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2017 Momentum

Equities Climb Mountain of Worry

Global equities experienced a rare opportunity of worldwide positive return momentum. The S&P 500 returned 21.8% during the year, with eleven of twelve months posting positive returns. Surprisingly, the largest drawdown came in at only –3%. This is the lowest intra-year pullback since the mid 1990's.

Foreign equities provided both diversification benefits and returns greater than those experienced stateside. (see page 2)

Quality bonds went on to produce low single digit returns in the 1-5% range, depending upon the applicable bond index. Lower quality bonds offered stronger performance with high yield returning 7.5%.

Expanding economies coupled with higher employment and well telegraphed global central banks' policies aided market momentum.

<u>Equity Style: Growth back in vogue</u>

The S&P 500 returned 21.8%. If you separate value and growth styles, the growth index returned 27.4% while the value index returned 15.4%. Growth style equities have done well for most of this economic cycle. Compared to the run in value stocks through most of the last century, we believe there is continued room for growth style outperformance due to this secular (longer term) story.

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2018 Market Themes

Expansions Don't Die of Old Age

1. U.S. Economic Growth
   - strong growth, ample liquidity and anchored inflation
   - wage pressures rise while employment peaks
   - business investment continues to strengthen
   - late stage of the economic cycle pressures growth
2. Global Growth Momentum
   - global growth strong and synchronized
   - non-U.S. momentum signals earlier economic stage
   - significant political/fiscal risks continue
   - non-U.S. margins/earnings below historical peaks
   - non-U.S. monetary/fiscal policy still expansionary
3. Monetary Policy
   - Federal Reserve may need to play catch up
   - market expects 3 interest rate hikes by the FOMC
   - asset purchases reduced at global central banks
4. Fiscal Policy
   - boosts growth, capital spending and earnings
   - foreign capital may drift to the U.S.
   - may quicken Fed's monetary tightening pace
5. Bond Yields and the Curve
   - expect higher short term yields
   - expect higher mid/long yields
   - expect flattening of the curve
   - more yield increases captured in short end
   - income demand pressures longer yields
6. Earnings and Margin Growth
   - positive impact from tax & financial reform
   - profit margins peak
   - wage inflation accelerates
   - late economic cycle pressures profits
7. Valuations
   - U.S. absolute equity valuations are high
   - forward market P/E is now 18.2 above 16 average
   - international equity valuations are more favorable
   - earnings drive returns not P/E multiple expansion
   - market up over 300% since low in March 2009
   - elevated expectations could lead to a bumpy 2018

S&P 500 Annual Returns Last 25 Years

Year Ending	Total Return Change
2017	21.8%
2016	12.0%
2015	1.4%
2014	13.7%
2013	32.4%
2012	16.0%
2011	2.1%
2010	15.1%
2009	26.5%
2008	-37.0%
2007	5.5%
2006	15.8%
2005	4.9%
2004	10.9%
2003	28.7%
2002	-22.1%
2001	-11.9%
2000	-9.1%
1999	21.0%
1998	28.6%
1997	33.4%
1996	23.0%
1995	37.6%
1994	1.3%
1993	10.1%
Avg. Annualized	**9.7%**

Table Source: S&P Dow Jones Indices

2017 Benchmark Index Performance

Asset Class	2017	As Measured By
Fixed Income		
Investment Grade Short	0.8%	Barclays U.S. Gov/Credit 1-3 Year
Investment Grade Muni	4.5%	Barclays Muni Bond 7 Year
Investment Grade Taxable	3.5%	Barclays U.S. Aggregate Bond
High Yield Bond	7.5%	Barclays U.S. Corp High Yield
Global Bond	10.5%	Barclays Global Bond Agg X-US
Equity		
Large Capitalization	21.8%	S&P 500
Large Capitalization **Growth**	27.4%	S&P 500 / Citigroup **Growth**
Large Capitalization **Value**	15.4%	S&P 500 / Citigroup **Value**
Small & Mid Cap (SMID)	16.8%	Russell 2500
Small Capitalization **Growth**	22.2%	Russell 2000 **Growth**
Small Capitalization **Value**	7.8%	Russell 2000 **Value**
International Equity	27.2%	MSCI ACWI X-US
International Developed	25.0%	MSCI EAFE
International Emerging	37.3%	MSCI Emerging Markets
Preferred Stock	9.1%	S&P US Preferred Stock
Gold	13.7%	S&P GSCI Gold Spot Price

Data Source: Tamarac and providers to Tamarac. Total returns.

2017 Performance Commentary

While 2017 was another year of equities outperforming bonds, as evidenced above; the year is more remembered by strong growth style, international equity performance and a lack of volatility.

One of the strongest performing equity asset classes was emerging markets returning 37.3%. As investors were questioning both U.S. equity valuations and their profit margins, international diversification proved to be a beneficial antidote to those fears.

In contrast to 2016, growth outperformed value style equities and "if history does indeed rhyme," as Mark Twain said, we may still be in the early stages of this trend. For small caps, the difference was even more in favor of growth.

Within U.S. fixed income, the riskiest asset class high yield, had the highest return of 7.5%. While almost double the return of investment grade bonds, this 7.5% return is mostly coupon related. Despite all the movement in yields, the 10 year U.S. Treasury yield ended right where it started in January, around 2.4%.

