Market Review & Outlook: Acceleration

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Executive Summary

- *Healthy fourth quarter equity performance finished a strong 2017 characterized by strong earnings growth and limited volatility.*
- *The Tax Cuts and Jobs Act should provide a tailwind for corporate earnings in 2018.*
- *This is a dangerous time to reach for yield in below investment grade bonds.*
- *We do not dismiss concerns, but believe the process of monetary policy normalization is working and that the markets have digested the normalization well.*
- *We still believe equities offer the highest probability of achieving returns greater than the rate of inflation over time because of the unique combination of human ingenuity and organized capital formation.*

Put simply, earnings drove the market higher in 2017. After several flat (or down) years, S&P 500 earnings will most likely grow around 10% for the full year. The French election, anticipated corporate tax cuts and healthy economic trends played supporting roles in motivating better investor sentiment. The Federal Reserve raised interest rates for the third time this year in December and plans for a similar program in 2018. Benign inflation, deliberate Federal Reserve communication, and stable long-term treasury yields have made the monetary normalization process seamless so far. Otherwise, the world seems pretty chaotic. Natural disasters have damaged a tremendous amount of property in the United States and Puerto Rico. The political tenor at home and abroad is negative and intense. North Korea and Iran remain provocative and we are reminded too often that the threat of terrorism is real and very difficult to detect beforehand. As we enter 2018, economies around the world are on a good trend. The recently enacted tax laws in the United States will reduce the US corporate tax rate to a similar level as the rest of the developed world. Investors are still confronted with relatively high valuations for common stocks and very low yields for bonds.

Healthy fourth quarter equity performance finished a strong 2017 characterized by strong earnings growth and limited volatility. Despite the strong earnings growth, valuations raise concerns among many that the equity market has reached some sort of zenith. At 18 times estimated 2018 earnings, stocks are definitely not cheap by any historical measure; however, valuations are not at levels seen in 2000, arguably the last incident when stock prices fell predominately because they were

Equity Market Index Returns

As of December 31, 2017

Asset Class	Index	4Q 2017 (%)	1 year (%)	3 years (%)	5 years (%)	10 years (%)
Large Cap U.S.	S&P 500 Index	6.64	21.83	11.41	15.79	8.50
	Russell 1000 Large Growth Index	7.86	30.22	13.80	17.33	10.00
	Russell 1000 Large Value Index	5.33	13.66	8.64	14.03	7.10
	DJ US Select Dividend Index	6.19	15.44	11.47	15.57	8.83
Mid Cap U.S.	S&P 400 Mid Cap Index	6.26	16.25	11.15	15.01	9.97
Small Cap U.S.	S&P 600 Small Cap Index	3.96	13.22	11.99	15.99	10.43
Developed International	MSCI EAFE Index	4.24	25.02	7.79	7.90	1.94
Emerging Markets	MSCI Emerging Market Index	7.44	37.28	9.11	4.35	1.68
Commodities	Bloomberg Commodity Total Return Index	4.71	1.71	-5.04	-8.46	-6.83
Real Estate	NAREIT Equity Index	2.49	8.68	6.74	9.88	7.79
Global Market Cap Weighted	MSCI World Index*	5.51	22.39	9.25	11.63	5.03

