MARKET COMMENTARY

January 2018

2017: As Good As It Gets?

By Kevin O'Keefe

For many investors, 2017 will be remembered as the year when almost everything went up.

U.S. Stocks

The Dow may not be the single best stock market gauge, but it is widely followed, which makes it relevant. The Dow steadily climbed to notch a total of 71 record highs last year, the most record highs ever in a calendar year for the blue chip bellwether. Along the way, it also eclipsed five 1,000-point milestones, before finishing the year just below 25,000.

The technology-stock heavy Nasdaq Composite Index was up even more than The Dow. Meanwhile, the S&P 500 Index managed to register positive total returns every single month — the first time that has happened. Although the Russell 2000 Index of small cap stocks lagged behind its large-stock brethren, after outperforming them in 2016, it still posted double digit percentage gains for the year.

A Dow That's Rarely Down

The Dow industrials surged past five 1,000-point milestones during an exceptional year-long run.

Source: FactSet

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Quarterly Performance Benchmarks

Passive Benchmarks*	Q4-2017	YTD	1 Year	3 Year**	5 Year**
S&P 500 Index	6.64	21.83	21.83	11.41	15.79
MSCI KLD 400 Social Index	6.02	20.92	20.92	10.16	15.20
DJIA (reinvested dividends)	10.96	28.11	28.11	14.36	16.37
S&P MidCap 400	6.25	16.24	16.24	11.14	15.01
Russell 2000 (Small Cap)	3.34	14.65	14.65	9.96	14.12
MSCI EAFE (Europe, Australasia, Far East)	4.23	25.03	25.03	7.80	7.90
MSCI Emerging Markets	7.44	37.28	37.28	9.10	4.35
Bloomberg Barclays Aggregate Bond	0.39	3.54	3.54	2.24	2.10
Morningstar Mutual Fund Benchmarks					
U.S. Large Cap Growth	7.25	31.15	31.15	12.87	16.85
U.S. Large Cap Value	6.55	15.09	15.09	10.49	13.69
U.S. Mid Cap Growth	6.61	25.67	25.67	9.93	14.35
U.S. Mid Cap Value	6.18	13.02	13.02	11.30	16.92
U.S. Small Cap Blend	4.78	15.03	15.03	9.58	14.17
Foreign Large Blend	4.09	26.70	26.70	8.17	7.97
U.S. Real Estate	1.73	6.67	6.67	5.39	8.91
Intermediate-term Bond	0.34	4.19	4.19	2.50	2.16

* Sources: Morningstar

**3-Year and 5-Year returns are average annual returns for that benchmark.

Performance data presented reflects past performance. Past performance is no guarantee of future results. Investing involves risk, including loss of principal. Passive benchmarks are unmanaged groups of stocks and are not directly available for investment. Information has been obtained from a source considered to be reliable; however, neither First Affirmative nor its agents can guarantee the accuracy of the numbers reported.

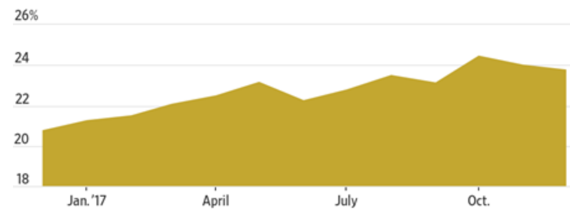
First Affirmative Financial Network, LLC

A significant player in U.S. stock indexes' rise last year was the tech sector. In 2017, the largest tech companies got even bigger as earnings surged. "FANG stocks" (Facebook, Apple, Amazon, Netflix, Google/Alphabet, Microsoft, etc.) were a key part of the 2017 story. At the beginning of the year, technology stocks comprised less than 21% of the S&P 500. By year-end they represented almost 24% and accounted for more than a third of the index's total return for the year.

