2017 Wrap Up

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> *"We make a living by what we get, but we make a life by what we give."*
>
> *Winston Churchill*

In this holiday abbreviated version of*Market Monthly* we'll recap some key themes and trends we've discussed throughout the year and begin setting the stage for 2018. In January we will release a 2018 Outlook edition to preview our thoughts for the year ahead.

With our first edition of *Market Monthly* in February 2017 we profiled Five Key Themes, which we revisit here.

1. **Global economic growth is improving and gaining momentum:**

We repeated this theme throughout the year, and our positive outlook actually underestimated the scale and strength of the synchronized global growth we've seen in 2017. As we write, signals of broad economic growth remain anchored and in some cases, are accelerating. The slow return to a normally functioning business cycle that is less dependent on central bank life support has been the tailwind behind the double-digit returns that global stocks markets have enjoyed this year.

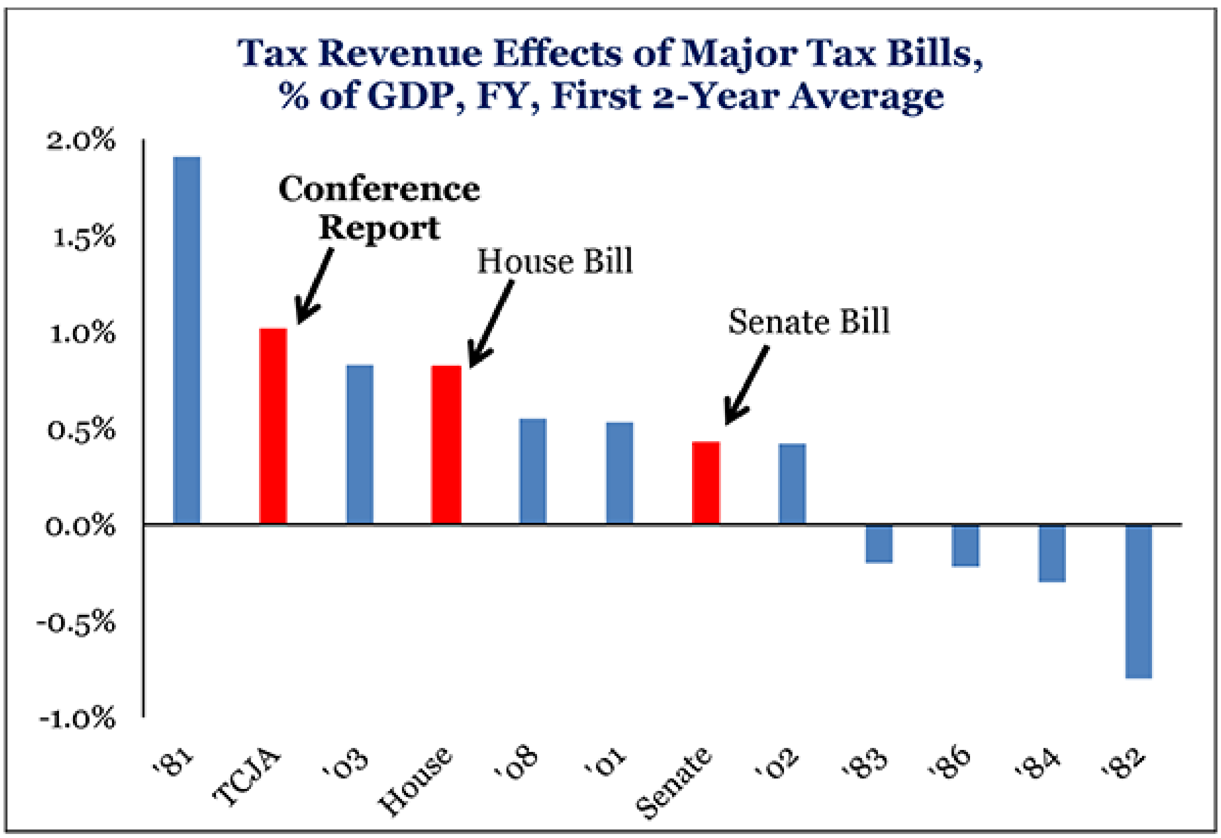
2. **Expansionary fiscal policy slowly takes the reins from extraordinary monetary**

policy:

