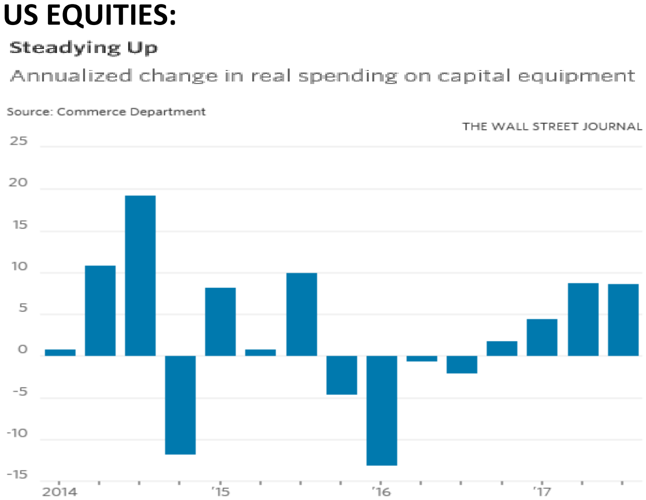
January 2018 Outlook

In many respects, 2017 was a remarkable year. We jumped from a decidedly pessimistic tone in the media's assessment of global markets and economics throughout 2016 to comparisons of the 1990's technology stock-market bubble in the span of about six months. Many investors were introduced to the terms "Bitcoin" and "cryptocurrency" for the first time and many jumped in, underscoring the true risk-on nature of this market. The ten-year Treasury yield of 2.41% finished the year *below where it began* at 2.45% despite three Fed rate hikes and strengthening economic indicators throughout the year. In the face of various concerns coming into the year (surprise election results, extended equity valuations, global politics), **the S&P 500 astounded us all by finishing the year without a single negative monthly return**. This is noteworthy because it has *never happened before!* In fact, the winning streak stretches back to November of 2016. As we write this in the waning days of January, the index is up over 5%, so it looks like the streak will extend to 15 months.

Here's another fact to consider, especially if you still feel stung by the financial crisis which rocked markets nearly a decade ago: The **ten-year trailing total return of the S&P 500 is 10.16%**. 2018 marks the tenth year since the beginning of that atrocious bear market.

US EQUITIES:



We would remind our readers that a turn of the calendar generally does not require a change of investment strategy. This is the time of the year when lists are generated, and predictions are made. Sticking to the fundamentals will show you that equities are still favored in this economic backdrop—a much improved backdrop from previous years. We believe future revisions to the just-released Q4 GDP estimate of 2.60% will be revised up closer to 3.00%. Increased (and temporary) economic activity tied to a rebound from Hurricanes Maria and Irma will likely inflate overall GDP growth. However, there are other factors contributing to growth, as outlined by Justin LaHart in the Wall Street Journal on November 22:

> *Through the first three quarters of this year, capital spending on equipment has risen at a 7.3% annual rate, the fastest pace in three years. The pickup continued in the current quarter: Wednesday the Commerce Department reported that shipments of nondefense capital goods excluding aircraft—something economists look into in order to gauge capital spending—rose 0.4% in October from September. It was the ninth gain in a row for the typically volatile series, marking the longest winning streak since 1994.*

US stocks remain expensive based on historical standards. However, bull markets do not die because of valuations—and history has proven expensive markets can remain expensive for extended periods. Since the corporate tax rate was cut from 35% to 21% late last month, we have seen a predictable scramble among analysts to revise their earnings projections upward. It is said by some that 1% cut in taxes yields approximately $2 in additional earnings for the S&P 500. We have read research from Goldman Sachs and UBS that the 14% tax cut will boost earnings growth for the index by 8.00% to 9.1%.

