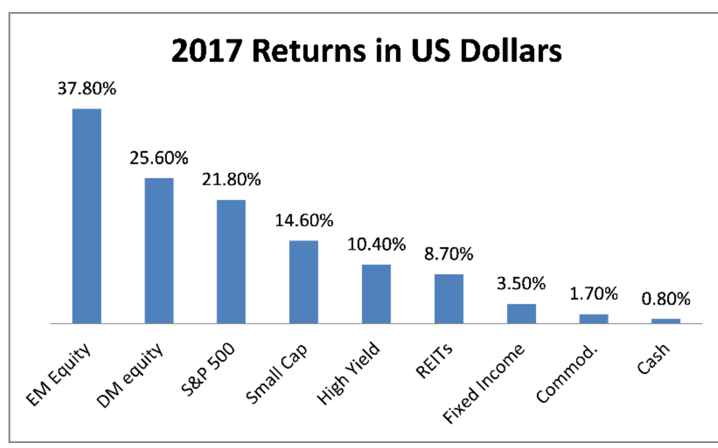
Market Summary Fourth Quarter 2017 and 2018 Outlook

At the beginning of 2017, a common view among money managers and analysts was that the financial markets would not repeat their strong returns from 2016. The global equity markets defied their predictions, with major equity indices in the US, developed foreign and emerging markets posting strong returns for the year. The chart illustrates how riskier assets, such as equities, outperformed high quality fixed income. Cash came in last, lagging inflation, which was around 2%.



International markets did particularly well, based on solid economic numbers, outperforming the US for the first time since 2012. Within the US, large cap stocks outperformed small cap stocks. The technology sector was by far the best performer with a whopping 38% return. Riskier fixed income (high yield) outperformed high quality; cash and commodities came in last.

What stood out in 2017 was the lack of volatility. In a typical year, the S&P 500 can drop by 14% (the average for the past 37 years) and still be up for the calendar year. In 2017, the worst drop for the S&P 500 was only 3%.

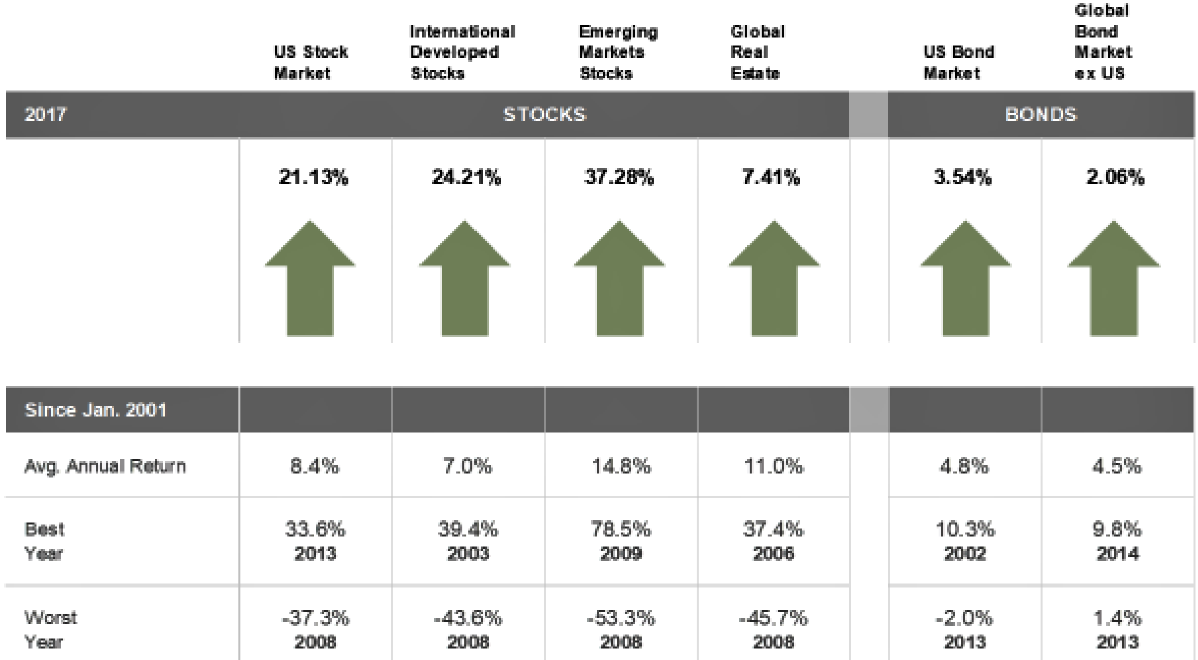
We believe the likelihood of a repeat of 2017 is low, although most economists are predicting at least modest appreciation of varying percentages, depending on the asset class.

Picking the Correct Asset Class versus Diversification

The chart below compares 2017 with longer time periods; it shows that asset classes outperforming in one year may severely underperform in other time periods. Because historical data demonstrates that no one can predict how each asset class will perform from year-to-year, maintaining a diversified portfolio is central to our investment approach. Note the worst return periods for stocks vs. bonds. Across the board for equities, their worst year was 2008. For fixed income, the worst year was 2013 when US high quality was down 2%. In 2008, that same category was positive while the equity returns ranged from -37% (US) to -53% (emerging markets).

