SYNCHRONIZED GLOBAL EXPANSION DROVE FINANCIAL MARKETS IN 2017

For the first time since the financial crisis of 2008, the economies of all 45 countries tracked by the Organization for Economic Cooperation and Development expanded. This synchronized global economic recovery not only drove the Dow Jones Industrial Average higher, by a surprising 25 percent in 2017, but also helped many global stock markets end the year at record or multi-year highs. U.S. GDP grew by 3 percent for two consecutive quarters as regulation rollbacks and potential corporate tax cuts appear to have lifted business and consumer confidence. Earnings for companies in the Standard & Poor's 500 Index, which were expected to rise by 9 percent at the beginning of the year, ended up rising 14 percent in 2017. A weaker dollar and higher oil prices, both a result of improving international growth, were primarily responsible for better corporate earnings.

The U.S. recovered more quickly from the financial crisis; however in 2017 other countries began to catch up. In fact, international stocks performed even better than U.S. equities for the year, fueled by emerging markets, which returned over 37 percent. Despite improving economic fundamentals, inflationary pressures remained muted in developed markets, which helped bonds offer low and yet positive single-digit returns. In the U.S., corporate bonds outperformed government debt.

STOCKS: RALLY AROUND THE WORLD

As the economic expansion spread beyond the U.S. into Europe and Japan, stocks around the world rallied, with many markets ending 2017 at record highs. U.S. stocks rose 6.4 percent in the fourth quarter and 21.2 percent for the year. Large multi-national companies, which benefit from their exposure to international markets and a weaker dollar, handily outperformed small and mid-size companies. This despite the fact that the territorial tax-reform package passed by Congress in December 2017 is more beneficial to smaller companies since a larger portion of their earnings are taxed in the U.S.

In 2017 international stocks, which had lagged U.S. markets since the financial crisis, began playing catch up. The MSCI All-Country World Index-ex U.S. returned 5.2 percent during the quarter and 27.8 percent for the full year. Within international markets, emerging markets continued their out-performance with a strong 37.3 percent return in 2017. Emerging markets are correlated to commodity and currency movements and both were favorable in 2017. A weaker U.S. dollar along with increased demand for...
commodities drove emerging market stocks. Within emerging markets, strong economic growth in China and India drove gains of 54.1 and 38.8 percent respectively, South Korea with its information technology exposure recorded a 30.1 percent gain, and commodity producers such as Brazil and Chile benefited from strengthening developed market demand and higher oil prices as the global synchronized economic recovery gathered momentum.

**BONDS: MODEST POSITIVE RETURNS**

Despite an accelerating global economic recovery, bonds offered U.S. investors low, single-digit, positive returns in 2017. The Bloomberg Barclays U.S. Aggregate bond index was up 0.4 percent in the fourth quarter and 3.5 percent for the year. All major fixed-income sectors posted positive returns as muted inflation and low yields on cash drove record inflows into fixed-income funds. The yield curve flattened throughout the year as short rates were driven by steady normalization of the federal funds rate, while the 10-year Treasury yield barely moved as there was little upward pressure from inflation. The Federal Reserve raised rates three times in 2017, and as a result, yields on the 2-year Treasury bond moved up 69 basis points. On the other hand, the 10-year Treasury moved down 3 bps ending the year at 2.41 percent. The 2-10 year spread tightened from 123 basis points to 51 basis points at year end.

Strong demand, positive economic releases, and improving credit fundamentals drove the investment-grade credit sector to outperform. Investment-grade credit spreads tightened throughout the year and the Bloomberg Barclays U.S. Credit Index returned 1.0 percent for the quarter and 6.2 percent for the year, outperforming both mortgages and U.S. Treasuries. Taking credit risk was rewarded for the year as BBB-rated securities outperformed higher rated credits.

The Bloomberg Barclays High Yield Index had the strongest performance returning 0.5 percent for the quarter and 7.5 percent for the year. High-yield continues to benefit from the steady pace of economic expansion and healthy credit fundamentals as defaults moved down and cash flow generation remained strong. Emerging market bonds returned 0.5 percent in the quarter and 9.3 percent for the year, benefitting from the global synchronized economic expansion, recovery in oil and commodity prices, a strong Chinese economy, and reduced fears of a destructive NAFTA overhaul.

Municipal bonds also posted solid positive returns despite record setting issuance of $63 billion in December. Issuance was heavy to get ahead of the passage of tax reform taking effect in 2018. The Barclays Municipal index returned 0.7 percent for the quarter and 5.4 percent for the year. The tax law that was recently passed should not be as detrimental to the municipal market as originally thought because it did not significantly change the top marginal tax brackets which might have reduced demand and made it more expensive for municipalities to refinance their debt which will likely reduce supply.

**CURRENCIES: U.S. DOLLAR RECORDS WORST YEAR SINCE 2003**

Last year the Wall Street journal Dollar Index, which measures the U.S. currency against a basket of 16 others, dropped 7.5 percent – its first drop in five years and its worst performance in a decade. A big part of the dollar’s decline in 2017 was due to the strength in the euro. The euro strengthened sharply in anticipation of rates being raised in Europe, largely eroding the U.S. interest-rate advantage. Investors also bet that a synchronized global economic recovery would result in faster monetary tightening outside the U.S. and more central banks around the world will begin unwinding nearly a decade of post crisis stimulus policies in 2018.