Current P/E as % of 15-year avg. P/E*

	Value	Blend	Growth
Large	123.0%	125.6%	126.7%
Mid	117.6%	117.3%	118.6%
Small	110.9%	120.6%	132.6%

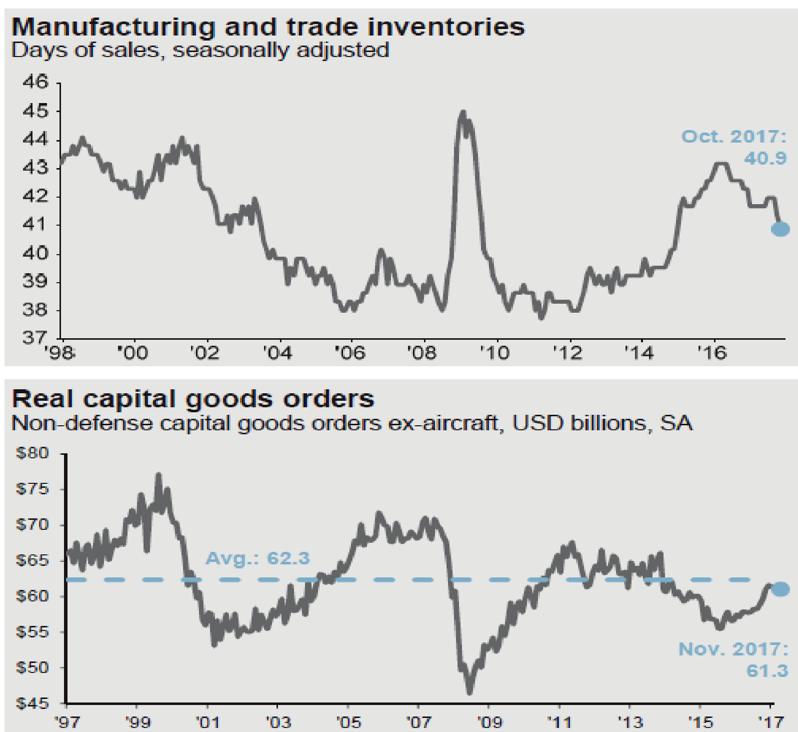
Russell style indexes with the exception of the large blend category, which is based on the S&P 500 Index. Past performance is not indicative of future returns. *Timeframe of average valuation decreased from 20 to 15 years because of a discontinued data series. The new data series is bottom-up calculation based on the most recent S&P 500 Index price, divided by consensus estimates for earnings in the next 12 months (NTM), and is provided by FactSet Market Aggregates.
Guide to the Markets – U.S. Data are as of December 31, 2017.

According to Factset, the median estimate for earnings of the S&P 500 is $132.89 per share (this remains an estimate because Q4 announcements are not complete). As earnings estimates are revised upward the denominator in the P/E relation increases, and P/E itself falls. By no means are we implying stocks become *cheap*, but high earnings growth generally justifies higher valuations.

That said, we think it is important to understand that fiscal stimuli, like tax-cuts, generally have a one-off effect on the markets. Earnings make their one-time upward adjustment, but the game then resumes. It is hoped and assumed (by some) that the lower tax rate boosts US *competitiveness*, which would have a longer lasting, repetitive affect.

