<u>4th Quarter and 2017 Year End Review</u>

Large U.S. stocks finished the year strong, with the S&P 500 Index gaining 6.6% for the 4th quarter. The index's total return for the year was 21.8%. 2017 became the first year in the history of the S&P 500 Index in which a gain was posted in every single month! Small U.S. stocks underperformed again in the quarter, despite expectations for a boost from corporate tax reform. The benchmark Russell 2000 Index increased 3.3% in the quarter, and returned 14.6% for the year. The extreme disparity between large U.S. growth and value stocks continued. The Russell 1000 Growth Index outperformed its comparable Value Index by 3.4% in the 4th quarter and by a whopping 16.5% for the year.

Developed international stocks slowed their ascent in the 4th quarter, but still ending the year trumping their U.S. counterparts. The benchmark MSCI EAFE Index improved 3.7% in the quarter and gained 25.1% for the year. 2017 was the first year since 2012 that the MSCI EAFE Index (large international stocks) outperformed the S&P 500 Index (large U.S. stocks), and was only the second year of such outperformance in the past ten years. Emerging markets stocks, measured by the MSCI Emerging Markets Index, increased 6.7% in the quarter and earned 37.2% for the year. Despite this improvement, emerging markets stocks have woefully underperformed developed international stocks over the past 5 years.

Bonds remained benign, trading within a narrow 35 basis point range for most of the year. The yield of the 10-year U.S. Treasury finished the quarter at 2.43%. Despite encouraging economic measures and solid corporate earnings, the 10-year Treasury *<u>ended the year yielding 5 basis points lower from its start.</u>*
The Barclays Aggregate Bond Index followed in suit, returning 0.5% for the quarter and 3.6% for the year. The Barclays High Yield Very Liquid Index of high yield bonds earned a respectable annual 6.0% increase. Municipal bonds also performed well in 2017. The S&P National Municipal Bond Index rose 4.5%.

Belying the dour message from sluggish bond markets, buoyant commodities markets reflected increased demand, and optimism for economic growth. Copper (NYMEX High Grade Copper continuous futures contract) tacked on 11.8% in the quarter, rising an astonishing 31.4% for the year. Crude oil (NYMEX West Texas Intermediate Crude continuous futures contract) broke out, gaining 16.9% in the quarter and closing above $60/barrel for the first time since May 2015. WTI crude increased 12.4% for the full year, pushing back on extremely negative narratives calling for a decline back to $30/barrel.

With attention focused on stocks and Bitcoin, gold stayed out of the "risk asset" spotlight. It still posted fine returns, at least partially due to the U.S. dollar's notable weakness against just about every global currency. The NYMEX Gold continuous futures contract nudged 1.9% higher in the quarter, and gained 13.6% for the year.

2018 – All Eyes on Inflation

The primary forces behind 2017's increase in global asset prices included:

- Synchronized global growth in GDP and corporate profits
- Copious global liquidity as the European Central Bank and the Bank of Japan continued their enormous quantitative easing (QE) programs, and the U.S. Federal Reserve initiated a slow, measured taper from its QE
- Stubbornly low interest rates, despite 3 Fed rate increases
- The broad decline in the U.S. dollar, which fell against every G10 currency and almost all emerging markets currencies
- Persistently low inflation
- Remarkably low price volatility

As we enter 2018, investors' and strategists' pressing questions are: "Will these factors continue to support in 2018? What change in them could threaten global stock and bond markets?"

The first two forces appear to be quite firm. Strong tailwinds are fanning global growth, while global monetary policy largely remains accommodative. IHS Makrit states that, "*given the strength of order book growth and hiring, as well as the elevated level of business optimism, the Eurozone should start the New Year on a solid footing."* China has resumed being a major driver of global growth, with its nominal GDP increasing 11.2% year-over-year. Newly passed U.S. tax reform legislation, and looming increases in defense and infrastructure spending, all pose to further stimulate the U.S. economy, at least in the short term. Nancy Lazar of Cornerstone Macro expects the corporate tax cut to increase 2018 corporate profits by +12% year-over-year. She believes this will help boost capital expenditures, wages and maybe even employment. Cornerstone has raised their 2018 real GDP forecast by 0.5%, with potential further upside. Strategas Research Partners' Dan Clifton believes that *"financial markets are not likely pricing in the unleashing of short-term fiscal stimulus from these shock & awe tax cuts."*

Further down the list, the factor we'll be watching closely is inflation. Inflation poses to influence asset pricing, liquidity and interest rates in 2018, and out to 2020. It is remarkable that global inflation has remained persistently below historical averages, and even below reduced expectations, during the last five years. This despite massive liquidity from central bank's QE programs, record low interest rates, and pre-crisis low unemployment rates – all of which have been classically taught as being critical influencers. In November, outgoing chair of the Federal Reserve Janet Yellen said that the Fed did not clearly understand the causes for 2017's shortfall of inflation from their 2% target, calling them "more of a mystery."

Central banks have pushed as hard as possible for some "good" inflation – firmer, sustainable growth, which could produce economic exit velocity from drastic monetary measures. Longer term, indebted nations will either need to grow their way out of their piles of accumulated debt, or devalue them. Some strategists question whether inflation, being so unresponsive to record amounts of stimulus, is non-existent or evenly permanently reduced in a paradigm shift. Narratives purported to explain this phenomenon include: globalization, aging demographics in major developed economies, huge sovereign global indebtedness, automation and robots, the "cloud," artificial intelligence and machine learning, burying the Phillips curve, and the "Amazon effect."

