HIGHTOWER
RDM FINANCIAL GROUP

RDM Market Update
January 2018

2017 is now in the rear-view mirror and we wanted to provide you with our thoughts regarding the markets and the economy as we enter the new year. First, looking back, 2017 was a positive year for both the equity and fixed income markets marked by continued liquidity, healthy economic data and historically low volatility. Similar to previous years, there were reasons to get more defensive or move to cash in 2017. However, because we did not see a recession ahead, we remained invested towards our client's stated allocations. For much of the year, fixed income markets remained range bound despite the Federal Reserve Bank continuing to gradually raise short term rates.

New tax law changes are coming and appear likely to provide a boost to economic growth and corporate profits in 2018. According to Strategas Research, the economy should receive a boost of more than $200 billion or just over 1% of GDP in the first year after implementation. Based on research from J.P. Morgan Investment Management, 62% of the benefits from the upcoming tax package will be realized during the first four years (i.e. tax cuts will be front end loaded). While the economy appears likely to benefit from tax law changes over the next few quarters, the longer-term benefits are less certain. We have started to evaluate what these tax changes mean for financial markets and the economy and will have more to say on this topic in coming months.

Looking ahead, we are currently experiencing a synchronous global recovery, corporate profits are rising, consumer and business confidence levels are at healthy levels and tax cuts appear likely to provide a tailwind for the economy and earnings in 2018. After growing at an average rate of 2.2% throughout the almost 9-year economic expansion, GDP appears likely to pick up somewhat in 2018.

Historical market valuation levels appear on the higher side but stocks remain competitively priced versus fixed income assets (which compete for investment dollars). There is an old saying in financial markets which goes something like… "buy the rumor, sell the news." Now that tax legislation has been signed into law, some investors may take the opportunity to lock in profits near term. This would not be surprising. As we have said before, market pullbacks from time to time are a normal part of investing and help relieve buildups which could lead to larger market corrections down the

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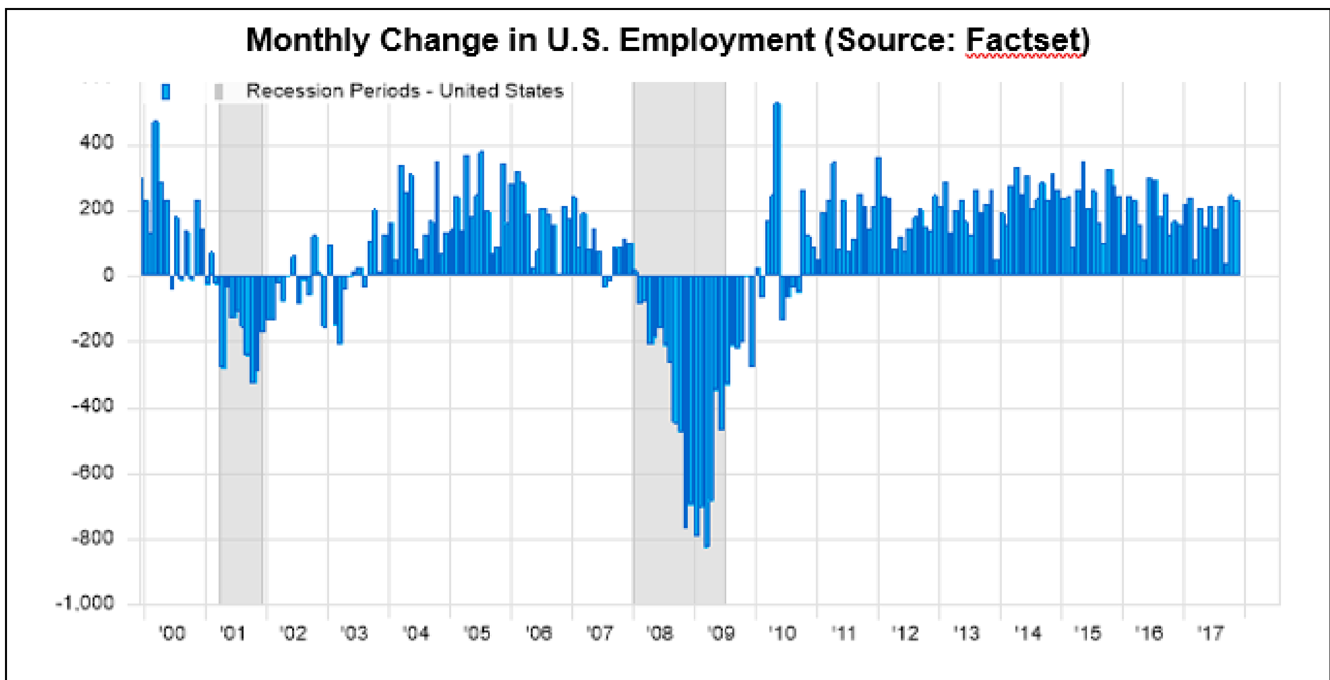
road. If a market pullback were to occur (for example in January or this Spring due to investors locking in profits or during the Summer in anticipation of mid-term elections), we would likely see this as a buying opportunity based on our relatively constructive economic outlook for the year. Yes, there are risks, there always are. We outline several of these in the investment market update that follows.

