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INVESTMENT ADVISORS

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INVESTMENT REVIEW AND OUTLOOK

Indian Summer

Like an extended stretch of good weather, the favorable economic and stock market environment continued in the final quarter of 2017. U.S. real GDP rose at an annual rate of 3.2% for the three months ended September, marking the fastest growth rate in over two years. The S&P 500 operating earnings are expected to grow over 8% for the full year. Inflation remained subdued with consumer prices rising 2.1% for the 12 months ended December. The economy continues to operate at full employment and average weekly earnings rose 3% year over year for the 12 months ended November. Interest rates rose during the quarter, but remain low by the standards of recent history. U.S. consumer confidence reached a 17-year high in December and, according to ISI Group, household net worth exceeded $100 trillion for the first time in early January.

Global economic growth mirrored U.S. strength with most geographies participating in what is often referred to as “synchronized global expansion.” The pace of global economic growth is reflected in a variety of barometers of activity and global measures of industrial production, business confidence and employment have all shown signs of acceleration in recent months.

In late December, major tax legislation was passed and signed into law. The key provisions of the law include a reduction in corporate tax rates and incentives for the repatriation of the foreign profits earned by U.S. domiciled corporations. The new law includes a reduction in individual tax rates and higher personal exemptions, along with limits on the deductibility of state and local taxes and mortgage interest expense. The long run effects of the new law on our economy can only be speculated on at the present. However, adjustments to payroll withholding will begin immediately, and dozens of corporations have announced repatriation of foreign cash to the U.S. In addition, many corporations have made additional year-end cash bonuses to employees.

Geopolitical risks remained elevated during the quarter, but tensions appear to have dropped from the very high level of last fall. The coalition against ISIS has made significant progress, a North-South dialogue has resumed on the Korean peninsula, and the Iranian nuclear agreement remains in force. The world is still awash in potential hot spots, but temperatures have cooled.

For the stock market, the fourth quarter produced a confluence of positive factors: low interest rates and inflation, robust economic growth, the anticipation of expansionary fiscal policies via tax reform, all against a backdrop of (modestly) lower geopolitical tensions. The S&P 500 returned 6.6% during the quarter and 21.8% for the full year, while the Lipper Balanced Fund Index returned 14.1% for

2017. The strongest segments of the market during the quarter included economically-sensitive sectors such as consumer discretionary, technology and financials. Defensive sectors such as health care and utilities lagged during the quarter. As was the pattern for all of 2017, growth stocks outperformed value stocks with the Frank Russell Growth Index returning 7.8% for the quarter, while the Russell Value Index gained 5.3%.

A New Decade

2018 marks the 10-year anniversary of the 2008-2009 global financial crisis and the accompanying recession. While almost a decade has passed since the crisis, memories are still fresh and many of the after-effects live on in our day to day lives. The most prominent of these effects is the ultra-accommodative monetary policy of the U.S. Federal Reserve and foreign central banks. While interest rates have remained low for the better part of a decade, there is general agreement among economists that the economy has performed below its potential growth rate. Many reasons are given for this phenomenon: psychological scars from the housing collapse were slow to heal, ultra-low interest rates had the unintended consequence of penalizing savings and capital investment, and crisis-era regulations, while providing important safeguards, also served as a restraint on lending. Two additional factors weighed on global economic growth in the post-crisis era. The first was the collapse of energy and industrial commodity prices. Between 2008 and 2016 crude oil experienced a peak to trough decline of over 70%, and the Goldman Sachs index of non-energy industrial commodities experienced a decline of close to 50%. The second factor was the growth in global debt leading up to the great financial crisis. Global debt to GDP rose steeply from 200% to 230% between 2005 and 2009. Much of this debt was incurred in emerging market economies which were severely impacted by the collapse in commodity prices.

Thus, the economic environment for much of the last decade has been shaped both by factors that led to the financial crisis, as well as unintended consequences of some of the policy responses to the crisis.

In an environment distinguished by subdued economic growth and deflationary forces, investment returns were dominated by asset categories that flourish in a low-growth environment. Growth stocks were a standout. In the decade ended December 31, 2017, the Frank Russell Growth Index had a compound annual return of 10% vs. an 8.2% annual return for the S&P 500, and 7.1% for the Russell Value Index. By contrast, the equity markets of economies impacted by strong deflationary forces or the collapse in commodity prices significantly underperformed U.S. stock markets. In Japan, where economic growth has been anemic, the Nikkei Index had a total annual return of 4.1% for the 10 years ending December 31, 2017 and the MSCI Emerging Markets Index had an annual total return of just 1.7% over the same period.

In thinking about the future, there are several developments which may auger for a change in the global economic and investment environment. Central banks, both in the U.S. and abroad, have employed record levels of stimulus over the last decade. The U.S. Federal Reserve, as well as the European Central Bank, have begun the process of monetary tightening through a combination of reduced open market purchases of securities and increases in benchmark interest rates. While it is still early in the process, short term interest rates, as measured by the 3-month U.S. Treasury Bill, have risen from 0.48% in late 2016 to 1.43% in early 2018. Changes in global monetary policies are, coincidently, being accompanied by tax, fiscal and regulatory reforms in many developed and emerging economies. In the U.S., the recent tax law changes are coinciding with regulatory reform initiatives across a variety of industries. Outside the U.S., we are witnessing signs of economic reforms in Europe, South America and Asia. The forces of monetary tightening, fiscal stimulus and regulatory reform are a powerful combination. While it is too early to draw conclusions of the impact on the world economy, signs of changes abound. In Japan, whose economy has been beset by decades of deflation, the year over year annual inflation rate has almost doubled from 0.5% last summer to a 0.8% at year end. Global commodity prices, as measured by the GSCI Commodity Index, have risen 17.8% over the last 6 months. Following stronger than expected growth in 2017, the World Bank recently increased its estimate for 2018 Global GDP from 2.9% to 3.1%.

Expecting the Unexpected

The year 2017 was a stark reminder that future events, be they economic, political or market-related, are nearly impossible to forecast on a consistent basis. Few prognosticators predicted the geopolitical, economic and market developments of the past 18 months. Conventional wisdom was turned on its proverbial head. Contemplating investment strategy for our clients, we are aware of the changing economic dynamics cited above, and we are mindful that the decade ahead is likely to be markedly different from the one just passed.

Our investment positioning is guided by our observations about the economy and the geopolitical environment, as well as our analysis of company-specific opportunities. Key portfolio themes for the coming year include:

- The shift to tighter global monetary policies has begun in earnest and this development can be viewed as a vote of confidence in the health of the global economy. **However, this poses special risks for longer duration financial assets such as long-term bonds and stock market sectors whose valuations are most sensitive to changes in interest rates.**
- It is quite likely that the deflationary forces of 2008-2017 have ebbed. While inflation still appears quiescent, we have recently increased our exposure to sectors of the economy that benefit from the tighter supply/demand picture in industrial and energy commodities.
- The financial services sector, and well-capitalized banks in particular, stand to benefit from the strong global economy and higher interest rates. The banking sector is an important theme in client portfolios.
- For the reasons cited above, our fixed income positioning continues to be quite conservative with an emphasis on high credit quality and duration below the benchmark.
- The above trends of regulatory reform and modest inflation are having a measurable impact on corporate profit growth in Japan, where we view valuations as attractive. We have recently increased our exposure to Japan.

As always, we welcome your comments and questions.