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MARKET REVIEW
DECEMBER 2017

MARKET BRIEF

LET'S NOT GET TOO EXCITED. IT HAPPENS.

Pop music divas, The Pointer Sisters, have a song with the following lyrics: “I’m so excited, I just can’t hide it, I’m about to lose control, and I think I like it.” Although it might be a stretch, that sentiment just about captures the latest perceptions of the remarkable rally in stocks this year. As measured by the Dow Jones Industrial Average (DJIA), stocks have added thousands of index points. Just a year ago, the DJIA hovered in the mid-19,000s, and recently topped 24,000. While some investors feel stocks have gone too far too fast, but certainly “like it,” but others are worried.

It only seems fair here to avoid punitively throwing cold water on those investors who believe the rally has legs by giving credence to those nervous investors fearful of a crash without a clear catalyst. Our focus here will be to take a moment to examine how the economy and markets often work together and influence each other.

EVERYBODY LOVES SURPRISES, EVEN THE STOCK MARKET

A theoretical underpinning of equity valuation is that stocks are considered a *forward discounting mechanism*. Put differently, the price of a stock today reflects the future cash flows discounted back to today using a specialized time value of money calculation. If the market is efficient, meaning prices fairly reflect all available information, then when new information appears stock prices should change to reflect that new information. On a near daily basis, new information with the potential to impact stock prices appears in items like economic data releases, company earnings reports, changes in monetary policy and so on. When data is released that is different from what the market expects, that information is a surprise and has the potential to affect prices.

If the surprise is better than expected, for example a Gross Domestic Product expectation of 3.1% and an actual reading of 3.3%, then stock prices could move higher to reflect a stronger economy. On the other hand, worse-than-expected surprises, like retail sales growing at a slower pace than expected, could push shares lower.

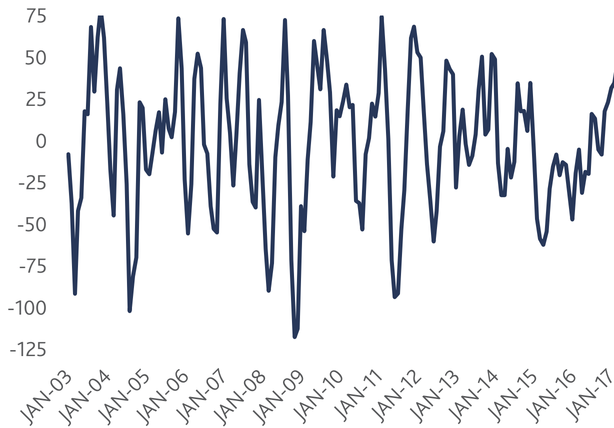
Citigroup has published an index that tracks economic surprises for nearly 15 years, and it appears on the top left side of page three. When the index is positive, surprises have been better than market expectations and vice versa. Observing on the graph that the trend has improved since early 2015, (despite a hiccup in early 2017) ought to help explain the strength of the equity rally and why it can still continue. As the economy and markets keep posting better-than-expected results, stocks have risen to reflect this new and improved data. As long as the economy keeps surprising to the upside, stocks have a good opportunity to keep rising.

WHAT ARE THE ECONOMIC SIGNALS?

If stocks move higher (lower) when economic surprises are positive (negative), then to some extent stock prices are dependent on economic data. Having an understanding of the latest economic trends may help investors better understand where stocks could be headed. The Conference Board’s Index of Leading Economic Indicators (LEI) measures changes in economic data to help discern whether the economy is growing or slowing. Going on 50+ years, it is one of the oldest and most respected economic forecasts.

CITIGROUP ECONOMIC SURPRISE INDEX (CESI)

JANUARY 2003 THROUGH NOVEMBER 2017



Source: Bloomberg. Past performance does not guarantee future results.

LEADING ECONOMIC INDICATORS (LEI)

MONTH OVER MONTH JANUARY 2003 THROUGH OCTOBER 2017

Source: Bloomberg. Past performance does not guarantee future results.

Reviewing monthly percentage changes in the LEI can indicate whether the economy is accelerating or decelerating. The graph to the top right shows this data over the past 15 years. It pretty clearly shows an economic deceleration beginning in 2007, nearly a year before the steep equity market decline sparked by 2008's sub-prime housing loan crisis. Considering that the more recent measurements of change in the LEI are positive, it seems premature to conclude that the economy is sufficiently decelerating to merit a response in stock prices.