WHAT IS YOUR OUTLOOK FOR THE MARKETS AND ECONOMY NEXT YEAR?

Based on a combination of steady job growth (see chart below – source: Factset), moderate wage increases, rising asset prices, increased business spending, rising corporate profits and recent tax law changes, we remain constructive in our outlook for the economy and markets in 2018. Interest rates and inflation also currently remain historically low and the Federal Reserve Bank is taking a gradual approach to raising rates. Outside the U.S., growth remains positive in a majority of both developed and emerging market countries. These are all positive factors as we head into 2018.

As we make our way through the year into 2019 (since we are likely in the later innings of the current expansion), we will be on the lookout for potential rain clouds that could turn the investment landscape less favorable. Potential issues could include higher inflation or rising wages that force the Federal Reserve Bank to tighten policy more aggressively, a sharp rise in global sovereign bond yields around the world, weaker than expected corporate profits or economic growth, overvaluation of various asset classes not supported by underlying fundamentals or geo-political developments in different regions around the world.



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What sectors of the market may benefit in 2018?

Four of our main assumptions for next year include: 1) The U.S. economy grows at a moderate rate in 2018 (somewhat faster than in 2017); 2) We are in the later innings of the current economic expansion (although there is no recession on the horizon for now); 3) Tax policy (reduced corporate tax rates, accelerated depreciation for capital expenditures etc.…) provides a boost to overall economic growth and 4) The Federal Reserve Bank continues to raise rates at a gradual pace in 2018. Certain parts of the economy and the market may benefit more than others from these changes over the next several quarters and these are issues we are currently evaluating. We will have more to say on this topic in the days ahead.

Small companies typically generate 80% of their revenues domestically (versus 70% for large companies - source: S & P) and pay higher tax rates than large companies. Therefore, small companies should receive a lift in 2018 from recent tax policy changes. However, small capitalization companies have also historically underperformed during the later stages of economic expansions. One other factor is valuation. According to Merrill Lynch, the Russell 2000 Index currently trades at the 97% percentile of valuation levels (i.e. it is has only been more expensive 3% of the time) versus the 88% percentile for the Russell 1000 Large Capitalization Index. When you put it all together, small capitalization stocks should benefit somewhat from new tax policy, but you want to have a balance between large and small capitalization companies.

What are some of the specific economic indicators we are watching?

One of the economic indicators that we watch closely each month is the Conference Board's Leading Economic Index (LEI) – see chart on page 4: Source, Factset. Historically, the index tends to forecast the direction of the economy looking out over the next 2-3 quarters. The fact that the index continues to improve bodes well for economic growth looking ahead over the next few quarters. Other indicators that we monitor include credit spreads, real i.e. inflation adjusted short term rates, labor market indicators such as weekly jobless claims, Federal Reserve Bank lending conditions, the trend in corporate profits and both business and consumer confidence levels (which are currently near multi-year highs). Lastly, we also keep an eye on surveys of business capital expenditures (note: according to the Institute for Supply Management, which has tracked manufacturing data for the economy for several decades, new manufacturing orders rose to the highest level last month since 2004) and housing related data.