This has been and will remain a focal point for the U.S. economy in particular for 2018. In our first edition for 2017 we asserted that “tax reform and deregulation are expected to nudge the U.S. back toward a more normal business cycle in 2017-2018, adding as much as .5 percent to GDP growth.”

We understand the concept of tax reform generates wide ranging economic and philosophical debates. Our views focus on those items related to corporate tax reform that can be expected to impact financial asset prices and investment returns not ideological values or ideas.

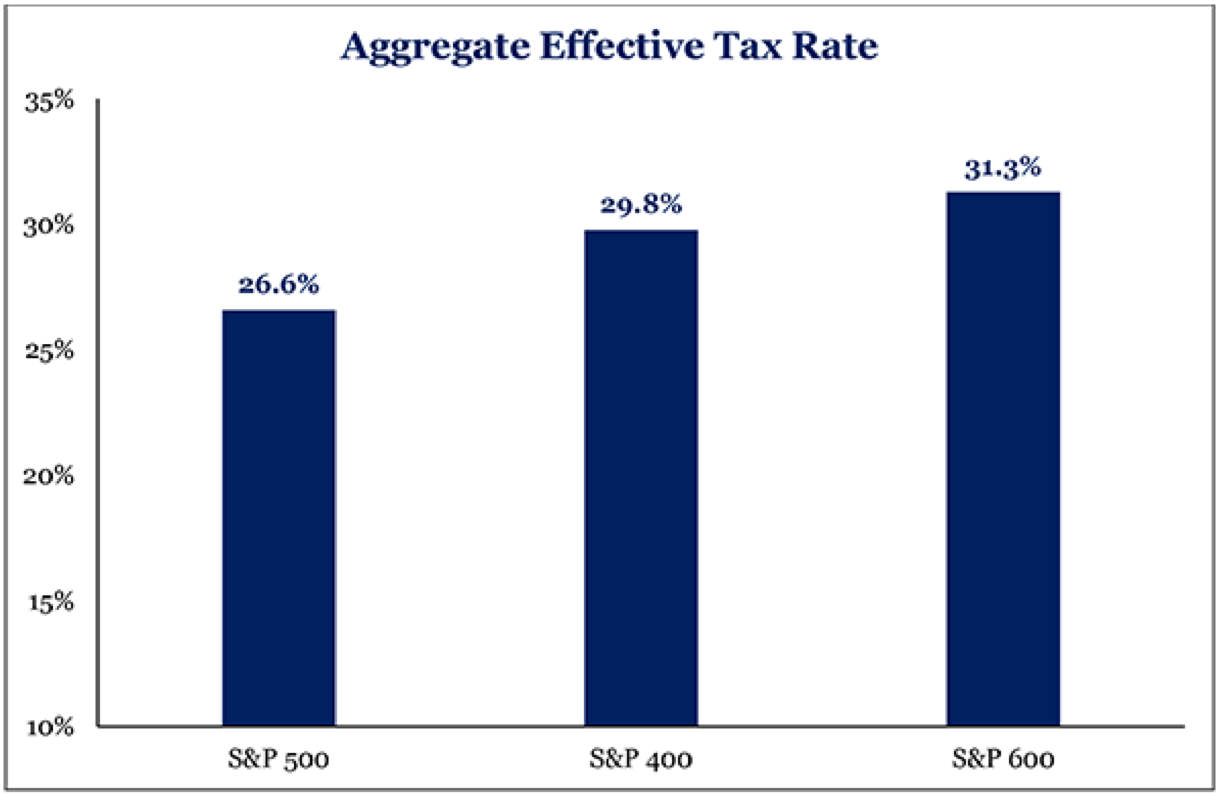
The chart below compares the anticipated economic impact from the latest version of the tax bill from last week’s Conference Report to prior tax law changes. It suggests that the tax bill could generate incremental GDP growth of 1 percent over the next two years. If this occurred, corporate earnings and therefore stock prices could get a boost. Likewise, this kind of stimulus would likely have an impact on Fed decision making and therefore, bond prices.



