HighTower
WESTCHESTER

Q4 2017 Market Commentary

What a Year!

That is a wrap folks, 2017 will go down as one of the most remarkable on record.

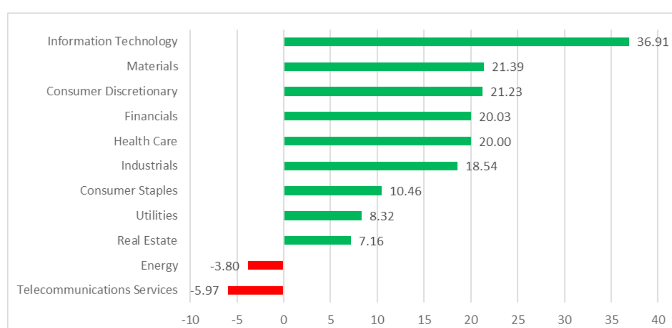
Few investors expected the S&P 500 to post gains of close to 20% with near-record low volatility while enduring geopolitical tensions, massive natural disasters, political infighting in Washington, and a tighter monetary policy. The S&P 500 saw returns unlike anything in the past 90 years; positive returns for all 12 months of the calendar year. In addition to steady gains month by month, the S&P 500 did not have a single day-to-day price swing of 2%, compared to eight fluctuations of this nature in 2016[1]. Every month garnered positive returns for the S&P 500 for the first time since 1970[1]. As of this writing, we are in the longest period in S&P 500 history without a 3%+ correction, with no move of that size since November 4, 2016[1]!

The final quarter of 2017 followed suit of those that came before it in respect to the success of U.S. equity markets. The S&P 500 ended a strong year with a fourth-quarter gain of 6.6%, the Dow Jones Industrial Average and the NASDAQ Composite both hit record highs in the final month of the quarter and are approaching the 25,000 and 7,000 marks, respectively[1]. All three indices remained supported technically at year-end, trading well above their 200-day moving averages[1].

As performance continues to dominate the headlines, it is important to note the extremely low volatility we witnessed last year. One way to measure just how smooth (or volatile) the market was is by looking at the readings of stock volatility expectations, in this case the S&P 500 Volatility Index, aka, the VIX. The VIX did not eclipse its average of around 19 once this year, with an average market volatility closing price at 11 through year-end, the lowest record level since the indexes inception in 1986[2].

The quarter and year also witnessed robust corporate earnings, particularly from the technology sector. According to FactSet, as of year-end, the estimated fourth-quarter earnings growth for the S&P 500 was 10.9%, with all 11 sectors projected to grow from third-quarter levels[1]. If we get this level of growth and analysts have made much smaller downward revisions than usual, it would mark the highest level of annual earnings growth for the S&P 500 since 2011. As fundamental performance ultimately drives long-term returns, this would be a strong tailwind for investors. Cyclical areas of the market performed well, with gains led by the consumer discretionary sector, technology and materials. The energy and telecommunications sectors underperformed. Will we start to see the rotation out of cyclicals, like technology, into cheaper more defensive sectors such as real estate or consumer staples? This is something to watch as we move into 2018.

Below is a chart that shows the Global Industry Classification Standard (GICS) sector price change for 2017. As you can see, cyclical areas of the market outperformed the defensive areas.



Source: FactSet[1]

1 FactSet financial data and analytics. www.factset.com

2 https://www.zerohedge.com/news/2017-12-28/2017-record-smooth-ride-stocks

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Larger, growth-style stocks carried the equities market in 2017, outperforming smaller, value-based stocks by upwards of 50% in the most extreme cases[1]. Valuations of growth stocks are extremely high, and the spread between growth and value stocks is the highest in over a decade[1]. The cyclical tendencies of trends such as this one suggests that the wide spread between growth and value stocks may soon begin to close. As the U.S. Federal Reserve (Fed) hikes further to tame inflationary pressures, real interest rates will likely go up. As real interest rates rise, "long duration" equities whose valuation is based on cash flows further in the future—i.e. growth stocks—get hurt more than "short duration" equities—i.e. value stocks. As a result, growth will tend to underperform value if inflation rears its head in a meaningful way.