Some may argue that all the good news is already baked in and that the only thing left is for the economic data highlighted above to slow down and weaken. If that were the case, we would start to see a broad-based decline in many of the economic indicators we watch in coming months. Eventually that will happen. However, at least for now, we believe that the most likely scenario is one of sustained moderate U.S. and global economic growth in 2018.

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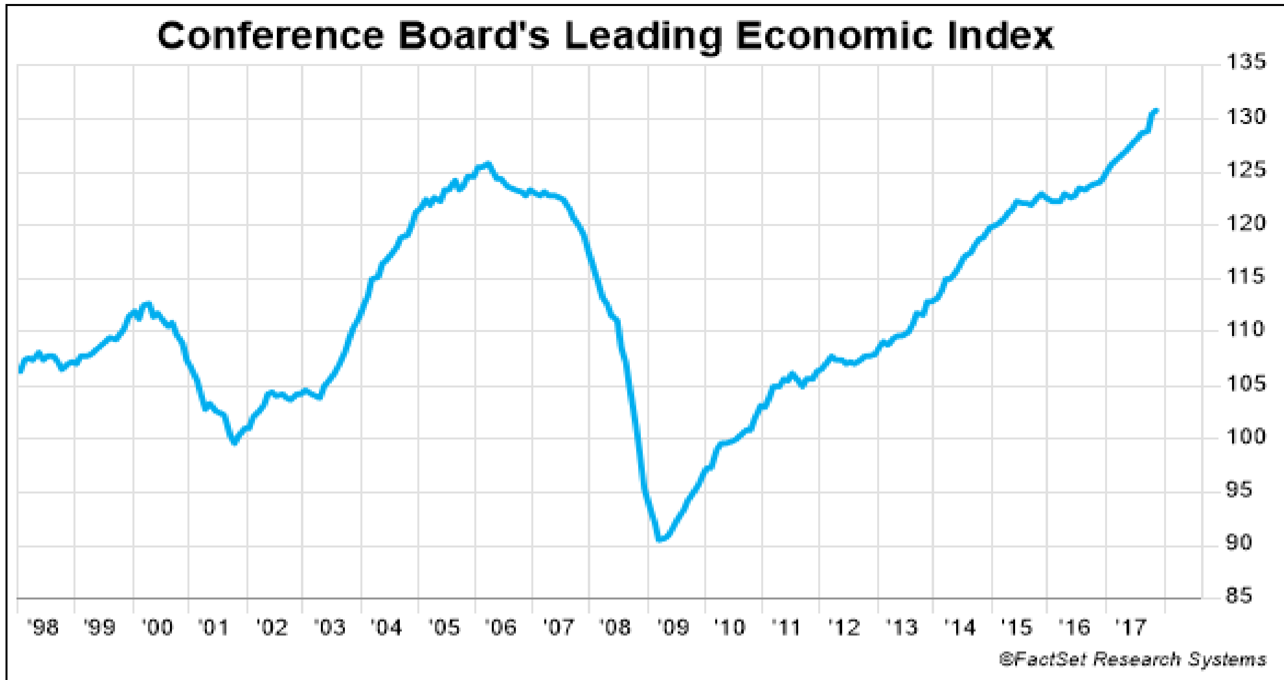

CAN YOU PROVIDE THOUGHTS ON MARKETS OVERSEAS?

For the first time in 10 years, all major markets around the world (according to the Paris based economic research firm OECD) are growing. Europe and Japan are somewhat behind the U.S. in terms of their economic recovery and thus likely have room to catch up over the next few years. Officials in China have so far done a good job managing their economy as they transition from infrastructure and commodity led growth to a more services and consumer based economy. Debt levels around the world remain high in many countries but for now do not appear to be a major source of concern.

Overall, central banks outside the United States remain accommodative. In terms of policy changes, The European Central Bank (ECB) will continue buying financial assets in 2018 but recently announced plans to reduce monthly asset purchases from 60 billion Euros to 30 billion Euros per month starting in January, 2018. The Bank of Japan (BOJ) has not yet taken its foot off the accelerator yet. Finally, despite fears of weaker economic growth due to Brexit, the Bank of England recently raised rates by a quarter point for the first time in several years.

