4th Quarter 2017

MARKET COMMENTARY

Markets in Review

Up, up, and away! The fourth quarter of 2017 was kind to investors across a wide range of markets and asset types. Stock indices tacked on further gains in both the U.S. and international markets, bond indices handily outpaced inflation, and commodities continued their rebound from their declines in the first half of the year.

For the year as a whole, stocks enjoyed the strongest performance among the various classes of investments. Large company U.S. stocks, as represented by the Dow Jones Industrial Average, the S&P 500 Index, and the NASDAQ Composite finished the year with returns of 25.08%, 21.83%, and 28.24% respectively. The Russell 2000 Index of smaller company U.S. stocks did less well, but still posted a very respectable 13.14% for the year.

International equity indices also gave investors reason to cheer, with the EAFE up by 21.78%. Some regions were stronger than others. The Hang Seng Index of Hong Kong rose by 35.99%, while Germany's DAX index gained 12.51%.

Commodities, as measured by the CRB Commodity Index, finished the year with a solid quarterly gain of 5.89%. Combined with the third quarter's results, the rebound from the first half's losses left the index in positive territory – if just barely – by the end of the year.

The U.S. Dollar did not enjoy a rebound, however, and fell in each of the four quarters to end the year with a loss of 9.87%.

The Federal Reserve hiked short term interest rates three times during the past year, bringing the total number of increases in the Federal Funds target rate to five since the Fed began its campaign of "normalization" two years ago. The Fed's action might have been expected to take a toll on a wide range of interest rates, and been hard on bond prices as a result. Not this year. The yield on the benchmark 10-year Treasury note got as high as 2.63% during the year and as low as 2.04%, but ended the year at 2.41%, almost exactly at the 2.44% level where it began it. The Dow Jones Equal Weight Corporate Bond Index added 0.94% during the quarter to bring its gain for the year to 5.99%, and the Barclays U.S. Treasury 20+ Year Index tacked on 2.55% for the quarter to end the year with a gain of 8.98%.

The aging bull market that began in March of 2009 got a second wind in 2017, and nearly nine years after it started running, it showed no signs of getting tired. With inflation of around 2%, even very conservatively diversified portfolios had the opportunity to build wealth for investors.

With such a strong year behind us, success in 2018 may end up being measured by how much of the bull market's gains investors manage to keep, rather than by how much more they manage to accumulate.

						One Month Change				
	Selected Indices	2016	Q1 2017	Q2 2017	Q3 2017	**Oct**	**Nov**	**Dec**	**Q4 2017**	YTD 2017
US Equities	DJIA	13.42%	**4.56%**	**3.32%**	**4.94%**	4.34%	3.83%	1.84%	**10.33%**	25.08%
	S&P 500	9.54%	**5.53%**	**2.57%**	**3.96%**	2.22%	2.81%	0.98%	**6.12%**	19.42%
	S&P 500 Total Return	11.96%	**6.07%**	**3.09%**	**4.48%**	2.33%	3.07%	1.11%	**6.64%**	21.83%
	NASDAQ	7.50%	**9.82%**	**3.87%**	**5.79%**	3.57%	2.17%	0.43%	**6.27%**	28.24%
	Russell 2000	19.48%	**2.12%**	**2.12%**	**5.33%**	0.80%	2.75%	-0.56%	**2.99%**	13.14%
Global Equities	EAFE (International)	-1.88%	**6.47%**	**5.03%**	**4.81%**	1.46%	0.88%	1.52%	**3.90%**	21.78%
	DAX (Germany)	6.87%	**7.25%**	**0.10%**	**4.09%**	3.12%	-1.55%	-0.82%	**0.69%**	12.51%
	Hang Seng (Hong Kong)	0.39%	**9.60%**	**6.86%**	**6.95%**	2.51%	3.30%	2.54%	**8.58%**	35.99%
	Nikkei (Japan)	0.42%	**-1.07%**	**5.95%**	**1.61%**	8.13%	3.24%	0.18%	**11.83%**	19.10%
Bonds	DJ Equal Wt US Corp Bond	5.84%	**0.86%**	**2.63%**	**1.43%**	0.13%	-0.25%	1.06%	**0.94%**	5.99%
	Barclays US Treas 20+ Yr	1.43%	**1.41%**	**4.18%**	**0.58%**	-0.07%	0.80%	1.81%	**2.55%**	8.98%
Currency	US $	3.63%	**-1.82%**	**-4.71%**	**-2.67%**	1.59%	-1.59%	-0.99%	**-1.02%**	-9.87%
Commodity	CRB (Commodities)	9.29%	**-3.44%**	**-5.98%**	**4.76%**	2.44%	0.86%	2.48%	**5.89%**	0.70%
Inflation	CPI (Inflation)	2.07%	**0.98%**	**0.47%**	**0.76%**	-0.06%	0.00%	-0.06%	**-0.12%**	2.11%

