Resnick Advisors
A FOCUS FINANCIAL PARTNER

2017 Year End Review and 2018 Outlook
"The Year of Many Pleasant Surprises"

There were many pleasant surprises in 2017: the NY Yankees made it to the playoffs and Aaron Judge emerged as the rookie sensation of Major League Baseball with enormous talent and equally impressive humility; Sergio Garcia won The Masters golf tournament and finally claimed his first major golf title after more than a decade playing on the PGA tour; American ski racer Mikaela Shiffrin won the overall season title in the Women's World Cup at the tender age of twenty-two; Nationalist/xenophobic candidates in European presidential elections (France, Germany, and Netherlands) failed to win and their parties lost seats; volatility in capital markets was depressed; the border adjusted tax (BAT) initiative proved impractical and the prospects of trade war legislation faded early in the year; there was no summer crisis in capital markets for the first time in eleven years; global stock market indices rallied and U.S. tax reform legislation added to market momentum to close the year on a high note. A year of extremely pleasant surprises is coming to a close!

Clients and investors are now frequently asking if the markets are heading for a disaster, given the magnitude of the global rally this year in risk assets and its longevity. My response is "No", but I also caution them not to expect outsized investment returns in 2018 like we enjoyed this year. To understand this year's investment results and the outlook for capital markets next year, it helps to examine the underlying driving forces.

2017 Events and Driving Forces:

Corporate earnings/profits recovered dramatically worldwide. Earnings improved approximately +20% in the U.S. and Japan, + 15% in Europe and +25% in Emerging Markets. This year's surging earnings follow multiple years of stagnant (U.S. and Japan in 2014 - 2016) or contracting earnings (2011 - 2016 in Europe and Emerging Markets). Consequently, stocks have been rallying globally.

Economic growth resumed a global synchronous recovery starting in the summer of 2016, and growth accelerated this year following two years (2014 - 2016) of flat or negative growth. The global composite purchasing managers index (PMI) now registers 54 (very solid growth) and is strengthening. The multi-year stimulus programs, implemented by numerous Central Banks in many developed economies, are the foundation for these recoveries. The slowdown in growth in China appears to have stabilized this year and has been a big contributor to the recovery in Emerging Market/Asian growth.

Inflation is very muted (1%-2%) in most developed economies and follows almost five years of deflationary forces attributable to China's controlled economic slowdown. Globally, connected labor markets, modest industrial demand for commodities, ubiquitous tech innovations that constrain costs, and unfavorable demographics in key global economies (U.S., Europe, Japan and China) are all contributing to containing inflation and supporting lower interest rates.

Real Interest rates are still negative in Europe and Japan, and are slightly positive in the U.S. and solidly positive in some Emerging Markets. Divergent monetary policies among key Central Banks restrain rates from rising significantly higher. High government debt levels, and modest consumption demand due to unfavorable demographics, also depress growth rates and help constrain interest rates from rising rapidly. Given these persistently low interest rates, investors are forced to invest in riskier assets for a real return on their money.

Geopolitical events of significance to markets have unfolded with more favorable outcomes than anticipated at the beginning of the year: European elections, China politburo election and economic platform, failed repeal of the ACA (Obamacare) and U.S. tax reform legislation is becoming reality, a “pro-business” climate in Washington is driving increased corporate investment (Capex) and improved investor sentiment, UK Brexit negotiations with the EU are now underway, and OPEC/Russia pledged to continue crude oil production cuts to stabilize oil prices. Collectively, these developments have helped improve investor confidence about the future. Markets recognize that tensions with North Korea, Russia, and Iran persist and are potentially significant, but those countries do not drive the global economy.

An important element of our portfolio construction and management process is to regularly monitor the relative valuation of asset classes in which we invest. Basically, we evaluate if different investments are expensive, fairly priced, or cheap. In conjunction with other fundamental considerations, we may then adjust our allocation weightings accordingly.

Current Asset Class Valuations:

- **Equities:**

    - U.S: the S&P 500 is modestly expensive at 19x price/earnings “P/E” multiple vs. 16x P/E historical average. The NASDAQ trades at 22x P/E. *Note*: For historical context in the year 2000 at its most extreme rich valuation, the S&P 500 index traded at 26x P/E and the NASDAQ traded at 86x P/E (that is not a typo!). That is what a bubble looks like.
    - International Developed: fairly valued and trade at historical averages of 15x P/E.
    - Emerging Markets: cheap and trade at 13x P/E and are 20% below their historic average.