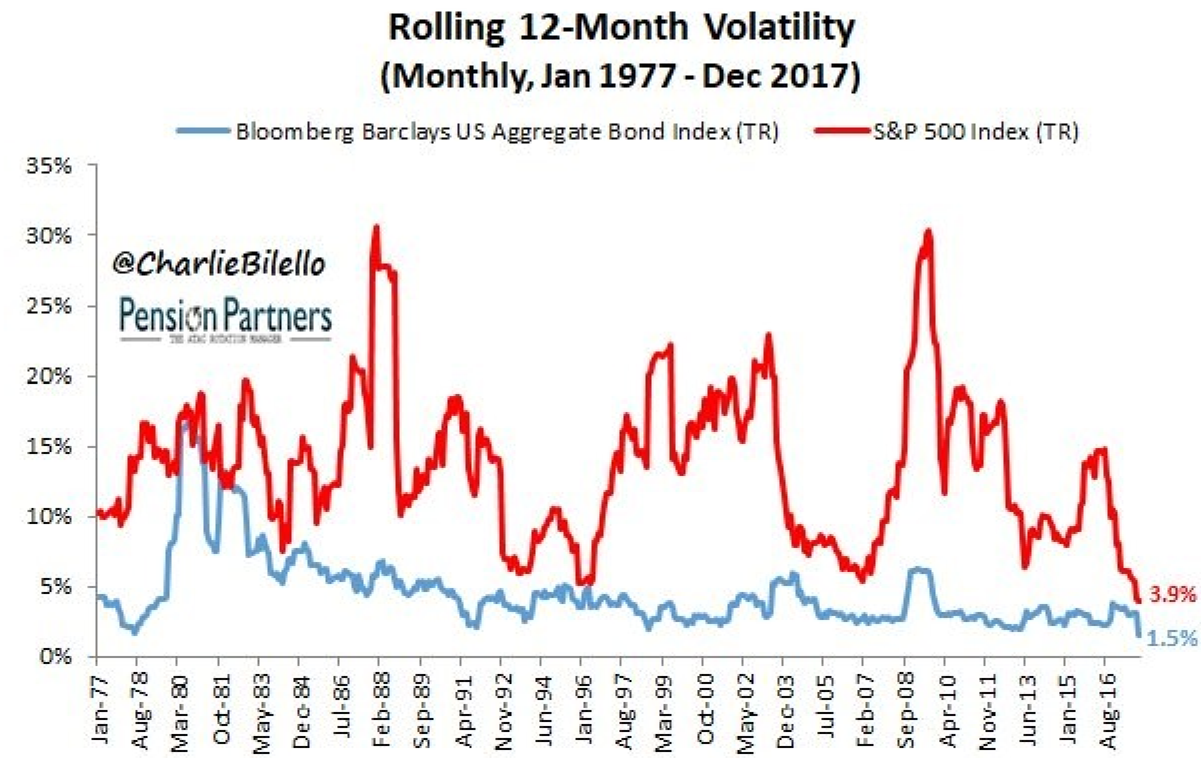
The clear drivers of broad benchmark performance in 2017 were large technology stocks. We commented in our second quarter Outlook last year that the breadth of the market's rally appeared quite narrow. CCR Wealth Management even made some slight rebalancing trades from growth to value late in the year—more to lighten up on the "momentum trade" than to seek out true "value". As the chart above indicates, there's not much value in "value" stocks either.

Our outlook for 2018 includes an expectation of <u>broader market participation</u>. We think the current rally in financial stocks continues as interest rates march upward, fattening the spread between deposit interest obligations and loan interest income. We see energy re-emerging based on steady demand outlooks from a rising global GDP, improved cashflows across the sector, and possible M&A activity. Our "unconstrained" portfolio already made a pivot to these sectors in the fourth quarter. We also think the industrial sector continues to perform well as the tax reform benefits their significant capital expenditure treatments—though the "low hanging fruit" has probably already been picked in many of these stocks. Weakness in the US Dollar has also bolstered exporter earnings. We do not see this trend continuing though. We expect the Dollar to be range-bound against a G10 basket of currencies in 2018. As we've pointed out in many reviews last year, the themes of Artificial Intelligence, Machine Learning and Cloud Computing will be very much alive in 2018 and beyond (they are not themes confined solely to 2017). Technology was a large driver of our portfolios in 2017—though stronger economic growth in the US provides more competition to this sector for the investment dollar.



BEA; (Top and bottom right, bottom left) Census Bureau, FactSet.
Capital goods orders deflated using the producer price index for capital goods with a base year of 2009. SA – seasonally adjusted. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – U.S. Data are as of December 31, 2017.

2018 is another election year. We caution investors against succumbing to "if-then" logical fallacies as they apply electoral outcomes to their portfolios. Certainly, times are good economically, but risks remain. We discuss, in more detail, our heightened expectations for inflation under "FIXED INCOME", below. Rising interest rates could, at some point, begin to offset healthy capital expenditure expectations. Some analysts had anticipated trade policies would be an issue in 2017, but they did not materialize. As actual NAFTA and other trade negotiations play out in 2018, we could see a return of volatility—beginning with Transportation Sector stocks and heavy exporting industries. As sunny as the current economic picture feels, we are reminded of the mean-reverting nature of realized volatility in the markets by this chart sent to us by Michael Gayed and Charlie Bilello of Pension Partners:

