JANUARY 2018

A 2018 PERSPECTIVE

WHAT LOOMS AHEAD FOR INVESTORS

DAVID BAHNSEN
CHIEF INVESTMENT OFFICER
MANAGING PARTNER
THE BAHNSEN GROUP

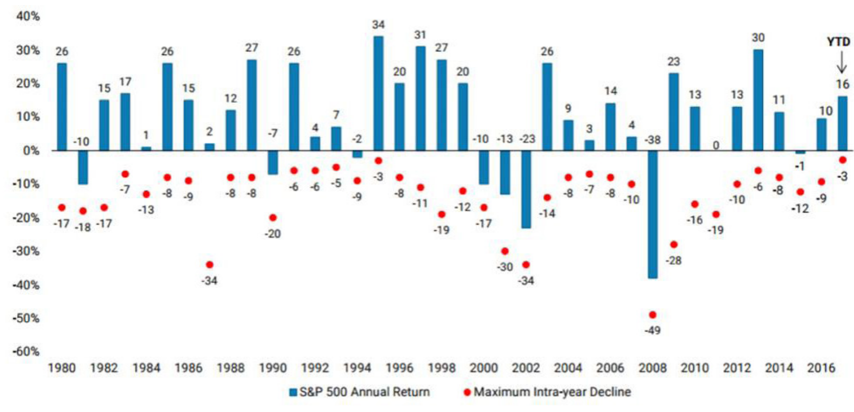
There is no question that 2017 will be one investors talk about for a long, long time. Markets defied consensus expectations, and in doing so, defied each micro-prediction that went along with consensus expectations as well. It would be difficult to imagine a year in which Wall Street consensus got things this wrong, and in which investor fears and phobias found less basis in reality. This transcends the mere fact that equity markets performed far above their historical return levels even as pundits forecasted more muted returns. Indeed, consider the following "accompanying expectations" of the punditry class, and the actual behavior 2017 produced:

PUNDIT'S EXPECTATION: The U.S. dollar would strengthen substantially as the Federal Reserve raised rates and the Trump administration's policies pushed deficits higher

ACTUAL: The U.S. dollar suffered its worst performance in fourteen (14) years, despite higher interest rates and pro-growth fiscal policy

PUNDIT'S EXPECTATION: Even if the Trump administration oversaw a rising stock market, the temperament of the new President, lack of experience in foreign policy, and general uncertainty would create extraordinary volatility for stock market investors

ACTUAL: Equities experienced their lowest levels of volatility in history, experiencing only a 3% drawdown at its worst moment, matching that of 1995, tied for lowest level of downside volatility in market history

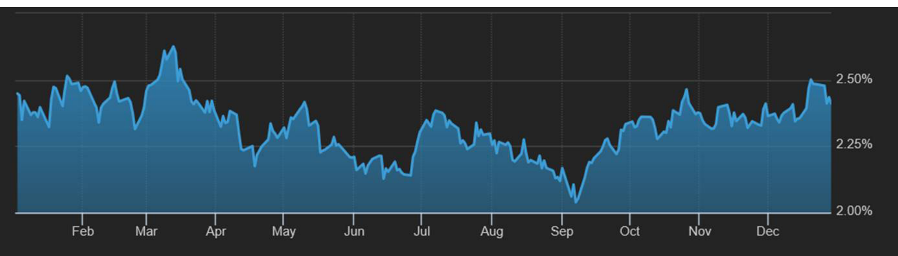


PUNDIT'S EXPECTATION: A rising dollar, weak oil prices, and protectionist landscape from the new Trump administration would render emerging markets highly unattractive

ACTUAL: A weak dollar, improved oil and commodity backdrop, and total lack of protectionist reality from the Trump administration, combined with accelerating economic growth created a +35% year for emerging markets (measured by the MSCI EM index)

PUNDIT'S EXPECTATION: Interest rates would move meaningfully higher between the Federal Reserve tightening monetary policy and fiscal stimulus out of the Trump administration

ACTUAL: The 10-year bond yield spent almost the entire year below its starting point of 2.5%, and much of the year meaningfully below it (sitting below 2.25%), before ending the year back in the 2.4% range, still lower than its starting point. This, despite three rate hikes from the Federal Reserve and robust GDP growth and successful passage of tax reform!