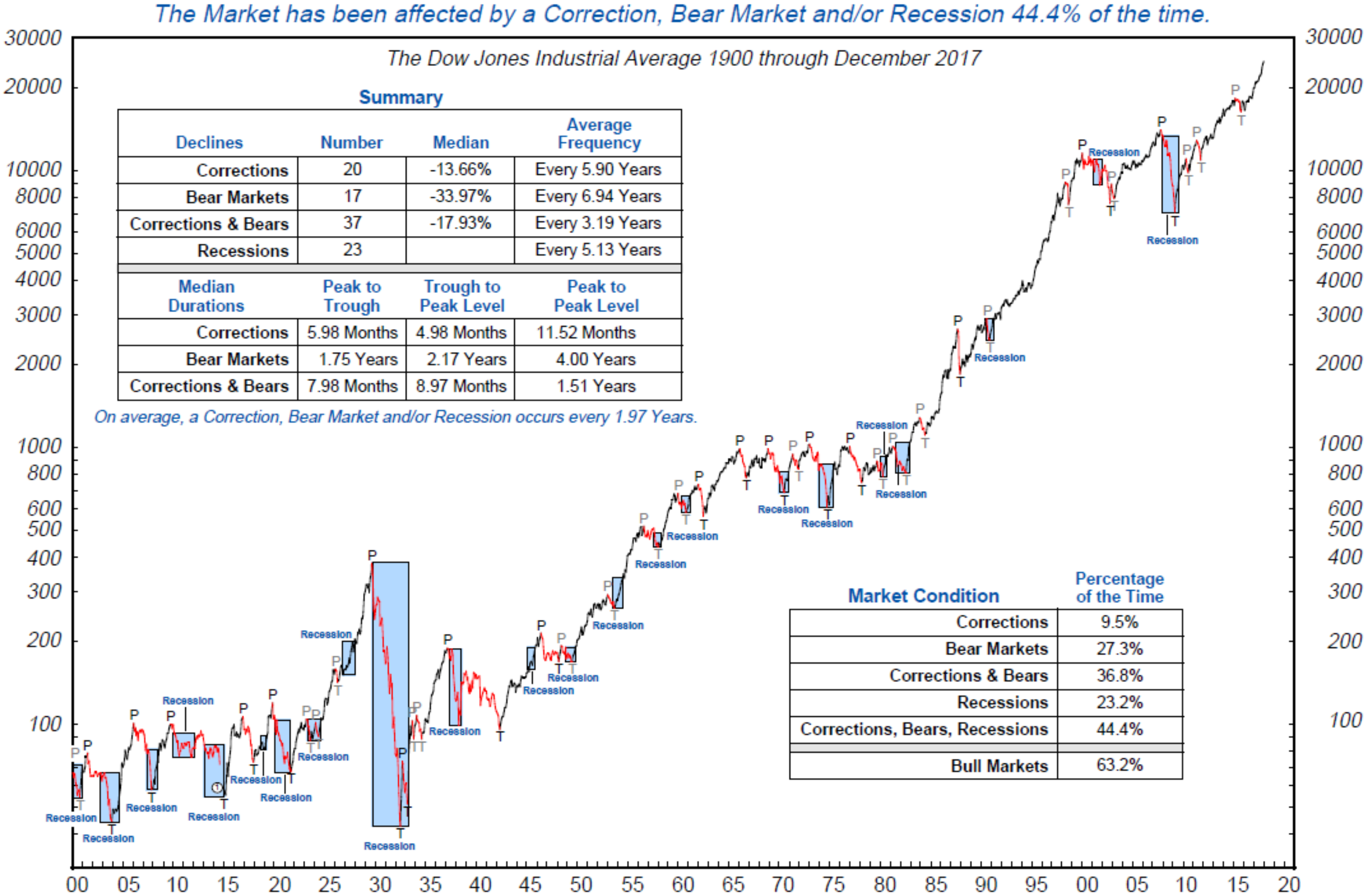
**The U.S. represents about 51% of the MSCI World Index.*
All returns greater than one year are annualized. Source: Greenhill Market Index Review as of December 31, 2017