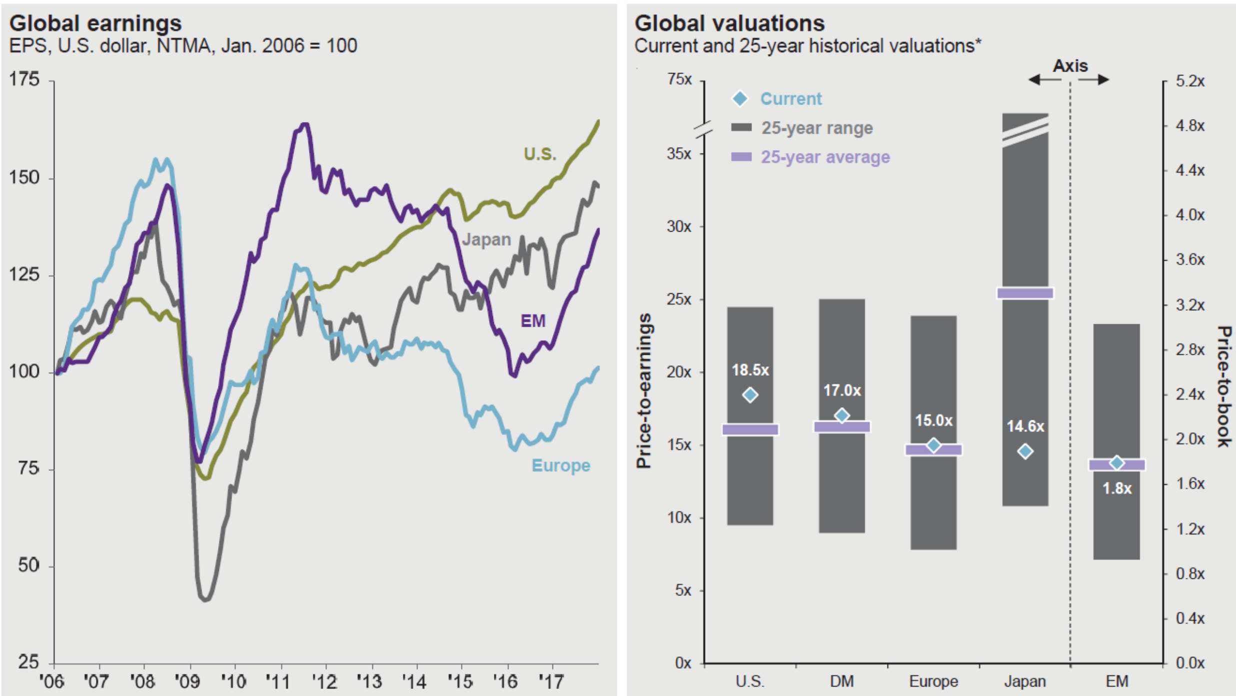


Non-US EQUITIES:

2017, as we pointed out over a year ago, was a "politically risky" period given the post-Brexit rise of populist parties across the European continent, dovetailing with important elections in Italy, The Netherlands, France, and Germany. We did not see (and do not anticipate in 2018) that political outcomes will threaten the expansion of Eurozone growth or the stability of markets. CCR Wealth Management has long held a healthy allocation to non-US developed markets, and

2017 was the pay-day, with our primary asset managers returning 29%-38%--well exceeding even the robust return of the S&P 500.

While "synchronized global growth" seems to be the catch-phrase in the media these days, we point out that market cycles across the globe are anything but synchronized—and this greatly benefits investors seeking diversification given the rich valuations in US stocks.