** Wall Street Journal, U.S. 10-Year Treasury, Dec. 31, 2017*

PUNDIT'S EXPECTATION: Technology stocks would suffer under a Trump administration, as Amazon has been in his political cross-hairs, Facebook took flak for the 2016 election, and net neutrality policies were under attack

ACTUAL: Technology was the top performer in the S&P 500, advancing over 36%. The war-of-words between President Trump and Amazon did not subside, and the controversy around Facebook ads actually heated up, and in fact, several other privacy-related controversies intensified inside the technology sector. And yet, new stratospheric valuations were reached!

PUNDIT'S EXPECTATION: The protectionist policies of President Trump could cause a trade war, worst case, and hammer multi-national companies, best case

ACTUAL: The protectionist rhetoric of President Trump never went from bark to bite, as the U.S. did not exit NAFTA, did not label China a currency-manipulator, and did not cancel free trade pacts with any of the countries he had threatened to do so.

WHAT TO LEARN FROM ALL OF THIS?

An obvious takeaway is that the punditry class can be wrong, but even that would not explain how they could be so wrong on so many things. The reality is that two major mistakes were involved in the way far too many approached 2017. One was the mistakes in the premises themselves. And one was in the movement from premises to conclusions, and the inability to see the market as a discounting mechanism.

The dollar has not historically advanced on the reality of central bank tightening, no matter how intuitive that may seem. Rather, it has advanced on the anticipation of such, which is actually what 2014-15 were.

Markets are not amateur cable-news watchers but sophisticated and comprehensive skin-in-the-game economic actors processing millions of data points and news events every second. The idea that President Trump's unique communication style and questionable temperament would cause markets to panic more than deregulation and tax reform and accelerating profits would cause markets to advance challenges all we know about the profit-making objective of market forces.

That interest rates would stay in a tight, moderate range when global yields themselves were anchored to such low levels makes perfect sense. The expectation that they would break out to new highs seems, in hindsight, to have been more of a fear than a real prediction, and one that has confounded pundits for many years now.

And that politicians have barked on a campaign louder than they have bitten in office is as American as apple pie. The shock is not that protectionist fears did not play out, but rather would have been if they actually did.

In a nutshell, much of what played out in 2017 actually makes a great deal of sense, especially in the context of the incredible earnings acceleration that defined 2017 around the globe. So-called pundits can be forgiven for not anticipating the magnitude of market movement in 2017. Fear of missing a downturn drives Wall Street right now, and the biases are inherently defensive. And it was a peculiar year – political dysfunction just *seemed* high, and for many, the natural result should have been market dysfunction as well. However, the permanent condition of markets as humility-generators is not going away, and the more confident pundits seem with certain forecasts *("X should happen, and therefore Y will happen"),* the more skeptical history has taught us to be.

THE BIGGEST STORY OF 2017

Our 2017 commentary exhaustively covered the news event that was tax reform, but no "story" more captured the reason for stellar market performance in 2017 than earnings growth – and not just domestically, but on a global basis.

Global Earnings

The chart above actually explains two things quite well for investors: Yes, it demonstrates why 2017 was as robust as it was for investors. But if one looks further back on the chart, it also explains why global equity markets essentially took a two-year pause from the middle of 2014 through the middle of 2016. No, markets did not collapse in that period, but neither did earnings themselves. Rather, growth-of-earnings stalled, and the result was a completely flat market period. This bull market will soon turn nine-years old (March 2018), but there was a two-year period (mid-2014 through mid-2016) where markets essentially started and ended at the same place (despite gyrations in between). The weakness of that two-year period provides much more context to the market rally we are currently experiencing. For while the two-year market return beginning March 2016 is dramatic, the four-year return is actually quite normal. These historical realities and contexts matter.

