ON OUR MINDS

Turn the Page

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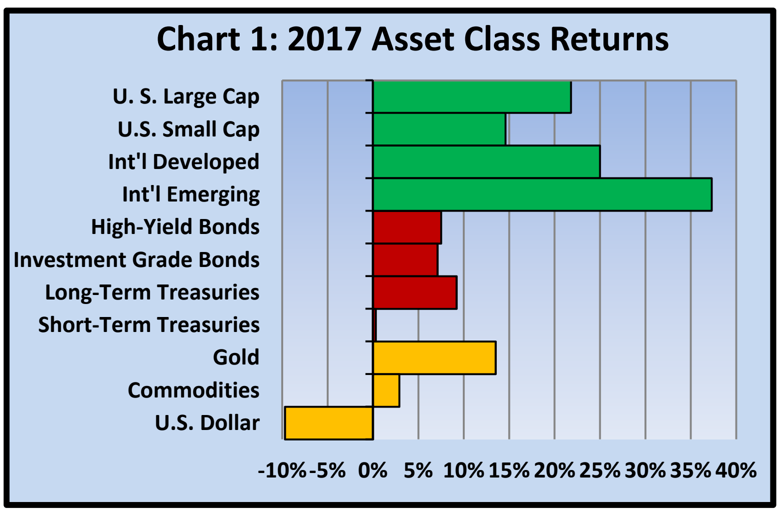
January 18, 2018

Unless you've gone to Katmandu, you're probably aware that 2017 was an extraordinary year for a wide array of asset classes. It was a classic "risk-on" year: Stocks soared, both in the U.S. and globally.[1] Long-term bonds did well. High-yield credit bounced. Commodity prices floated upward. Gold had a great year, too, unless you sold bitcoin to buy it. In retrospect, pretty much the only asset classes to miss the party were the safest, including cash and short-term government bond funds. Chart 1 shows a representative sampling of major asset class returns:



Sources: FactSet, Bloomberg

Although the year was dominated by appetite for risk, investors were still mostly cautious in their attitudes; rare was the "rambling gambling man" attitude that we've seen in prior bull markets. This sense of pervasive caution and doubt helped tamp down rallies and bolster dips; markets were remarkably calm throughout the year, taking in stride any number of potentially disruptive events. The VIX volatility index remained at depressed levels throughout the year.

It is in this context that we undertake our annual review of our tactical asset allocation. Each year in mid-January, we look back at the prior year to evaluate how well we responded to different types of risks and whether our investment strategies were successful. We can then take a snapshot of the U.S. economy as it stands today, and construct our investment strategy for the coming year.[2]

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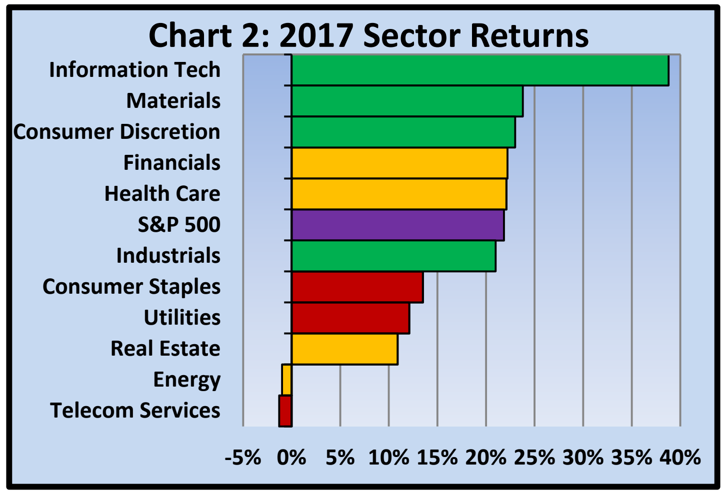
[1] Even in Katmandu you may have noticed this, since emerging markets stocks and bonds staged a huge rally through the course of 2017.