Since the market bottom in March 2009, the S & P 500 has advanced 295% while MSCI All Country World Index (ex-USA) has advanced just 127%. These kind of things run in cycles (see chart on page 5 – source: JP Morgan Asset Management).

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With corporate profits for Europe and Emerging Markets both still below prior peaks and valuation levels below average (based on data for the past 25 years), we believe there is additional upside in overseas markets in the period ahead.

Comments on New Tax Changes?

New tax law policy was recently signed into law just before Christmas, 2017. The 2017 Tax Cuts and Jobs Act appears likely to provide a boost for the economy starting this year. There are a number of important changes that will affect different parts of the economy (for both consumers and businesses) over the next several years. This is not the place for tax advice. However, from an investment perspective, we wanted to highlight three of the most important aspects of the current tax legislation.

First corporate taxes are set to decline substantially (which should provide a boost to company profits). Second, U.S. corporations will be able to immediately expense capital equipment purchases (which should bring business spending forward from the future) and third, businesses with large amounts of cash held overseas will be able to bring some of that back home at reduced tax rates (which should help provide more cash for stocks buybacks, dividend increases and hopefully, increased hiring and business expansion).

Most individuals are also likely to benefit in the form of reduced tax rates but these changes (unlike lower tax rates for U.S. corporations which are permanent) are currently set to expire in 2025. One negative is that Americans who live in states with high income and property taxes may be negatively impacted by upcoming tax law changes.

Potential Unintended Consequences

One of the unintended consequences of upcoming tax law changes is rising long term deficits. It used to be that Republicans were the political party that was more concerned about rising deficits. However, based on upcoming tax law changes, the nation's deficit is currently forecast to rise by $1.46 trillion dollars over the next decade. There is a lot of debate about whether increased growth in the economy over the next several years (as a result of tax law changes) will ultimately pay for the deficits. Time will tell. It may ultimately depend on how much of increased corporate profits get spent on stocks buybacks and increased dividends as opposed to building new plants, buying capital equipment and hiring new workers. Unfortunately, much of the research we have viewed from independent think tanks so far indicate that rising deficits may be with us (and younger generations) for many years to come.

What is the outlook for corporate profits in 2018?

Looking ahead to 2018, the current forecast based on estimates collected by the data research firm Factset (at the end of 2017) is for earnings per share (EPS) for the S & P 500 to rise 11.2% next near (compared with an increase of about 10% in 2017). Currently, all 11 sectors in the S & P 500 are forecast to generate an earnings increase with four sectors currently forecast to post 10% or more earnings growth in 2018. The three sectors currently forecast to generate the highest earnings per share growth include energy, materials and financials while the three sectors currently forecast to post the weakest growth include telecom, utilities and REIT's. Revenue growth in 2018 is currently forecast to increase 5.5% versus estimates of 6.2% in 2017. The three sectors currently forecast to generate the highest revenue growth include technology, energy and consumer discretionary while the three sectors currently forecast to post the weakest growth include telecom, utilities and financials.

Note: the estimates highlighted are likely to rise in coming months as tax law changes get implemented and companies provide increased financial guidance.

Are upcoming tax law changes already incorporated into company outlooks?

This is a difficult one to answer but we will give it a try. When the large global package company FedEx (FDX) reported financial results on December 19th, they beat analyst sales and earnings per share estimates. However, more importantly, they made some comments about what future tax law changes might mean for their company. Management commented that if tax law changes being discussed in Washington pass, it would likely boost earnings per share by $.85 - $1.00 for the remaining 5 months of the company's current fiscal year and could have a materially positive impact on overall GDP growth

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in the U.S. in 2018. These are comments from just one company (i.e. this is a very small sample size). However, if more companies provide similar commentary, it would seem that Wall Street analysts may have to raise their profit forecasts for the quarters ahead.

What is the Federal Reserve Bank likely to do next year?