There was no story more significant to markets in 2017 than global growth. There has not been a year this century in which every economy in the world was experiencing positive economic growth simultaneously, until

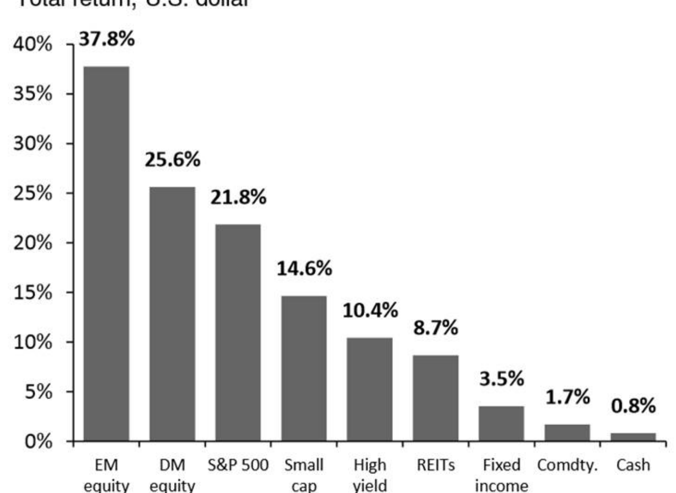
now, that is. From emerging markets, to Japan, to Europe, to the U.S., global GDP growth meant growing profits, and growing profits meant growing stock prices.

MORE FROM 2017

The positive landscape for risk assets contained more than just earnings growth in 2017. Oil prices substantially stabilized, and even advanced to two-year highs (closing the year above $60 and recently making new 30-month highs). This produced a less anxious environment in the high yield credit space, where spreads tightened to unprecedented levels, and went hand-in-hand with a strong global demand story.

Within the stock market, Technology led the pack with a massive 39% gain (and we would add, much of this was our beloved "old tech" – not merely the "new tech" of cloud, social media, and e-commerce). But Consumer Discretionary, Financials, Health Care, and Materials were all up in the 22-23% range. Only Telecom and Energy were down, and they were down by just 1% (3).

Risk assets dominated the investing landscape in 2017, and yet not according to a perfect script. Generally, a "risk-on" environment would see small-cap stocks outperform large-cap stocks, and commodities post a big return in a reflationary environment. Last year saw the normal cast of characters post outsized returns (emerging markets, high yield, etc.), and yet saw small-cap and commodities meaningfully under-perform.



** Barclays, Bloomberg Finance LP, FactSet*

The yield curve substantially flattened in 2017, with short-term rates moving higher as the Fed brought the federal funds rate up three times (a total of 75 basis points), but long-term rates actually declined on the year. So for 2017, the longer duration bonds one had, the greater price-performance they experienced in their bond portfolios (proving that it is not just the stock market which exists to humiliate investors, but the bond market too).

US Treasury Yields

Maturity	End of 2016	End of 2017	Change
1-Month	0.44%	1.28%	0.84%
3-Month	0.51%	1.39%	0.88%
6-Month	0.62%	1.53%	0.91%
1-Year	0.85%	1.76%	0.91%
2-Year	1.20%	1.89%	0.69%
3-Year	1.47%	1.98%	0.51%
5-Year	1.93%	2.20%	0.27%
10-Year	2.45%	2.40%	-0.05%
30-Year	3.06%	2.74%	-0.32%
10-Yr Minus 2-Yr	1.25%	0.51%	-0.74%

Pension Partners — THE ATAC ROTATION MANAGER | @CharlieBilello

Presumably bond investors (particularly municipal bond investors were quite pleased with the way rates behaved in 2017, as not only was the annual fear of a rising rate reality check deferred yet another year, but quite impressive positive performance was achieved. But for those who use the bond market and rate market as a sort of indicator about the entire economy, this flattening yield curve was rather confusing. Unemployment continued to dip lower. GDP growth expanded more than it has in many years. Both consumer and business confidence reached their highest levels in years. And yet interest rates at the 10-year and 30-year mark moved lower, not higher, and even with three Fed rate hikes, the short-term real rate (net

of inflation) remains a *negative* number.

