2017 in Review

The year 2017 was noteworthy in that for the first time in this century, all the major economic basins of the world were growing simultaneously, albeit at different rates. Before this period, at different times, Europe, Japan, or the emerging markets dealt with significant headwinds, and growth here at home was plodding and sluggish. We regard the synchronization of global growth as a somewhat underappreciated positive trend that has continued thus far into early 2018.

U.S. Markets:

The fourth quarter capped yet another stellar year for U.S. stocks. Larger-cap U.S. stocks gained 6.6% for the quarter and ended the year with a 21.7% total return. This was the ninth consecutive year of positive returns for the index—tying the historic 1990s bull market and capping a truly remarkable run from the depths of the 2008 financial crisis.

Asset Class	4Q	1 Year	5 Years (Ann.)
U.S. Large-Cap	6.61%	21.67%	15.62%
U.S. Large Growth	7.98%	29.95%	17.11%
U.S. Large Value	5.45%	13.45%	13.82%
U.S. Small Blend	3.28%	14.59%	14.16%
Developed Int'l Stocks	4.34%	26.42%	8.17%
Emerging-Markets Stocks	5.87%	31.48%	3.37%
REITs	1.37%	4.83%	9.11%
Investment-Grade Bonds	0.38%	3.46%	1.91%
Municipal Bonds	0.75%	5.45%	2.82%
High-Yield Bonds	0.41%	7.48%	5.80%
Global Bonds	1.04%	7.49%	0.12%

The broad driver of the market's rise for the year was rebounding corporate earnings, which was supported by solid economic data, synchronized global growth, still-muted inflation, and accommodative monetary policy. Markets got an additional catalyst in the fourth quarter with the passage of the Republican's Tax Cuts and Jobs Act, presumably reflecting investors' optimism about its potential to further boost corporate after-tax profits, at least over the shorter term.

We're running out of superlatives to describe the U.S. stock market, but we'll throw out a couple more factoids that reflect just how unprecedentedly steady its recent performance run has been. The market's 1.1% gain in December crowned 2017 as the first year ever that stocks rose in each and every month. By year-end, the S&P 500 Index had rallied for more than 400 days without registering as little as a 3% decline. This is the longest such streak in 90 years of market history, according to Ned Davis Research.

Foreign Markets:

Foreign stock returns were even stronger than those of our primary domestic indices, with developed international markets gaining 26.4% and emerging markets up 31.5% for the year. European stock market gains reflected improved corporate earnings and the strongest economic growth in the region since 2007. Similarly, emerging markets are experiencing a rebound in corporate earnings growth, and perhaps more importantly, are becoming less dependent upon commodity-oriented sectors as technology and consumer sectors have assumed greater importance.

Fixed Income Markets:

Moving to the fixed-income markets, core bonds gained 3.5% in 2017, closely mirroring the index's yield to start the year. Municipal bonds rebounded nicely from a flat 2016 to return roughly 5%. Amid the surge in stocks, the Federal Reserve raised short-term rates three times (75 basis points) and cautiously continued the well-publicized reduction of its multi-trillion-dollar balance sheet. Investors took central bank actions in stride and were seemingly reassured by the appointment of Jerome Powell as the next Fed chair late in the year. Intermediate-term interest rates changed little during the year with the benchmark 10-year Treasury yield ending at 2.5%. Corporate bonds across all credit qualities and maturities had positive returns, but were outpaced by the more credit-sensitive sectors of the fixed-income market. High-yield bonds gained over 7% and floating-rate loans rose 4%.

Market Outlook:

In terms of the near-term macro outlook, the consensus view is that there is little risk of a U.S. or global economic recession in 2018.

The market expects the in-sync global growth that we saw in 2017 to continue. Many of the investors and strategists we respect seem to share this view, although we constantly remind ourselves that no one knows what the future holds. Without a recession, a bear market in stocks is unlikely—although a run-of-the-mill 5% to 10% "correction" can happen at any time (the recent tranquil market notwithstanding) and an unexpected macro/geopolitical shock could obviously cause a larger drop.