Market Summary

Index Returns



2017	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
	STOCKS				BONDS	
	21.13%	24.21%	37.28%	7.41%	3.54%	2.06%

Since Jan. 2001	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
Avg. Annual Return	8.4%	7.0%	14.8%	11.0%	4.8%	4.5%
Best Year	33.6% 2013	39.4% 2003	78.5% 2009	37.4% 2006	10.3% 2002	9.8% 2014
Worst Year	-37.3% 2008	-43.6% 2008	-53.3% 2008	-45.7% 2008	-2.0% 2013	1.4% 2013

Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio. Market segment (index representation) as follows: US Stock Market (Russell 3000 Index), International Developed Stocks (MSCI World ex USA Index [net div.]), Emerging Markets (MSCI Emerging Markets Index [net div.]), Global Real Estate (S&P Global REIT Index [net div.]), US Bond Market (Bloomberg Barclays US Aggregate Bond Index), and Global Bond ex US Market (Citi WGBI ex USA 1-30 Years [Hedged to USD]). The S&P data are provided by Standard & Poor's Index Services Group. Frank Russell Company is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes. MSCI data © MSCI 2018, all rights reserved. Bloomberg Barclays data provided by Bloomberg. Citi fixed income indices © 2018 by Citigroup.

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Equity Markets

International Equity markets outperformed US equity markets in 2017. Many investors are asking whether this trend can continue. Our belief is a resounding "YES!" The chart illustrates this point. If we look at stock valuations based on P/E, or price to earnings (most simplistically, looking at how much a share of a stock costs in relation to how much earnings are being generated), the valuations are lowest for the international markets, especially emerging markets. Their valuations are below their 20-year averages.

Stock Market Valuations

Benchmark	P/E
MSCI Emerging Markets	12.51
MSCI EAFE (Developed Markets)	14.95
S&P 500	18.21
NASDAQ	22.47
NASDAQ in March 2000	189.47

While US Equity lagged international equity markets, the S&P 500 still returned a very healthy 22%. US equities rose steadily throughout the year but responded especially well to tax reform (particularly since the new law lowers the corporate tax rate permanently).

As is the case with international markets, US markets continue to enjoy strong economic numbers. Unemployment is now around 4%, the lowest it's been since the 1960's. GDP growth has hovered around 2.5%; it has remained low in recent years not due to lack of consumption but instead low capital spending. Perhaps with the lower

corporate tax rates companies will begin spending more. Part of the challenge will be finding enough workers to do the work with a decreasing unemployment rate.

Inflation continues to be low. The only component that drove up prices in 2017 was energy. At least for the near term, economists expect overall inflation to remain around 2%.

Profit expectations for the S&P 500 remain strong. A lower US dollar will continue to make our exports competitive.

While we predict continued appreciation in the global and US markets, we do not believe investors will see the same growth in their portfolios as they did in 2017. Future US market appreciation will depend primarily on economic growth which, as we previously stated we expect to be strong.

Fixed Income
For the first time in a decade, the Federal Reserve raised rates (1/4% - 3 times in 2017). The yield on the 10-year Treasury barely moved, remaining at 2.5%. The Fed is expected to raise rates another 3-4 times in 2018, again at 1/4% each time. We do not know how this will affect bond markets, as they have continued to maintain their value despite the rate increases (which typically drives down the price of bonds).

Market timers have been predicting the collapse of the bond market ever since the end of the Great Recession in 2009, and so far they have been wrong. Instead of trying to time the markets, we continue to believe maintaining a portion of a diversified portfolio in high quality fixed income is a good move for the long term.

Tax Reform
While we are seeing a positive market impact due to tax reductions for American businesses, we don't know how it will affect individual tax payers. For our typical client, tax reform is a big deal, especially for those who itemize deductions, including state income tax and high property taxes.

Understanding the tax changes as well as any specific/individual effects will help in mitigating any negative effects. We will be writing more about this subject over the next few months, as you wrap up your 2017 tax preparation, and as more information is available. Because there is so much confusion, we encourage each of you to talk with your accountant about how the new rules will affect you personally.

For now, gifting and retirement plan contributions are clear - so, if like many of our clients, you are making gifts directly to family members, or through vehicles such as 529 Education Savings Accounts, *please note that the annual maximum gifting limit has increased from $14,000 to $15,000*. If you are *making contributions to retirement plans* please click here for 2018 data.

Closing Comments

There were plenty of economic risk factors in place in 2017. These included, but were not limited to:

1. Uncertainty about the global economy (in particular, the Chinese economy)
2. Trade wars
3. Political turmoil in the US
4. Implementation of Brexit
5. Conflicts in the Middle East
6. North Korea's weapons buildup

Although none of these factors affected investments in a particularly adverse manner in 2017, they continue to be potential spoilers as we begin the New Year. Every type of investment carries risks as well as benefits. As always, we recommend maintaining a long-term outlook and resisting the temptation to respond emotionally with regard to investments. We take our fiduciary responsibility to our clients very seriously and spend a lot of time researching investments and markets to make sure we are providing the best risk-adjusted returns. We will continue to do so.

Sincerely,
Janet & Barry

Sources: Dimensional Fund Advisors (DFA), PIMCO, JP Morgan, Morningstar, New York Times, Schwab, Vanguard, Wall Street Journal.

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