![Wealth Health Personal Wealth Management]

Wealth Health
Personal Wealth Management

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Market Review

2017 was a very uncommon yet certainly welcomed year. Stock and bond markets around the world showed incredible resilience as they continued to set new records. Equity markets especially displayed unrelenting strength as virtually every stock index in the world hit a new all-time high. Concurrently, volatility continued to set new all-time lows as global growth expanded above expectations.

Index Returns — *Through 12/31/2017*

Index	QTD	YTD	1-Year (Annualized Returns)	3-Year (Annualized Returns)	5-Year (Annualized Returns)
S&P 500	6.64%	21.83%	21.83%	11.41%	15.79%
Russell 2000	3.34%	14.65%	14.65%	9.96%	14.12%
MSCI EAFE	4.23%	25.03%	25.03%	7.80%	7.90%
MSCI All Country World Index	5.72%	24.00%	24.00%	9.56%	11.03%
MSCI Emerging Markets Index	7.44%	37.28%	37.28%	9.10%	4.35%
Barclay Capital US Aggregate Bond	0.39%	3.54%	3.54%	2.24%	2.10%
Barclay Capital Municipals	0.75%	5.45%	5.45%	2.98%	3.02%
Bloomberg Commodity Index	4.71%	1.70%	1.70%	-5.03%	-8.45%
HFRI Fund of Funds Composite Index	1.96%	7.73%	7.73%	2.60%	3.99%

Aided by a weakening dollar, Emerging Market and International indices fared exceptionally well with the U.S equity market not far behind. Looking at the commodities market, the price of oil rose 10% in 2017, further supporting the idea of a continued global expansion as economic activity invariably leads to a higher demand for oil.

Looking at the bond markets; emerging market debt, long dated treasuries and high yield municipal debt led the way with corporate junk bonds not far behind. As has been the story thus far, investors have been taking on an increasing amount of risk in their search for yield and ended up finding it in the more questionable parts of fixed income world. Often-times these investors go too far in their search for yield and their exuberant behavior becomes visible through anomalous events which are hard to justify. Below is a chart showing the Greek two-year government yield at 1.5% (in blue) and the U.S. two-year treasury yield at 2% (in white). In essence, "the market" is valuing Greek debt safer than U.S. debt.

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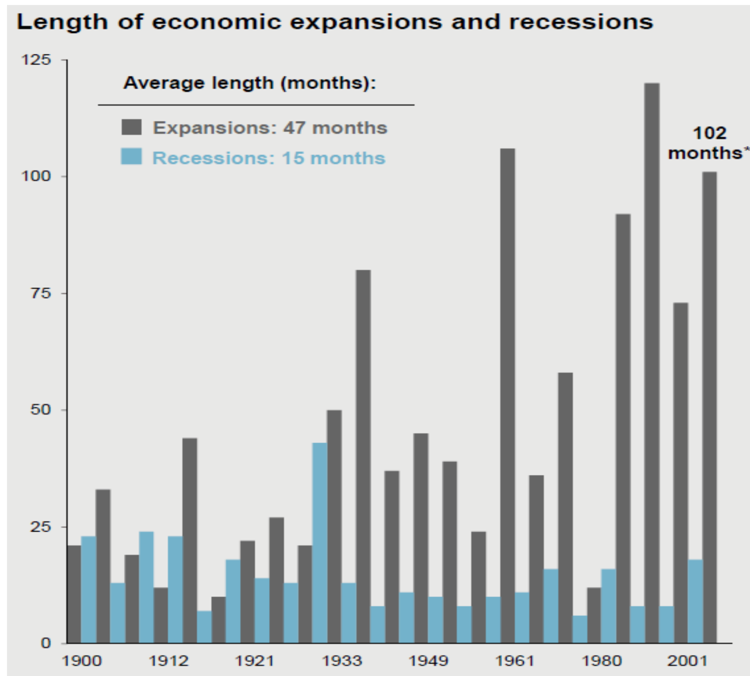
Broad Look

Although the economy has been doing well and there is increased enthusiasm from the business and consumer segments, there has also been a growing concern as to just how long this period of expansion can last. Forecasters point to the fact that this is one of the longest periods of economic expansion in our history. Moreover, some economists are concerned and are beginning to question if this expansion is somewhat "long in the tooth". The chart below shows all of the periods of economic expansions going back one hundred years. Currently, we are in the third longest recovery in over a century. However, if we have another good year in 2018, it would make this recovery the second-longest period of expansion in the last one hundred years. At that point investors may really start to question rosy economic forecasts calling for robust growth over the coming years. Simply put, future economic expectations may have to be re-adjusted to more accurately reflect historic patterns.