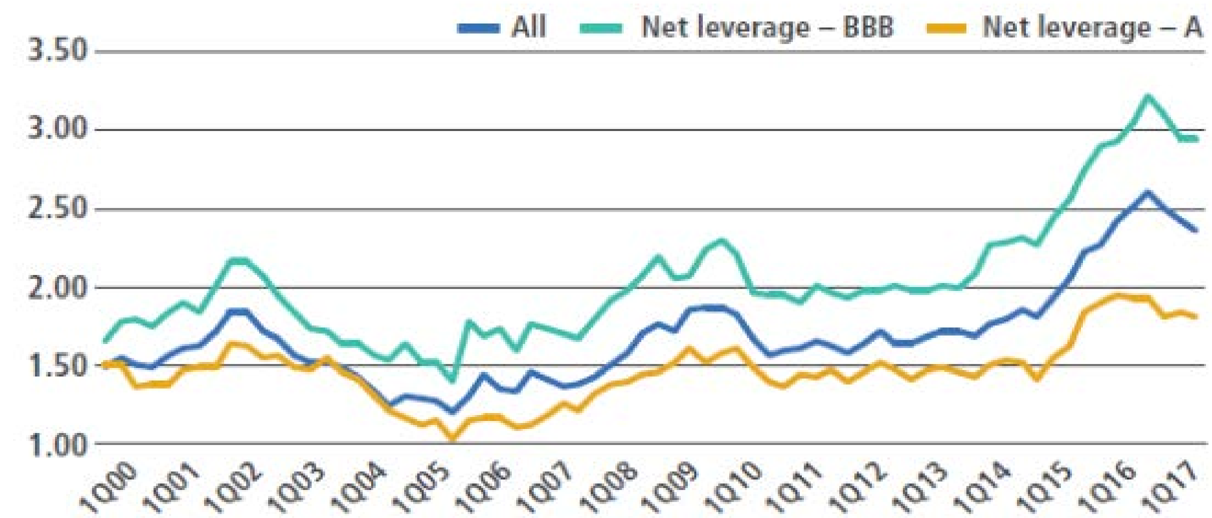
Source: FactSet, MSCI, Thomson Reuters, Standard & Poor's, J.P. Morgan Asset Management.
*Valuations refer to NTMA P/E for Europe, U.S., Japan and Developed Markets and P/B for emerging markets. Valuation and earnings charts use MSCI indices for all regions/countries, except for the U.S., which is the S&P 500. All indices use IBES aggregate earnings estimates, which may differ from earnings estimates used elsewhere in the book. MSCI Europe includes the Eurozone as well as countries not in the currency bloc, such as the U.K., Switzerland, Sweden and Norway (which collectively make up 49% of the overall index). Past performance is not a reliable indicator of current and future results.
Guide to the Markets – U.S. Data are as of December 31, 2017.

While US growth and earnings were sluggish through much of 2014-2015, Europe's debt crisis sent economies into a recession (though mild by recent standards). Ex-US global expansion is in its 24th month, whereas the US expansion is currently in it 103rd month. While monetary policy is well on its way to "normalization" here in the US (and interest rates will become an increasingly decisive market influence), monetary policy around the world remains extremely accommodative, which boosts asset prices. We expect the ECB to continue purchasing assets through 2018, though at a declining rate. Expectations for Eurozone GDP growth are ~2%-2.25%. Unlike the US, inflation is expected to remain uncomfortably low, and we do not envision an actual interest rate increase until well into 2019. We should note that the early portions of market cycles tend to be the most decisively bullish. Given this, and cheaper valuations, CCR Wealth Management maintains significant equity exposure to non-US developed markets, most of which is Euro-centric.

FIXED INCOME & INFLATION:

In recent client portfolio reviews, we have expressed our growing unease with bond valuations. Our concern has been that credit risk has become less compelling to us given historically narrow credit spreads. We began to act in November by eliminating discreet high-yield positions in our model portfolio. We should note that eliminating funds that invest specifically in high-yield does not eliminate the asset class entirely from our bond portfolios as the PIMCO Income Fund and John Hancock Bond Fund have broad latitude in their investment policies. However we have

Figure 1: Net leverage in U.S. investment grade credit markets remains high



Source: J.P. Morgan calculations as of 2Q 2017. Net leverage is defined as (total debt – cash – short term investment) / EBITDA.

spoken to both asset managers recently and they too have reduced high-yield exposure significantly. PIMCO has even produced a white-paper recently expressing caution on BBB-rated bonds, given the rise in leverage this market sector has taken on in recent years by availing ultra-low interest rates. For much of this long bull market, we have pointed to the BBB credit rating (the lowest of the "Investment Grade" category) as being the "sweet spot" for risk-adjusted return potential. This may be changing.

The Bloomberg Barclay's Aggregate Bond index turned in a surprising 3.55% return in 2017. Some of this return may perhaps be a snap-back from the Q4 '16 loss of 2.98%. Never-the-less, this return exceeds our long-term expectation of 0%-2% for this index. Our expectation remains unchanged, especially as our outlook for inflation has increased.

We tuck inflation as a topic of discussion into our Fixed Income outlook because the two are inextricably linked. "Fixing" a portion of a portfolio's return via bonds (so as not to be completely exposed to the whims of equity markets) comes with a countervailing risk. Your return must remain above the rate of inflation lest you lose buying power in the long run. However, bond yields are generally fixed, while inflation is free to advance, if conditions are ripe.