This is a reflection of the reality in monetary policy (both in the United States but around the globe as well), that while some snail's pace movement towards normalization is under way, we remain in a hyper-accommodative era in monetary policy. Central bank balance sheets are still extremely high, and in many countries still expanding, and even announced plans for quasi-reductions were taken by markets to be practical rounding errors. There is a bullish argument to be made out of this – that for whatever one may think about the present monetary landscape, it does bode well for risk assets, and that is certainly legitimate prima facie. But to the extent that built-up monetary stimulus still lies deeply in the foundations of this economy, it behooves us not to ignore the future risk that has built up as well (particularly for leveraged asset classes, real estate, etc.). Humility and history both call for the avoidance of wild predictions around central bank possibilities, and 2017 reinforced the need to avoid investing around worst-case scenarios. But prudence and cautious analysis are mandatory as it pertains to understanding the role of Federal Reserve coddling of asset prices in the economy, and more specifically, the removal of that coddling.

SO DOES THE PARTY CONTINUE INTO THE NEW YEAR?

We would argue two major things about markets in 2018, neither of which are particularly profound, but both of which are especially important:

1. The risk of a "melt-UP" is real – meaning, markets could very well continue in this advancement to a higher magnitude than many investors realize.

2. Muted downside volatility is very likely to go away, with normalcy resuming in equity market fluctuations.

There are plenty who would argue such a melt-up has already taken place. The DJIA is up 35% since President Trump was elected. The euphoric confidence in so-called FANG stocks is well documented. This bull market is not only nearly nine years old now (tracing its origin to the March 2009 bottoming of markets out of the financial crisis), but the multiple that comes with present index-buying is a solid 19x earnings or so, certainly above historical averages, even if not at the level of past market tops.

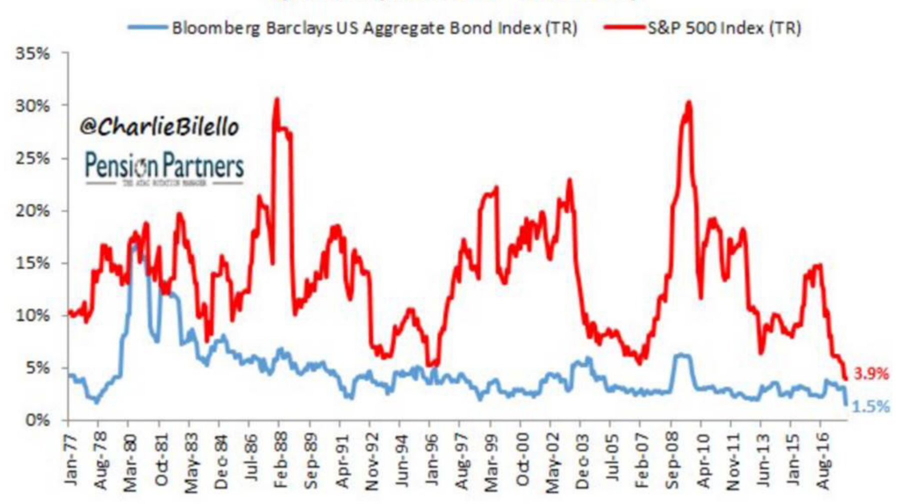
Of course, the multiple became harder to evaluate with the passage of historical tax reform late in 2017. The after-tax profits by which companies

are valued were all given a significant boost both in terms of immediate benefit (full expensing for capex), and perpetual benefit (dramatically lower rates). This reset the tables for a lot of corporate America, providing instant increase to earnings that therefore meant an instantly lower P/E ratio. Much of 2018 will depend on how much of tax reform has already been priced into the market, and what peripheral benefits to tax reform make their way into the economy and company income statements (increased demand, business investment, confidence, etc.).

