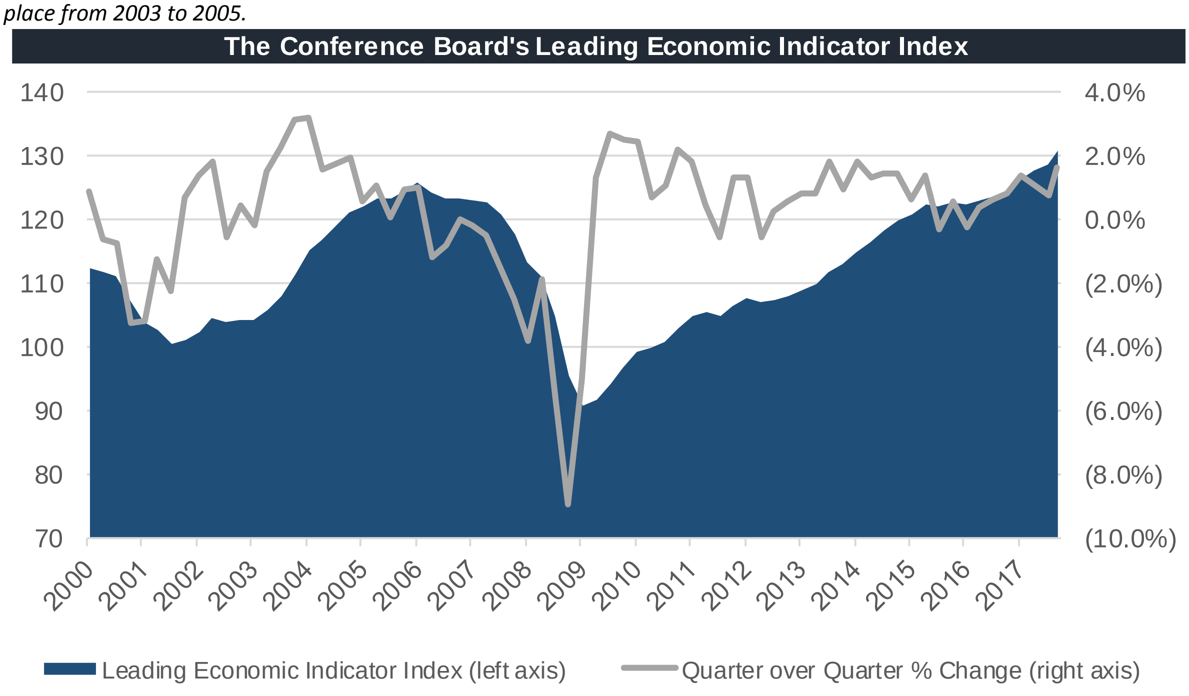
2017 Review and 2018 Outlook

"As Good as it Gets" – Title of Goldman Sachs Research Paper, November 15, 2017

2017 was a remarkable year in many ways. Despite a myriad of reasons to worry about potential pitfalls, markets steadily rose with very little volatility for the bulk of the year. Very few pundits predicted strong double digit growth in equity markets, yet the global rise of markets meant the majority of sectors, geographies and market caps did just that. Despite near universal acceptance that valuations were stretched in the second half of the year, buyers kept stretching them higher. While real growth did support some expansion in markets, the levels still remain fairly stretched by most indicators. Some recent headlines have noted that the highs of recent months marked the most expensive markets in the last century. **We are wary of valuations that seem to have expanded beyond the fundamental backdrop. However, we believe that real growth and leading economic indicators continue to suggest minimal risk of a recession in the near-term. The forecasted direction of the economy and the low risk of recession both support capital markets stability. Ultimately, we believe that it has been too long since we have had a meaningful correction in equity markets and that we will experience corrections in 2018 of greater than 5%. However, our view is that while this will mean more volatility in 2018, the real economic growth will lead to another year of positive returns in equity markets, especially as rising rates make fixed income markets more difficult to navigate.** Specifically, we project that despite the increased volatility, the S&P 500 could still finish 2018 up, but likely less than 10%. We expect three rate hikes in the year, and a flattening yield curve. Finally, we expect commodity markets to rebound, with positive medium-term views on energy and precious metals.

Leading Economic Indicator (LEI) Index*: The LEI combines 10 measures of data thought to predict economic activity into a single metric. Three consecutive periods of either increasing or decreasing readings is usually interpreted as a trend. On a month over month basis, the index has been positive for fifteen consecutive periods, suggesting a moderate pace of economic activity for the near term. This is the second longest streak of positive monthly growth since 2000. The record of 22 consecutive months took place from 2003 to 2005.*



Source: Bloomberg. As of 11/30/2017.

