MARKET REVIEW & COMMENTARY

DECEMBER 2017

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Diana Joseph, Co-Chief Investment Officer
Direct: (312) 870-1902 • djoseph@telemus.com

David Post, Co-Chief Investment Officer
Direct: (424) 281-1125 • dpost@telemus.com

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MARKET REVIEW

DECEMBER 2017

December continued the persistent string of stock market gains which characterized 2017. In general, large caps beat their smaller brethren and 'value' continued its nascent out performance versus 'growth'. We had commented on this possibility in last month's letter. Small caps of both flavors were the only losers of the month. The November outperformance of U.S. equities was short-lived, as emerging and frontier equity markets trounced their U.S. counterparts and most international bourses beat the U.S. in December. Fixed income was generally and modestly positive. Unprecedented municipal issuance ahead of the tax bill and the continued flattening of the yield curve (short rates rising faster than long rates) resulted in the best returns following maturities across the curve. Most alternatives and real assets sported positive returns with energy and precious metals accelerating the quarter's gains.

Specifically, the S&P500 rose +1.11% while high dividend payers gained +1.30%. Large cap value climbed +1.46% while large cap growth gained +0.78%. Small cap value was down -0.35% while small cap growth lost - 0.67%. Emerging markets, one of the year's best performers, gained another +3.59% just this month, while frontier markets, also a standout this year, rose +3.13%. EAFE continued to climb, gaining +1.61%, as did Europe, which was up +1.51%.

Fixed income returns varied markedly. The Bloomberg Barclays long credit index rose +2.03%, 10 year municipals gained +1.20% and TIPS rose +0.92% in December while 3-5 year Treasuries lost -0.04%. Intermediate corporates eked out a +0.30% return, mortgage backed paper gained +0.33% and T-bills gained a skinny +0.11%. Three of the best 2017 performers had lackluster December performance, possibly marking a digestion period or risk-reduction trade. High yield paper gained only +0.30% this month while emerging market bonds were up +0.63% and world bonds gained +0.16%.

Alternatives and real assets were up across the board although returns spanned a wide range. The HFRX Global Hedge Fund Index gained +0.73% and world real estate appreciated +0.79%. However, the year's laggards jumped, with the Bloomberg Commodity Index up +2.99%, precious metals gaining +5.78% and global natural resources up +5.30%.

MARKET REVIEW

YEAR

December was a fitting end to what can be described as an extraordinary year for equity investors. All flavors of stocks did well but there was a wide chasm between the returns of ‘growth’ and ‘value’ stocks. U.S. growth stocks were up between +22.17% (small cap growth) and +30.21% (large cap growth). U.S. value stocks have garnered only one-third of those returns. U.S. value stocks were up between +7.84% (small cap value) and +13.66% (large cap value). The S&P500 gained +21.83%, high dividend payers were up +18.63% but microcaps gained ‘only’ +13.17% year-to-date. As we had posited, international markets outperformed U.S. markets for the first year out of the past five. EAFE was up +25.03% and Europe was up +25.51%. Emerging and frontier markets lead the pack; up +37.28% and +31.86%, respectively. We think that the relative outperformance by internationals may continue due to lower valuations and recovering economies. The U.S. had dominated the performance derby versus internationals since 2008.

Contrary to repeated cries of ‘rates will rise’, all but shorter rates fell and fixed income was universally positive for 2017. Municipals outperformed taxable bonds in general, and longer maturities of all bonds greatly outperformed short paper. Short Treasuries were up +0.42%, short credit was up +1.66% and short-term municipals were up +1.56%. The 10-20 year Treasury Index is up +4.19%, Barclays Intermediate Corporate Bond Index is up + 3.92% and the Bloomberg/Barclay 10 Year Municipal Index has gained +5.83% year-to-date. TIPS are up +3.01%, emerging market paper (EMBI) was up +8.29% and high yield bonds are up +7.50% through December.

Alternatives and real assets experienced varied returns in 2017. The HFRX Global Hedge Fund Index was up a respectable +5.99% , while world real estate was up +14.65% and precious metals were up +9.98%. The Bloomberg Commodity Index gained +1.70, while the S&P energy index was down 1.01% and the dollar was down -8.87%.