[2] We do this in the middle of January rather than at the beginning, to give us a chance to digest important year-end economic data that is published in January and to get an early sense of December-quarter earnings reports.

2017 Markets Review

Domestic equities. After spending more than two years stalled in a broad trading range, the U.S. stock market burst into a prolonged rally in November 2016. The large-cap S&P 500 index soared 21.8% last year, driven by a steady supply of strong economic data, tame inflation, easy money, and regulatory changes – all of which led to a resurgence in corporate earnings growth. For the market as a whole, valuations didn't change all that much; P/E ratios were slightly elevated throughout the year, but it was the denominator – earnings – that drove the market higher. Only in the last couple of months did anticipation of a tax reform package elevate P/E ratios, and only for tax-sensitive stocks.

While market-level volatility was at historically low levels, we still saw a wide dispersion of returns across companies and industries. Chart 2 shows the dramatic difference in performance from the best sectors to the worst; within most sectors, similar disparities appeared between the best and worst stocks. It was, in short, a "stock-picker's" year in which individual stock selection mattered – in contrast to recent "macro" years in which dispersion was low and nearly all stocks acted alike.



Source: FactSet

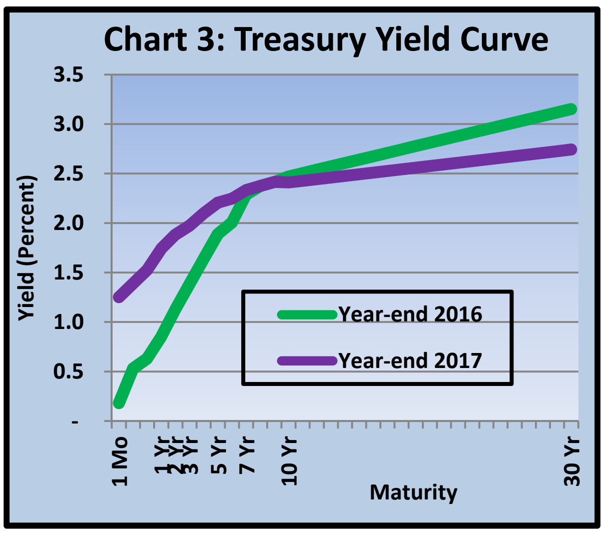
In Chart 2, the dichotomy between "risk-on" and "risk-off" shows up clearly. Cyclical (risk-on) sectors are colored green, and more defensive (risk-off) sectors are colored red; as with the overall array of asset classes last year, investor appetite for risk was evident last year even within a single asset class: The green risk-on sectors enjoyed a terrific year, while risk-off sectors languished.

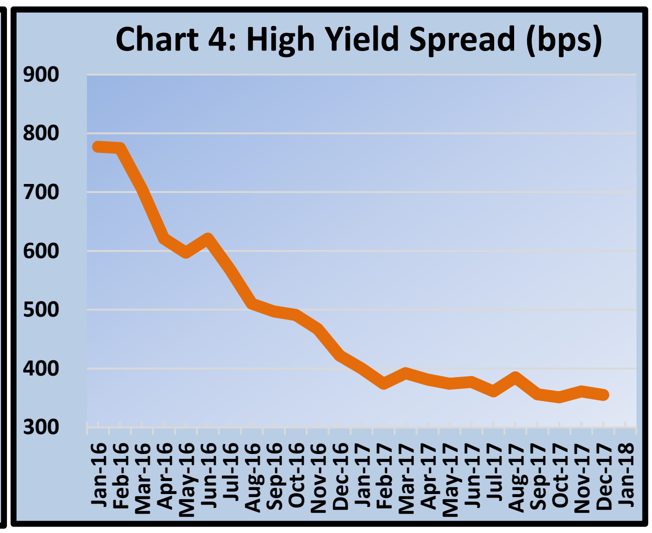
Global equities. For the first time in nine years, international stocks outshone domestic equity markets – another sign of risk-on behavior, but also a recognition that foreign economies are finally building strong momentum. Emerging markets soared, benefiting from a weak dollar (which made their debt cheaper to repay) and from strong local demand for their products. Rising commodity prices helped some emerging markets (Brazil and Chile, for example, which were up 27% and 30%), but the benefits of rising global trade were felt much more broadly.

