2018 MARKET OUTLOOK

In our annual market outlook, we review the key themes that are likely to drive investor sentiment during the year, the most relevant changes to the tax code and our outlook for each of the asset classes we invest in on behalf of our clients.

2017 was a very strong year for investors across global asset classes. 2018 should bring more of the same in the early months of the New Year. Why the optimism? How about:

- Rising forecasts for economic growth, both in the U.S. and abroad
- Strong employment numbers
- Low interest rates
- The prospect of rising wages here in the U.S. thanks to the tax law changes

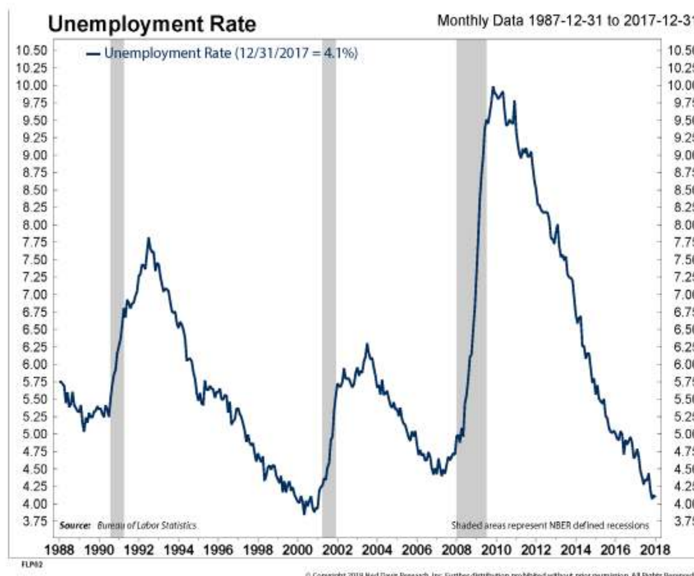
WILL THE FED CRASH THE PARTY?

We begin with the Federal Reserve ("Fed") and the state of inflation in the U.S., as we believe the interaction between the two in the year ahead is likely to dominate the financial headlines and be a key driver of investor expectations.

The U.S. labor market begins 2018 with significant momentum given an ***unemployment rate that is sitting at its lowest level in 17 years*** and likely heading lower. Current levels of unemployment coupled with a low rate of inflation are largely unprecedented in U.S. history. Inflation as measured by the Consumer Price Index (CPI) is projected to show a rise of just over 2.0% for 2017. Low levels of unemployment typically result in labor shortages and upward pressure on wages that eventually works their way into broader inflation metrics. We expect this historical relationship will reassert itself during 2018 and lead to an uptick in inflation, although the increase may not be dramatic given long-term trends in productivity and globalization. The bond market is already beginning to reflect an increase in inflation with the 10-year implied inflation rate at 2%, up about 65% from the lows experienced in early 2016. If inflation consistently and significantly exceeds the Fed's stated goal of 2% in 2018, the market may be underestimating the extent to which the Fed will increase interest rates. The Fed has guided markets to expect three interest rate increases in 2018, but the futures market reflects a probability of only 43% that they will follow through with this many rate hikes. If our inflation expectations prove to be accurate, it is possible that the Fed could increase interest rates up to four times in 2018.

We will be watching carefully the evolution of Fed policy guidance in relation to both rates and balance sheet reduction as new leadership takes over this important financial institution.

The basic investment implication of our inflation and Fed policy expectations is that fixed income markets could be in for tough sledding while companies that benefit from rising interest rates (e.g., banks) and/or exhibit significant pricing power (e.g., HMOs) will become increasingly valuable.



Volatility - Or A Lack Thereof

Perhaps the financial market story of the year in 2017 was the utter lack of price volatility, particularly in the large cap segment of the U.S. stock market. The S&P 500 tallied exceptional gains without falling more than 2.8% from peak to trough at any point during the calendar year. The stability of interest rates, while less heralded, was also remarkable, even as the Fed steadily pushed short-term interest rates higher. The lack of financial market volatility was even more surprising as it occurred in a period of extreme volatility in the outlook for change in public policy. Public policy expectations swung from an unexpected result in the 2016 election, back to gridlock and finally culminated with an overhaul of the tax code late in the year.