World markets finished 2017 resilient in the face of great political uncertainty. Markets focused upon the economics, which are positive. Global growth remains synchronous, good and rising. Valuations remain toward the high-end in the historical record but so does corporate earnings growth. The forward P/E ratio on the S&P 500 is 18.2x versus the 20 year average of 16.0x while earnings growth for the next 12 months is projected at 10.1% versus the 20 year average of 5.8%. Longer term we are concerned about a global debt buildup and the implications of reduced quantitative easing. We also note that the bull markets in most everything are getting old. At the moment we think that appropriate asset allocation and frequent rebalancing to targets will allow continued participation in the upside while putting away money for an inevitable correction.

INDEX RETURNS AS OF 12/31/2017

BASIC INDEX RETURNS

BASIC INDEX RETURNS	MONTH TO DATE RETURN	QUARTER TO DATE RETURN	YEAR TO DATE RETURN	LATEST 3 YEARS RETURN	LATEST 5 YEARS RETURN	LATEST 10 YEARS RETURN
BALANCED INDEX (25% ACWI, 60% US Gov. Cr 1-5, 5% HFRX, 5% commodity, 5% bill)	0.61%	1.55%	6.81%	9.28%	16.33%	28.81%
HFRX GLOBAL HEDGE FUND INDEX	0.73%	1.50%	6.00%	4.69%	11.08%	-3.99%
CPI - SEASONALLY ADJUSTED	0.00%	0.49%	1.96%	4.79%	7.12%	17.10%
S&P 500 COMPOSITE	1.11%	6.64%	21.83%	38.29%	108.14%	129.29%
LIPPER LARGE - CAP CORE	2.00%	6.93%	21.62%	35.42%	98.61%	110.98%
WISDOM TREE LARGE CAP DIVIDEND	1.30%	6.70%	18.63%	35.93%	98.54%	122.44%
MSCI ALL COUNTRY WORLD INDEX NET	1.61%	5.73%	23.97%	30.56%	66.98%	58.88%
MSCI EAFE NET	1.61%	4.23%	25.03%	25.25%	46.23%	21.50%
BLOOMBERG BARCLAYS MUNICIPAL BOND 5Y (4 - 6)	0.46%	-0.70%	3.14%	5.24%	9.47%	41.08%
BLOOMBERG BARCLAYS US AGGREGATE	0.46%	0.39%	3.54%	6.87%	10.95%	47.17%
BANK OF AMERICA / MERRILL LYNCH US T - BILL 3MONTH	0.11%	0.28%	0.85%	1.23%	1.34%	3.94%

EXTENDED INDEX RETURNS

EXTENDED INDEX RETURNS	MONTH TO DATE RETURN	QUARTER TO DATE RETURN	YEAR TO DATE RETURN	LATEST 3 YEARS RETURN	LATEST 5 YEARS RETURN	LATEST 10 YEARS RETURN
RUSSELL 1000 GROWTH	0.78%	7.86%	30.21%	47.32%	122.31%	162.99%
RUSSELL 1000 VALUE	1.46%	5.33%	13.66%	28.27%	92.84%	101.63%
RUSSELL MIDCAP GROWTH	0.54%	6.81%	25.27%	34.17%	103.81%	143.19%
RUSSELL MIDCAP VALUE	1.24%	5.50%	13.35%	29.51%	98.34%	144.68%
RUSSELL SMALL CAP COMP GROWTH	0.50%	5.99%	26.44%	36.40%	111.07%	159.02%
RUSSELL SMALL CAP COMP VALUE	0.39%	3.91%	11.10%	29.88%	84.97%	129.19%
MSCI EM (EMERGING MARKETS) NET	3.59%	7.44%	37.28%	29.88%	23.66%	19.88%
BLOOMBERG BARCLAYS US TREASURY BILL 6 MONTH	0.11%	0.28%	0.98%	1.92%	2.23%	7.38%
BLOOMBERG BARCLAYS US AGENCY	0.12%	-0.02%	2.06%	4.53%	6.77%	31.67%
JP MORGAN EMERGING MARKET BOND INDEX(EMBI) + COMPOSITE	0.63%	-0.32%	8.29%	20.87%	17.65%	92.44%
CITI GROUP WORLD GOVERNMENT BOND	0.16%	1.04%	7.49%	5.31%	0.61%	28.36%
BLOOMBERG COMMODITY	2.99%	4.71%	1.70%	-14.36%	-35.69%	-52.25%
PHILADELPHIA STOCK EXCHANGE GOLD / SILVER	7.37%	0.73%	8.13%	23.97%	-48.51%	-55.20%
LIPPER GLOBL NAT RES	5.30%	6.18%	6.03%	9.60%	5.47%	-22.96%
LIPPER PRECIOUS METAL FUND	5.78%	1.06%	9.98%	24.26%	-40.75%	-36.82%
MSCI WORLD REAL ESTATE	0.79%	4.38%	14.65%	18.15%	38.56%	39.98%
LIPPER REAL ESTATE FUND	0.31%	2.90%	7.27%	18.30%	46.42%	72.78%