Developed markets, too, rebounded handsomely last year. Huge monetary stimulus (especially from the European Central Bank) helped somewhat, but the more important trigger was an uptick in corporate earnings. As global economic growth has accelerated, developed markets exporters and financial institutions are finally seeing the benefits to their profitability. Despite the modest outperformance last year, international stocks are still valued at a discount to U.S. stock markets.

Fixed income. The Federal Reserve raised its benchmark Fed Funds rate three times last year, accelerating its tightening cycle. The central bank also began shrinking its long-term balance sheet holdings by refraining from re-investing proceeds from maturing bonds. And yet the big story of the year wasn't a rising-rate or tighter-money environment; instead, it was the flattening yield curve. Through the course of last year, as shown in Chart 3, short-term interest rates rose while long-term interest rates fell slightly.

Market lore says not to fight the Fed; when the central bank is tightening policy by raising short-term rates or reducing its long-term bond holdings, most investors would normally sell their longer-term bonds. Yet last year it was wiser to sail against the wind, buying long-term bonds even as the Fed was effectively selling. The reason is twofold: First, U.S. bonds are remarkably inexpensive in comparison with foreign sovereign debt; and second, some investors have begun to look beyond our current economic health toward the next recession. Indeed, the yield curve is flatter now than it has been in a decade, suggesting that it might invert soon; whenever long rates have been lower than short rates in the period since World War II, a recession has followed within a year.





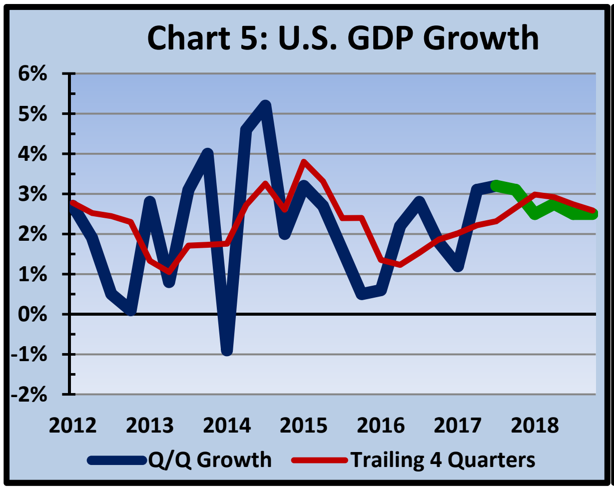
Source (both charts): FactSet

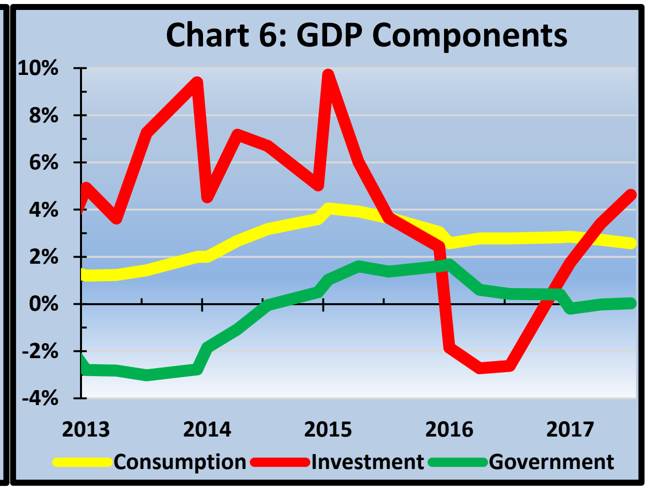
As the yield curve flattened, investors in long-term bonds felt the fire down below; the small dip at the long end of the curve (i.e., the drop at the right edge of Chart 3 from the green 2016 rate to the purple 2017 rate) still translated into hefty double-digit returns. Conversely, the big jump in rates at the short end of the curve didn't translate into big losses for short-term bond investors, because the shorter maturities protected them.