While past episodes of low volatility have sometimes persisted for years – as noted in our 6/30/17 newsletter – we expect the eerie calm that has settled over financial markets over the past year or so will break at some point later in 2018. While a return to normal levels of volatility could prove disquieting to investors who have grown accustomed to steady gains, we believe it would be a healthy development for financial markets. Indeed, there are many potential catalysts for an increase in financial market volatility. Rising inflation and interest rates could certainly inject some uncertainty during 2018, but so too could shifts in the political landscape that to date have been taken in stride by financial markets. The partisan political climate and looming mid-term elections also seem like a potential recipe for higher volatility in 2018 but that remains to be seen. Events that could increase political uncertainty further are numerous, with a geopolitical mishap, the Mueller investigation, and additional policy changes pushed through quickly by a majority with a limited window of opportunity representing just a few examples.

If economic fundamentals remain intact, a return of volatility due to political uncertainty could provide attractive buying opportunities during the year.

“we expect the eerie calm that has settled over financial markets over the past year or so will break at some point later in 2018.”

Uncle Sam

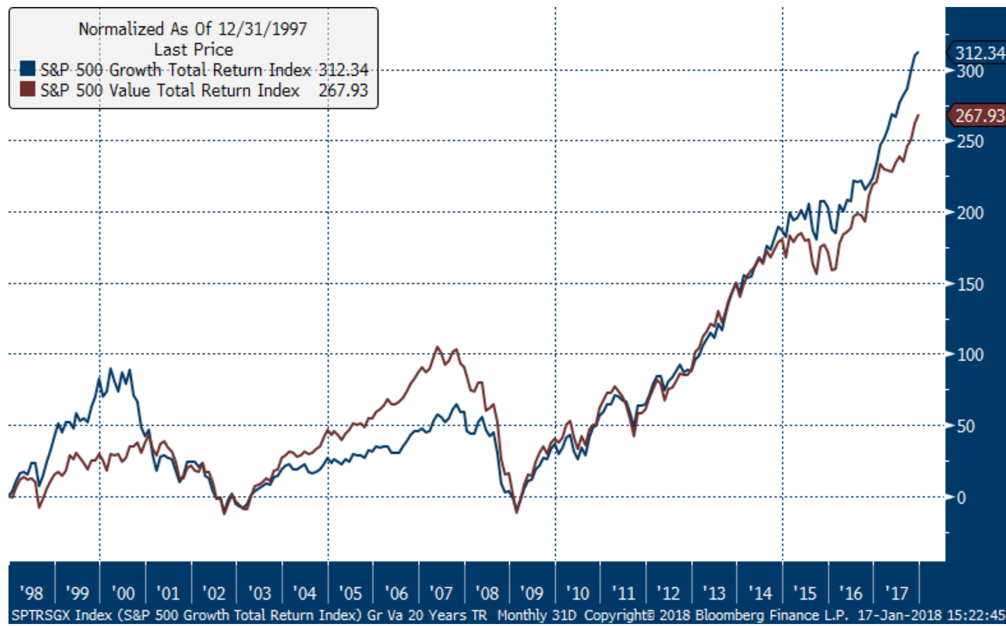
While tax policy has clearly shifted under the new tax regulations, the ultimate impact on individuals and corporations is still being sorted out and this process will take some time before the full picture is understood. The fear has been that corporations will use the additional earnings solely for the benefit of their shareholders by buying back stock and hiking dividends. However, this may be too cynical a view. Early evidence suggests that employees may also be a major beneficiary via higher wages and that some of the tax savings may well make their way into the broader economy in the form of new capital investment. In many cases, these investments likely would not have been made under the old tax code.

See page 6 for a breakdown of the most meaningful changes in the tax code as it relates to individual taxpayers in particular.