There are some signs of potential change underfoot. Peter Boockvar, editor of the Boock Report and long-time strategist at Miller Tabak, recently spoke on the subject during a recent Real Money podcast: *"I'm seeing a buildup of inflationary pressures – in U.S. (Beige Book) and global wages, U.S. and Eurozone manufacturer, supplier and services capacity constraints, commodity prices, Japan base pay increases, Great Britain 3% consumer inflation. I think these will definitely show up in CPI and PPI stats as we move toward Q2 2018."* Others agree. Strategas' Don Rismiller writes, *"U.S. CPI is under 2% now, but heading up based on evidence we are starting to strain the system (ISM operating rates, supplier delivery times lengthening, not enough qualified workers, commodity prices, narrowing output gap)."* IHS Makrit states, *"the PMI price gauges and indicators of depleted capacity suggest that inflationary pressures will pick up next year."*

Some wage gains would certainly be welcomed by markets in 2018, and could add momentum along with the expected increased corporate earnings. As always, the question is "what is already being priced into the market?" Have 2017's gains already priced in a good deal of this news? What if markets are already discounting mildly increased growth, but are disregarding the potential for any measurable inflation? Julian Bridgen of Macro Intelligence 2 Partners worries that *"due to behavioral bias, the market isn't braced for any inflation."* He says that *"the claim of no inflation is just not true. Over the past two years, U.S. CPI has increased steadily."* Boockvar agrees, stating that *“over past five years, everyone has become numb. (They have come to believe that) Inflation didn’t show up through all of the money printing and QE. It definitely won’t show up if central banks begin reversing themselves.”*

We are not overly concerned by whiffs of inflation in the near term. Markets would most likely initially welcome them. But we must be reminded that inflation is a trailing indicator. It is possible that calm could flip to fear should measures of inflation jump sharply, surprising markets. Central banks, or markets just by themselves, could respond by reducing liquidity and increasing interest rates. Peter Boockvar claims that liquidity will already begin to taper, albeit very slowly, in 2018:

> *“Things are going to start happening on January 1 regardless of what inflation statistics say. The Fed is going to double the amount of liquidity they are taking out of the market, and the ECB is going to cut their QE by 50%. Other monetary tightening is coming in 2018 – South Korea became the first Asian central bank to raise rates in December, and the Bank of England is going to raise rates again.Even Bank of Japan could further talk about backing off further, back off their ETF purchases and let the yield curve steepen.”*

Ultimately, it is possible that a re-emergence of tempered inflation, along with a gradual moderation of liquidity, will begin to affect equity and fixed income markets by the second half of 2018. Joachim Fels, Global Economic Advisor of PIMCO, writes:

> *“We have examined the key constituents of bond supply and demand to conclude that (2017’s) excess demand for fixed income will not be repeated. . . The principal issue to consider is simply that the marginal buyer in 2018 (or a least by the end of 2018) will be a rent-seeking, profit-motivated actor, rather than a price-insensitive policy-driven central banker.”*

Portfolio Strategy and Asset Positioning

VWG Wealth Management respects the solid global economic and earnings fundamentals currently being witnessed. These are confirmed by positive market technical evaluation. Investor psychology and money flows, which are positive but far from ebullient, give additional support. Aside from potential geopolitical risk, we see no dark clouds looming over the coming six months. We caution against buying into forward narratives and unfounded predictions. We continue to hold full portfolio weightings and most "risk" assets. We are not further increasing allocations to stocks. For some clients and their specific planning requirements, some trimming of some "risk" assets is merited. VWG expects volatility to return to equity markets sometime in 2018, and we expect that any gains in stocks over the course of the year will be more difficult to achieve.

Within equities, we recommend trimming large U.S. capitalization stocks, and increasing allocations to more attractively valued US small value and international stocks. Domestic-focused mid- and small-sized U.S. businesses could be prime beneficiaries of new tax legislation.

As always, VWG Wealth Management stresses diversification. Most portfolios earned returns beyond clients' planning objectives in 2017, and it is just as important to protect these as it is to reach for further gains. Diversification is an investor's best response to the challenge of balancing risk and reward. Regretfully, it also means that one will always hold an under-performing asset, or asset class. Holding a reasonable amount of cash and safe, stable assets is always warranted. The time to buy warm coats and mittens is in summer. Markets are currently pricing in a rosy future, and we hope it will continue. Someday uncertainty will return - either due to unexpected adverse events, or due to fallout from pockets of excessive speculation.

In bonds and fixed income, we remain underweight, primarily due to unattractively low yields and the aforementioned potential for a return of mild inflation and rising interest rates. Bonds should be diversified by type and quality, and shorter durations should be favored. A few favored niche managers are still finding selective value in their spaces. We continue to believe that there is value in certain municipal bond strategies.
VWG expects to continue our strategic implementation of structured note strategies in 2018. Partial downside-protecting structures could be particularly attractive in the U.S. large cap equity index space, as valuations have increased. We also continue to sift through and evaluate private real estate and other private boutique strategies and managers. It is our goal that prudent inclusion of these, for appropriate clients and portfolios, could add significant diversification and meaningful sources of return over time.

Best wishes to everyone for a very healthy and deeply rewarding 2018!

For those who reside in the middle and eastern parts of the U.S., we hope you safely weather this winter's artic blasts, bomb cyclones and polar vortexes. No matter how bitter the cold, the time to buy your straw hats is now (perhaps done best online, within the toasty confines of home).
Regards,

VWG Wealth Management
Suzanne, Ashley, Rashmi, Lynette, Michelle, Christina, Amanda, Sarah, Patricia, John, Rick and Jeff

**Index Data Sourced from FactSet Research, Morningstar, and Strategas Research*