2017 REVIEW

While we expected to see improving economic growth and positive equity returns in 2017, it is fair to say that the pace of economic growth and market returns exceeded our expectations. Although tax reform did not become law until the end of the year, the anticipation of potential business-friendly tax reductions led to increased confidence from businesses of all sizes. Regulatory relief occurred throughout the year and it positively impacted business investment and corporate profitability. That along with an improvement in consumer confidence helped to drive the better-than-expected economic growth for the year. The economy is expected to have grown at a 3.0% annual pace in the fourth quarter, and if that happened it would mark the first time since 2004 that we have seen three consecutive quarters of GDP growth above 3.0%. Equity markets responded positively to increasing confidence, improved economic activity, and rising corporate profits. The S&P 500 gained 21.8 % for the year, the best annual return since 2013. Cyclical sectors and companies outperformed more defensive areas of the market, as is expected when growth is improving. The Federal Reserve (Fed) continued to normalize interest rates, raising short-term rates three times. In addition, the Fed began the process of reducing the size of its balance sheet. This process is expected to be slow and take place over several years. Despite the increase in short-term interest rates and the increase in GDP growth, longer-term interest rates remained relatively unchanged for most of the year.

MOMENTUM FOR 2018

There is no reason to believe that the positive momentum in both the economy and the financial markets will not continue this year. All the positive drivers of growth remain in place and the addition of tax cuts could spur more business and consumer spending. The recently passed tax cuts will have a real tangible impact on the overall economy and corporate profits. As we have expected for some time, 2018 will be the year that fiscal policy becomes the main driver of the economy, which is not to say that the Fed will not be active. We still expect the Fed to continue its course of normalizing interest rates and reducing the size of its balance sheet, but these actions should not significantly impact the markets or the economy. The global economy is also showing signs of momentum, and exposure to international economies and markets should be beneficial. On the political front, we will see key elections in Brazil, Italy and Mexico as well as mid-term elections in the U.S. These elections, along with an elevated level of geo-political tensions, the implementation of Brexit, and the uncertainty about U.S. trade deals could all lead to increasing volatility or short-term market disruptions. However, the fundamentals of the economy and the financial markets remain strong, and they are the key to long-term market performance.

The Economy is Supported by the Healthy Consumer.

The consumer has been the primary driver of the economic recovery that began in 2009. Consumer spending accounts for two-thirds of GDP and it has grown on average 3.8% a year over that time. The consumer continues to benefit from the health of the labor market, modestly rising wages, and healthy balance sheets. The economy added an average of 171,000 jobs per month in 2017, and the unemployment rate ended the year at 4.1%. Stronger economic growth should continue to lead to job gains this year. However, with the unemployment rate at 4.1%, it will be harder for employers to find new workers. Wage gains have been relatively modest, rising around 2.5% a year for the past few years, but to retain employees and fill vacant positions, companies will likely have to increase wages at a faster pace. We expect another year of healthy consumer spending, supported by the strong labor market, rising wages, and the impact of the tax cuts.

Business Investment is Expected to be a More Consistent Contributor to Growth.

Throughout the recovery, business investment has been inconsistent, sometimes adding to GDP growth and other times negatively impacting growth. More recently, we have seen business confidence rising for both small businesses and large corporations which generally translates into future investment. Surveys from U.S. small businesses show that they are seeing increased demand for goods and services, which is driving a need to hire more workers. The increased demand is also leading to increasing trucking and rail activity, which is testing current capacity of drivers and trucks. Industrial production is rising and available capacity at factories is declining due to some increase in demand. Manufacturing surveys show broad-based gains in activity, which is highly correlated to GDP growth. While some of this increase in activity may have been in anticipation of the tax cuts, we would still expect to see more a positive impact as the new cuts are implemented.

The Positive Impact of Tax Cuts is not Fully Realized.

The ability of Congress and the President to get tax cuts passed before the end of 2017 was a surprise to us and to others. We had begun to be concerned that the cuts would not occur until the first quarter of 2018 and that the momentum in the economy could stall. But now, even with the tax cuts signed into law, the potential positive impact from the cuts does not seem to be fully realized. Polls show that most Americans do not believe that they will be receiving a tax cut, but estimates show that 80% or more should see a tax cut. The federal withholding tables are set to be adjusted on February 15th, and once that occurs, most workers should see an increase in take-home-pay. The corporate tax cuts are already beginning to have an impact as hundreds of companies have announced increased wages, bonuses, contributions to pension plans and other employee friendly initiatives that they have directly attributed to the cuts. The reduction in the corporate tax rate is expected to increase earnings for the S&P 500 by more than 7% in 2018, which, along with pre-tax cut estimates, suggests earnings could grow double-digits this year. The repatriation tax will allow multi-national corporations to bring foreign-sourced profits back to the U.S. at a reduced rate. This could lead to additional business investment and more employee and shareholder-friendly actions that will support the economy.