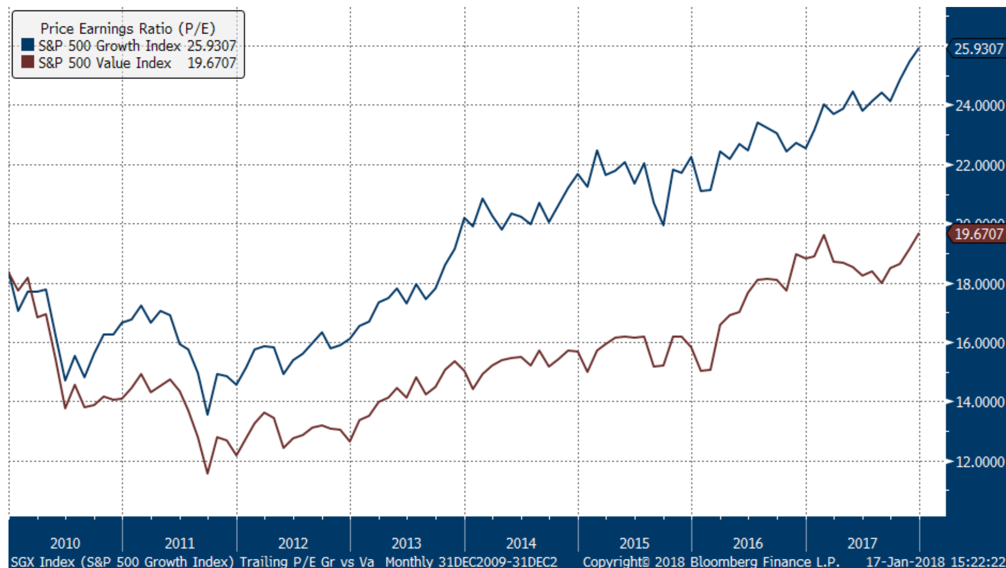
Growth vs. Value - Don’t Underestimate the Tortoise

The story of the tortoise and hare is an oft-cited, if not trite, allegory for successful investing. When it comes to the topic of growth vs. value investing however, it is an inescapable analogy. ***Growth companies are the fast growing, innovative, up and comers that have stock prospects to match.*** Technology and biotech stock are prime examples. ***Value companies tend to be stodgy and boring, but with steady, plodding growth and stock performance to match.*** Big oil and banks as examples are some of the main players. The race between growth and value stocks has been playing out for nearly 100 years, and like the fable, there are periods where growth outperforms, until inevitably, value catches up. Using the last 20 years as a sample, growth dominated value in the mid-to-late 1990s until the technology bubble burst and value had a similar period of dominance.

Growth vs. Value - Don't Underestimate the Tortoise cont.



The race has continued in similar fashion, but in the wake of the financial crisis of 2008, growth stocks (the hare) have led the race and in 2017, left value stocks (the tortoise) in the dust: Growth stocks returned 27.5% while value stocks returned 15.4%. Unavoidably, as growth stocks outperformed, the valuation measures between growth and value have sharply diverged. Looking back to the start of 2010 as the market showed signs of emerging from the financial crisis, both the growth and value indexes had a P/E ratio of 18.4. Since that time, the growth index P/E has expanded to 26 times while the value index has expanded to only 20 times. It certainly can be argued that this gap in valuation has been earned as growth stocks have delivered excellent earnings growth while value stocks have struggled in comparison. History suggests that ultimately investors will rotate toward more attractive relative valuations. Macro indicators are also lending support to value stocks as higher interest rates and oil prices will favor large banks and energy companies. Value stocks also tend to gain favor as volatility increases.

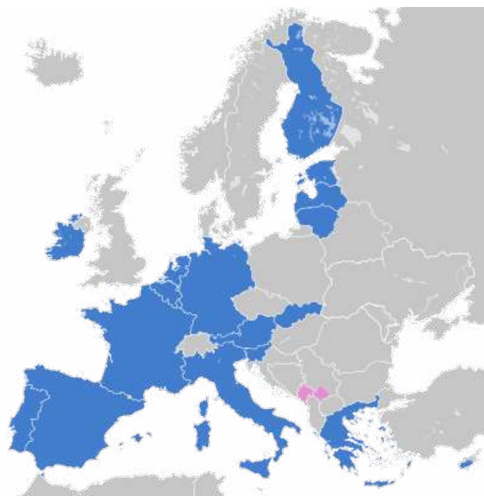


As we start 2018, the lesson for investors has echoed for generations: Don't underestimate the tortoise.

Cast Your Eyes Across the Sea

Synchronized global expansion continues.

Economic conditions across most developed markets remain buoyant, with both the Eurozone and Japan now in clear recovery mode from the financial collapse of 2008. While tightening labor markets and increasing capacity utilization might portend wage growth and rising costs, inflationary pressures in the Eurozone and Japan remain subdued and monetary authorities appear committed to an accommodative stance over the near-term. In contrast to the U.S., which we believe may be entering the latter stages of its economic recovery, international economies appear to be earlier in theirs. The implication is that international economies have more potential for sustained growth as well as the possibility of accelerating growth during the course of 2018.