3. **U. S. Stocks will be driven by economic fundamentals:**

Earnings for U.S. corporations have now experienced five consecutive quarters of growth and leaders have been led by revenue growth rather than financial engineering through stock buybacks. Over 90 percent of the world’s economies are in expansion territory, and it is this broad-based growth that has fueled equity returns for 2017. We see this continuing in 2018 but suspect returns may be more subdued.

In 2018, opportunities may present themselves at either the market cap level or even the sector level. Incremental return opportunities may be available at the margin through allocations to corporate beneficiaries of tax reform. For example, the S&P 600 Small Cap index has an aggregate effective tax rate that is almost 5 percent higher than the S&P 500 Large Cap index and is thought to be a key beneficiary of lower taxes.



There may be selective opportunities we will discuss in more detail come January. We emphasize, however, that tax reform is just one lens through which to view stocks or any investment decision. It would be a critical error to invest solely based on anticipated effects of tax reform as markets quickly reflect this in their prices. Tax reform is important in that it could impact stocks prices, but it is a marginal issue, not the key issue.

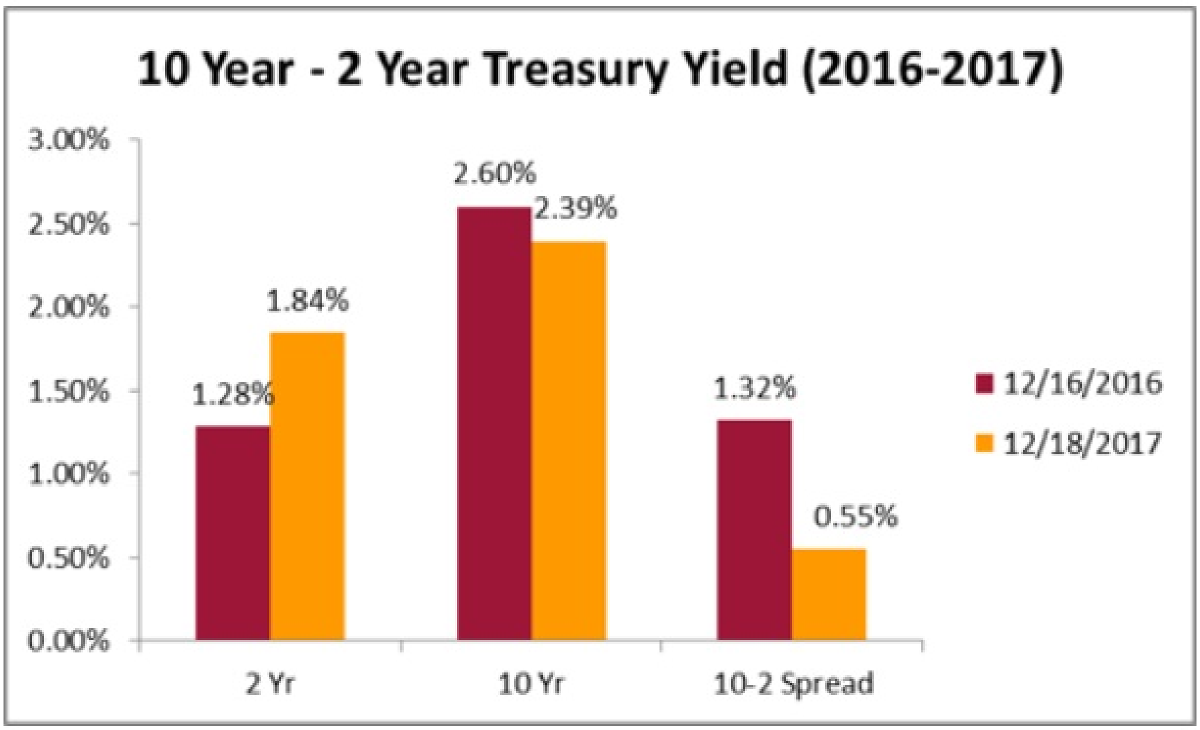
4. **International stocks are becoming more attractive but the dollar matters:**