valued too richly. Valuations do matter, but valuation is not a static variable. Interest rates and earnings growth can move an individual company from a "reasonable valuation" into a great deal. Then there is emotion, which creates most of the equity market's dispersion. However, this dispersion is no worse for equities than it is for many assets commonly perceived as "stores of value." We would argue that gold prices are driven almost purely by emotion. Farmland, forest land, homes, rent producing real estate, bonds, and nearly every asset that an investor might hold is to some degree susceptible to emotion. Two things can happen to create an investment return: cash flows and changes in perceived value. Cash flows can be retained (and invested in the business) or distributed to shareholders. Value increases when these cash flows increase over time. The perceived value is more of a guess. An investor should start with a forecast of inflation and use other variables such as scarcity, brand, quality, and growth to inform a more educated guess. Perceptions change all the time with biases too numerous to count confounding any purely scientific means of determining a precise present value. At this point, we believe that it is wise to assume that future equity returns will be lower than the average recorded since the financial crisis. However, we still believe equities offer the highest probability of achieving returns greater than the rate of inflation over time because the basis for intrinsic value (cash flow) has the greatest potential to grow through the unique combination of human ingenuity and organized capital formation.

The US economy is growing at or near 3%. The final revision for third quarter GDP was 3.2% despite the adverse impact of storms, led by consistent growth in consumption and very strong growth in private investment. Employment, housing, and business indicators all look healthy as we enter 2018. Inflation remains below the Fed's 2% target, but there are legitimate questions about sustainability at 3% GDP growth. Non-farm payroll growth disappointed in December after a very strong November reading. The trend is still positive and healthy in our opinions. Unemployment is very low and we really do not know how much investment and hiring the new tax laws will drive. The ISM Purchasing Manager's Index (PMI) accelerated in December to 59.7 from 58.2 in November. A PMI reading above 50 represents improved expectations. The PMI is a relatively reliable forward-looking indicator that suggests that investment should remain a healthy tailwind to GDP growth. Economic cycles usually end due to some kind of overheating, rather than simple fatigue. Imbalances emerge in the form of inflation, asset price bubbles, or excess capacity. The Fed is usually forced to respond with monetary constraint. We do not know what the imbalance will look like this round, but we are more likely to see it at 3% growth than 2.5%. Specifically, we will be looking for evidence of accelerating inflation or reversals in leading indicators such as the PMI for evidence that the economic environment might be changing. Not only do we not know when the next market correction will arrive, but also we do not know how deep it will be or how long it will last once it arrives. We do know that there will be one, but the most recent memory tends to define our expectations. 2008 was a terrible recession and an outlier in terms of market performance versus history. Crandall, Pierce & Company published timely research this week, illustrating that recessions, corrections, and bear markets are common occurrences. The general slope of the line suggests that attempts to time the market are mostly futile (see below). We do not see risks that warrant any special preparation beyond the normal process of rebalancing to maintain portfolio diversity and strategic discipline at this time.

Why Have a Disciplined Investment Approach?

The Market has been affected by a Correction, Bear Market and/or Recession 44.4% of the time.



Note: On average, the market's trough occurs 5.3 months prior to the end of a recession.

Red Line Segments: Corrections (P,T) - Minimum 10% decline but less than 20% & Bear Markets (P,T) - Minimum 20% decline. Data: Dow Jones Industrial Average (end of month)
Recessions are as defined by The National Bureau of Economic Research. ©The Stock Exchange was closed due to World War I.
Sources: Dow Jones & Company; National Bureau of Economic Research •

The Tax Cuts and Jobs Act became law on December 22, 2017, to mixed reviews. On the individual level, the law seems to mean something different for about every taxpayer. The lines at County Commissioner offices around the country accepting pre-payments of property taxes are the first indication that whatever one's opinion of the law might be, it is significant. The lower corporate tax rate (21% versus 35% for most) is the source of the greatest anticipation in our opinion. On the surface, the lower tax rate will increase earnings per share (EPS). How much credit investors will give for the extra earnings is an open question. Typically, analysts go straight to the tax rate to determine whether earnings benefitted from anything other than sales and profitability: the "quality of earnings." If the tax rate is lower than normal, analysts "normalize" it and separate the one-time benefit from the underlying trend. In this case, lower tax rates are permanent (for most companies), which is different, but not fundamental. We will see. More importantly, the lower tax rate will reduce cash taxes paid, which is often very different from the taxes reported on the income statement. This will leave companies with more free cash flow to invest in new plant and equipment, people or returns to shareholders. This is the "pro-growth" concept behind the changes in the tax law and it is longer term in nature relative to an immediate response to higher EPS in any given quarter.