Just as taking duration risk was rewarded last year, so too was taking credit risk. High yield bonds outperformed investment-grade bonds; within the "junk" category, the worst credits (rated in the C-range) did much better than the better-quality B-rated bonds. Overall, as shown in Chart 4, the interest rate differential between high-yield and investment grade (the spread) shrank sharply in 2017, as investors were willing to take increasingly more credit risk to get only slightly better yields.

Domestic Economy

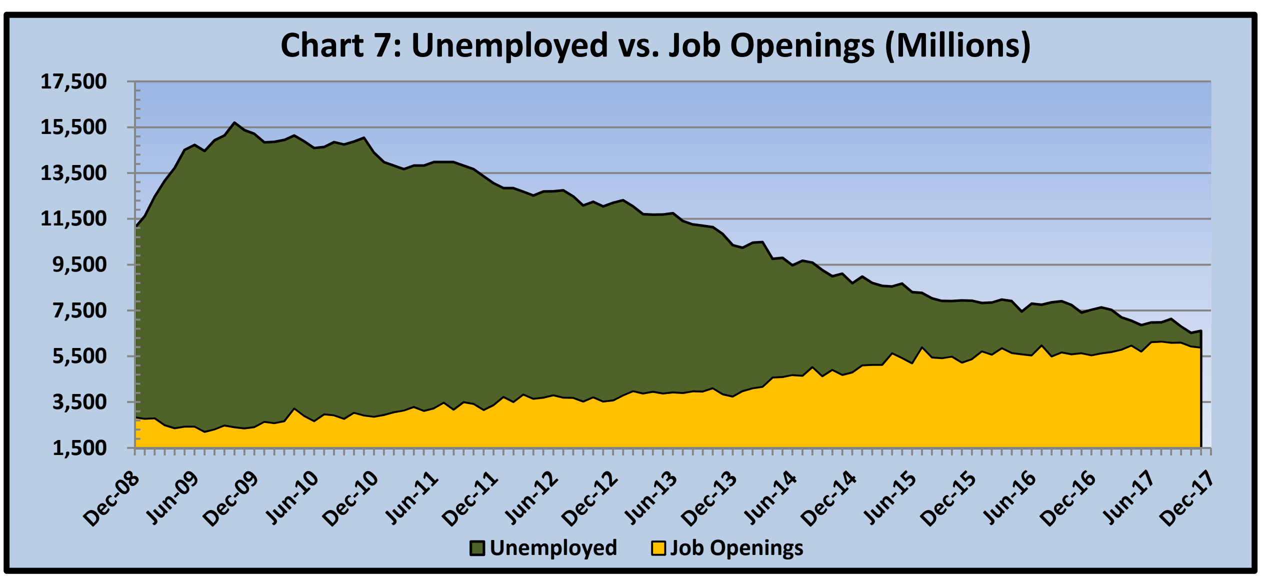
It isn't surprising that risk-on attitudes prevailed in 2017 financial markets. Economies at home and abroad were firing on all cylinders. In the United States, GDP growth topped 3% for three consecutive quarters for the first time in more than a decade, as shown in Chart 5. Down on Main Street, consumer spending and housing remained stalwarts of American demand, but it was heartening to see business investment accelerate after a multi-year lull. (See Chart 6.)