- **Interest sensitive bonds** (treasuries, municipals, agencies): are all expensive, with prices that are well above historical averages, offer paltry yields and currently have limited upside potential.

- **Credit sensitive bonds** (corporates, high yield/junk, Emerging Market sovereigns, asset backed, bank loans): are all modestly expensive, but are still more attractive than interest sensitive bonds. As economic conditions improve, so too does their credit quality.

- **Real estate:** is expensive with elevated prices and limited incremental yield.

- **Currencies:** valuations diverge broadly based on local Central Bank monetary policies that are increasingly in transition.

    - U.S. Dollar: is modestly expensive and may soften marginally
    - Euro and GB Pound Sterling: cheap and beginning to firm slowly
    - Japan: Yen weakening
    - Emerging Market and Commodity countries (Canadian and Aussie dollar): cheap and strengthening

- **Commodities:** oil seems fairly valued while industrial metals are moderately cheap.

2018 Outlook:

All indicators suggest the U.S. economy is continuing to strengthen at a modest pace. U.S. tax reform, whose final details are still to be determined in Congressional conference in the next few weeks, should add some modest incremental growth to our economy over the next few years. The scoring committee, who works for Congress, estimates tax reform will add +0.5% / year to GDP. Consequently, I do not anticipate any risk of recession before 2019.

Economic recessions always lead to contraction in corporate earnings and significant loss of value (> 20%) in risk assets (equities, real estate, commodities) . . . "bear market". Recession induced bear markets usually last 1-3 years in duration and is extremely unpleasant! The single best warning indicator of approaching recession is an "inverted yield curve" in the Treasury bond market.

The "yield curve" is the differential in interest rates between longer dated 10 year Treasury bonds minus shorter dated 2 year Treasury bonds or the Fed Funds rate. When the yield curve differential is expanding or "widening", it is the Treasury bond market's way of signaling increasing growth and potential inflation. Conversely when the yield curve is shrinking or "flattening", it is the Treasury bond market's signal for slowing growth and reduced inflation.

In 2014 the yield curve spread was wide (260 basis points), but has progressively flattened to currently 60 basis points/0.6% differential. The Federal Reserve's policy to make money more expensive and try and normalize interest rates is causing the yield curve to flatten. The Fed has raised rates four times in the past two years and again this month (December 13) and plans three more rate hikes in 2018 and two additional increases in 2019. Moreover, the Fed has just begun "Quantitative Tightening" by actually withdrawing money from the economy to help shrink the Fed's balance sheet of debt by 40% progressively over the next 3-4 years. Rate increases and Quantitative Tightening are driving short term rates higher, but oddly long term rates are not moving higher . . . yet.

The big question for 2018 is will tax reform cause the Treasury bond market to anticipate enough incremental growth in the U.S. economy to cause long term bond rates to start to rise again. If long term interest rates rise, that will be healthy news! Conversely, the Fed could pause or delay their pace and degree of monetary tightening if long bond rates don't rise. The Fed does not want to induce a recession.

The newly appointed Fed Chairman, Jerome Powell, was intentionally chosen for his dovish disposition and to support the Administration's plans to boost growth in the economy. With mid-term elections in less than one year, I doubt the Fed will cause the economy to slow despite fiscal stimulus from tax reform. We will have to wait and see. We should know by spring or early summer.

If the yield curve spread continues to flatten and approach zero, that will compel me to sound the alarm in our Investment Policy Committee to reduce our allocations to higher risk assets (equities, real estate, credit bonds, commodities) and increase our allocations to lower risk defensive assets (Treasuries, agencies, municipals).

We remain focused on constructing investment portfolios that incorporate passive index strategies and actively managed strategies as cost efficiently as possible. We are pro-active in our asset allocations and oversight of fund managers relative to developing conditions in capital markets.

Understand that diversification among asset classes and specific investment strategies helps to smooth some of the fluctuations in the value of your portfolios. Extreme dislocations in investment markets, however, will substantially impact portfolio values. Consequently, it is important for you to think carefully about how much change in the value of your wealth you are emotionally comfortable sustaining. It is important for you to contact us directly if you feel the need to have an up-to-date discussion about this matter.

We send you our best wishes for the holidays. We thank you for your trust and allowing us to work for you and your families. May 2018 bring you only good health and prosperity!