The yield on the 10-year Treasury has drifted back up from its 2017 lows to 2.41% at year-end in response the Fed rate increases and the healthier growth outlook. The continuation of low long-term rates remains a bit of a mystery, but very important. There are plenty of explanations for why this benchmark yield remains relatively low in the face of Fed rate increases, Fed balance sheet reduction, and higher growth. The most obvious explanation is inflation. Inflation is stubbornly low for this point in the economic cycle with relatively full employment and healthy credit demand. We believe the wise approach to bonds in this environment is to maintain high credit quality, limit the length of maturities and stagger maturities so that there is an opportunity to reinvest maturities consistently at higher prevailing rates. This is a dangerous time to reach for yield as yields on high-yield (junk) bonds offer historically low excess yield (spread) over their investment grade counterparts. We continue to believe that investment grade bonds remain the most economical and time-tested means of managing total portfolio risk.

The European and Japanese economies continue to perform well. The Japanese economy grew 2.1% in the third quarter and Europe grew 2.6%, both healthy relative to recent history. Unemployment is falling in Europe after a stubbornly slow and protracted economic recovery. Purchasing Managers' Indices

Fixed Income Market Index Returns

As of December 31, 2017

Asset Class	Index	4Q 2017 (%)	1 year (%)	3 years (%)	5 years (%)	10 years (%)
U.S. Taxable Bonds	BC Aggregate	0.39	3.54	2.24	2.01	4.01
	BC Intermediate Government Credit	-0.20	2.14	1.76	1.50	3.32
	BC US Intermediate Credit	0.11	3.67	2.74	2.43	4.55
U.S. Municipal Bonds	BC Municipal Bond (5 Years)	-0.70	3.14	1.72	1.83	3.54
International Bonds	Citigroup Non-US Government Bond	1.57	10.33	1.99	-0.29	2.44

All returns greater than one year are annualized. *Source: Greenhill Market Index Review as of December 31, 2017*

(PMI) from around the world are indicating continued expansion. We believe the equity markets in these countries should continue to perform well relative to US markets because of the lower valuations and the earlier phase of the economic cycle. Along with US large cap growth stocks, international stocks led the market in 2017 with much of the return (for US investors) attributable to the euro appreciating versus the dollar. The local market returns were healthy, but not spectacular. We believe investments in international stocks will continue to contribute to portfolio performance as investors become accustomed to healthier economic growth and corporate profitability in Europe. Emerging market equities were the strongest contributor to 2017 performance after a long period of underperformance. Stable commodity prices, accelerating global economic growth and low valuations explain most of the recovery so far. Export-oriented emerging market economies should continue to perform well given the healthy outlook for nearly every significant economy in the world.

As we enter 2018, we are looking at a very noisy domestic and international political environment and the most stable economic momentum since the great recession. There are many risks to consider, but none of them reach the level of probability that justifies an extreme response in our opinion. Since the "taper tantrum" (a temporary spike in interest rates on the Fed's decision to curtail its bond purchasing activities) in 2013, we have been anticipating the fallout from the withdrawal of unprecedented money printing initially implemented to head off deflation. We do not dismiss concerns, but believe the process of monetary policy normalization is working and that the markets have digested the normalization well. Government debt is high and justifies concern as well, but we believe in the faith and credit of the United States Government. We are part of it and US individuals and non-profits have almost $100 trillion in net worth compared to $20 trillion in Federal debt. So for now, we recommend sticking to a well-organized plan for retirement and estate planning, reserving for contingencies, and trying to take a constructive approach to a chaotic world.

We wish you a happy and prosperous 2018! ■