However, with the recent passage of tax-cuts expected to be a boost to corporate earnings and increasing evidence of inflation, 2018 could well be another good year with 2019 following in a similar fashion. The eurozone is enjoying its fastest economic expansion since 2011. Emerging market growth looks self-sustaining, even if powerhouse China slows more than markets currently expect. The breadth of the global recovery has expanded. Manufacturing figures are up in about 80% of countries, a share that has steadily increased over the past year.

Conversely, if inflation appears too quickly, it may encourage central banks to hike interest rates more rapidly than the market currently anticipates. This has the potential to slow down the current pace of growth not only in the economy, but also in the stock and bond markets as well. For example, there could be a rare occurrence where both stocks and bonds both enter a corrective phase.

Concurrently, the Federal Reserve will be reducing its balance sheet, i.e. selling bonds instead of buying them with the European Central Bank nearing the end of its asset-purchase program. This is a monumental amount of monetary support that will be withdrawn from the capital markets. Again, potentially putting a further strain on the market momentum that has been enjoyed thus far. As we have been saying for the past few quarters, we believe this will lead to an increase in volatility across all markets. This reduction in monetary stimulus may prove to be extraordinarily challenging and not quite as "riveting as watching paint dry" - Reserve Bank of Philadelphia President Patrick Harker.

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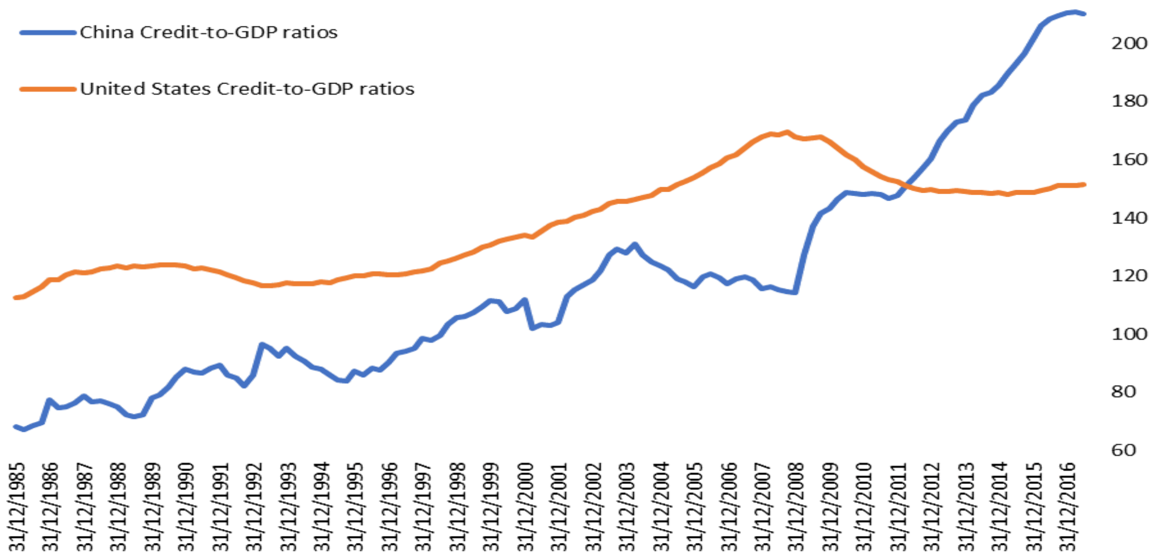
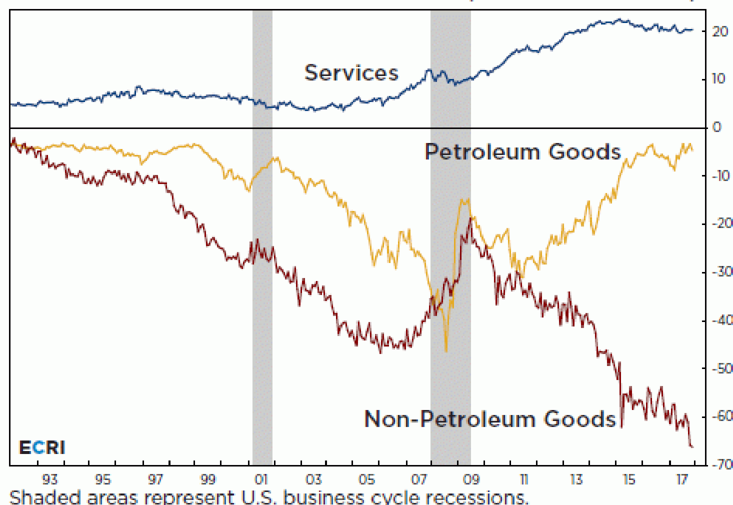
In addition, we continue to see risks abroad. Specifically, in China where the growth of credit over the last few decades is especially worrisome. China now has one of the highest Credit-to-GDP ratios of any nation. More worrying, Bloomberg notes that "Total debt will reach 327 percent of economic output by 2022, double the level in 2008, Bloomberg Economics estimates. That would put China among the most indebted countries." As is often the case when credit reaches these types of levels, painful restructuring tends to ensue.