CONCLUSION AND INVESTMENT IMPLICATIONS

The Citigroup Economic Surprise Index (CESI) and LEI are currently rather strong, and that strength is reflected in excitement for stocks. What if that excitement is misplaced? So what. History shows us that something always goes wrong. Experienced investors have seen markets disrupted by factors and events outside of the economic data, which would not appear in the CESI nor LEI. Though difficult to generalize, market breaks precipitated by non-economic events have tended to be very sharp and short lived.

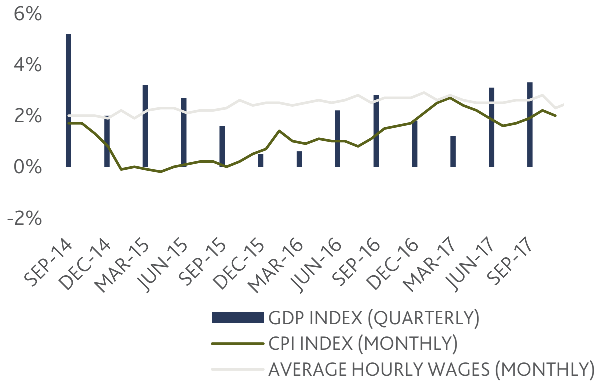
Stock prices can overshoot in both directions, and may very well have recently. Still, that label alone is not a sufficient condition to abandon equities entirely. The up and down pattern of both the economy and stock market are named "business cycle" and "market cycle," respectively, for exactly this reason. To borrow a phrase from a 1980s bumper sticker "Overshoot happens."

Our portfolio team works hard to understand our clients' goals and objectives, and to help them choose a strategy that has the best opportunity to deliver. A crucial part of these deliberations is presenting the inherent rewards and risks in proper context, including awareness of both the ups and the downs which will occur in any investment horizon. Being appropriately diversified among stocks, bonds and lower correlated alternatives, and periodically rebalancing when allocations have drifted sufficiently far from targets is an important component of the investment process.

ECONOMY

GDP, CONSUMER PRICES AND WAGE INFLATION

SEPTEMBER 2014 THROUGH NOVEMBER 2017

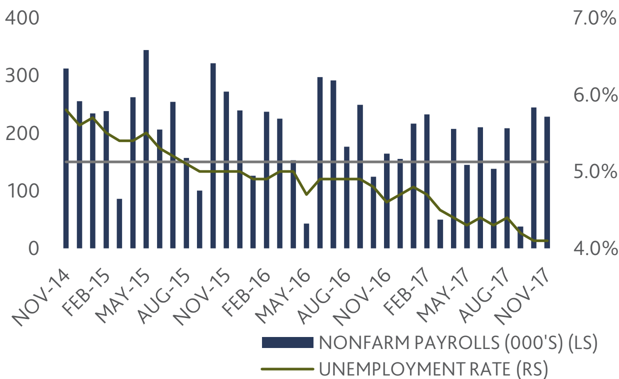


Source: Bloomberg

- Third quarter U.S. GDP was revised upward to an annualized rate of 3.3% from 3.0%, driven by strong investment from businesses and government agencies. This is the highest growth rate since the third quarter of 2014.
- The core Personal Consumption Expenditure (PCE) price index rose 0.2% in October. The YoY reading for Core PCE increased 1.4%, matching September's rise, but still well below the Fed's 2.0% target.
- Headline CPI, which includes volatile food and energy costs, rose by 0.1% in October. The annualized rate for broad consumer prices declined to 2.0% from 2.2% in September.

LABOR MARKET

NOVEMBER 2014 THROUGH NOVEMBER 2017

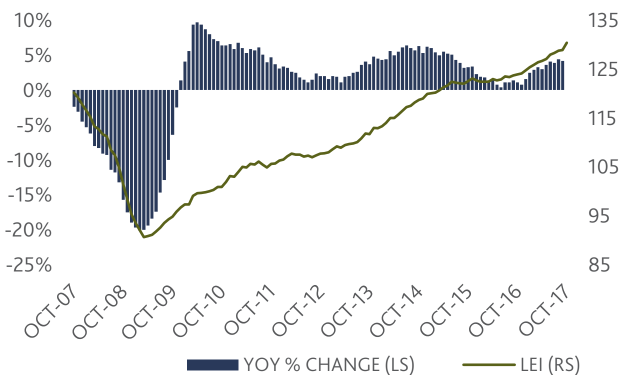


Source: Bloomberg

- U.S. nonfarm payroll employment increased in November, adding 228,000 new jobs, coming in 38,000 jobs ahead of the consensus estimate.
- The stronger-than-expected payroll data in November was driven by outsized gains in manufacturing and professional services which added 31,000 and 46,000 jobs, respectively.
- The unemployment rate remains unchanged from October at a 17-year low of 4.1%. U.S manufacturing unemployment rate hit a record low of 2.6% in November.