The table to the left should provide a constant reminder of the long-term perspective as the S&P 500 has still averaged almost 10% annually over the last 25 years despite periodic years of negative returns.

Portfolio Positioning

Asset Allocation

Overall, our asset allocation remains slightly in favor of equities over bonds. At the start of 2017 we added international equities to our portfolios and increased the position mid-year. In addition to positive economic prospects, valuation indicators have become more favorable for international equities with the forward P/E at 14.3 compared to the U.S. forward P/E of 18.2. As we enter 2018, we have once again added to international establishing an overweight position.

U.S. Equity Style

We include growth, core (blend) and value securities in our portfolios. While each style has its unique quantitative characteristics, we look for equities that will deliver above average earnings and revenue growth but are not too expensive. Throughout 2017, we maintained our discipline by selling or reducing appreciated positions and reallocating proceeds to equities with better relative value characteristics across all three styles. Entering 2018 our style remains in favor of growth equities.

Equity Sector Commentary

Despite the lack of volatility there was certainly quite a bit of divergence across companies and sectors in the stock market. We continue to have a favorable view of the technology sector and this is expressed with our overweight positioning.

While economic growth may be low by historical standards, growth in the technology sector remains robust. There is still substantial spare capacity for those firms focused on the cloud, data analytics, electronic payment processing and artificial intelligence.

On the defensive side, rising interest rates reduce the relative attraction of higher yielding sectors. Therefore, we are cautious in our outlook on the telecom, consumer staples, utilities and REIT sectors. Despite this caution, we recognize the U.S. economy is entering the late stage of the economic cycle and the aforementioned sectors tend to provide stability during this stage.

Summary of Tactical Views

Asset Class	Current Tactical View
Cash	Overweight. Money market yields are nominally low but have increased. Cash, a lower risk asset class, will benefit from any increase in short term interest rates.
Fixed Income **Investment Grade** **High Yield**	Underweight & Defensive. We are currently positioned defensively within fixed income in three ways. We have a lower overall fixed income allocation than the longer term strategic targets; we use lower duration targets (higher than last year but lower than long-term targets) to reduce sensitivity to changing interest rates; and we have a reduced allocation toward direct high yield (higher risk) exposure.
Equity **Large-Cap** **Small & Mid-Cap** **International**	Overweight. Overall, the overweight to equities is marginal. We reduced small/mid cap exposure and allocated to international equities and hybrids (preferred equities). Our portfolios are now overweight international equities and underweight U.S. small/mid cap equities.

Tactical views are focused on the shorter term market cycle defined as the next 3 years. Strategic views are the underlying investment discipline focused on longer term market cycles up to 10 years.

Summary

Some key market dynamics that we are positioning portfolios for:

1. Lower corporate tax rates may draw foreign capital and investment to the U.S.
2. U.S. stocks are a bit more expensive as the S&P 500 forward P/E multiple increased to 18.2 as compared to a 25 year historical average of 16.
3. Tightening monetary policy coupled with anchored inflation.
4. While all rates are rising, continued demand for income/yield puts downward pressure on longer term rates flattening the yield curve.
5. Late stage of the economic cycle suggests caution.

To help prepare for the aforementioned themes, we have positioned portfolios closer to their strategic asset allocation with a slight overweight in equities. We continue to increase the number of holdings and reduce appreciated position sizes in many portfolios. Additionally, we enhanced the overall portfolio diversification globally and continue to use 'pooled investment vehicles' (also know as mutual funds and exchange traded funds—ETFs) to complement individual securities.

A better than expected 2017 has paved the way for a robust start to the new year. Such optimism always reminds me of a common investing phrase should 2018 turn into a bumpy ride; "The stock market has predicted 27 of the past 11 recessions", meaning 16 false alarms. However, the glass is half empty crowd would respond, "economists have yet to forecast even one recession". Having said that, despite periods of exuberance and volatility, we encourage investors to be strategic and focus on the investment journey rather than each bump in the road.

Balanced, cautiously optimistic and strategic are all applicable descriptions of our outlook.

Sincerely,
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Sources include: Goldman Sachs Global Investment Research*, 2018 Outlook: Remain pro-risk but time is running out for Goldilocks*, December 5, 2017. Goldman Sachs Global Investment Research, *2018 Outlook: Too Much of a Good Thing*, November 17, 2017. Liz Sonders and Jeffrey Kleintop and Brad Sorensen, Schwab Market Perspective: The Bing Picture Heading into 2018, December 8, 2017. Allison Nathan and Goldman Sachs Global Investment Research, Top of Mind Late-Cycle for Longer?, November 9, 2017. Charlie Himmelberg and Allison Nathan and Goldman Sachs Global Investment Research, Interview with Charlie Himmelberg, November 9, 2017. Nikola Schmidt and Alan Levenson, Broad Expansion Confronts Withdrawal of Monetary Accommodation, December 13, 2017. Mark Vaselkiv, Fixed Income Enters a New Era, December 13, 2017. JP Morgan Market Insights, *Guide to the Market*, December 31, 2017. Blackrock, Global Investment Outlook 2018, December 2017. Data source providers include Thomson Reuters, S&P Dow Jones, Tamarac and providers to.