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Fourth Quarter 2017 Review & Outlook for 2018
by Whitney Brown

INVESTMENT OUTLOOK

- Stocks show strength in the 4th quarter.
- Global economy enjoying broad-based momentum.
- Inflation remains dormant.
- Positive trends in economy should continue in 2018.

Stocks showed impressive strength in the fourth quarter. All of the closely followed market indexes from the Dow Jones Industrial Average to the small cap Russell 2000 Index to the international MSCI EAFE rose in the latest quarter and have finished the year with double-digit returns, many exceeding 20%. Please see the table below for details. After taking a breather in 2015 and most of last year, U.S. equity markets are showing strong and increasing demand across all market capitalization segments from small to large.

The current major stock market uptrend dating back to 2009 and the ongoing economic expansion are both running long in duration compared to historical averages. Age alone will not bring about the end of a bull market. Usually, recession is the culprit. Yet, economic indicators show very low risk of recession at present. The recovery from the Great Recession was slow to develop and only recently seems to have entered the stage where it has become self-reinforcing without life support from the Federal Reserve. There is also broad-based momentum in the global economy with inflation remaining muted.

Market Measures	4th QTR	YTD
S & P 500 (price)	6.1%	19.4%
Dow Jones Industrial Average	10.3%	25.1%
NASDAQ Composite	6.3%	28.2%
Russell 2000	3.0%	13.1%
MSCI EAFE	4.5%	21.8%
Barclays Capital Inter Gov't/Credit Bond Index	-0.3%	2.0%
	12/29/17	12/30/16
10-Year U.S. Treasury Bond Yield	2.41%	2.45%
Three-month U.S. Treasury Bill Yield	1.39%	0.50%

In the U.S., with unemployment very low and economic output growing closer to capacity, dormant inflation is a puzzle to Fed Chair Janet Yellen as well as central bankers in other countries. There is debate among economists whether it is even appropriate for central banks to have inflation targets in the current era. The application of technology to nearly every aspect of modern consumer and industrial life has made the manufacture and sale of goods, delivery of services, production of raw materials, and purchasing of everyday items generally less expensive. You can find the lowest price on just about anything for your family or your business with a few swipes on your smart phone or clicks on your computer.

Equity markets can do well in 2018, but there are some areas of concern that could trigger a correction. Relatively high price-to-earnings ratios of U.S. stocks could be a problem if earnings growth slows in coming quarters. The tech sector may be more vulnerable to selloff than some other areas because it has done so well. Tech is also where we see the strongest growth, and a pullback could provide a buying opportunity. Compared to the U.S., there may be better value in some of the international markets. Parts of Asia, Latin America, and Europe are doing well, and stocks there are not as richly valued. The Federal Reserve's deliberate and carefully scripted program of normalizing short-term interest rates with gradual quarter-point hikes could collide with a near-term pop in the economy from the new corporate tax overhaul. If the economy heats up unexpectedly, the Fed could be spooked into accelerating the pace of rate hikes which would be a negative for stocks.

The coming year will have its share of surprises, good and bad, but equity investors should focus on the supportive trends in economic growth, corporate earnings, and inflation. Positive developments in housing, consumer spending, and industrial production are likely to continue. The pro-business climate in D.C., including lower corporate taxes, should bolster business confidence. Finally, new leadership at the Federal Reserve is very unlikely to make any disruptive changes to the current path of monetary policy.

Market Timing vs. Diversification by Jim Hall

With the strong market performance we have enjoyed over the past year, more questions have been arising about the strategy of selling holdings, converting to cash, and waiting for a pullback to re-enter the market. The thought behind these questions is tied to a belief or feeling “the market has come too far too fast and is due for a pullback.”

Without addressing any potential tax consequences, if one could successfully exercise a market timing strategy, the rewards would be exceptional. However, in reality, timing the market successfully is nearly impossible as it requires one to be exactly right three times (buying, selling, and buying again). Since the inception of market trading, any attempt to create a method to accurately predict when a stock climbs to its peak or falls to the lowest point of its valley has been met with frustration. Due to many, sometimes seemingly random influences, a particular stock may advance or decline in complete opposition to its anticipated or predicted direction.

With this sort of variability, it is obviously difficult to attempt to call a “top” or a “bottom” and move to an “all stock” or “all cash” position. Of course, an all cash position would protect the value of an account but at the expense of foregoing possible dividends and future growth if the value of the stocks that would be owned rises. The investing strategy offering the best opportunity to enjoy higher returns and a lesser degree of risk involves keeping a perspective of the investing time horizon (a longer time before anticipated cash needs allows invested funds to be exposed to more stock) combined with maintaining a diversified exposure to both stocks and bonds.

Even further diversification may be gained by owning quality stocks within many of the 11 market sectors (Information Technology, Financials, Utilities, Industrials, etc.). Depending on market trends, exposure to individual sectors may be reduced or increased depending on how that particular sector is fairing in the economy. As one might expect, each market sector will contain different companies enjoying varying degrees of success. Exposure to only the best of the companies within each invested sector will offer the greatest opportunity for “better than market” returns.