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Confidence Game

On a recent frigid night, the right front tire of our car had an unfortunate encounter with a large, but well hidden, pothole. It did not go well for the tire.

About two and a half hours later, a remarkably pleasant young man from roadside assistance arrived and apologized for the delay. He explained that he was swamped with service calls, and expected to be out most of the night trying to help folks get back on their way. I held a flashlight for him as he zipped through the tire change like an experienced member of a pit crew.

I thanked him for his help, and expressed my sympathy about the prospect of his working for many more hours in such bitter cold. He said, "I won't have to do this much longer. I was just thinking about how much money I'm making on Bitcoin during the time I've been changing your tire." He seemed very confident.

Now it's possible that this young man is an experienced currency trader, with a robust understanding of cryptocurrencies and the implications of possible future regulation by global governmental agencies… or maybe he just bought it because it has gone up a lot. In either case, I hope things work out well for him (he seemed like a nice fellow), but I fear he may be providing roadside assistance for much longer than he expects.

The encounter reminded me of the story I heard in early 2000 about the investor who was amazed at how much people liked chocolate milk, as she watched the price of her Yahoo stock rocket higher. She may have fared better buying a case or two of Yoo-hoo the beverage, as the price of internet provider Yahoo plunged more than 90% from its January 2000 high by September 2001.

An old Wall Street story recounts that Joseph Kennedy purportedly decided to get out of the stock market just before the Crash of 1929 when a shoeshine boy gave him stock tips. In a related vein, the highly respected investor Sir John Templeton offered this assessment of the life cycle of the market:

"Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria."

Somewhere along the scale from optimism to euphoria lies confidence, and evidence of confidence is currently widespread.

- *Among consumers:*
  - ✓ The Conference Board Consumer Confidence Index® hit a 17 year high in November before declining slightly in December.
  - ✓ The Bloomberg Consumer Comfort Index recently hit its highest level since March 2001.
  - ✓ The most recent data from the Federal Reserve shows that consumers are spending on credit, with revolving credit (as in credit cards) growing at a 13.3% annual rate – the largest monthly gain since 2001. Consumer installment debt has never been higher at 3.8 trillion dollars, evidence consumers are confident they will be able to make the payments on their ever-increasing balances.
  - ✓ The Manpower Employment Outlook Survey for the first quarter of 2018 hit its highest level since the first quarter of 2007.
- *Among businesses:*
  - ✓ The Duke University/CFO Magazine Business Outlook Survey reports Chief Financial Officers' confidence is the highest since 2004, and optimism about their own companies is the highest since the first quarter of 2007 – just before the start of the Great Recession.
  - ✓ The NFIB Small Business Optimism Index hit its second highest level ever in November.
- *In the housing market:*
  - ✓ The NAHB/Wells Fargo Housing Market Index increased to its highest level since July 1999.
  - ✓ Existing home sales rose 5.6% in November, the highest sales rate since the middle of the housing boom in December of 2006.
- *Among investors:*
  - ✓ A recent Investors Intelligence Advisors Sentiment measure shows nearly five times as many investment newsletters are bullish than bearish. According to the publication, this lopsided survey result is the most bulls and fewest bears since April 1986.
  - ✓ According to Ned Davis Research, the S&P 500 rose on a total return basis every month in 2017 for the first time ever; on a price only basis it ended the year having gone 282 trading days without a 3% correction – the longest run ever, and the Dow Jones Industrial Average set a record by hitting 71 new highs during the year.

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What could come along to rattle some of this confidence?

- ✓ The new tax law brings with it a reduction in corporate taxes, reducing a big expense for many companies and allowing more of the income they earn to drop to the bottom line – profits. However, the non-partisan Congressional Budget Office estimates new tax law will also bring with it an increase in the Federal deficit of *1.455 trillion dollars* over the next 10 years. If deficits soar, how will that affect confidence in the prospects for the U.S. economy?