Economy & Markets – Outlook

Global growth outpaced expectations in 2017, with real GDP growing by more than 3.5%. This was the first time that real GDP outpaced Bloomberg's survey of economic expectations since 2010. The strength in global growth has been broad based across the globe. Both emerging and developed economies have generally outpaced expectations recently, and financial conditions in those markets seem to support continued growth in 2018. Most economic growth indicators in the U.S., such as non-farm employment and industrial production, also support a steady economy. In addition to innocuous leading economic indicators, the U.S. has shown generally positive income, savings and growth trajectories. The U.S. tax reform has also added an additional potential catalyst to growth expectations. With the top corporate tax rate falling from 35% to 21%, there is expected momentum building in labor and wage growth. According to Goldman Sachs, the effect of tax reform should be to add an additional 0.4% to real GDP due to fiscal policy.

The unemployment rate has held steady or improved throughout the year, continuing to fall below the Federal Reserve's long-term projections for full employment. Despite this strength in both growth and unemployment, the inflation rate continues to underperform expectations. **While we continue to believe that solid global economic growth both domestically and globally should provide strength to the markets, we also believe that inflation cannot remain this low through 2018. This combined with valuation metrics that are stretching the equity markets lead us to believe that all the capital markets will sustain higher volatility in 2018.**

That leads us to specific expectations and projections for 2018, some of which are consensus views and some of which are a little more contrarian in nature. The following summarizes many of SharpVue's expectations for 2018:

Improving fundamentals will drive further small gains in the equity markets
Even excluding the potential tax reform benefits, 2018 earnings estimates were expected to rise roughly 8% over the next year.[1] While most of the market is still digesting and analyzing potential tax reform benefits, additions to S&P 500 earnings seem to range from $4-10 in EPS, representing an additional 3% to 8% increase over current levels. We also believe that infrastructure build, declining regulatory burdens or potential favorable trade developments could all be sources of potential upside. The only element that continues to keep our outlook less bullish is our belief that current valuations seem to have expanded to historically high levels in the current market. However, we believe that while this will affect volatility, ultimately fundamentals will support another positive year in the equity markets. These fundamentals include low unemployment, increasing industrial production, steady retail sales and personal income, and a growing global economy.

More volatility
Market volatility collapsed in 2017 with the VIX indicator that measures volatility in the S&P 500, measuring roughly 11 for the year. We believe that could increase to roughly 14 this year. While that is a 30% move higher, it is still low relative to the long-term average of about 19. Tax reform should begin to reveal winners and losers, which could help reduce stock correlations, one of the main drivers of the low volatility environment. Also, traders that spent 2017 betting on lower volatility will likely close these positions as the VIX ticks up. On the other side of that trade, it is probable that many market participants

[1] JP Morgan, "Equity Strategy and Quantitative Research," 14 December 2017

could begin to hedge gains next year which may also push the VIX to higher levels. Finally, higher interest rates should put some pressure on leverage in the stock market, again supporting higher volatility ranges.

Weakening USD supports profits margins and gold

Though many market participants believe that higher interest rates could potentially support a stronger U.S. dollar, we believe that global growth will trump any upward moves that accompany interest rate hikes in 2018. We think global growth will drive a demand for funding that will continue to increase pressure on the dollar. The large companies that compose the S&P 500 earn a significant portion of their revenues abroad, and we believe a weakening dollar may provide an additional tailwind to the value of these international sales, and boost profit margins. With this macroeconomic backdrop, both gold and commodities could outperform after a relatively dull 2017 in those markets.

Steady inflation

There seems to be little consensus on the trajectory of inflation in 2018, with many seeming to support rising inflation versus others that maintain a continued slow pace. Goldman Sachs recently suggested that since output has been steady, inflation has only remained low due to a long-lasting drag in import and commodity prices. We believe this drag will reverse in 2018. Though it may still lag some central bank expectations, we believe that inflation should begin to gradually rise in 2018, nearing the 2% expectations of the Federal Reserve. This move will support some central bank tightening, including the expected three rate hikes in the U.S.

Rising bond yields means that there is no great place in fixed income

Our projected three rate hikes and a potentially flattening U.S. yield curve could lead to a tough year for fixed income. We believe short-term bonds and good credits will outperform other fixed income in this macroeconomic backdrop, but will likewise be burdened by a rising interest rate environment. Fixed income managers will have to remain nimble and look to alternative income sources, such as preferred stocks, convertibles, and dividend-paying equities to outperform in 2018.

Within Equity markets:

Rotation into Value Stocks

We expect value companies to see relatively greater EPS benefits from tax reform in 2018 as those companies typically have higher domestic revenue than growth companies. In addition, growth stocks outperformed value stocks significantly in 2017 and have become much more expensive relatively. We expect that relative valuation gap to close.