Source (both charts): Commerce Department, Bureau of Economic Analysis

Paradoxically, the most encouraging *and* worrisome aspect of the U.S. economy is the labor market. Unemployment remains at two-decade lows, and monthly job creation numbers remain positive; but the *rate* of job creation has slowed. The reason is that we are running out of qualified workers for high-skilled jobs, while we still have many millions of workers whose skills don't qualify them for those jobs. This is evident in Chart 7, which shows job openings in comparison to the number of unemployed Americans. At the beginning of this decade, we had more than seven workers fighting for every job opening; today, it's almost a one-to-one ratio.



Source: Labor Department, Bureau of Labor Statistics

2018 Economic Outlook

U.S. GDP Growth. We anticipate continued economic growth this year, driven partly by trends that have been in place for months and in part by the stimulus effect of the recently enacted tax reform legislation. Even so, we don't think GDP growth will dazzle anyone; we feel like a number around 2.5% is most realistic. In part, our muted expectations reflect some technical details, such as the significant build-up of inventory that contributed to 2017 GDP growth and that will need to be worked off in 2018.

But two bigger concerns are trade policy and demographics. If the Trump Administration curtails or abandons Nafta and other trade agreements, we would likely see a meaningful reduction in economic growth and perhaps even a recession. And if the Trump Administration limits immigration and expands deportations, population growth would likely stall; fewer residents equals lower overall spending. Assuming no policy blunders, though, we think the U.S. can post another solid year of economic growth.

Inflation. Ever since the current recovery and expansion began in 2009, inflation has been notably subdued, kept down by excess slack in the system – in wages, in production capacity, and in energy prices. Yet this dynamic has been changing. Energy prices have risen steadily for more than a year, with oil topping $60 / barrel in recent trading. Hourly wages are still growing only 2.5%, but total compensation is rising more quickly due to higher bonuses. Housing prices continue to outpace broader inflation measures, registering about 5% gains over the past year. Health care prices, too, are growing in the mid-single-digit range – albeit slower than in recent years. Even the dollar's modest decline this year has caused some import prices to rise.

So why don't we see the Consumer Price Index rising sharply? In a word, Amazon. We have collectively shifted so much of our purchasing to online channels that brick-and-mortar retailers have had to cut prices to compete. Splitting the CPI into its component elements leads to a startling fact: While the aggregate prices of *services* continue to rise, the prices of all *goods* are actually falling. We have entered a period of sustained disinflation (or even deflation) in the retail marketplace. This may be a welcome development for consumers, who get more value for money, but it has caused distress across many industries: apparel, food, department stores, etc.[3]

Corporate Profits. While not the same thing as GDP, corporate profits do reflect economic growth and are in some ways a better measure of the stock market's earnings power. A year after bursting out of a two-year profits recession, EPS growth remains on a steep upward trajectory. Strong economic demand worldwide – synchronized global growth – provides the underpinning, and fiscal stimulus from the tax reform package is the accelerant. We think S&P 500 earnings growth can maintain a double-digit pace through 2018, but the outlook for 2019 is probably a bit dimmer; the year-over-year comparisons will be against higher numbers, and the front-loaded benefits of the tax package may begin to attenuate.

[3] Deflation is usually considered a catastrophic circumstance for an economy, because the "rational consumer" is presumed to prefer waiting for prices to drop before purchasing anything; taken to its logical extreme, in a deflationary world no one would ever buy anything. In the very real world of American retail, however, consumers have shown no signs of waiting until tomorrow to buy goods; they're buying plenty of things, but exercising their ability to do so for lower prices.

Interest Rates. More than two years after the Fed finally began lifting short-term interest rates, the fed funds rate remains about 1.5% – about two percentage points below where it has been at comparable points in previous economic cycles. Under new Chair Jerome Powell, the Fed's Open Market Committee "dot plot" anticipates three hikes this year. Financial markets have been growing more comfortable with this outlook; prices of futures contracts for Treasury bonds now factor in the likelihood of two or three hikes. Some economists expect four hikes, as the Fed tries to stay ahead of a potentially overheating labor market. We think three is about the right expectation. We also think that the Fed will continue to reduce its long-term bond holdings, though this will have little impact on the long-term bond market unless the central bank actually sells long-dated bonds (as opposed to simply letting some holdings mature without reinvesting the proceeds).