An unexpected fall in the U.S. dollar — the most in a decade — was a key factor in last year's rally. A lower dollar helped expand profits and make exports cheaper. The acceleration in U.S. stock prices worries some investors because prices are at high levels relative to past earnings. But compared to future expected earnings, prices don't seem so extreme.

Tech-Tonic Shift

The tech sector's big rise in 2017 has grown its share of the S&P 500's market value.



Note: As of Dec. 28
Source: S&P Dow Jones Indices
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Low Volatility

The S&P 500 had only eight daily moves of 1% or more in 2017, the fewest since 1965. The "VIX", which measures expected volatility in the S&P 500 based on option prices, has trended lower for most of the last year. What does this suggest for 2018? Here is what market history shows on that question: the research team at LPL selected all the years in which the S&P 500 had less than a 5% pullback during the year. They found that the average maximum pullback during the following year was 12%, and that the number of 1% daily moves increased significantly. Of the six previous times this happened, the S&P 500 advanced two-thirds of the time.

LOW VOLATILITY YEARS TEND TO SEE MORE VOLATILITY THE NEXT YEAR

Year	S&P 500 Return	Max Pullback	Next Year Max Pullback	1% Moves	1% Moves Next Year	S&P 500 Return Next Year
1954	45.0%	-4.4%	-10.6%	15	42	26.4%
1958	38.1%	-4.4%	-9.2%	18	22	8.5%
1961	23.1%	-4.4%	-26.4%	14	58	-11.8%
1964	13.0%	-3.5%	-9.6%	3	8	9.1%
1993	7.1%	-5.0%	-8.9%	17	27	-1.5%
1995	34.1%	-2.5%	-7.6%	13	38	20.3%
2017	19.4%	-2.8%	?	8	?	?
Average	25.7%	-3.9%	-12.1%	12.6	32.5	8.5%
Median	23.1%	-4.4%	-9.4%	14.0	32.5	8.8%
% Positive	100.0%					66.7%

Source: LPL Research, FactSet 01/09/2018

International Stocks

International stocks continue to look attractive. Especially strong performance from emerging markets helped propel the MSCI All-Country World Index to even greater gains than US stocks. There was broad global economic growth last year, and that trend should continue. Correlations among stocks of major countries and regions have fallen to the lowest levels in decades. This is a good thing for investors. If the stocks of various countries tend not to move in the same direction at the same time, the benefits of diversification are demonstrated and reinforced.

Or as Charles Schwab & Company's Chief Global Investment Strategist Jeff Kleintop puts it, "The return to the lowest average correlation across stock markets seen in 20 years implies globally diversified investors may benefit from less volatility without sacrificing return on the path to their financial goals—in essence decreasing risk without decreasing return."

World Stocks Climb Ahead

A rally in emerging markets has helped international stocks soar in 2017.

Indexed
Source: FactSet
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Looking Ahead

It appears that the market still has legs and room to run, and a recession seems unlikely this year. Global economic growth, driven largely by capital spending by businesses and improving productivity, will probably continue to boost corporate earnings. But we may be entering the later stages of the bull market cycle, and with elevated valuations — the trailing 12-month P/E ratio for the S&P 500 is in the mid-20s, well above the 10-year average of 17.0 — caution is advised.

Given the tight labor market, expect wage growth and accompanying inflation. Depending on whether and to what extent this develops, the Federal Reserve could raise short-term interest rates more than expected to keep inflation in check and prevent the economy from growing too fast. Tighter monetary policy could in turn bring increased volatility. ▪

Key Themes in 2018

International Stocks

Valuations are generally lower than U.S. stocks and corporate earnings are growing more quickly. Add to that the momentum of international stocks last year, and it's a powerful combination going forward. Questions remain – e.g., whether Brexit compromises with the EU can be reached and whether reform efforts to improve economies in Asia and Europe have political support — but signs are positive. Consider the progress evidenced by the National People's Congress in China and Emmanuel Macron's economic policies in France. If further progress is made, expect international stocks to continue to deliver.

