One might think that Wall Street strategists, a group that is paid to be optimistic, may be part of this recent swoon for US equities. However, perhaps due to career risk factors, the estimate for S&P 500 2018 gains is 7.8 percent – right at the long-term average. The problem is, buying has been so robust during the first 9 trading days of 2018 that the S&P has already achieved more than half that estimate, rising over 4 percent.

S&P 500 Quickly Overtaking Estimates for the Full Year

Source: Bloomberg

Not surprisingly, this has led to very high valuation levels by virtually any measure. As you can see below, various measures are more overvalued than they were between 86 percent and 100 percent of *past bull market tops*. It can certainly be said that valuation levels were high a year ago as well, but valuation study is more instructive over a longer term time frame.

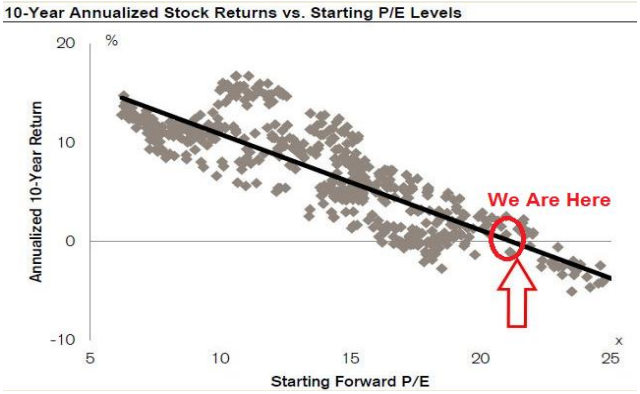
US Stocks More Overvalued Than Most Prior Peaks



Source: Ned Davis Research; Mark Hulbert

So what does this say about the future then? Most studies suggest that expectations for returns from these levels should be modest at best and perhaps even negative over a 10 year annualized period. That is not encouraging. As Credit Suisse illustrates in the following chart, history is not on investors' side.

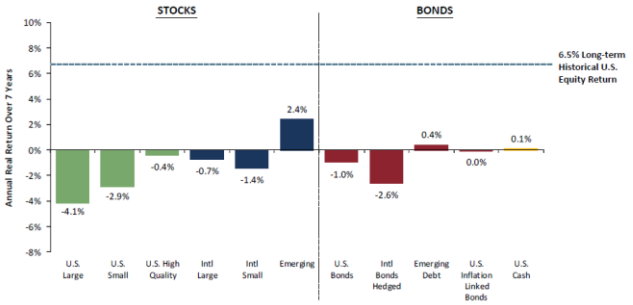
Current US Valuation Levels Suggest Modest Expectations



Source: Credit Suisse; ZeroHedge

On the upside, if prices hold more or less steady in 2018 while earnings increase due to tax cuts or share buybacks fueled by the repatriation of overseas cash for example, valuation may become less of a headwind. However, notable investors like Jeremy Grantham, founder of the deep-value investment firm GMO, recently published an update to their widely watched seven year asset class return forecasts. In no uncertain terms, they see very little value and opportunity anywhere globally with one exception.

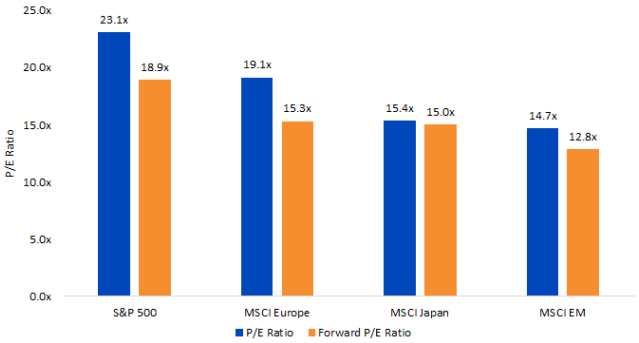
GMO Seven Year Asset Return Estimates Not Optimistic



Source: GMO

That exception happens to be emerging markets, which despite being up 37 percent in 2017, Grantham firmly advocates, suggesting, "I would own as much emerging market equity as your career or business risk can tolerate and some EAFE. I believe each of these, especially emerging markets, has more potential than most think". That is a dramatic statement from a legendary investor who has built his success on a risk-averse, long-term investment horizon philosophy. And we would agree. As we said, US equity is expensive, but when we look globally, virtually all other regions present a more compelling opportunity.