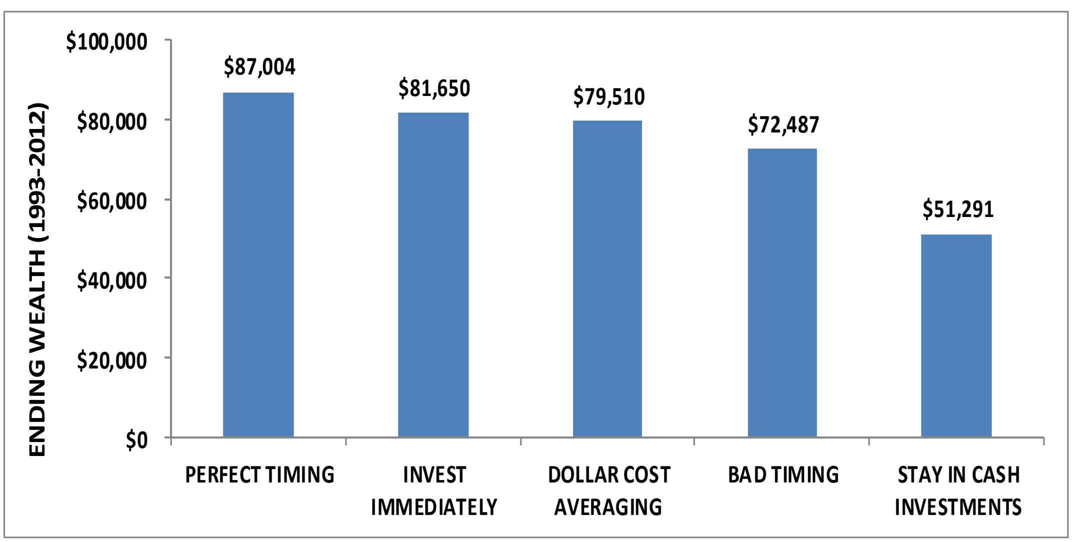
To illustrate the potential differences between investing approaches, in 2013 Charles Schwab Corporation published an article comparing investing results for someone receiving and investing $2,000 annually over 20 years. Their research examined every rolling 20-year timeframe dating back to 1926. The returns were compared based on the following five scenarios:

- If someone timed their buys perfectly at the low of each year;
- If someone invested all $2,000 as quickly as they received it;
- If someone divided their $2,000 and invested 1/12 each month;
- If someone tried to time but always bought at the high for the year;
- If someone never thought it was a good time to buy and left the funds in Treasuries.

In all cases, the perfect timing scenario generated the best returns over the 20 years; however, that was closely followed by the person investing as quickly as the funds were received (only a $5,500 difference). The dollar-cost average was generally third with the bad timing person fourth and the non-investor last. The most striking part of the study pointed out the four investing styles outpaced the non-investing style by at least $11,000 and as much as $26,000.

Instead of focusing on the magic of market timing, the focus might more appropriately be described as “time in the market.”

Courtesy Charles Schwab “Does Market Timing Work?”

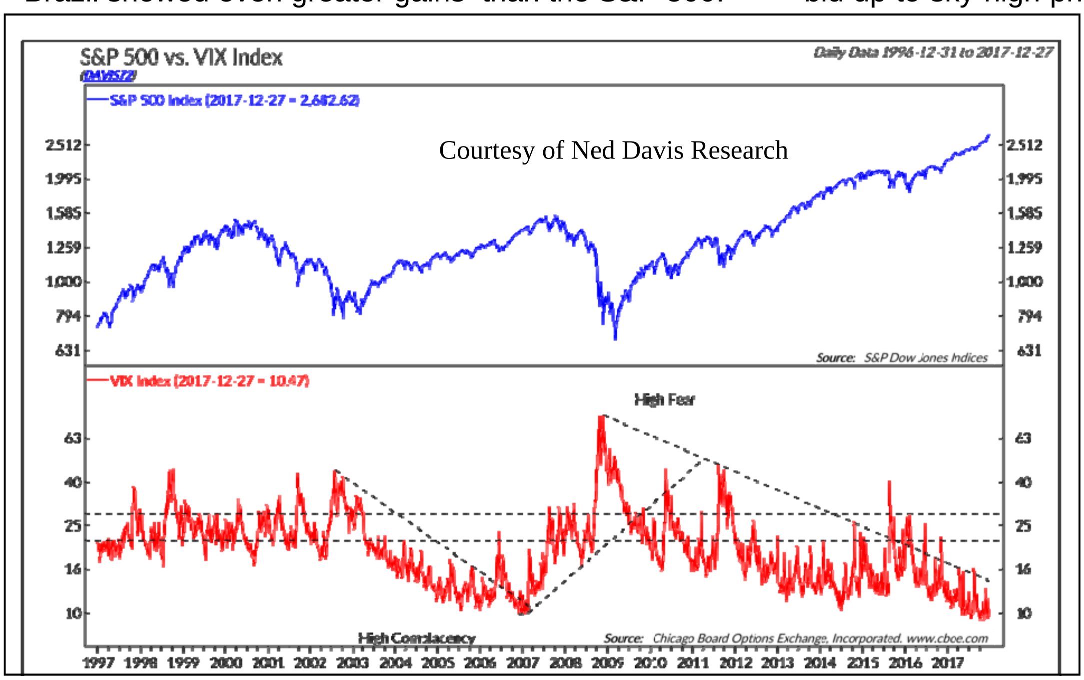


Is the Stock Market in a Bubble? by Watt Dixon

The current bull market in stocks is over nine years old. Stock prices have more than tripled since this bull market began in March of 2009. While Bitcoin gets most of the press concerning bubbles, the stock market gets its fair share of “bubble“ press as well these days.