Yes, it is entirely reasonable to believe the "risk" of a melt-up market is real (which also generally means ending with a blow-off top), while also seeking caution and prudence in one's overall investment perspective. The reality is that other countries around the globe are largely still in Quantitative Easing (QE), our own Fed is slow-walking their movement towards normalization, and there is a $200bn+ stimulus plus tack-on effects about to work its way through our economy. Combine that with the sudden oil recovery, and the fact that most retail investors (and even a shockingly high amount of institutional ones), and one can easily see why this market could very well see the euphoric characteristics that generally mark the final innings of a bull market surface.

The mere possibility of continued positive market movement does not imply blind bullishness. In fact, should such a melt-up take place we would suggest the next act to the play would not be a positive one. And even along the way, as 2018 goes about its business, we are quite adamantly suggesting that a more normalized volatility is likely to re-surface.

The market went 239 days last year with less than a 1% move up or down within the trading day (note: there are only 251 market days per year). Consider that in 2015, there was greater than a 1% move up or down over 50% of market trading days (1). That is how severely low volatility was last year, where "drawdowns" were historically non-severe, and even intra-day movements were historically insignificant.



Another +20% year without even a 3% drawdown would almost certainly bring out the euphoric bad behavior that generally means the end is nigh. However, a good, old-fashioned 5-12% correction would at least demonstrate some semblance of normalcy, health, and function. It would also demonstrate resolutely that fear still exists in the market, and as long as there is fear, this bull market which began March 6, 2009, is alive.

We would be remiss if we did not perpetually point out the elephant-in-the-room of potential market disruptors (which sure sounds like the very opposite of a black swan): China. It was fears of a violent deceleration in Chinese growth that last caused substantial market disruption and led to more systemic fears of global anemia (August 2015 and January 2016). However, it was China's impressive needle-threading throughout 2016 that caused global markets to re-load, and most economic data from 2017 pointed to a continued environment in China that made global markets feel just fine. Too many very smart people have had their heads handed to them betting on China's imminent collapse. But yes, the risk of unforeseen distress in China taking hold and spreading to other global markets can never be discounted.

THE BAHNSEN GROUP

PORTFOLIO POSITIONING IN 2018

Our desire for properly balanced portfolios with slight biases towards caution, and heavy biases for active management, continues into 2018. This approach leaves our clients exposed to the upside possibilities of the present pro-growth period while respecting the various risks embedded in this stage of the cycle. We neither see a ripe opportunity for piling into risk, nor the prudence of taking it all off. Within our commitment to asset allocation disciplines, the following themes will be tactically present in our 2018 positioning:

1. THE YEAR OF ROTATION

Those predicting a shift in leadership from "growth" names to "value" have had their patience tired, to say the least. Nevertheless, valuation levels in many growth-heavy names and sectors, combined with genuine fundamental strength in so much of the "value" side of the market, is screaming for 2018 to see this forecast actually play out. There is the obvious benefit – defensiveness. Should a market correction surface, Value names can be expected to substantially outperform their very expensive Growth cousins. However, we would expect to see Value come back into flavor even in a positive market environment this year, as the more value-centric sectors of Energy and Financials benefit from the policy landscape, and as simple price value has become far more compelling in the traditional Value style vs. the more popular Growth style.