The Evolving Role of China

The critical geopolitical relationship between the U.S. and China will evolve as China flexes its muscles. Consider China's Belt and Road Initiative, whose objective is to connect Europe to China in an economic super-region, as well as a continuation of its large trade surplus with the U.S. While debates about fair trade will go on, the two countries are inextricably linked. North Korea remains a significant geopolitical issue for 2018, and its economic reliance on China adds another dimension to China-U.S. interactions.

Fed Policy in 2018

On February 3, current Federal Reserve Governor Jerome "Jay" Powell is scheduled to be sworn in as the new Fed chairman. Monetary policy should not change materially, and the Fed's balance sheet will continue to unwind. However, the outlook for short-term interest rates gets murky beyond mid-year. How will Fed officials act in response to a tighter labor market and a strong economy? The answer will have some impact on the dollar and long-term interest rates in the U.S. and abroad.

Investing: More Tech, Info, Choices

Technology creates ever faster and less expensive means to participate in the global financial markets. Packaged products for individual investors have proliferated in a market once dominated by institutions that traded far fewer investments. Handwritten trade tickets have been replaced by algorithms, while multi-asset class retirement income portfolios have taken the place of CDs and individual bonds. Modern markets are complex, and individual investors are faced with ever-increasing information and choices. The good news is that financial planning software and professional advisors have kept up, enabling clients to confidently plan and implement strategies for achieving long-term financial objectives.

The Secular Bull Market

Stocks are enjoying a bull market similar to the decades long post-World War II and 1982-2000 markets. If you mark the beginning of each bull market not from the bear market low, but instead from the point where it eclipses the previous bull market high, on average secular bull markets have lasted about 14 years, producing annualized returns of around 16%. Under this definition, the current secular bull market began when it surpassed the 2007 peak in 2013, meaning it remains relatively early in its cycle. Of course, stocks tumble periodically during secular bull markets, but historically these pullbacks have turned out to be favorable opportunities to buy. The S&P 500 is up almost 300% since the March 2009 bottom, but it's only a fraction of the 1400% gained during summer 1982 to March 2000. ▪

Be Grateful, Be Humble, Be Patient

Some years ago, the stock market was well into an extended bull run, much like what we have been witnessing lately. A senior member of the investment strategy team I served on was asked whether investors should be worried, and whether they should take action of some kind. I still remember his response: Be grateful, be humble, be patient.

It's human nature to protect what one possesses; thus, worrying about a pullback (or worse) from market highs is only natural. (Conversely, "FOMO" – Fear of Missing Out – afflicts those bothered by parties they weren't invited to.) But isn't gratitude an even more important place to begin at times like these, when investors can look back to see that they have achieved above-average returns?

Humility for investors is, above all, recognizing the role of good fortune, luck, chance. Every well-diversified investor has done well over the last several years. No special skill was required; no crystal ball. Only patience and prudence. It's important to recognize that – for just as making good profits during boom times doesn't mean you're a genius, neither does suffering setbacks during lean times mean that you're a fool.

No one knows how high the stock market will go, or how deep or how prolonged the next bear market will be. Adjusting portfolios beyond what is dictated by one's Investment Policy Statement is dangerous, which is why we advise our clients against making changes based on market conditions. It is far better to simply adjust your expectations. While we could very well be in the early stages of a secular bull market that could last for many more years, it's better not to expect the next few years to be a continuation of the excellent returns we have experienced so far this decade. Neither should you worry very much about the occasional, inevitable market setbacks. Patience — especially when times are tough — is the price you have to pay for long-term investing success. So what should you do? We recommend that you check to make sure your asset allocation is in sync with your investment time horizon and risk tolerance, and then be patient. This is the best strategy we know of for achieving lasting investment success.