LEADING ECONOMIC INDICATORS

OCTOBER 2007 THROUGH OCTOBER 2017



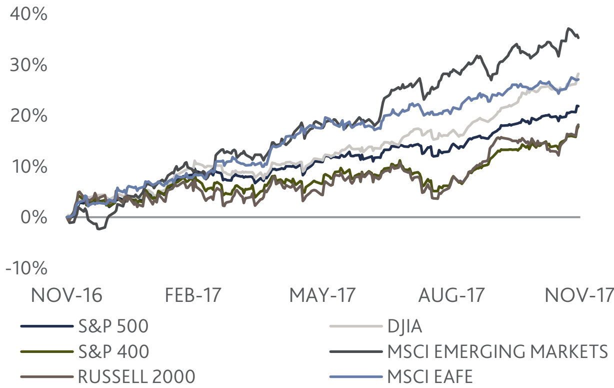
Source: Bloomberg

- The LEI Index, published by the Conference Board, is comprised of ten economic components, and is considered a helpful gauge for estimating economic activity for the subsequent three to six months. The LEI Index increased 1.2% in October to 130.4, following an increase of 0.1% in September.
- Nine of the ten components of the LEI increased for the month of October. The largest contributors were average weekly initial claims for unemployment insurance (inverted), building permits and new orders.
- The broad-based strength in this month's reading of the LEI index was partially attributed to the dissipating impact of this summer's hurricanes. The data in October sets a strong backdrop for the U.S. economy entering the holiday season and into the new year.

EQUITY

TRAILING 12-MONTH EQUITY RETURNS

PRICE APPRECIATION, NOVEMBER 2016 THROUGH NOVEMBER 2017

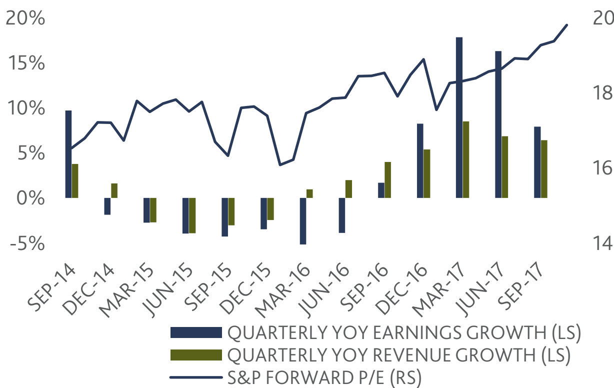


Source: Bloomberg

- In the U.S., progress on Republicans' tax bill fueled another strong month for domestic equities. The S&P 500, S&P 400, and Russell 2000 each returned around 3.0% or better last month. The S&P 500 reached 13 consecutive months of positive total returns, its longest streak in history.
- Foreign developed equities trailed domestic equities last month as MSCI EAFE gained 1.1%. The United Kingdom weighed on EAFE amid Prime Minister Teresa May's declining support in her Conservative Party. Lack of unity within the Conservative Party could complicate Brexit negotiations. Japan's 3.0% monthly gain made it one of the best performing countries globally. Japanese equities are benefitting from a weaker yen and good earnings.
- Emerging markets were the weakest equity market in November as the MSCI EM index rose 0.2%.

S&P 500 YOY EARNINGS & REVENUE GROWTH

BY QUARTER, SEPTEMBER 2014 THROUGH NOVEMBER 2017

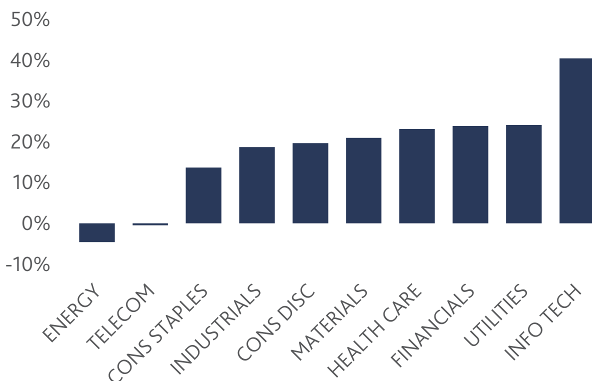


Source: Bloomberg

- The third quarter earnings reporting season is essentially complete with results reported from 99% of S&P 500 companies. S&P 500 earnings growth was about 7.0%, well above analysts' for 3.7% estimate. The technology sector was the largest contributing sector with 23.5% earnings growth.
- The financial sector was the largest detracting sector with an earnings decline of 8.9%. Insurance was the primary detractor within financials due to hurricane-related costs. Excluding insurance, the financial sector would have experienced earnings growth around 6.0%. Analysts are expecting S&P 500 earnings to rebound next quarter to double-digit growth.