So far, the Federal Reserve Bank has raised short term rates 5 times during the current rate cycle. Despite these rate hikes, real i.e. inflation adjusted short term rates remain negative and monetary policy remains stimulative. For 2018 the Federal Reserve Bank forecasts that it is likely to raise rates 3 times while slowly reducing the size of its $4.5 trillion-dollar balance sheet. There is a new Federal Reserve Chairman (Jerome Powell) who will be taking over for Fed Chair Yellen in charge starting in 2018. At least historically, he has shown a tendency to vote with the majority at the Federal Reserve Bank and does not seem likely to change policy dramatically over the next few quarters. If the economy continues to expand at a moderate rate next year, 2-3 additional rate hikes seem like a reasonable expectation to us right now. However, the central bank has always said that they remain "data dependent." Therefore, if economic data starts to slow somewhat, the Federal Reserve Bank may reduce the pace of rate hikes in 2018.

What are some of the biggest risks you see in 2018?

The biggest risks we see in 2018 that could lead to a market pullback or correction include geo-political i.e. North Korea / South Korea, Iran / Saudi Arabia etc…., the potential for central banks around the world to become more aggressive than markets expect, and rising valuation levels not justified by positive market fundamentals or weaker economic data. Political issues either at home (i.e. the 2018 mid-term elections) or overseas could also have an impact on financial markets during 2018.

Inflation has not been a big factor on the minds of investors in recent years. However, if that were to change as we go through the year, that could lead to higher bond yields (or faster central bank tightening) and have an impact on market valuation levels and negatively impact stock prices. One last comment is that debt levels in the U.S. economy (because of new tax law changes) are forecast to increase by over $1 trillion dollars over the next decade. We are just not sure when this will become an issue for the markets so for now, it is just another factor we will put on our radar.

Is a market pullback likely in 2018?

In the chart on page 8 (source: JP Morgan Asset Management), you can see that market pullbacks are a normal part of investing over time. A majority of the time (but not 100% of the time), equity markets experience intra-year pullbacks or

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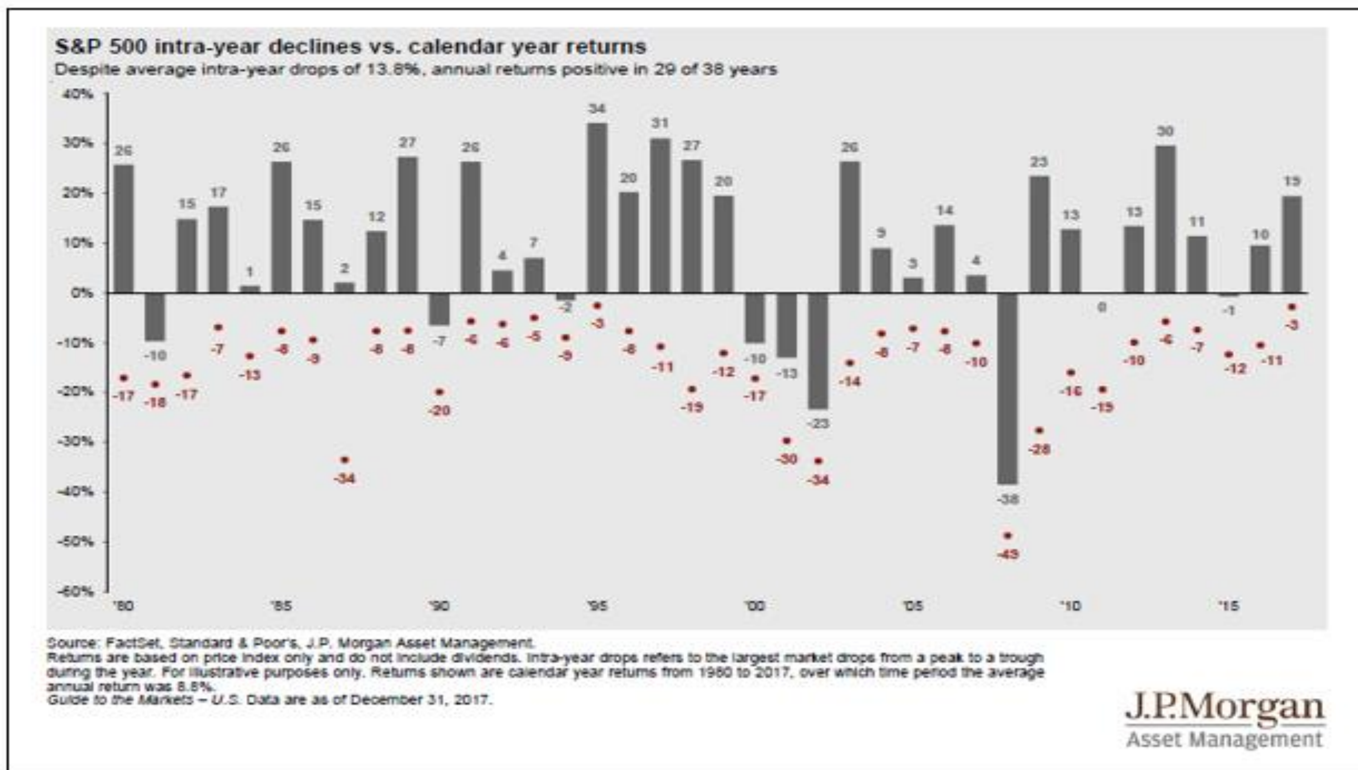