Fixed Income Commentary

By Colleen Denzler

Bond Market Review

2017 was another great year for bond investors as most categories of bonds produced not only positive returns for the year, but also outperformed their historical 3- and 5-year annualized returns. The backdrop for this outperformance was economic growth, low inflation and global demand as investors from all over the world reached for yield. This performance came despite the Federal Reserve doubling the federal funds rate from 0.75% to 1.50% during the course of the year. While it might seem counterintuitive for bonds to outperform when the Fed is raising rates, (bond prices normally fall when interest rates rise, and vice-versa) it only goes to prove the old adage that "not all bonds are created equal."

In fact one only has to look at US Treasury bond yields, represented by the yield curve, to see this adage in action. As one might expect, the shorter maturities, which are most affected by Fed policy, saw significant increases in yield. The yield on the 6-month T-Bill moved up 0.92% (92 basis points) to a yield of 1.58%. However, when we look further out on the curve we see a diminishing impact of the Fed and an increasing awareness of future inflation, or in this case, the projected lack of inflation. The 30-year Treasury bond yield actually went down 0.21% (21 basis points) to 2.80% during the year.

It was the combination of a relative lack of movement on the yields of longer maturity bonds with strong demand for spread-type bonds, (bonds that are not Treasury bonds and have a yield "spread" to reflect credit risk relative to Treasury bonds), that led to positive bond returns for 2017.

Municipals Get "Reformed"

Municipal bonds (tax free state and local bonds) experienced the same trends that Treasury bonds (curve flattening) and Corporate bonds (spread tightening) did in 2017, which ultimately led to positive performance for the year. Municipals were first affected by potential and then by actual tax policy changes during 2017, as Congress proposed and then passed tax reform legislation. The biggest fear was the whispering that municipals wouldn't maintain their tax-exempt status, which would have been an obvious catastrophe for this type of bond.

However, once the tax law passed, municipals maintained their tax-exempt status. There were, however, a few changes to the tax law that will impact municipal bond values in 2018: 1) the reduction of the corporate tax rate from 35% to 21% (expected to decrease demand from corporations), 2) the reduction of the top federal personal marginal tax bracket from 39.6% to 37% (expected to have minor impact to municipals as 37% is still a high enough tax bracket to warrant the use of municipal bonds), 3) a cap of $10,000 for the state and local tax deduction (expected to increase demand from investors looking for exempt income, particularly in high tax states), 4) elimination of tax-exempt status for other specialty-type bonds used by issuers to reduce interest expenses (expected to reduce supply in 2018). The net effect of the tax reform is still under debate and will unfold as the year progresses, but for now municipal bond yields in relation to treasury bonds have stabilized.

Outlook

Outside of supply and demand and interest rate movements, the biggest determinant of bond performance is inflation. If inflation rises, then bond investors demand more yield to compensate them for the negative impact inflation has on bonds. Inflation has remained tame over the last 10 years, which is a big reason why the Fed was able to keep rates low. The issue regarding inflation this year is that it has been so steady that even a small spike from the 2.2% current rate could increase yields. The outgoing Fed Chair Janet Yellen stated recently her belief that rates need to increase three times in 2018. Of course, what happens will ultimately depend on the pace of inflation. With the expectation that incoming Fed Chairman Jerome Powell will continue the gradual policy of tightening, it would seem the Fed intends to stay ahead of inflation if it needs to.

One significant positive for fixed income investors is the higher yield now available in the shorter maturities. With the longer maturities having performed so well this year, the emphasis might shift to capturing yield on the shorter end of the spectrum. One of several techniques to navigate this tricky bond market is for bond managers to capture the positive total returns of 2017 and then move on to investing at higher yields on the short end of the market in 2018. This might be a way to guard against a possible spike in inflation as well as adding in some higher income. This trade has certainly gotten "cheaper" with the curve flattening that has occurred in 2017. In the long run, more yield is not the enemy of the bond investor, especially if yield increases gradually over time. ▪

Sources: Bloomberg, Barron's, Bond Buyer, Gurtin Municipal bond managers, SNW, Wall street Journal

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