The Fed has to be careful. If we get three short-term hikes, the overnight fed funds rate would be 2.13%. The 10-year Treasury bond is currently yielding only about 2.6%, so the slope of the yield curve could continue to flatten. We believe the Fed is considering ways of nudging long-term bond yields higher, in order to maintain a positive slope to the yield curve while also avoiding potential price bubbles in the bond market from forming. Yet if the Fed is too clumsy (for example, if it starts selling long-term mortgages when the housing market is already a bit concerned about the impact of the tax bill's limitation of mortgage interest deductibility), the bond market may get spooked and send long-term interest rates much lower – thereby inverting the curve and causing exactly the outcome the Fed had hoped to avoid.

International Economies. Consumer-driven markets such as Europe and Japan have gained significant positive momentum in the past year; yet they still have a long way to go. Global exporters domiciled in those regions will continue to benefit from strong demand in the United States, now supplemented by healthy demand at home, too. Commodities-driven emerging markets fared surprisingly well last year, helped immensely by the recovery in oil prices and by associated gains in industrial metals and other goods as well. China remains a wild card; fundamental demand is improving, but government crackdowns on excessive debt could short-circuit any growth acceleration.

2018 Portfolio Construction

Tactical Asset Allocation. For the past three years, we have let our overweight equity positions grow as stocks have outperformed bonds. We had set a +3% overweight target[4] at the beginning of 2016, which grew to 6.5% by the end of that year due entirely to market movements. Last year, we opted to retain the +6.5% overweight for 2017, and it's a good thing we did. By year-end 2017, however, stocks had risen to a +13.5% overweight, again entirely due to market movements. In effect, our clients owned a much larger position in a more expensive asset class than they had owned just a year earlier. We have opted to pare back that overweight position in 2018; we remain bullish on stocks and we remain overweight, but given current valuations we think a +4.5% overweight position is warranted.

[4] Our tactical asset allocation works as a percentage of a client's long-term equity target. If, for example, a client has a 60% long-term equity allocation, then a "5% tactical overweight target" means that we would set the client's portfolio to hold 63% in stocks for the year. (60% long-term target x 1.05 [i.e. 5% overweight] = 63% tactical allocation.)

Bonds. With short-term interest rates likely to rise slightly and long-term interest rates pinned by aggressive monetary policy abroad, we think bond investors are headed for a challenging year. The Treasury market, in particular, is likely to be pressured by expectations of higher inflation and wider fiscal deficits. We are still using Treasury Inflation Protected Securities (TIPS) to provide some insulation from higher interest rates caused by higher inflation. We also retain our exchange-traded fund that focuses on short-term floating-rate debt, providing further protection against higher interest rates.

We are comfortable owning credit risk; the still-rising tide does help most debtors. The tight spread against investment grade bonds limits our appetite for high-yield, but only to a degree; even if spreads stay steady in 2018, the higher absolute rates can help bond portfolios. The combination of ultra-low global interest rates, healthy U.S. corporate balance sheets, and lower tax rates leaves us more sanguine about credit risk.

Equities. We have been singing a consistent tune since 2012, and this year it's still the same: U.S. equities, while verging on expensive, are the most attractive asset class within our purview. Valuations are still within one standard deviation of their historical average, so we are not concerned that prices have gotten at all out of hand. We think that stocks will find support from domestic economic strength, from improving corporate earnings (especially as companies begin updating their outlooks to reflect lower taxes or improving capital spending trends), and from continued cash inflows.