corrections only to finish the year higher. For example, over the past 38 years, the S & P 500 has experienced an average intra-year decline of 13.8% (captured by the red data points in the bottom half of the chart) while finishing positive for the year 76% of the time (source: JP Morgan Asset Management).

For reference 2017 tied the record as one of the lowest volatility years on record. According to data from the research firm Strategas, looking at the 10 years with the lowest volatility (dating back to 1945) the average intra-year decline in the following year was 12% (with a range of -6% to -26%) while the average full year total return for the market was 5% (with a range of -17% to plus 26%). So yes, volatility is likely to pick up somewhat in 2018. It is hard to see less volatility than the year we just experienced. As we have said before, it's very hard if not impossible to accurately time the market over short periods of time. Instead, we believe that focusing on the outlook for the economy and business fundamentals is the most prudent step we can take for our clients over time.

WHAT DO YOU SEE FOR FIXED INCOME MARKETS NEXT YEAR?

Over the past few decades, yields on the 10 year U.S. Treasury Bond have fallen from around 15% in 1981 down to a 2012 low of around 1.5% (see chart on page 9 – source: Factset). More recently yields have been range bound between approximately 1.5% and 2.5% over the past several years (except for a brief rise to around 3% back in 2013). Due to low rates overseas, moderate inflation and the fact that the

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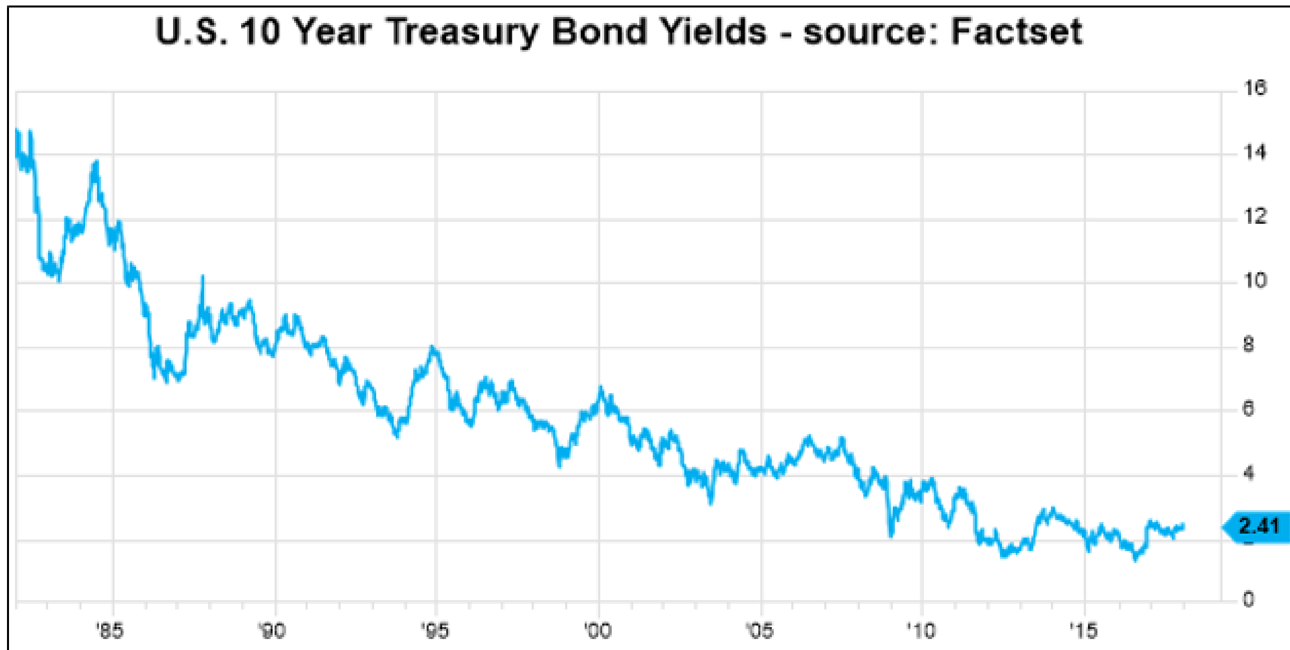