A bubble occurs when investors put so much demand on an asset that they drive its price beyond any accurate or rational reflection of its actual worth. In the case of a stock, the actual worth would ideally be determined by the performance of the underlying company. However, valuation methods differ greatly amongst investors. By many measures, stocks were overvalued in the late 1980s. Despite this over-valuation, stock prices continued to rise for many years. If an investor had sold just because he thought stocks to be overvalued in the late 1980s, he would have missed out on one of the great bull markets.

Although the market has been chugging along for some time now, most of the growth in the market has been due to some solid factors and not just mania-type behavior like we saw in the dot-com bubble of the late 1990s. The year 2017 saw simultaneous positive economic growth in the U.S., the emerging markets, and developed markets like Europe and Japan. This last occurred in 2010. The global economy appears strong. The stock markets in Hong Kong, India and Brazil showed even greater gains than the S&P 500.



In the U.S., corporate earnings, which are always a key factor in stock prices, have continued to increase and the gains have kept stock prices from becoming wildly expensive. Inflation and short-term rates have remained low. The 10-year Treasury yield is at 2.5%, about where it started the year. Low interest rates and inflation rates have typically been good for stock prices.

So with all these positives going for stocks now, what could cause trouble? Paradoxically low interest rates, while usually good for stocks can be a problem. With rates being low for a long time now, other asset classes get little investor attention and investors take on too much risk. In addition, the VIX index, which measures investors’ anticipated volatility has been low for much of 2017. See chart below. Often this stability of the VIX can forebode instability in the stock market. An inflation or interest rate shock in the economy during a period of low volatility can often send stocks tumbling on a little bit of bad news.

Most bubbles in the stock market share some similarities. The “this time it's different mentality” is one of the most common. The New Era euphoria of the 1920s and the dot-com/Internet Economy of the 1990s both were prime examples of this type of thinking. Irrational exuberance and “story” stocks are also both characteristics of bubbles in the stock market. Many internet stocks and some biotech stocks have been companies with no real earnings but plenty of hope for earnings. These types of stocks often get bid up to sky high prices with no underlying support; a little bit of selling on bad news can burst these bubbles very quickly.

The above examples are two of the main traits of a speculative bubble. These examples lead to a herd-type mentality, investors mindlessly following the herd. While this current bull market is showing some age, and a correction could happen at any point, this market lacks the euphoria and “throwing caution to the wind” mentality present in stock market bubbles. Bitcoin, on the other hand, is quite possibly a different story.

Highlights of the Tax Cuts and Jobs Act by Ted Feinour

On Wednesday, December 20th, 2017, Congress passed a comprehensive tax reform bill. Recently, the President signed the bill into law. The Tax Cuts and Jobs Act is the largest piece of tax legislation since the Tax Reform Act was adopted in 1986. The bill leans heavily on tax cuts for corporations and business owners, but it also expands or restores some tax benefits for individuals relative to the earlier bills passed by the House and Senate. The individual provisions of the law will expire by the end of 2025 if not made permanent by Congress prior to that date, but most of the corporate provisions are to be considered permanent.

Since the provisions of the law are quite voluminous, we will not spend time analyzing all the regulations, but will only discuss a few of the highlights which will affect our clients. There are still seven tax brackets, but the top maximum rate is reduced from 39.6% to 37%. This top rate applies to individuals with an adjusted gross income in excess of $500,000 and married couples over $600,000.

The new tax law also doubles the standard deduction. For single filers, the bill increases it to $12,000 from the current $6,350. For married couples filing jointly, the standard deduction increases to $24,000 from $12,700. This primarily means that the percentage of filers who choose to itemize their deductions will drop significantly.

The new bill also doubles the Estate Tax Exclusion. Currently the old tax regulations set the estate exclusion at $5.49 million for individuals and $10.98 million for married couples. The exclusion will be increased to $10 million for individuals and $20 million for married couples.

Another type of account used by many of our clients is the Section 529 plan. Under the current law, distributions from 529 plans may only be used for expenses relating to higher (post-secondary) education. Under the new law, in addition to higher (post-secondary) education, distributions from 529 plans of up to $10,000/year per student can be used for tuition in connection with enrollment or attendance at an elementary or secondary public, private, or religious school. These provisions will NOT expire in 2025.

As mentioned earlier these are just a small sample of the many aspects of the tax reform package, but members of our firm are pleased to discuss these provisions and others with you or your tax professional as part of future tax or financial planning.