The fact remains that we are on the heels of the longest rally in 90 years of U.S. market history. By any number of metrics, U.S. stocks are not cheap, with forward P/E and CAPE ratios higher than 25-year averages. While earnings will probably see a boost in the short term under the new tax plan, over the long term we expect the incremental margin benefit from lower taxes to largely be competed away. The new tax plan's additional incentive for companies to pursue capital expenditures and repatriate cash could also increase shorter-term economic activity, boosting overall profits. But this would come at a time when we are in the later stages of the business cycle, and when the economy arguably is running close to full employment. This may create inflationary pressures and/or cause the Fed to raise rates faster than communicated, both of which may counteract the benefit from rising profits.

Longer term, it's less certain how markets will adjust to tightening global liquidity, as the Fed and other sovereign central banks shift into a more hawkish position after nearly a decade of supportive monetary policy. This period continues to be a challenging one because of the disconnect between market levels, interest rates, different stress points in the global economy, and the sizable impact of central bank policies. Overall, this combination of factors should keep any sensible investor from being overly confident about how things will play out, and highlights the importance of diversification. A diverse portfolio – one that reaches across all market sectors, foreign and domestic – ensures that at least some of a portfolio's investments will be in the market's stronger sectors at any given time – regardless of what's hot and what's not and irrespective of the economic climate.

It Seems Quiet…

Going back to 1980, the *average* intra-year decline in the S&P 500 has exceeded 14% (compared to 2017's 3% max drawdown), but annual returns have been positive in 29 of these 38 years. The lesson gleaned from this is that temporary market declines are not to be confused with permanent loss of capital, and that the most effective antidote to volatility is the passage of time. That's easier to point out while volatility is at historically low levels, but there's no reason to believe that markets will remain this quiet going forward.

The long-term lack of volatility we have seen has provided a false sense of security for many. Accordingly, when the next big market correction comes – and it will come eventually – all of us will feel it and some of us will be overwhelmed by it. This is inevitable and may be unsettling, but it will also be *temporary*. Just remember that we're here to help you reason through it, that our portfolios are built to withstand a wide range of outcomes, and that market volatility is a feature, not a bug.

Big Picture Focus:

During times of exuberance and euphoria in the stock market, we find it prudent to remind ourselves why we invest in the first place. Most of our clients are working on multi-decade and even multi-generational plans for life altering and defining goals such as education funding, achieving financial independence, and cementing legacies. Current events in the economy and the markets are in that sense distractions of one sort or another. For this reason, we make no attempt to infer an investment policy from today's or tomorrow's headlines, but rather align clients' portfolios with their most important long-term goals, risk tolerance, and cash flow situation.

Given the sustained run-up in equities, we will continue to rebalance client portfolios as needed to ensure they remain in-line with their target asset allocations. We will do this without emotion, allowing us to effectively sell high and buy low in a calculated, thoughtful manner.

We want to be clear on several points. We don't forecast the economy; we make no attempt to time markets; and we cannot – nor can anyone else – consistently project future relative performance of specific investments based on past performance. In a nutshell, we're planners rather than pundits, and believe our highest-value services are comprehensive financial planning and behavioral coaching. By helping clients avoid overreacting to market events both negative and positive, we strive to remain laser-focused on what truly matters in the long-run.

In order to be successful long term investors, we adhere to the practice of "rationality under uncertainty." We'll never have all the information we want, in terms of what's about to happen, because we invest in and for an essentially unknowable future. Therefore we practice the principles of long-term investing that have most reliably yielded favorable long-term results over time: planning; a rational optimism based on experience; patience and discipline. These will continue to be the fundamental building blocks of our investment advice in 2018 and beyond.

As always, we appreciate your confidence and welcome questions about your individual portfolio or financial situation.

-We thank you for your continued support!