Yet we cannot ignore the possibility of an overly zealous Fed, or of a foreign policy debacle. Nor can we forget that profit margins are vulnerable to rising labor costs, and that rising capital expenditures represent a double-edged sword. We can imagine any number of reasons that stock prices could tumble into a correction, but we don't think the end of the bull market is near at hand. Healthy earnings growth and acceptable valuation levels suggest that we can ultimately see near-double-digit returns from year-end 2017 levels. We don't pretend to be market timers; we intend to remain fully invested in equities even through any potential correction.

Most of our U.S. equity participation is in large-cap companies, either directly or through exchange-traded funds. Among the ETFs, we have taken profits in two of the hottest sectors of 2017, technology and health care. We redirected some of the proceeds into the energy sector, where stocks were battered last year even though oil prices rose consistently. We also maintain our participation in smaller companies through other ETFs, in part because they likely will benefit disproportionately from the tax legislation. Smaller stocks also trade at a discount to large-cap stocks, giving us an attractive valuation point.

We have redirected some of our international equity participation, retaining our focus on Europe but concentrating more specifically on the Eurozone countries and on the improving financial sector. We have also expanded our participation in emerging markets. We remain absent Asia and Japan, but for different reasons. Our avoidance of Asia is based on concern that China's debt crackdown could adversely affect demand in nearby countries, which we consider a temporary phenomenon. We think Japan's problems stem from its negative population growth rate and are more intractable.

To summarize, we are positioning our model portfolios and client accounts as shown in Chart 8:

Chart 8: Asset Allocation	New	Jan. 2017	Change
Tactical Equity Weighting	**+4.5%**	**+6.5%**	-2.0%; slight pullback
Equities:			
U.S. Large-Cap Stocks	73.0%	73.0%	0.0%; some sector shifts
U.S. Mid/Small-Cap	3.0%	6.0%	-3.0%; shift to foreign
SPDR S&P 500 Trust	0.0%	2.0%	-2.0%; shift to foreign
Energy ETF	2.0%	0.0%	+2.0%; tactical opportunity
Financial ETF	2.0%	2.0%	0.0%; no change
Health Care ETF	0.0%	2.0%	-2.0%; took profits
Industrial ETF	2.0%	2.0%	0.0%; no change
Technology ETF	0.0%	2.0%	-2.0%; replaced with stocks
Total U.S.	**82.0%**	**89.0%**	-7.0%
Benchmark	**~82.0%**	**~82.0%**	
Developed Europe ETFs	6.0%	4.0%	+2.0%; accelerating growth
Asia / Japan ETFs	0.0%	0.0%	0.0%; no change
Emerging Markets ETFs	5.0%	3.0%	+2.0%; stable commodities
Global Small-Cap ETF	2.5%	2.0%	+0.5%; global GDP growth
MSCI ACWI ex-U.S. ETF	4.5%	2.0%	+2.5%; global GDP growth
Total International	**18.0%**	**11.0%**	+7.0%
Benchmark	**~18.0%**	**~18.0%**	
Fixed Income:			
U.S. Investment Grade	75.0%	76.2%	-1.2%; six-year ladder
Inflation-Protected ETF	7.0%	6.0%	+1.0%; rising CPI expected
Floating-Rate Notes ETF	2.0%	4.6%	-2.6%; duration risk mgmt.
Intermed. Credit ETF	8.0%	5.5%	+2.5%; duration risk mgmt.
Intermed. Gov't ETF	3.0%	2.7%	+0.3%; duration risk mgmt.
High-Yield ETF	5.0%	5.0%	0.0%; no change

Chart 8 shows targeted allocations for our flagship Multi-Asset model using actively selected individual stocks and corporate bonds. We have developed comparable models for client portfolios that use mutual funds and ETFs instead of individual securities (our "Funds-Based" or "Wealth Accumulation" portfolios), and for variants of the Multi-Asset style including Core (which excludes international assets) and three Sustainable and Responsible Investment styles. All of our model portfolios are derived from the same economic analysis and market interpretation, and therefore have analogous asset allocation targets. Individual client portfolios often differ from these models because of factors unique to each client, so these targeted allocations should be read as guidelines rather than as reflections of actual accounts.

