NEW YEAR, NEW CONFIDENCE?

Market Review **JANUARY 2018**

Another year has come to a close. Now, the performance of economies and financial security markets can be journaled into history. Last year, domestic and foreign stocks alike recorded their fifth best year of returns from the prior twenty-years of stock market investing. US stocks were abnormally calm in the year 2017. For example, the full-year range of near-term future price uncertainty, measured by a popular volatility index, was a quarter of what it was in the year 2016. Furthermore, a broad measure of the US stock market only drew down 1.5% or more in two trading days last year; whereas, in the year 2016, there were ten such trading days.

Last year's stock market boom technically began in late 2016 right after the US general election results. A political paradigm shift was made in the US by electing both a Republican President and Congress. The party had campaigned on loosening regulations, repealing and replacing health care legislation, and reforming tax law. In one short-year, the party has accomplished much of their intended agenda except for overturning existing health care legislation. Ultimately, the US stock market received exactly what it had expected and was driven even higher as new policy became less speculative.

Future real economic growth will ultimately be the verdict of the true importance and impact of Republicans' efforts. Through the third quarter of last year, annual real expansion of the US economy was 2.3%. Most impressive is the average number of new jobs being added to the US economy. This has remained well above 150 thousand per month over the last five years bringing the unemployment rate down to near 4%.

Upbeat economic and financial market statistics are undoubtedly changing the moods of consumers and investors. Consumer confidence, for example, has recently risen to new levels not seen since before the Great Recession of 2008 and 2009. Now, almost three out of every four investment institutions believe the US stock market can rise higher next year. Individual investors, however, are less optimistic and their optimism is sliding despite this nine-year bull market.

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Actions by the US Central Bank (Fed) should theoretically prevent the US economy from overheating. The Fed planned for three interest rate increases in the year 2017. They delivered all three by raising 0.25% in each decision. The target Fed-Funds rate, an interest rate important to commercial banking, now stands at 1.5%. Although the Fed is tightening and beginning to unwind a $4.5 trillion-dollar balance sheet, they do not expect to derail potential stimulus from the new tax cuts.

Coincidentally, Fed policy has moved up US money market yields and short-term US Treasury debt yields. Yields on ninety-day US Treasury debt rose almost a whole percent to end last year near 1.45%. Longer-term Treasury debt, however, has failed to move by as much. The difference between rising short-term yields and stagnate long-term yields is forcing the yield curve to flatten. This is important, because historically flat or even inverted yield curves have presaged actual recessions. Fed officials say this time could be different and maybe they are right. Possibly the economy has experienced a secular change that will keep general price inflation low for a considerable amount of time and thereby also keep long-term yields low.

What can we expect in the new year? Well, another year of monstrous stock returns seems unlikely. Stock returns may experience some sort of mean reversion back to historical norms. There are a variety of reasons that support stock market strength such as corporate profits and acquisitions fueling valuations and corporate bond spreads falling to historical lows.

Market Movers

As 2017 closes, investors should be pleased with returns from almost every financial market. Investments made in global stocks, global bonds, hard assets, or hybrids provided gains over the course of 2017. Fortunately, our Investment Team anticipated last year to be the year of global growth. Therefore, our bullish tilts towards global stocks (especially emerging markets) lifted the performance of the Core Allocation portfolios ahead of their benchmarks: Morningstar's World Allocation and Tactical Allocation category averages. No year is exactly the same as the last when it comes to investing. However, the Investment Team remains cautiously optimistic as the investment climate seems to have improved with better economies, low interest rates, higher corporate profits, and rebounding commodity prices. Several allocation changes will be made in the near term in an effort to most appropriately position portfolios for 2018.

Asset Categories	*Monthly*	*YTD*
US STOCKS	0.56%	16.17%
FOREIGN STOCKS	2.49%	30.35%
US BONDS	0.45%	4.01%
FOREIGN BONDS	0.46%	8.56%
HARD ASSETS	1.74%	8.04%
HYBRIDS	0.04%	10.92%

DATA USED IS SOURCED FROM MORNINGSTAR®, DATE ENDING DECEMBER 31, 2017.

US STOCKS finished December in the black and ended the full-year with average gains of approximately 16%. Year-end return performance by US Large Caps, US Mid-Caps, and US Small Caps ranked in sequential order. At the beginning of last year, we were particularly bullish on Large-Cap Growth stocks and neutrally-bullish on US Small Cap stocks. This turned out to be a good stance, and resulted in positive contribution to portfolio returns.

FOREIGN STOCKS were one of the best performing categories last year. Sometimes, Developed Foreign stock returns are a drag on portfolio performance when adjusted for risk. This was certainly not the case last year. Developed Foreign stocks made average gains of over 28% and Emerging Market stocks grew by over 34%. At the beginning of last year, we noticed that foreign growth seemed to be priced cheaply. Our attraction to the category benefited the portfolios over the course of 2017.

US BONDS made modest gains last year. Year-to-date returns averaged roughly 4%. Investment-grade Corporate Bonds and High-Yield Corporate Bonds led the category's performance. We maintained a broadly diversified bond allocation in 2017 which included these types of corporate bonds. Many expectations for higher interest rates (and falling bond prices) set by investment professionals were not met last year. We chose to maintain a modest position in Long-Term Treasuries for portfolio protection which did not offer blockbuster returns but reduced portfolio risk and provided modest returns.

FOREIGN BONDS performed better than domestic bonds last year even though international economies were already dealing with near-zero-to-negative real interest rates. As global economies improved last year, monetary stimulus set by global central banks showed little signs of backing down in spite of professional wisdom. We selected Emerging Market bonds for our Foreign Bond allocation in 2017. This decision exceeded our return expectations with a 2017 return of over 10%.

HARD ASSETS ended the year positive, but were slightly weighed down by the performance of Master Limited Partnerships (MLPs). At one-point last year, our MLPs position had a negative double-digit return. However, this asset class rebounded and finished the year with a near 2% loss. Our allocations to Precious Metals and Global Real Estate more than offset these losses in the MLP sector. Both asset classes finished the year with total returns of over 13% and 14%, respectively.

HYBRIDS delivered the most consistent total return pattern last year. Investments in Convertibles and Preferred Stocks were handsomely rewarded ending the year with respective total returns of roughly 12% and 10%. We felt a high conviction for both of these asset classes at the beginning of last year, and the Core Allocation portfolios widely benefited from those convictions.