Equity Volatility Could Increase this Year.

Equity market volatility remained near historically low levels throughout 2017 as markets seemed to absorb the increase in global geopolitical tension without much reaction. The most recent decline in volatility has been associated with rising expectations for improving economic growth, and rising corporate sales and profits. During this time, equity markets have generally moved higher, with down-days few and far between. It has been nearly 400 days since we have seen a 5.0% market decline. This is an unusually long-time period, which we do not expect to see continuing this year. Mid-term elections have tended to lead to increased volatility and the potential for short-term market disruptions as uncertainty about future policy increases. Given the contentious political environment, we would not expect to see a smooth election cycle. In addition, outside of the U.S., we still have the on-going negotiations for BREXIT, Presidential elections in Italy, Brazil, Venezuela, Mexico and Russia, and trade negotiations with significant U.S. partners that could cause short-term disruptions. While the fundamentals are solid, it is not likely that we will experience a straight line higher this year as we did in 2017.

With Inflation in Check the Federal Reserve Should Not Be a Factor.

The Fed raised the short-term Fed funds rate by 0.25% in December, setting the new range to between 1.25% and 1.50%. This marked the third increase for 2017. Forecasts for 2018 show that the Fed will raise the funds rate two to three more times, taking it to a top range of 2.0% to 2.25%. The Fed expects to reduce the size of the securities held on the balance sheet from a peak of $4.5T. The long-term target for the size of the balance sheet is $2.5T, which at the current pace will take well into the next decade to complete. The Fed has been able to be very measured in these processes because, even though unemployment is nearing what is defined as full employment, inflation has remained below target. Inflation, as measured by the Personal Consumption Expenditure (PCE) index, is currently 1.5%, and it has not exceeded the Fed's 2.0% target since 2012. This target is the level they believe to be most consistent with the long-term goals of maximizing employment and providing price stability. Inflation can rise above that level and still be healthy for the economy and, in fact, the long-term average PCE is 3.2%. However, with near-full employment and accelerating economic growth, the potential for increasing inflation pressures does exist. A sustained increase in inflation could cause the Fed to move faster than anticipated.

Equity Markets Remain Attractive.

Given the strength of the equity markets in 2017, it is hard not to question where we go from here. We maintain a positive outlook on the equity markets this year based on the fundamentals of the economy and the outlook for corporate sales and profit growth. There are many ways to evaluate the attractiveness of the equity market. One of the most commonly referred to by investors is the price-to-earnings ratio (P/E). This ratio, at current levels suggests that stocks are fully valued, but with expected earnings increases, there is still room for positive returns without seeing the valuation worsen. Measures that value the equity market relative to other asset classes show that equities are still attractive, especially in comparison to the bond market. Equity market bull runs have often gotten ahead of themselves and needed to pause, but they do not typically end in an environment where economic growth, corporate sales, and corporate profits are rising. We continue to monitor the market for signs of a top, but for now we believe that strong fundamentals will continue to be the foundation of future equity market returns.

Global Economic Growth is Accelerating.

Much of the good news that we are experiencing in the U.S. is also occurring in the major economies around the world. GDP growth is accelerating in both developed and emerging economies. For the first time since 2011, World GDP growth exceeded the 3.5% long-term trend. Expectations are for growth to remain above that trend through the end of 2019. Along with stronger economic activity comes improving opportunities for increasing corporate sales and profit growth. Foreign-based corporations have also experienced a return to year-over-year earnings growth, and that trend should continue along with better economic activity. International markets remain attractive given improving fundamentals, as well as attractive valuation of the equity markets. International equity markets have underperformed the U.S. markets by a substantial margin for the last 5 years, creating an attractive opportunity for relative value. We expect to benefit from the improving economic outlook through our investment in multi-national corporations that will see earnings improve along with the global economy. In fact, the companies that make up the S&P 500 generate 43% of sales from outside the U.S. In addition, where appropriate, we remain invested directly in international companies through an exchange-traded fund.

IMPACT ON YOUR INVESTMENTS

We remain optimistic about the economy and financial markets, and as such, expect to stay close to fully invested. However, we recognize that equity markets are no longer cheap, and so we will look for opportunities to reduce the position size in companies that have outperformed the market and reinvest those proceeds in new opportunities or in current holdings that are under-sized. In the growth portfolio, we are focused on holding companies that offer attractive valuations, and can deliver stronger sales and earnings from a stronger global economy. In the income portfolio, we will continue to identify high-quality companies that pay an attractive and growing dividend, but that also provide some potential to participate in better economic growth. We will continue to take advantage of higher short-term interest rates to invest in high-quality corporate bonds in the fixed income allocation. As we look at the landscape for 2018, we continue to be optimistic and believe that we are well-positioned for the future. We continue to watch for signs of a shift in the long-term fundamental outlook and remain poised to act as we see those changes on the horizon.

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