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Most observers of the global financial markets found 2017 to be a surprising year. Even the bulls were surprised at the relentless rise in the equity markets in the face of mixed economic fundamentals, as well as meaningful political and geopolitical uncertainty. However, investors seemed to be focused on improving corporate earnings in the U.S. and continued improvement in some economic metrics in Europe and Asia. While earnings have improved in the U.S. and economic green shoots continue to show up in Europe and Asia, we think it important to provide some further perspective.

Indeed, following much improved corporate earnings in Q2, earnings growth in the U.S. continued its rebound in Q3 and earnings growth in Q4 is expected to exceed 10% year-over-year. Moreover, earnings growth of the S&P 500 is expected to have grown 9.6% in calendar year 2017, which would mark the highest annual earnings growth rate for the index since 2011. Clearly, the earnings improvement over the past three quarters had a meaningful impact on equity share prices this year. Additionally, equity market performance in 2017 was aided by the anticipation of and the December signing of a tax bill that is highly favorable to corporate America. This tax bill was sold to middle class America as "The Tax Cuts and Jobs Act" with the clear implication that corporate tax cuts would result in new business investment and the creation of new jobs. However, students of corporate behavior during the current recovery fully expect that additional cash flowing into corporate coffers will likely not be used for business investment and new jobs, but rather to buy back stock and pay dividends. Accordingly, it is likely that earnings will continue to improve under these circumstances.

It is important to note that while corporate earnings have improved over the past two quarters and are posed for a third consecutive quarter of strong earnings growth, trailing twelve month S&P 500 earnings at the end of December are likely to come in at best around $109 per share, which is approximately 3% higher than the $105.96 trailing twelve months earnings at the end of September of 2014. This represents compounded nominal earnings growth of about 1% per year. However, since September of 2014 the S&P 500 has increased 37% or compounded annual growth of about 10%. It is important to recognize the disconnect between economic growth (2.5%), earnings growth (1%), and S&P 500 growth (10%) and understand that the performance of the equity markets over this time period is a result of earnings multiple expansion, which implies investor confidence that earnings growth will continue to expand at the pace of the last three quarters. Moreover, investors seem quite content, if not complacent, with this current market dynamic. In 2017 the S&P 500 has had an average daily move of just 0.30% through November 30th, meaningfully lower than the 0.81%

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average daily move over the past 10 years, and the index has delivered positive returns in all twelve months of the year.

What is of concern to us is that year-over-year quarterly comparisons will get tougher in the year ahead, especially considering the current economic expansion, at 103 months, is the third longest in history and that at some point recessionary pressures will mount. A further headwind is the Federal Reserve Bank's current monetary policy of increasing rates and decreasing its balance sheet, both of which will put downward pressure on the bond market. In addition, higher interest rates in the U.S. may increase the value of the U.S. dollar, which would negatively impact U.S. multinational earnings. In the meantime the S&P 500 has breached 2,700, which represents a market multiple of 25X trailing twelve month earnings, well above historical valuation metrics and well deserving of due caution.

While we have focused this commentary on the resounding performance of the equity markets in 2017, the underlying earnings fundamentals, and equity market valuations, we would be remiss not mention that there remain a number of other issues that are potentially impactful on the financial markets. To wit, Congress has continued to kick the can down the road regarding the federal budget and debt ceiling, jockeying for mid-term election votes may impede any meaningful infrastructure legislation, and the Mueller investigation remains a political wild card. Moreover, irresponsible tweets regarding nuclear buttons makes the North Korea situation more treacherous than it needs to be, meaningful and sustainable economic improvement in Europe has been fleeting, and China's debt bubble threatens their economic growth, as well as the rest of Asia and the world.

Conclusion

Last month we quoted Brett Ryder in a recent article in The Economist in which he made reference to the world being "in the throes of a bull market in everything." We continue to believe that we are in uncharted waters relative to interest rates and central bank balance sheets; we are flirting with all-time high equity market valuations and a continually increasing global wealth disparity that is impacting politics across the developed world. Contrast this with generally improving economic conditions in the U.S. and abroad and rising global asset values and the equation becomes more difficult to solve. If ever there was a time to be circumspect, it is now. As such, we remain committed to our asset allocations and continue to rebalance on a regular basis.

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