S&P 500 SECTORS 12-MONTH RETURNS (PRICE)

NOVEMBER 2016 THROUGH NOVEMBER 2017



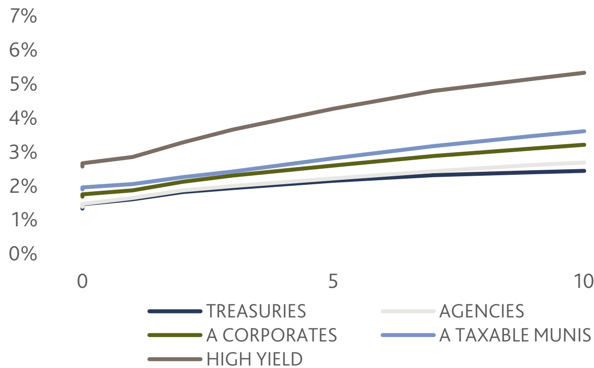
Source: Bloomberg

- The technology sector lost momentum last month as it was the second worst performing sector with a gain of 0.9%. One explanation for technology's weak performance was sector rotation out of technology to protect large gains this year and into defensive sectors and companies, such as banks, that will benefit the most from a reduction in taxes.
- Consumer staples and telecommunications were the best performing sectors last month as each gained over 5.0%. Their strong performance is another sign of a sector rotation into some of this weaker groups thus far year-to-date.
- Retail stocks led the consumer discretionary sector to strong performance last month. The S&P 500 Retail Industry index gained 9.5% in November. Strong Black Friday online sales indicate the holiday selling season is off to a robust start.

FIXED INCOME

CURRENT YIELD CURVES

YIELD CURVES AS OF NOVEMBER 2017

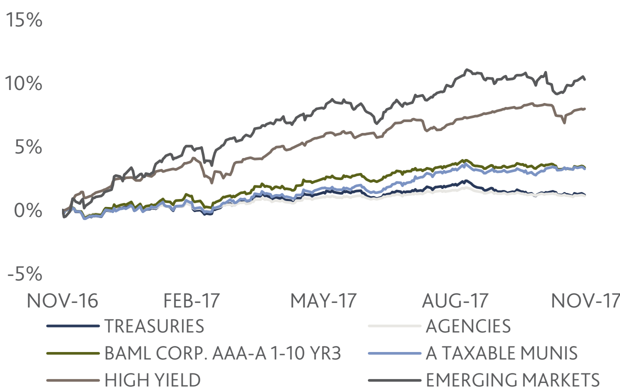


Source: Bloomberg

- The yield curve (the yield differential between the 2-year U.S. Treasury note and the 10-year) continued flattening significantly in November after fluctuating between a range of 75 basis points and 95 basis points between June and October.
- The yield curved ended November at 62 basis points, down from 78 basis points at the end of October and 85 basis points at the end of September.
- Bloomberg's BVAL AAA Baseline Curve, a measure of tax-exempt muni yields, saw the yield differential between 2-year and 10-year terms of its curve fall 25 bps in November, perhaps indicating that investors disagree with the theory that a global search for yield is causing curve flattening.

12-MONTH RETURNS, TAXABLE BOND SEGMENTS

NOVEMBER 2016 THROUGH NOVEMBER 2017

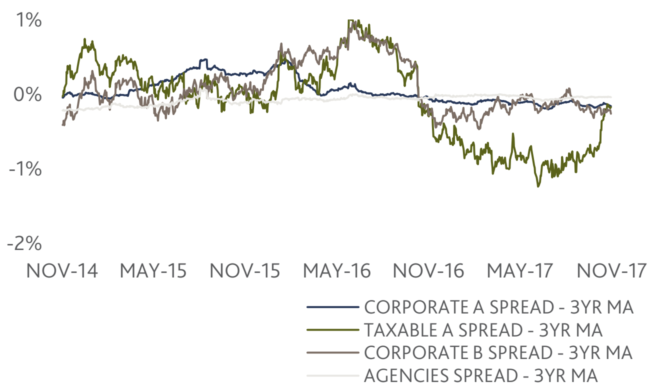


Source: Bloomberg

- Despite a challenging October, high yield and emerging market bond returns stabilized in November. These two sectors continue to maintain their rolling twelve month performance leadership by a wide margin over the rest of the major fixed income asset classes.
- If interest rates move higher in December, U.S. Treasury and Agency bond indexes may be in danger of posting a negative total return in 2017. Low coupon rates and investors' preference toward higher yielding securities have weighed on their relative performance this year.
- Investment-grade corporate bond and taxable municipal bond indexes have provided about 2.0% of excess total returns over their U.S. Treasury and Agency bond counterparts over the last twelve months.