The Eurozone

International equity markets still provide opportunities.

With this positive economic backdrop, we expect continued economic expansion, corporate earnings growth and improved corporate profitability. While it's true that recovery among the Eurozone economies remains uneven – with peripheral countries still seeing high unemployment and the UK's exit from the European Union posing long-term risk to the UK economy – Japan's solid economic turnaround is often overlooked. Restructuring efforts in countries like France – along with the collateral impact of higher near-term growth in the U.S. via tax reform – provide incremental support to the already positive economic backdrop. Expectations for better relative fundamental performance from these overseas economies – both in terms of economic growth and fiscal outlook – in turn augurs well for foreign currencies relative to the U.S. dollar (see page 5). This positive currency effect is likely to provide yet another tailwind for U.S. dollar-based investors.

Valuations, while no longer cheap, are still attractive relative to the U.S.

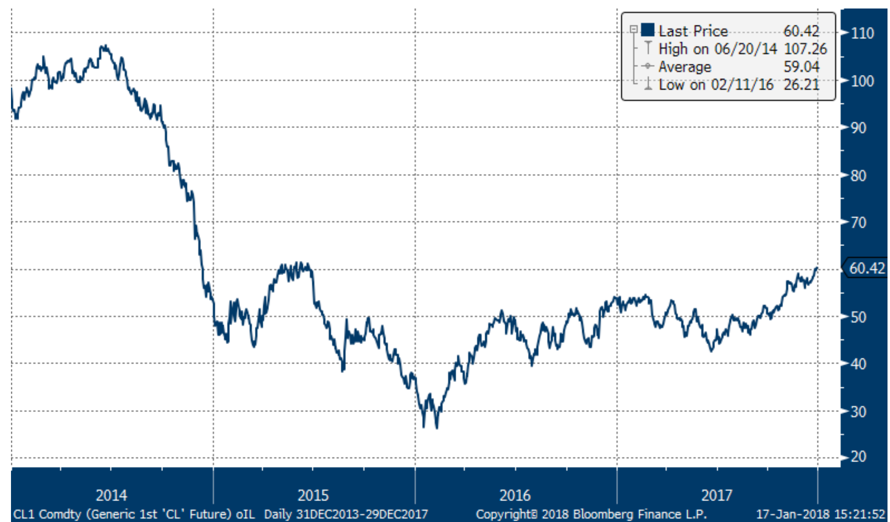
The 12-month forward price/earnings ratios for EAFE index (developed international markets) and the TOPIX index (Japan) are 14.9 and 15.9 times, compared to 19.9 times for the S&P 500 (U.S.) – see chart above. While geopolitical risks such as North Korea's nuclear program, Saudi Arabian and Iranian proxy wars, and potential U.S.-China trade frictions remain and could crimp market optimism, we feel they're more likely to take a back seat to economic fundamentals and financial performance, as they did in 2017. Further, as U.S. and international economies increasingly diverge with respect to monetary policy (tighter in the U.S.) and interest rate regime (steadily rising interest rates in the U.S.) during 2018, we expect international markets to continue to deliver strong returns on a relative basis.

Downward Dollar

The U.S. dollar fell 10% during 2017 versus an average annualized return of 0.1% over the past 40 years, according to Ned Davis Research. Importantly, this dollar decline had a lot to do with the strong returns experienced by U.S. investors on international investments last year. We expect more of the same in 2018, as the dollar appears overvalued versus most other currencies based on Purchasing Power Parity comparisons and negative economic differentials (i.e., non-U.S. industrial production is now rising faster than U.S industrial production). True, interest rate differentials favor the U.S. dollar (i.e., interest rates are higher in the U.S. than internationally) but economic differentials tend to be more influential in a low-yield environment. Recently passed U.S. tax reform also suggests dollar weakness as it's likely that the U.S. budget deficit will widen as a result. In stark contrast, many European countries have budget surpluses or receding deficits, which is dollar-negative.

Bottom line: Our expectation of further dollar weakness in 2018 - coupled with lower valuations overseas - leads us to reiterate our positive outlook on international investments for U.S. dollar-based investors.