2017 Report Card

Finally, we think it is appropriate to evaluate our investment decisions in the year just ended. This evaluation necessarily must cover only our hypothetical guideline models; since each client's portfolio is unique, it would be impossible to judge any individual client accounts here. Instead, we look back to our *On Our Minds* 2017 preview, "Long Strange Trip Ahead," published January 20, 2017, to review our predictions and judge how well we did.

- U.S. economy. Our hypothesis at this time last year was that the U.S. economy was on track for 2.6% growth, which turned out to be very slightly too optimistic.[5] We got the basics right: Strong housing demand, a tighter jobs market, rising capital spending, and higher oil prices. Our 2.5% estimate for CPI turned out to be almost perfectly accurate. We also recognized both the benefit of tax reform and the likelihood of some stumbles along the way. We weren't perfect, in that we doubted the Fed's resolve to raise short-term interest rates three times last year. We also underestimated the power of U.S. corporate earnings growth, forecasting an acceleration to 10% but still undershooting the actual 14% posted by S&P 500 companies.

- Asset allocation – by asset classes. For the sixth consecutive year, our asset allocation decisions added value to client portfolios. Our consistent preference for stocks over bonds paid off handsomely, as the S&P 500 provided a 21.8% total return while the Barclays Aggregate bond index gained only 3.5%. We were tempted to take profits at several points during the year, but ultimately held firm in our conviction – and the result was a jump in equity overweight from +6.5% to +13.5% by year-end.

- Asset allocation – by geography. Our biggest single error last year was to reduce our positions in Europe. We had anticipated the Continent's turnaround two years ago, but after too many fumbles in 2016 we lost some of our resolve. However, by redeploying some funds into emerging markets for the first time in many years, we still participated in the synchronized global growth that lifted equities worldwide.

- Fixed income. In client fixed income portfolios, we aim to produce stable and predictable cash flows with limited reinvestment risk; most accounts use a multi-year individual bond ladder. This results in portfolios with shorter duration than most bond benchmarks. Since our objective (cash flow and capital preservation) differs from that of the benchmark (total return), performance assessment is of only limited utility. We do use ETFs and some mutual funds to sculpt overall credit and duration risk, so it is still a mostly fair comparison. Through 2017, we kept our duration close to the market index, and took on some credit risk through our high-yield ETF. These were smart decisions, resulting in performance that was close to that of the Barclays fixed income benchmarks.

[5] Final numbers for 2017 GDP won't be released until early March, but based on the first three quarters and on recent estimates of 4Q activity, we think the final number for 2017 was about 2.4% or 2.5%.

- Equity stock selection. Our client portfolios beat their benchmark indexes and were well ahead of our competitive peer group as well, across all of our equity styles. We won't always do as well as we did in 2017, but last year was superb. Our Core equity portfolio models gained 23.7%, nearly 200 basis points ahead of the S&P 500 and more than 300 basis points ahead of the peer group. We didn't do anything differently than in 2016 (when we missed the benchmark but paced alongside our peers). No overnight moves, no day trading, no sudden shifts of focus. Instead of seeking a silver bullet, we stayed true to our discipline of finding cheaper companies with solid prospects.

All in all, 2017 was an excellent year for our clients' portfolios. With temptation and false opportunities around every corner, we are gratified that our stable and consistent approach protected and enhanced our clients' investments. We approach 2018 with optimism but also with a keen awareness of what can go wrong. This will be a challenging year in many ways, even though the stars are favorably aligned for continued economic growth. Things have changed and will continue to change; we turn the page[6] and begin anew each January at zero. We thank all of our clients for placing their trust in our stewardship of their financial assets, and we hope to see you all in the new year.

[6] If you've been counting, this is the ninth and final Bob Seger title check, plus one reference to his backing band.