SPREAD VS. TREASURY LESS 3-YEAR MOVING AVERAGE

NOVEMBER 2014 THROUGH NOVEMBER 2017



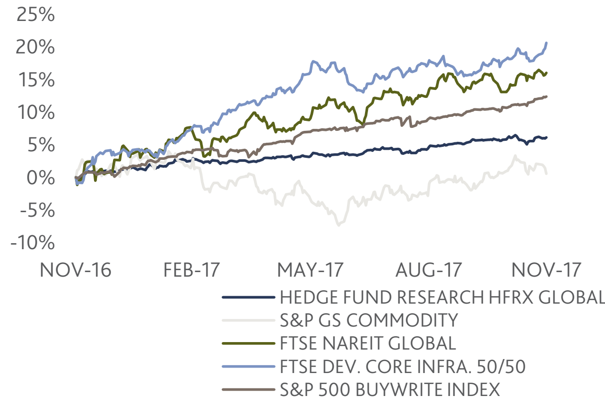
Source: Bloomberg

- Municipal bond spreads widened significantly in November, as issuance surged driven by a rush from states and cities to issue debt before the GOP tax legislation rolls back tax breaks tied to municipal bond coupon payments.
- After the recent widening of municipal spreads, the interest rate differential compared to U.S. Treasury Bonds of all four fixed income asset classes shown in the graph to left remain very close to their respective three year moving averages.
- Tight spreads, particularly in riskier asset classes, tend to signal turning points in the credit cycle. Despite narrow spreads, defaults remain below their historical norms. This suggests the current credit cycle may still have legs.

ALTERNATIVES

ALTERNATIVES, 12-MONTH RETURNS

NOVEMBER 2016 THROUGH NOVEMBER 2017

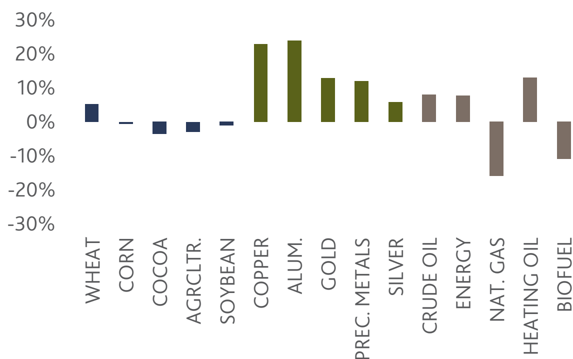


Source: Bloomberg

- Four of the five alternative asset class indexes tracked in the chart at left posted November total returns of at least 1.5%, led by global developed market infrastructure. Most participated to some degree in the latest leg of the U.S. equity market rally in November, which saw the S&P 500 Index generate a monthly advance of 2.8%.
- An allocation to alternative strategies significantly benefited fixed income investors for the 12-month period ending November 30. All five of the alternative investment indexes shown in the graph at left outperformed the 3.2% total return of the Bloomberg Barclays U.S. Aggregate Total Return Index over the period by at least 2.9%.
- The broad hedge fund asset class posted mixed returns in November, as the HFRX Global Hedge Fund Index posted a monthly gain of 0.1%.

COMMODITIES, 12-MONTH SPOT RETURNS

NOVEMBER 2016 THROUGH NOVEMBER 2017



Source: Bloomberg

- U.S. crude oil prices extended their October gains in November, breaking through $55 per barrel on November 3 and advancing 5.6% for the entire month. On the final day of November, the Organization of Petroleum Exporting Countries (OPEC) and its allies decided to extend their current production cuts until the end of 2018.
- Gold prices closed November at $1,273/oz. and traded in a very tight $30 range since the end of September. Prices have declined 5.5% since their closing level peak of $1,347/oz. in early September. Reduced tensions on the Korean peninsula and a slightly stronger dollar in recent months have likely weighed on prices over the last twelve weeks.

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