- ✓ The Federal Reserve has now raised interest rates five times since December of 2015, most recently this past December, and is expected to hike them again three or four more times in 2018. Rising interest rates have historically been a drag on economic growth. Even if higher rates don't drive the economy into a recession, how will consumers respond as interest rates – and the monthly finance charges on their record credit card balances – go up?

- ✓ As interest rates rise, mortgages become more expensive. The ripple effect of rising mortgage rates not only hurts affordability, but also often results in falling house prices. Homes are often a family's largest asset. How would weakness in the housing market affect confidence?

- ✓ Washington DC appears to be at least as dysfunctional as ever, as our elected representatives grapple with issues ranging from immigration policy to simply keeping the government from shutting down. Since 2018 is an election year, how likely is it that political partisanship will become less rancorous, and important issues of the day will actually be resolved?

- ✓ Overly enthusiastic investor sentiment has long been considered a leading contrarian indicator of trouble ahead. A market "melt-up" can certainly be exciting, but could it also be a last hurrah? Once everybody who's positive on the market's prospects has loaded up on stocks, who's left to buy?

According to Behavioral Finance research, people are predisposed to be optimistic, overconfident, and to believe that whatever is happening now is likely to continue happening indefinitely. People may need some degree of optimism and confidence in order to make decisions and move forward. Still, when the emotional "Fear of Missing Out" becomes the pervasive motive for investing, optimism may already be in the bull market's rear-view mirror – and euphoria may be right around the corner.

As investment managers, we're very happy to find ourselves in the midst of an historic bull market run. As professionals entrusted with the care of our clients' money, we believe it's important to keep a sharp lookout for bumps in the road that may lie ahead.

What are *we* confident in? For more than twenty-five years, we've relied on a responsive, risk-managed approach to navigating through the twists and turns of the investment landscape as the economic environment changes. As our clients drive toward their important investment goals, our goal is to help them steer around the financial potholes that could leave their portfolios out in the cold.

- Gary E. Stroik

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NOTES

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Additional risk is associated with international investing, such as currency fluctuation, political and economic uncertainty.

Annualized Rate of Return is the return on an investment over a period other than one year (such as one quarter or two years) multiplied or divided to give a comparable one-year return.

Index Definitions

- *The Dow Jones Industrial Average* (DJIA or "The Dow") is a price-weighted average of 30 of the largest blue chip issues traded on the New York Stock Exchange.
- *The S&P 500 Index* includes a representative sample of large-cap U.S. companies in leading industries. The *S&P 500 Total Return Index* includes the performance effect of the dividends paid by the stocks in the index.
- *The NASDAQ Composite Index* (NASDAQ) is a market-value weighted index of all common stocks listed on NASDAQ.
- *The Russell 2000 Index* includes the smallest 2,000 stocks in the Russell 3000 Index (approximately 8% of the total market capitalization of the Russell 3000 Index) of the Russell data series.
- *The MSCI EAFE Index* (EAFE) is an unmanaged index based on share prices of approximately 1,470 companies listed on stock exchanges around the world. The stocks of twenty countries are included in the index.
- *The Hang Seng Index* is a capitalization-weighted index of 33 companies that represent approximately 70% of the total market capitalization of the Stock Exchange of Hong Kong.
- *Nikkei-225 Stock Average* (Nikkei) is a price-weighted index of 225 blue chip Japanese companies listed in the First Section of the Tokyo Stock Exchange.
- *The Dow Jones Equal Weight U.S. Issued Corporate Bond Index* is an index of 96 bonds issued by leading U.S. companies designed to represent the market performance, on a total-return basis, of investment-grade bonds.
- *The Barclays Treasury Bond Index* is an unmanaged index that includes public obligations of the U.S. Treasury that have remaining maturities greater than 1 year.
- *The U.S. Dollar Index* is computed using a trade-weighted geometric average of six currencies. The six currencies and their trade weights are: Euro 57.6%; Japanese Yen 13.6%; UK Pound 11.9%; Canadian Dollar 9.1%; Swedish Krona 4.2%; Swiss Franc 3.6%. These specifications are subject to change.
- *The Commodity Research Bureau Index* (CRB) provides a broad measure of commodity price trends by averaging prices of seventeen commodities from energy, grain, industrial material, livestock, and precious metal groups.
- *The Consumer Price Index* (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

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