2017

	Value	Blend	Growth
Large	13.7%	21.8%	30.2%
Mid	13.3%	18.5%	25.3%
Small	7.8%	14.6%	22.2%

** JP Morgan Asset Management, Guide to the Markets, p. 9, 2018*

2. SMALL CAP: YES

The thesis here is quite simple: Small and Mid-Cap companies under-performed their large-cap cousins in the great bull market of 2017, and heading into 2018 we believe small and mid-cap companies with large domestic revenue sources are set to benefit from tax reform most emphatically. The very important caveat to this recommended positioning is that a passive index approach may be the worst way to execute the thesis, for indeed, too many small and mid-cap companies do not even have positive earnings. Only companies that make money benefit from tax reform, obviously. 30% of the companies in the Russell 2000 index actually have negative earnings (2). A careful and active approach to companies whose price valuation is sensible and who are about to reap the benefits of a 10-20% increase in their own free cash flow (via instant tax benefit) seems quite prudent in the current environment.

3. RECKONING FOR BIG TECH

Our forecast of reckoning is not a call on performance, struggle, or price reversal. Rather, it is a very simple statement about the political and even cultural environment for many of the major technology, internet search, e-commerce, and social media names that have captivated market observers for several years. The technology sector overall has largely gone unscathed from political pressures for a couple of decades, and we see 2018 being the year that the tide shifts from energy and financials as the “hated sectors” to technology becoming one under intense social scrutiny. And yes, we do suggest this will have a significant drag on expected return into the future.

Whether it be traditional class warfare arguments, routine anti-monopoly forces, or more unique pressures around social and societal fears, we believe that the noise surrounding this space will increasingly carry a negative or skeptical tone, and that as we have seen with other large and successful companies in the past, will create distractions, strategic adjustments, impacts to business model, and even some existential scrutiny. The unprecedented cash flow creation of big tech behemoths may very well not be impacted at all in 2018, and frankly, we would be surprised if it were. But when a company or sector transitions from civic darling to cultural bogeyman, it is impossible to think it will not impact expected rates of return going out three, five, and ten years.

Two Major Apple Shareholders Push for Study of iPhone Addiction in Children

By Luke Kawa
January 7, 2018 7:30 PM Updated on January 7, 2018 8:13 PM

- Investors push tech giant to give parents more access control
- Studies needed to determine effect of usage on mental health

The Amazon Monopoly Problem: Prime Time For Antitrust Action Vs. Internet Giants?

JED GRAHAM | 9/18/2017

Reprints

mazon.com (AMZN) kicked off its Whole Foods takeover on Aug. 28 by slashing the

4. INFLATION

Global deflation has been such the predominant driver of investment markets for so long, and has so colored the macroeconomic picture, that almost seems like a discussion of inflation in formulating investment positioning was on permanent hiatus, or reserved for those who could not see what was staring them right in the face. Deflationary forces have dominated the economic picture not just in media narratives since 2008, but in reality. Frustrating central bankers many times over, inflation has been impossible to artificially create, because the deflationary woes of over-indebted economies with inadequate organic growth has made a velocity of money impossible to come by, the key variable in generating monetary inflation.

But alas, with copper prices up 30% in 2017, lumber prices up 40%, the dollar declining against most major currencies, and even crude oil ascending higher, has the reflation of 2017 given way to inflationary forces in 2018? We know better than to predict a resurgence of something that has been sorely lacking for years with any time specificity to it, but we do believe that if inflation itself does not begin to show itself in the data this year, at the very least, the possibility of a resurgent inflation expectation will. Markets respond to expectations about inflation, and central bank distortions have allowed the rate market to reflect expectations of disinflation for too long. There is a chicken or egg problem there, no doubt, as one could legitimately argue that disinflation has led to central bank distortions, not the other way around. However, the noteworthy call here is that by the end of 2018, we expect the narrative to begin changing from one of market

inconsistency (stock markets calling for reflation, while bond markets indicate deflation), to a more harmonized message around inflation. This will force investors to think about something they haven't had to think about in a long time (4).