Financials and industrials continue to outperform

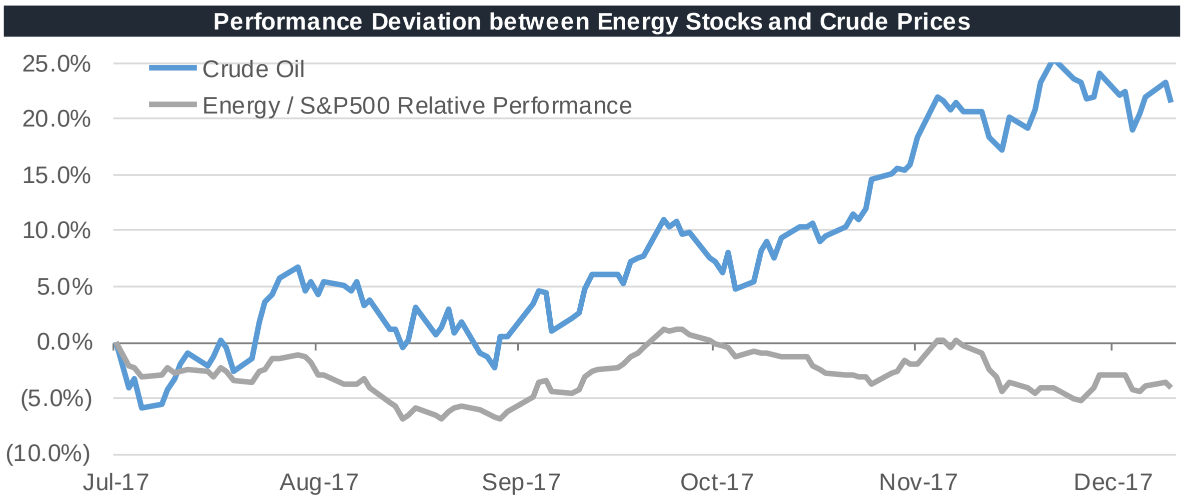
It is our belief that financials stocks are benefiting from a "goldilocks" type scenario. Rising interest rates, reduced regulation and declining credit costs due to a healthy labor market and some reasonable wage growth leads to strong markets for financial stocks. Industrial strength could benefit from rising demand globally and increased profit margin expansion due to tax reform.

Technology begins to underperform

We have been positive on technology stocks for years, but believe that 2018 could begin to dampen its positive trend. We still believe that the fundamental drivers of growth are much more available in technology than other sectors. However, from a technical standpoint, there may be headwinds given a broader rotation into value stocks from growth stocks. Also, technology stocks have been the most crowded trade of 2017, and we expect some reversion to other sectors.

Energy outperforms

Despite strong aggregate gains across the broader equity markets, the energy sector was a notable laggard throughout much of 2017. This sector-level underperformance came despite a surge in crude prices into the end of the year. We believe this divergence in performance between crude prices and energy stocks may correct itself in the New Year. Although supply-side concerns have burdened this sector for several months, OPEC's recent communication and compliance with its own output targets seems to be creating a virtuous feedback loop for the member countries as global reserves have begun to fall, supporting higher pricing and encouraging future compliance.



Source: Bloomberg.

Our Biggest Concern: Geopolitics

Our greatest concern to the market and our projections remains the unpredictable nature of potential geopolitical events. The recent saber rattling with North Korea and the ongoing political and trade differences with China and Russia will be closely monitored. Since this remains the most unpredictable risk as well as a potential systematic risk, we will vigilantly follow developments that we believe could undermine our broader market expectations.

Positioning Portfolios – Wealth Management

Throughout our individualized wealth management portfolios, we are tactically reducing long term fixed income exposure, while increasing equity and alternative positioning. We believe the risk-based analysis of individual portfolios will produce an asset allocation that will help our clients reach their long term financial goals. Our tactical positioning alters this allocation only slightly to attempt to provide less volatility and more proactivity in reacting to ongoing and projected market trends.

We understand the longevity of the current bull market and continue to be wary of potential pitfalls in the market. We believe we will see more "normal" markets in 2018, with more frequent corrections in the stock markets. And, we believe that our investment discipline, which leans on macroeconomic analysis to inform allocation decisions, will continue to inform us on potential recessionary conditions that could lead to extended losses in the equity markets. Given that those elements are fairly innocuous, we believe that markets should continue to gain ground in the face of more volatility and we will seek to manage our portfolios to take advantage of pullbacks. As always, regardless of what 2018 brings, we will remain dedicated to our efforts to provide our clients with exceptional risk management in all market environments.

As always, thank you for your support and confidence in SharpVue. We wish you peace and prosperity in the year to come.

Sincerely,
Geremy Connor
Chief Investment Officer

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