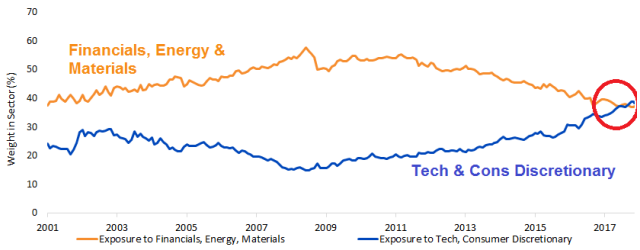
Valuation Levels Outside of the US are Compelling



Source: Wisdomtree; Factset

Clearly from the chart above, one can see that Europe, Japan and Emerging Markets all trade at cheaper valuations than the US despite fact that each region also outperformed the US in 2017 as we highlighted earlier. Emerging markets in fact, trade at roughly 15 times earnings, right in line with their 25 year long-term average. This is after a 70 percent return over the past two years! And with regard to the question of what exactly emerging markets represents in 2018, they are no longer dominated by the boom and bust cycles of commodities as they were in the past. In fact, technology and consumer discretionary companies now represent a greater proportion of the EM Index than do financials, energy and materials companies.

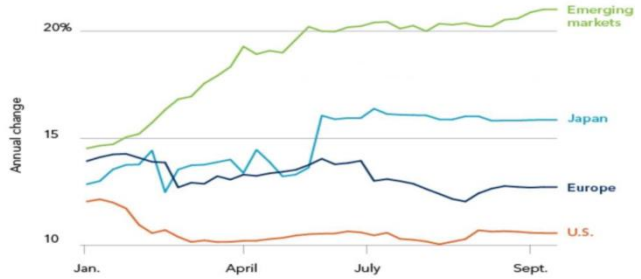
EM Evolution: Tech and Cons Discretionary Now Largest



Source: Wisdomtree; Bloomberg

Cheap valuations alone are not enough to attract investor capital. The second important component of an investment opportunity is reasonable valuation *combined* with a growth catalyst. Again, here we find much more reason to allocate to areas outside of the US in 2018 where the earnings growth dynamics are far and above what is conceivably achievable here in the US.

Earnings Growth Much Stronger Outside The US



Source: Blackrock

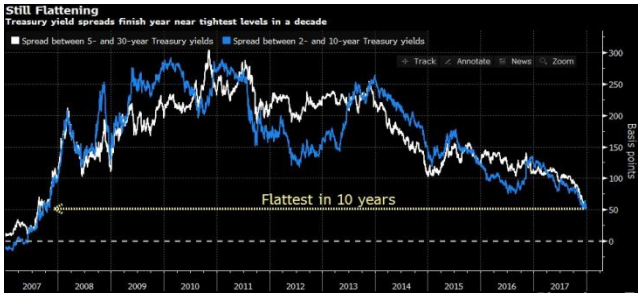
Outside of Non-US and Emerging Markets equity, we also see the commodity space as an attractive opportunity for 2018. As you can see below, the GSCI Index which represents a basket of 24 different commodities, is far below the cheapest level it has ever been relative to stocks, even beyond the Tech Bubble days. There is value and return potential here.

Commodities at All-Time Low Versus Equities

Source: Bloomberg

And conversely, our biggest concern looking ahead to 2018? As we have said for many months, it is the caution signals we are receiving from the bond market. The spread between to the 10 Year bond and the 2 Year bond has collapsed to just 49 basis points.

Warning: Yield Curve Flattest Since 2007 – Now 49 bpts



Source: Bloomberg

As we have discussed in previous Insights letters, the flattening of the yield curve, (and inevitably, its inversion) has *always* preceded a recession. If bond investors believed that global growth was accelerating and inflation was set to move higher, the curve should be steepening dramatically off of the very low levels ushered in by quantitative easing.