Energy Prices Are on the Rise



As much as the lack of volatility in the equity markets has been enthralling, the pinball action in oil prices has captured investors' attention in recent years. Oil prices peaked in the fall of 2014 and proceeded to fall by 75% over the following 18 months as investors realized that growing oil supply from U.S. shale wells was swamping slow but steady demand growth. Oil prices bottomed in early 2016 and the market has since tried to gauge the scale of the supply and demand imbalance and how long it will take for the market to find equilibrium. When the market turned down in 2014, Saudi Arabia, the largest producer in the OPEC cartel, contributed to the pressure by attempting to push upstart U.S. producers out of the market by ending a decades long practice of supporting the oil price. At the same time, the global economy was far from firing on all cylinders, with major growth worries surfacing in China, one of the key drivers of oil demand, all of which served to put downward pressure on oil prices.

Today the oil market is in a very different position – the Saudis are once again supporting the market by limiting supply and the global economy is in a synchronized upturn, pushing demand higher. With supply and demand moving in the right directions, global oil and product inventories are being worked down and the price of oil per barrel is responding to the upside, moving into the low $60s. The concern in the oil market today is that OPEC has been replaced as "swing producer" by the collective U.S. shale producers, whose breakeven costs have come down significantly over the last three years. The idea is that higher prices will incentivize U.S. producers to grow production, taking the market back into an oversupply situation. While U.S. production will likely be up in 2018, the majority of global oil production, which is from more conventional oil fields, is under pressure after three years of underinvestment. It appears unlikely that U.S. shale production will grow enough to offset the volume pressures elsewhere in the world and higher demand levels as the global economy advances.

While we expect the typical seasonal trends in oil and oil product prices, the price of oil appears poised to move higher in 2018 as underinvestment in recent years begins to bite. We believe that the benchmark U.S. oil price will approach the $70 mark in 2018, likely benefiting energy stocks globally.

	CURRENT TAX LAW	NEW TAX LAW
PERSONAL TAX RATES	Seven tax brackets: 10%, 15%, 25%, 28%, 33%, 35%, 39.6%	Seven tax brackets: 10%, 12%, 22%, 24%, 32%, 35%, 37%; 35% bracket starts at $200,000 single/$400,000 married and 37% bracket starts at $500,000/$600,000
MAXIMUM PASSTHROUGH TAX RATE	39.6%	Ordinary rates with deduction of 20% of qualifying domestic income; limited deduction for income from lower-income service businesses. Service businesses excludes engineers and architects
MAXIMUM CORPORATE TAX RATE	35%	21%
PERSONAL STANDARD DEDUCTION	Married filing jointly: $12,700; Head of household: $9,350; Single: $6,350	Married filing jointly: $24,000; Head of household: $18,000; All others: $12,000
PERSONAL EXEMPTION	$4,050	Repealed
CHILD TAX CREDIT	$1,000 per child	$2,000 per child (refundable to $1,400 per child); $500 for non-child dependents; phase outs increased to $200,000/$400,000
PERSONAL STATE INCOME, SALES TAX & PROPERTY TAX	Allowable as an itemized deduction	Deduction for property tax and either income or sales tax limited to $10,000
MORTGAGE INTEREST	Deductible on up to $1.1 million of debt; interest on second home deductible	Deductible on up to $750,000 of debt (including second home); no home equity interest; $750,000 limit effective for debt incurred after 12/15/17
MEDICAL EXPENSES	Deductible to the extent they exceed 10% of AGI	Deductible to the extent they exceed 10% of adjusted gross income (AGI) (7.5% of AGI for 2017 and 2018)
CASH CHARITABLE CONTRIBUTIONS	Allowed up to 50% of AGI	Allow up to 60% of AGI
INDIVIDUAL ALTERNATIVE MINIMUM TAX (AMT)	Imposed when minimum tax exceeds regular income tax	Increases AMT exemption amounts and phase-out
ALIMONY	Deductible to payor; taxable to recipient	Not deductible to payor; not taxable to recipient for decrees executed or modified after 2018
INDIVIDUAL HEALTH INSURANCE MANDATE	Individuals penalized for failure to carry minimum essential health insurance coverage	Repealed
AMOUNTS PAID FOR COLLEGE ATHLETIC SEATING RIGHTS	Taxpayer may treat 80% of donation to college as charitable deduction even if they received tickets/seating rights in return	No charitable deduction allowed for any donation in which tickets or seating rights are received in return
529 PLANS	Only allowed to be used for qualified higher-education expenses	Allowed for tuition at elementary or secondary public, private or religious schools up to $10,000
INCOME FROM EQUITY GRANTS	Income from equity grant transferred to an employee in connection with the performance of services is recognized when the stock vests.	Employee may elect to defer income from stock options exercised or RSUs settled for up to five years
GIFTS AND ESTATE TAX	Tax of up to 40% imposed on gifts and estates, subject to a $5.49 million lifetime exemption per spouse	Lifetime exemption doubled ($11.2M/$24.4M); estate tax remains in effect (40% rate). Step-up in basis retained