We think conditions are in the process of ripening. Much has been made of the lack of wage growth in this country during the recovery, and even over the last twenty years or so. A shifting economy (manufacturing to information-based), shifting demographics (baby boomers retiring, younger replacements in the workforce being paid less) and automation have all been blamed—and all likely play a part. The Labor Participation Rate has also fallen significantly over the last two decades. This measurement counters the Unemployment Rate (used by the Fed) which often depicts a fully-employed economy by counting the number of working-aged Americans not fully employed (i.e. two or more part-time jobs), or "off the grid", no longer officially seeking full employment.

Chart 5: Participation Rate (%)

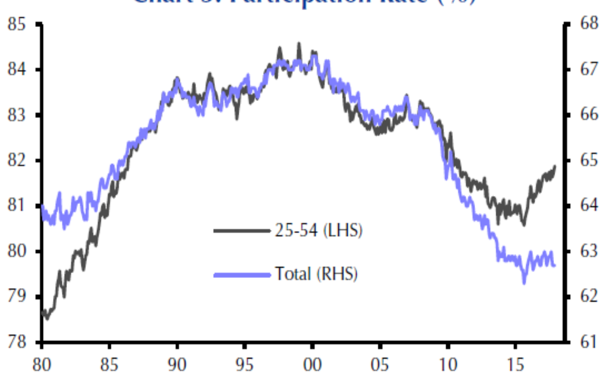
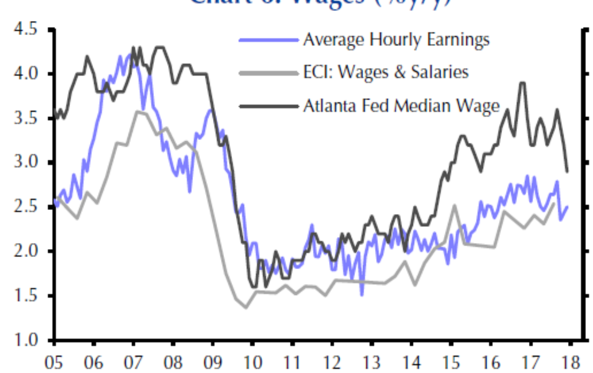


Chart 6: Wages (%y/y)



In a recent research piece titled "Rebound in inflation could be the big story in 2018", Capital Economics lays out the case that a confluence of indicators, from output and economic activity to capital investment indicators will likely push the core rate of inflation higher in the coming quarters. We feel the most influential of these indicators surrounds the very tight labor conditions in the US (4.1% unemployment), with the prospect of wage inflation being the potential spark.

The strength of the labour market has been drawing more people into the labour force. The prime-age participation rate has recovered around half of its decline since 2007 (5). So far, there have been few signs that very tight labour conditions are feeding through to higher wages (6), but we suspect that wage growth will pick up gradually this year.

As a result, we swapped our high yield bond funds into a Treasury Inflation Protected ETF in November. To be sure, this is a very modest allocation across all portfolios, in which high yield funds were held. We continue to allocate TIPs modestly across portfolios both to increase the credit profile of our bond holdings and own a type of bond which makes an adjustment to its "fixed yield" based on CPI data.

Another reason to discuss inflation under the Fixed Income heading is its direct relationship with interest rates (which of course are a primary influencer of bond prices). The Federal Reserve is charged with a "dual mandate": to promote full employment and to adjust money supply to combat excessive inflation (i.e. promotion of "price stability"). While inflation has been virtually non-existent in the US since the financial crisis, the promotion of "full employment" appears to be complete. If our thesis of higher than expected wage-growth plays out in the months ahead, we think a shift in the expected pace of Fed rate hikes in 2018 could rise from three to four. Data to motivate such an adjustment would necessarily be a "surprise", and therefore we would see the potential for a reintroduction of volatility—not only into the bond market, but into equity markets. This is important because interest rates underpin virtually all asset pricing mechanisms.

While we see inflation as being a potential issue in 2018, we think it important to point out that opinions vary among market participants. On a recent call with Jeff Givens, co-PM of the John Hancock Bond fund, he downplayed expectation of increased core inflation until late 2019. Also, we should clarify that we are not expecting a "spike" in inflation anytime soon, nor are we acting by loading up on "hard assets" like commodities. Our concern, rather, is with the reaction to market-wide adjustments of expectations, and the ensuing volatility which could be attendant.