Commodities finished the year on a strong note. While the overall sector has been recently lifted by gains in crude oil, copper and gold, it still remains well below 2008 highs. After much worry around the geopolitical turmoil in the Middle East and the constant question of a hard or soft landing in China, commodities remained resilient despite these headwinds. West Texas Intermediate (WTI) Crude rose above $60 per barrel for the first time since 2015. It is important to note that you generally see commodity highs right before or during recessions. Many market pundits are calling for a strong year in commodities in 2018.

As had been widely anticipated, the Fed lifted interest rates by 0.25% in December, pushing the federal funds target range increase to 1.25%-1.50%. That totaled three Fed increases of the federal funds rate in 2017. Historically, prime rate and credit card rates have followed suit of the Feds Fund Rate, and they will likely see an increase in 2018. The Fed also raised its growth forecasts for 2018 to 2.5% from 2.1%.

President Trump's nomination of Federal Reserve Governor Jerome Powell for Fed Chair contributed to the already low volatility in the market and may have even spiked market growth in the later months. Powell, already experienced on the Federal board, seems likely to continue most of the policies set by previous Fed Chair Janet Yellen without any real drastic change. Jumps in the market in late November were helped by positive investor sentiments regarding the newly named nominee.

International markets also had a successful year. The MSCI EAFE Index, which tracks developed markets, gained 1.6% for December, 4.2% for the fourth quarter, and 25% for the year[1]. The more volatile MSCI Emerging Markets Index returned 3.6% for the month, 7.5% for the quarter, and a whopping 37.3% for the year[1]. Like U.S. markets, international markets closed the year with strong technical support, trading well above their trend lines.

Last year marked a strong year for international investing as international funds pulled in over $221 billion, the highest yearly total since 2000[3]. With domestic valuations reaching elevated levels, investors looked abroad in hopes of greater return potential and diversification. While Brexit has remained in the headlines throughout most of the year, it is still too early to make any determination on whether it will be a hard or soft exit for the United Kingdom from the European Union. The European Central Bank (ECB) declared that it would cut back on its bond buying program each month from €60 million to €30 million, but the program will be extended another year at the very least.

Emerging markets (EM) witnessed a terrific year. Consistent growth in the global markets led investors to venture into the undervalued sectors in EM. These are higher risk sectors, but the extremely low volatility we saw this year made them the most profitable. It is important to note that this performance came at a time with high commodity volatility and headwinds, something that generally hinders emerging market performance.

Fixed income had an underwhelming and more volatile year than equities, as early outperformance was offset by rising rates. Although the rate hikes are indicative of the Fed's confidence in the ongoing economic expansion, rising rates can hit fixed income markets, and that is exactly what we saw. Getting away from traditional fixed income paid in 2017. The best performing sectors, convertible bonds and high yield bonds, is where we had a healthy

3 http://beta.morningstar.com/

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allocation. Markets currently anticipate two to three rate hikes in 2018, which could have similar effects.

Despite the rate hikes, the Bloomberg Barclays Aggregate Bond Index gained 0.5% in December, bringing the quarterly return to 0.4% and capping the annual return at 3.5%[1]. The Bloomberg Barclays U.S. Corporate High Yield Index had similar returns of 0.3% and 0.5% for the month and quarter, respectively; however, a stronger start to the year left the index with an annual return of 7.50%[1]. 2017 witnessed the difference between the yields of 2 and 10-year Treasury notes shrink from 1.25% to 0.64%[1]. This decline in the yield curve of 10-year notes due to a hike in the Fed funds rate sees the yield curve approaching flat in the coming years if it continues this same trend.

The Tax Cuts and Jobs Act represents positives for municipal bondholders, but potentially adds additional financial pressure on municipal issuers, specifically in high-tax states. Many experts do not believe lowering the top federal income tax rate to 37% from 39.6% will curtail individual demand. The $10,000 maximum deduction for a combination of state and local income taxes or property taxes could increase demand, particularly for those who live in high-tax states.

Over the last six weeks, market inflation expectations have undergone a signal shift to the upside. The U.S. five-year break-even inflation rate has climbed from below 1.7% in early December to 1.95% recently[1]. In other words, market expectations for U.S. inflation, which had long remained markedly subdued, have now played catch-up with the Fed's own projections, which see core inflation rising to 1.9% this year and 2% in 2019.