Significant Shift in 2018: Central Banks No Longer Buyers

Source: JP Morgan; Financial Times

To make matters worse, the ultimate buyer of bonds and other risk assets, global central banks will become net *sellers* of risk assets and bonds in particular (they may either sell or simply not purchase further assets removing demand) as quantitative easing measures are either curbed or eliminated. This is a huge shift since it represents one of the key drivers of the nine year global expansion that has occurred since the Global Financial Crisis. As JP Morgan describes it, "The coming changes in global monetary policy is nowhere near priced in and is actually grossly underestimated". This is perhaps why many have termed the following chart the "Most Important Chart in the World". As demand for bonds decreases, prices fall and yields (which move inversely to price) move higher. As the chart below shows, we are close to repeating a pattern that has indicated significant disruption in the past.

10 Year Yield Close to Levels Marking Prior Market Tops

Source: Societe Generale

Going Forward

With the recent surge higher to start 2018, we are concerned that the combination of overly optimistic sentiment in the US, stretched equity valuations, overbought conditions, international tensions, and Trump's unpredictable behavior with both other global leaders and members of his own Congress is setting the stage for disappointment further down the road. While identifying the specific factor that will shift the tide of the markets is a difficult task, we can say that the risks are certainly weighted to the downside as 2018 beckons. As we discussed, although the US may end the year with modest gains, we believe that risk reward scenario is more compelling outside of the United States for 2018.

Large Cap U.S. equities led the market by a wide margin in 2017 and we continue to place our emphasis on this segment within the US. Looking forward into 2018, we favor the information technology, financial and energy sectors in particular. The technology sector continues to display very strong growth and profitability. Financial names are still reasonably priced relative to their history and to the market and will benefit from a raising rate environment and a reduction in their tax rates. The energy sector is recovering from what was a -20 percent return in the summer of 2017 and the fundamental supply and demand environment has now become a tailwind reinforced by the recent move higher in oil prices. We also look to selected industrial and material names to outperform in 2018 as the demand dynamics and global growth look to be a tailwind for 2018.

With the momentum in non-US economies and a trending of weak dollar this year, domestically focused small and mid cap stocks have been out of favor. With valuations relative to large cap almost exactly in line with historical averages, we would not choose to commit new capital to those segments for the time being, however, changes in the corporate tax policy could quickly change the business environment for many of these companies, a scenario that would cause us to increase exposure to the group.

Equity markets outside of the US are compelling in our view. After years of lagging the US market, International equities now display faster economic growth than the U.S., combined with reasonable valuation levels and stimulative fiscal policies. Europe and Japan in particular are attractive in our view. With regard to emerging markets, we also see opportunity. China will always be the wildcard, but as a group they are demonstrating strong profit growth and improved balance sheet stability. While EM equities have experienced solid gains thus far in 2017, valuations still remain very attractive relative to the rest of the world due to the multi-year period of underperformance.

Our biggest concern from the bond market is the continued flattening of the yield curve. Historically, this has been an ominous precursor to economic trouble ahead so we will be monitoring it vigilantly. Additionally, with the wave of global quantitative easing subsiding in 2018, the supply and demand picture could become skewed to the downside. With a broad anticipation of rising interest rates in 2018, we continue to place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. Many have noted the recent move higher in the 10 Year bond yield as a precursor to the "end of the 35 year bond bull market" so it is something we will monitor closely this year. Our exposure to municipal bonds performed nicely in 2017 and we continue to believe that the opportunity in the muni markets is attractive with reasonable valuations and compelling yields.

Amidst a rapidly changing macro environment, Gold served its purpose in 2017 as a stabilizing diversifier in a time of policy uncertainty. We have also experienced the added benefit of the commodity producing above average absolute returns with gold rising roughly 12 percent. We have maintained a position in many of our portfolios as a non-correlated asset and continue to do so. The US Dollar is at a three year low and inflation measures could turn higher in 2018, both tailwinds for gold, however an overly aggressive increase in interest rates could counter these factors.

Thank you for taking the time to read our thoughts and opinions on the markets this month and we look forward to speaking with you soon.