WealthHealth Investment Research, BIS

While we currently have a relatively smooth global trade system, a tougher U.S. approach on trade looms as a potential threat to the delicate web of trade agreements. What's more, U.S. tensions with China over trade and security are increasing and this has serious potential repercussions to global stability as these two nations represent the two largest economies. It is notable however, that the current US trade deficit is near all-time highs. Something the current administration mentioned numerous times and has on the agenda for further discussions.



Shaded areas represent U.S. business cycle recessions.

Seen in the chart to the left, the US trade deficit has become so large that it would be extremely difficult to return it to positive levels as the current administration hopes to do. Conversely, doing nothing is equally problematic and is simply unsustainable over the long term as other nations may eventually start to question the validity of receiving paper dollars for hard assets.

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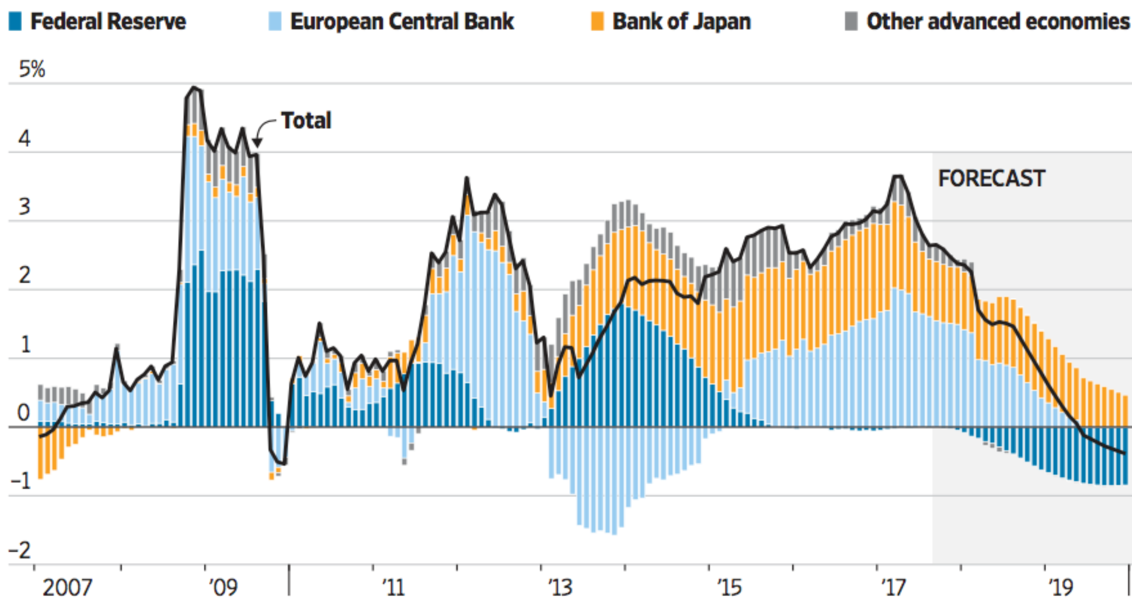
Looking Ahead

As mentioned a number of times before, we continue to watch what is perhaps the biggest event over the next two years, the unwinding of central bank balance sheets.



There is an ongoing debate whether capital markets can withstand a deleveraging from the global central banks. As these mammoth private institutions move to sell their assets, investors will have to step up and absorb hundreds of billions of dollars in new supply of stocks and bonds. Some believe that there will simply not be enough demand to offset the enormous amount of securities that will be offered for sale. As such, this will put pressure on the value of both stocks and bonds.

In Summary

In aggregate, the global economy continues to expand. More recently, higher than expected economic numbers surprised a lot of economists causing them to revise their future expectations even higher. This newfound enthusiasm remains theoretical at this point, but thus far, business confidence and economic activity is at levels indicative of a healthy economy. And while risks are always present, currently, there is very little evidence suggestive of a recession in the near-term. As such we remain cautiously optimistic yet realistic.

Business cycles come and go and currently, we are nearing the end of this cycle. This brings about a different set of challenges and expectations and in response, we will be making changes accordingly.