Over the last couple of months, two main lines of reasoning have been advanced for why inflation pressure should remain subdued. First, the individual tax cut passed into law last month could encourage enough people to reenter the labor market to check, or even reverse, the fall in the unemployment rate, and by extension reduce upward pressure on wages. With the labor market at its tightest in years, there are reasons to doubt this argument.

First, in the past when job market tightness has propelled a rise in the labor participation rate, the increase was insufficient to reverse the decline in unemployment. In order to have a significant effect this time around, labor force participation would have to rise at a considerably faster pace than in past decades. Demography makes that unlikely. With stimulative tax changes likely to boost labor demand, the economy will have no difficulty absorbing any increase in the supply of workers.

The second reason some believe inflation will remain subdued is that there is still considerable excess capacity in the U.S. economy, at least as measured by the Fed's manufacturing capacity utilization rate, which stood at a modest level in the fourth quarter. Therefore, inflation should be kept in check even if tax changes boost capital spending. However, there are shortcomings in the Fed measure, which requires companies to assess their full capacity regardless of any bottlenecks in obtaining the necessary materials or skilled labor. In contrast, such constraints are factored into the ISM manufacturing operating rate, which in December was much tighter. This discrepancy suggests labor market tightness is the key constraint on business activity, and that any increase in capacity utilization from here is likely to accelerate both wage pressures and consumer inflation. Both points suggest market inflation expectations have further to rise to catch up with the reality of the stimulative effect of tax reforms against a backdrop of labor market tightness. While we expect this to occur, we do not expect inflation to increase at a runaway level.

After watching the market grind slowly and, for the most part, steadily higher with very little volatility in 2017, most investors we speak with have one question on their minds: "What is the market going to do in 2018?" They ask this question with a sense of both anxious anticipation and maybe a little fear. Anxious about the possibilities of what a new year might bring, but at the same time fearing the volatility that an uncertain world could always produce at some point. The memory of the Great Recession of 2007-2008 remains fresh in many investors' minds. Will the world be more uncertain in

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2018? Only time will tell. Equities compared to many fixed income investments, offer quality dividend-paying stocks with attractive yields and the chance to participate in a growing economy and a rising stock market.

Are we expecting equity prices to surge as they did last year? Hardly. But keep in mind the economy will likely grow at a reasonable but still below-trend pace over the next year. And earnings growth should get a big boost from the new tax code in 2018. Without the tax change, we would have expected earnings growth to slow this year relative to last year. As we attempt to read the tea leaves, our work suggests the United States will be in a modest-growth/modest-inflation environment throughout the year. We see the S&P 500 gaining ground again this year but don't expect the same magnitude of returns as 2017's.

As we look forward into 2018, we think it will be important for investors to anchor their expectations. Many questions remain on the geopolitical front around trade deals, infrastructure, and North Korea to name a few. Yet, there are reasons to be optimistic, and the new tax code will likely help extend the current expansion. We think the probability of a recession this year is low. In the near term, the stock market appears ready to trade modestly higher on recent momentum and better economic news. The new year should not be a year to dump all deposits into sectors that saw success in the previous year, and diversification will be key to managing a bullish market coming off such a successful year. Something we at Hightower Westchester are proponents of.

Looking around the globe, other developed economies such as Japan and Europe will also likely see reasonable economic growth in the quarters ahead. But will the ECB back away from its easy money policies sooner than we expect? How about the Federal Reserve? The stock market would, in our opinion, react negatively to measures that reduce central bank liquidity policies too quickly.

Increased market volatility is very possible. But even then, any short-term shocks should be offset by the strong economic and corporate fundamentals. As always, a well-diversified portfolio matched to your risk tolerance remains the best way to meet your financial goals over the long term. With all of the hysteria around speculative investments such as Bitcoin, we continue to stay true to our process of building diversified portfolios around multiple time horizons, while garnering ideas on and off Wall Street.

Thanks again to all our clients for their support throughout the year and we look forward to what we hope will be another successful year.

To discuss this commentary further, please contact us at 914-825-8630.

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