The market leadership baton that passes between U.S. and international markets often experiences cycles of three to seven years. At the beginning of 2017, we said: “Improving fundamentals could make 2017 a comeback year for international stocks. A flat or declining dollar helps international stock returns for U.S. investors.”

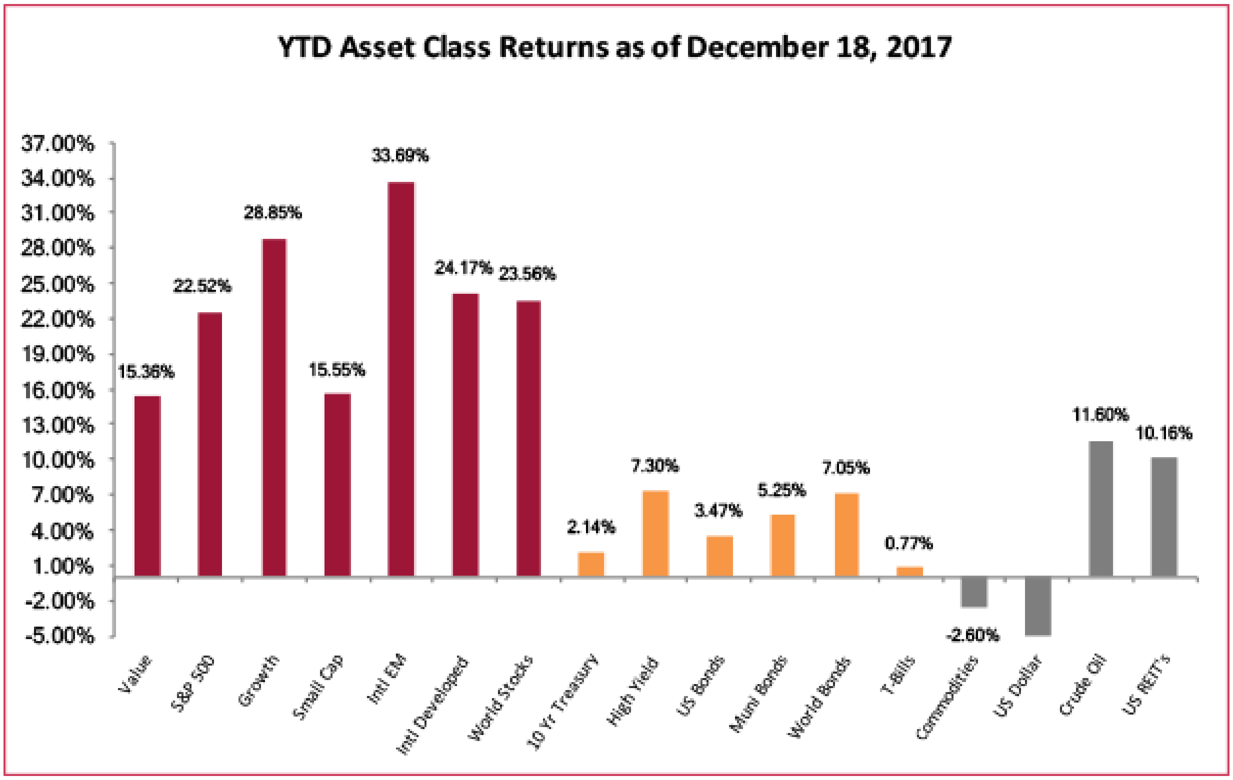
Both of these themes played out in 2017. International earnings accelerated and earnings revisions were upward. Additionally, the U.S. dollar has declined roughly 8 percent since January providing U.S. investors a tailwind behind already healthy international returns.

