December 31, 2017

4Q Fixed Income Perspective

2017 was an amazing year from a financial markets perspective. The S&P 500, for the first time ever, had a positive return in each of the 12 months of 2017. The S&P 500 had its strongest quarter of the year in Q4, returning 6.63%. For the year, the S&P 500 was up 21.8%. The S&P has now had a positive annual return nine years in a row. And stocks continue to roar in 2018. The Dow Industrials index rose 1,000 points, from 24,000 to 25,000, in the shortest time ever (November 30 to January 12).

The Barclays Aggregate Index returned 3.54% in 2017, its best performance since 2014. While not as dramatic as the equity market returns, the Barclays Aggregate had a positive return each quarter in 2017.

The US economy continues to hum, leading the rest of the world out of the QE era, hopefully into a period characterized by much less central bank manipulation. But the US Federal Reserve will again be critical in 2018. The Fed has telegraphed that it intends to hike rates three times in 2018. Financial markets, on the other hand, are pricing in two hikes, and it probably wouldn't take much (a modest stock market correction?) to eliminate at least one of those rate hikes. We have witnessed a dramatic flattening of the yield curve. Early in the year, the 30-year Treasury yield was 1.9% greater than the 2-year yield. That differential has narrowed to only 0.8%. As we have mentioned in the past, investors fear a potential "policy mistake." If the Fed hikes too aggressively, the economy could tilt into recession.

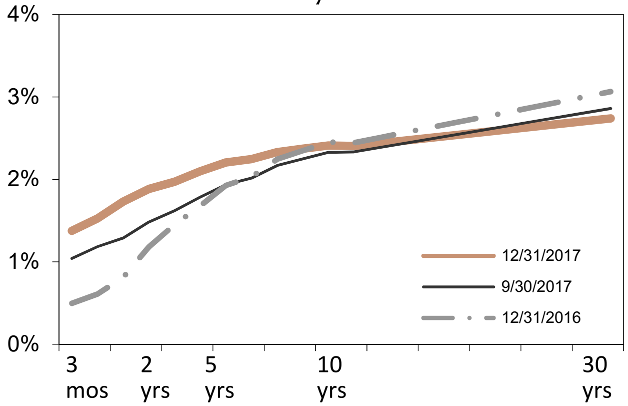
In addition to rate hikes, the Fed has begun to withdraw some of the liquidity pumped into the system during the various stages of quantitative easing. Never before has the Fed attempted to drain liquidity on such a massive scale. For financial markets that have become addicted to the high of monetary heroin, we wonder how financial markets will react when the Fed curtails the dosage?

To justify its hawkish stance, the Fed continues to dismiss concerns about low inflation, and is focusing instead on "financial conditions" as the tool for evaluating monetary policy. One of the biggest factors influencing financial conditions is the level of stock prices. No doubt, the Fed is concerned that years of accommodative monetary policy has pushed up stock prices to unsustainable levels. The Fed would like to see equity valuations gradually decline to a level more in line with economic fundamentals. Thus, despite low inflation and moderate growth the Fed believes that further rate hikes are necessary to prevent the economy from overheating.

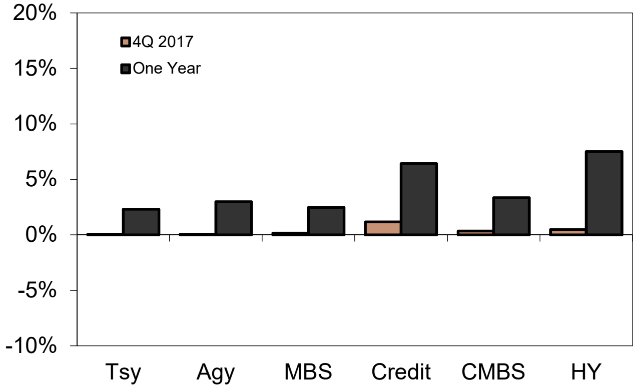
Fixed Market Commentary

December 31, 2017

US Treasury Yield Curves



Sector Index Returns



Given the Fed's increasingly hawkish stance, active fixed income management is the key to protecting the invested principal of client portfolios from rising interest rates. We will continue to tactically adjust portfolio durations to take advantage of anticipated interest rate changes. Our client portfolios are underweight government and mortgage-backed securities, while maintaining an overweight position in the investment grade credit sector.

Equity Market Commentary

December 31, 2017

4Q Equity Perspective

The fourth quarter of 2017 saw a continuation of the strong equity markets we have witnessed for the better part of the last nine years, both domestically and internationally. The S&P 500 Index posted a 6.6% return for the quarter and a 21.8% total return for the year. Small cap stocks, as represented by the Russell 2000 Index, posted a 3.3% return for the quarter and a 14.6% return for the year. Additionally, large cap stocks outperformed small cap stocks and growth stocks outperformed value stocks, both for the quarter and the calendar year. However, returns for developed and emerging International markets were even better. Foreign, developed market stocks, as represented by the Morgan Stanley (MSCI) World ex-U.S. Index, rose 4.2% for the quarter and 24.2% for the year. The MSCI Emerging Markets Index had an even more impressive showing, rising 7.4% and 37.3%, respectively.

2017 offered numerous examples of the difficulty of predicting the performance of markets, the importance of diversification, as well as asset allocation, and the need to maintain discipline in investing, if investors want to realize the long-term returns the capital markets offer. For the quarter, the top performing sectors were Consumer Discretionary, Financials and Technology. The Consumer Discretionary sector was up 9.8%, as this sector steadily improved throughout Q4 as the economy surged thanks in large part to full employment and tax reform. The Financial sector, which was up 8.6%, continues to thrive, boosted by the impressive strength of the large cap segment. Technology, which slowed some in Q4, being up just 8.5%, led the way for the entire year, up 34.3%.

A last note and a bit of perspective for those that may not have been paying attention during the year. The Dow Jones Industrial Average (DJIA), arguably the most noted and quoted of the U.S stock market indicies, was up 25.1% for the year, and along the way, posted a record 71 NEW all-time highs. Paradoxically, the world around us for the last year seemed fraught with volatility and anger, while the financial markets were calmly rewarding those who set aside their emotions and stayed invested. We'll see what 2018 has in store for us, but we see little to indicate any major changes in politics, the economy or the financial markets. Stay long!