Federal Reserve Bank has been taking a gradual approach to raising rates, 10 Year U.S. Treasury Yields do not currently appear headed substantially in 2018. However, rates are still likely to rise somewhat.

Our outlook this year is that interest rates are likely to move moderately higher because of continued tightening in U.S. labor markets, rising wages, solid global economic growth, and weakness in the U.S. dollar combined with a pick- up in growth as a result of recent tax law changes. In addition, central banks around the world (led by the Federal Reserve Bank and Bank of England) are slowly starting to reduce their asset purchases which should start to have an impact on financial markets over a period of several years. The effect of all of these factors highlighted above should lead to a moderate rise in interest rates during the year ahead.

HOW DO YOU APPROACH FIXED INCOME INVESTING?

At RDM, we believe that nobody can accurately forecast the direction of interest rates consistently over time. Therefore, to try and provide stability and predictability on the fixed income side of client portfolios, we take a majority (in larger accounts) of fixed income assets and ladder corporate bonds (municipal bonds where appropriate). With the remaining 25% or so of fixed income assets, we invest in a select basket of short duration multi-sector bond funds. The bond ladder provides steady cash flow while the bond funds represent liquidity and dry powder to take advantage of future investment opportunities.

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SUMMARY

There is an expression in financial markets that economic expansions don't simply die of old age, they die of fear or fright. This fear is the result of aggressive Federal Reserve Bank rate tightening that raises interest rates, chokes off economic growth and leads to a decline in corporate profits. If the economy keeps growing, corporate profits continue to rise, business spending picks up and the Federal Reserve Bank stays on course and raises rates gradually over the next year or two, there is no reason to think that the current expansion is about to end. Our opinion could change as we head into the second half 2018 and beyond but the chances of a near term downturn in the economy currently appear fairly low.

The stock market is likely to experience modest pullbacks from time to time and the next one could occur at any time. Potential triggers for the next pullback could be investors reacting to new tax law changes in early 2018 or uncertainty surrounding mid-term elections later this year. Market technicals currently appear supportive as we start the year with the Dow Jones Industrial Average, Dow Jones Transportation Index, Russell 2000 Small Cap Index and New York Stock Exchange advance-decline line having all recently posted new all-time highs. Historically, internal market divergences typically occur before the markets run into serious trouble.

When you put it all together, we believe that some additional upside in the markets in 2018 appears likely although returns are likely to be less robust than we have witnessed in recent years. Potential risks include rising rates, higher inflation, geo-political factors or weaker than expected economic growth or corporate profits. As we had through the year, we will keep an eye on changing economic fundamentals that may lead to a less favorable investment landscape during the second half of the year heading into 2019.

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Description

The S & P 500 is widely regarded as the best single gauge of the U.S. equities market. The S & P 500 focuses on the large-cap segment of the market and includes a sample of 500 leading companies in leading industries throughout the U.S. economy.

The MSCI All Country World Index (ex-USA) represents a free-float adjusted market capitalization index designed to measure the equity market performance of developed and emerging market outside the United States.

RDM Financial Group

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