5. **Bond returns will be tied to Fed policy and tax-reform policy:**

Admittedly, this will always be the case. Bonds will always and forever be tied to the business, credit and economic cycle. We did not anticipate the degree to which the U.S. yield curve would flatten in 2017. A common barometer and forward indicator of the economic cycle measures changes between 10-year and 2-year Treasury Notes. As the chart below shows, the difference or spread 10- and 2-year Treasury Notes shrunk from 1.32 percent to today's .55 percent. Two-year bonds increased .56 percent and 10-year bonds decreased .21 percent. This is not unusual for this late stage of the cycle and is something we will continue watching closely in 2018 for potential signs of economic stress. Often a flattening yield curve leads recessions by as much as two years but generally does not set off alarm bells until and unless short-term rates exceed long-term rates. This is not a near term concern.



2017 Performance Discussion: The chart below tells how 2017 has unfolded through Dec. 18th. Red bars represent equities, orange bars represent bonds and grey bars represent real assets. This year has been a very good for equity investors in particular.



Equities:

- Global economic growth fueled stock returns in 2017
- Anticipated corporate tax reform served as a tailwind to earnings expectations and stock prices
- Growth stocks outpaced value stocks and was led by the technology sector
- A weak dollar boosted developed and emerging market returns by up to 8 percent

Bonds:

- High-yield bonds performed well with strong economic growth and diminished fears of default
- Muni bonds rebounded from early fears about retaining their tax-exempt status
- World bonds returns were strong but returns were accounted for by a weak dollar

Final Thoughts:

Fed Policy continues to head down a path toward incremental rate hikes with new voting members. In 2018 the key will be striking the right balance between tighter Fed policy and easier fiscal policy. The simultaneous execution of these contrasting policies must be delicate so that further rate hikes don't diminish the anticipated economic impact of tax reform. It will be one of the most important stories of 2018 and one we will cover closely here.

We remain constructive on global equities in 2018 but caution investors against a complacent 2017 victory lap without the balance of a forward reality check. Global stock benchmarks remain at their lowest levels of volatility in over 30 years and this is a temporary condition. Investment themes need to focus on stocks, sectors and regions where business is good not just where taxes are lower. This year's stock returns have, to some extent, borrowed against the benefits of anticipated tax reform. At some point, stock markets will shift from the current steep return/flat volatility regime to a flat return/steeper volatility regime. Stay tuned and stay invested.

At this writing on Wednesday December 20th, the House and Senate have both passed the joint Conference Bill for tax reform along party lines. The Conference Bill resulted from melting together the original House and Senate bills after debate and negotiation. The final bill could be signed by the President before Congress adjourns for Christmas. Please refer to our more detailed coverage of the tax plan at https://bbtperspectives.com/category/market-news/in-the-news/.

This has been a terrific year for many investors, and we remain cautiously optimistic as we head into 2018. Strong economic growth, anchored inflation, low interest rates, anticipated tax reform and resurgent corporate profitability have supported a pro-risk investment posture for 2017. Put simply, anything that jeopardizes the above arguments threatens the extended recovery and market rally. Economic cycles, market environments and geopolitical events all have their own seasons. Through all of them we objectively apply the information we have to make informed investment decisions.

We are currently working on our 2018 Outlook edition of *Market Monthly,* which we will share with you early in the new year. We remain thankful year-round for the opportunity to be of service to you, and wish you and your families a safe and happy holiday.

Thank you!

Sources: Strategas Research Partners, Evercore ISI, FactSet, Goldman Sachs Global Investment Research, Morningstar, BCA Research

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