**COMMODITIES: DISCIPLINED OPEC HELPS CRUDE OIL RALLY**

Crude oil futures ended the year above $60 a barrel for the first time in two years. Members of OPEC were disciplined in executing production cuts and agreed to extend the cuts into 2018 to reduce excess oil inventories and bring supply in balance with demand. Production hiccups in the North Sea and Libya, along with geopolitical tensions in Iran and falling production in Venezuela, have also helped support oil prices.

WTI crude oil futures rose 15.6 percent in the fourth quarter and were up 4.1 percent in 2017. The Bloomberg UBS commodity index, which tracks 22 commodities, rose 4.7 percent in the fourth quarter and was up a modest 1.7 percent in 2017.

**OUTLOOK 2018: STEADY GLOBAL GROWTH**

The U.S. economy ended the year with positive momentum, and we expect it to further benefit from fiscal stimulus through tax cuts, regulation rollback, and a positive shift in business and consumer confidence in 2018. Over 2 million jobs were created in 2017 by the economy, and the unemployment rate ended the year at a low of 4.1 percent. Labor markets appear to be at or near “full employment” and the probability of upward wage pressures has increased. However, secular headwinds of an aging population and displacement of labor due to technology will continue to restrain inflation. This will force global central bankers to be very slow in reducing monetary accommodation. The manufacturing sector should benefit from improved global growth and we see few signs of a recession in 2018. While monetary policy around the world remains accommodative and inflation pressures are still low, the Federal Reserve, along with
other central banks, are reacting to the global economic recovery and beginning to reduce easy money policies. The Federal Reserve is expected to raise rates three times in 2018. The European Central Bank and even the Bank of Japan are moving toward either reducing or ending their asset purchase programs and preparing financial markets for eventual rate hikes. Monetary policy will become a headwind to financial markets. However, since inflationary pressures remain subdued we expect central bankers to tighten gradually.

The tailwinds which underpinned equity markets in 2017 (low interest rates and inflation, steady earnings growth across sectors, and global growth) will now be joined by the additional benefit of successful U.S. tax reform in 2018. As such, it is reasonable to believe that the burgeoning economic recoveries around the world will continue to take their cues from the ongoing strength in the U.S. economy. We believe equities will continue their relative outperformance given the entrenched nature of the aforementioned tailwinds. In particular, earnings growth appears poised to continue its key role in driving equity outperformance as companies in the consumer, material, and industrial sectors begin to demonstrate financial benefits from the global synchronized recovery. Though technology companies may not duplicate their recent momentum, we don’t expect the secular demand trends propelling their results to reverse.

We anticipate 2018 to be driven by many of the same trends seen in 2017, and continue to look for exposure to quality companies within sectors and geographies that would benefit from sustained synchronized global growth. We believe there may be more value in international equities, particularly emerging market stocks, because they are playing catch-up to the strong performance of U.S. equities since the end of the financial crisis. Risks to our current outlook include excessive appreciation in commodity prices or wages, which could cause an undue rise in inflation or interest rates, thus dimming the relative allure of equities.

We anticipate that in 2018, fixed-income returns will likely be more muted than last year’s strong results. Spreads have reached pre-crisis levels meaning there is less room for spread compression to drive performance, leaving investors with the carry, which is low. Also, there is pressure on the front end of the curve as the Fed would like to hike rates three more times in 2018. Without a further increase in inflation this will likely cause the yield curve to flatten with short rates going up more than long rates.

We maintain an underweight position in short and intermediate U.S. Treasury bonds and government mortgages in favor of sectors that offer spread and interest income. We are tactically underweight mortgages because of the Fed’s plan to reduce its balance sheet. We continue to be overweight investment grade credit and high yield bonds. With no recession in sight, we expect credit fundamentals to continue improving. We continue to see value in municipal bonds. Demand from buyers should remain strong given the small reduction in the higher marginal tax brackets. Diminished supply as a result of tax reform should be supportive of municipal bond prices.

We expect oil prices to be supported by OPEC production cuts, outages, and geopolitical risks. However, higher oil prices are also likely to increase U.S. shale production and cap prices near $60 per barrel. We have no position in commodities, but maintain positions in material and energy stocks and energy pipelines. We expect the U.S. dollar to do better than in 2017. The dollar faces downward pressure as investors bet on faster monetary policy tightening outside the U.S., and more central banks around the world to begin unwinding nearly a decade of post-crisis stimulus policies in 2018, paving the way for interest rate increases down the road. This would reduce the gap in yields between the U.S. and other developed economies. Shifts in capital flows from the U.S. to resurgent international economies should also weigh on the dollar. However, it is unlikely that export-oriented foreign countries are going to sit still and watch the weaker dollar hurt their industries.

**KEY RISKS:**

**Interest Rates** – Inflationary pressures and Fed balance sheet unwind cause interest rates to move up faster than what the market expects.

**China** – A hard landing in China poses one of the biggest risks to stocks and other risk assets.

**Geopolitical** – North Korea, Middle-East, cyber-attack or increase in terrorism.