ASSET ALLOCATION FORECAST

	Asset Class	Outlook
EQUITIES	**U.S. LARGE CAP STOCKS**	Among the top performing asset classes in the world since prior to the Great Recession, U.S. large caps stocks should produce positive returns again in 2018 but we expect the S&P 500 to underperform other major equity asset classes during the year.
	U.S. MID & SMALL CAP STOCKS	These asset classes are considered to be the major beneficiaries of the recent corporate tax cut to 21% and underperformed large cap stocks significantly in 2017. If stocks post positive gains in 2018, mid and small cap stocks would be expected to outperform their large cap brethren.
	DEVELOPED INTERNATIONAL	The valuation gap between international and U.S. equities continues to widen and looks to represent good value relative to the U.S. Extremely low interest rates and accommodative monetary policy coupled with any pickup in growth rates overseas could lead to exceptionally strong performance.
	EMERGING MARKETS	Bright prospects for continued moves higher are tempered by the strong relative performance of emerging markets in 2017. An easing of U.S./North Korean tensions would go a long way to helping emerging market returns, but this seems like a long-shot at best. Either way, we are positive on the prospects for emerging markets.
FIXED INCOME	**MUNICIPAL BONDS**	The impact from tax changes will keep investors guessing as to prospects for municipal bonds in 2018, but with limited deductions available to high net worth investors, municipal bonds should see strong demand.
	CORPORATE BONDS	A strong backdrop for U.S. corporations will be offset by a rising rate environment. Best case scenario for corporate bonds is that they earn their coupons in 2018.
	TREASURIES	Expected to be the worst performing sector of the fixed income market. Given our forecast of rising rates in 2018, treasuries are insurance against a black swan event, but should earn no better than cash returns in the calendar year ahead.
	HIGH YIELD CORPORATES	While this asset class is expensive relative to historical norms, a small allocation to high yield should add diversification to an otherwise investment grade allocation and boost returns slightly.
	INTERNATIONAL FIXED INCOME	Very low yields and rising growth rates abroad make this an unattractive asset class to start the year.
	EMERGING MARKET FIXED INCOME	Unlike developed international markets, emerging markets offer a healthy yield and could garner our interest should global growth rates continue to improve.
	LIQUID ALTERNATIVES	Equity alternatives will offer better downside protection than traditional equity investments but should underperform the traditional markets again in 2018. Credit-oriented alternative investments should outperform traditional investment grade fixed income in a rising rate environment.
	PRIVATE EQUITY	Private Equity investments still look attractive relative to traditional equity investments, however the vintage year is important. For those embarking on a private equity program we would continue to move forward and for those who have built private equity investments over many years, we would recommend a reduced allocation to new investments in 2018.
	PRIVATE REAL ESTATE	Even more than Private Equity, the vintage year of real estate funds is important. Given the duration of the economic recovery, real estate in many geographies has become expensive and the new tax law will have a yet to be determined impact on U.S. real estate markets. We are cautious in our approach to real estate in the current environment.
	HEDGE FUNDS	Volatility pickup should allow skilled long-short managers to deliver solid risk-adjusted returns in 2018 in equity and fixed income funds alike and equity strategies would be expected to produce higher overall returns in the event that global growth prospects sour.

Meet the Investment Team

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$1.7 Billion: Total Assets Under Management
536 Clients
- 93 Instituions
- 443 Individuals and Families

29 Employees
- 7 CFA® chartholders
- 2 CFP® practioners

22 Years
- Average industry experience among the Investment Management Team

Data as of 12/31/17

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