It would be more courageous for us to make a call right now as to what will win out – inflation or deflation. Predicting that a "narrative" will surface around inflation is quite different than forecasting actual unexpected inflation, so it may seem rather cowardly to neuter the forecast as such. However, it is not cowardice but prudence and awareness that keeps us reserved in this forecast. The powerful (but distorted) voice of the bond market is speaking to perpetual deflation for as long as the eyes can see, even as so many other indicators point to something different. And indeed, even positive growth indicators are often of the productive but not inflationary variety. This is a tension embedded in the current discussion that no one can say with certainty how it ends. We can only say that we believe the discussion will have an impact in capital markets in 2018 different than has been the case in recent years.

5. BONDS THAT ACT LIKE BONDS

Extremely tight credit spreads in the corporate bond market do indicate that companies seeking to borrow have ample room to do so, and that may be a perfectly positive event for the economy and overall investing landscape. But it does not mean that investors need to be directly levered to it, thereby increasing that pro-cyclical risk in both their bond and stock portfolios. We are content in 2018 to extract our risk premium from equity risk assets (dividend stocks, small cap, emerging markets, etc.), and allow our diversifier asset classes to function less opportunistically (especially in the bond market). Modest investment grade corporate exposure is acceptable, but limiting credit risk is prudent given the risk on the equity side of our asset allocation. Bond weightings themselves should command a modest underweight allocation, despite equity pricing, because of interest rate risk and credit frothiness. Whatever the macro weighting, though, the composition should be biased towards bonds that act like bonds – protective diversifiers should risk markets face turbulence.

CONCLUDING THOUGHTS

Bull markets end on euphoria, and one can certainly argue that euphoric conditions have increased in 2017, and here into early 2018. But the extreme euphoria that has marked the end of most significant bull markets is nowhere to be found, yet. This has been the most disrespected bull market I have ever observed or studied, and yet there is no question that this is slowly changing. Investors, frustrated by having missed on a 30%+ move in barely a year, are re-entering the market, attracted to the economic prospects of tax reform and improved business and consumer confidence. As contrarians, we see a half full and half empty glass in all of this. Skepticism is "buyable" for us – and we have done well by investing against the naysayers. But should that sentiment fully shift – to a point where the market is no longer met with doubt but rather universal complacency, then we shall know the paradigm has finally shifted.

But in the meantime, we have never had a recession when corporate profits were advancing, and corporate profits are highly likely to continue advancing with the headwind of corporate tax reform. A standard correction around a market that gets ahead of itself is far different from a recessionary bear market. The former strikes us as possible in later 2018; the latter does not.

Investors ought to learn the messages that Mr. Market taught them in 2017, and maintain fidelity to all the disciplines that successful investors practice. Asset allocation will drive healthy trade-offs in risk and reward. Successful investing in 2018 will involve the right response to inevitable tick-up in volatility.

At The Bahnsen Group, that response will be seeking to add to dividend growth companies whenever value and expected rates of return become more compelling. In other words, 2018 should be like any other year – celebrating the very opposite of what the general population is celebrating, and worrying about the very opposite of that which worries them.

DAVID L. BAHNSEN, CFP®, CIMA®

CHIEF INVESTMENT OFFICER, MANAGING PARTNER

DBAHNSEN@HIGHTOWERADVISORS.COM

WWW.THEBAHNSENGROUP.COM

(1) Pension Partners, Charlie Biello, January 5, 2018

(2) Marketwatch, August 19, 2017

(3) Strategas Research, Year in Charts, January 3, 2018

(4) Pension Partners, Charlie Biello January 5, 2018

The Bahnsen Group is a team of investment professionals registered with HighTower Securities, LLC, member FINRA & HighTower Advisors, LLC a registered investment advisor with the SEC. All securities are offered through HighTower Securities, LLC and advisory services are offered through HighTower Advisors, LLC.

This is not an offer to buy or sell securities. No investment process is free of risk and there is no guarantee that the investment process described herein will be profitable. Investors may lose all of their investments. Past performance is not indicative of current or future performance and is not a guarantee.
This document was created for informational purposes only; the opinions expressed are solely those of the author, and do not represent those of HighTower Advisors, LLC or any of its affiliates.