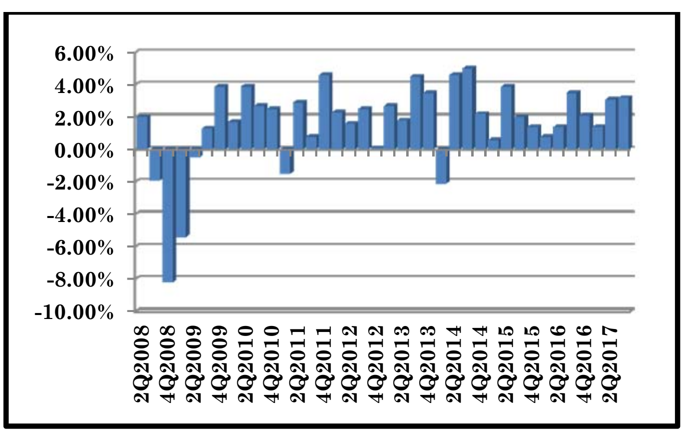
Quarterly Commentary

U.S. Economy

The U.S. economy grew for the fourteenth straight quarter. The final estimate of GDP growth for the third quarter (results are lagged one quarter) came in at 3.2%. The strength of the quarter was attributed to personal consumption which is the largest component of the measure. Government spending and personal inventories also helped the results while a worsening balance of trade and lagging residential fixed investments hindered them. Some economists have said that Hurricane repairs helped boost the quarter, but those gains are difficult to quantify.

The increased personal consumption came at the expense of personal savings and credit since wages have shown little growth. The personal savings rate is now the lowest it has been since April of 2008, which is surprising given consumer confidence fell for the quarter. Credit card debt, on the other hand, is the highest it has been since April 2008.

U. S. GDP Growth Rate



Unemployment dropped to its lowest levels in 17 years although labor participation fell again to 62.7%. Inflation as measured by the 12 month change in CPI came in at a rather modest 2.2%. Some attribute this to the wage stagnation mentioned earlier while others point to the slowing velocity of money (M2).

The Case Shiller Home Price Index shows housing continuing to improve and the Lundberg Survey shows oil and gas prices rising. Gold and silver even rose slightly for the quarter which is unusual given the low volatility of the markets and muted inflation fears.

Global Economy

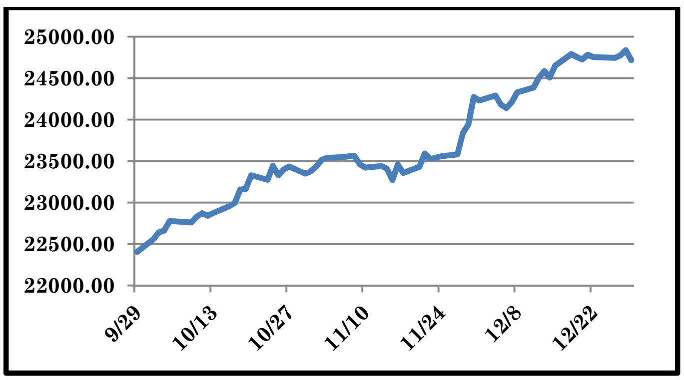
The global economy also continued to improve in the fourth quarter. Europe weathered several contentious elections and the accompanying protectionist sentiment. Its recovery lags the US however, for several reasons. The austerity measures that were implimented early on seemed to have delayed the recovery rather than helped it. Quantitative easing was harder for them to impliment and the uncertainties of Brexit continue to hang over the continent.

Asia is improving also, with China being the driver. Over 55% of the region's exports are imported by China. They continue to focus on becoming a consumer based economy with a 6.5% GDP goal and this has pulled the rest of the region's GDP up to the 5% range. It has also resulted in a corporate debt bubble which many fear to be the cause of an eventual slow-down.

US Equities

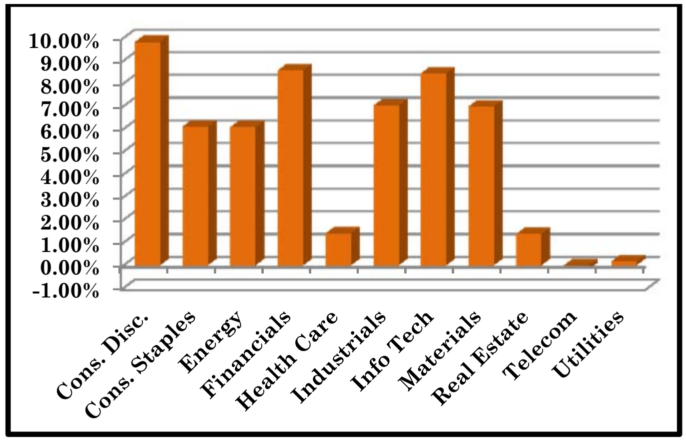
It was the ninth straight quarter for S&P 500 and DJIA gains. The S&P 500 was up 6.64% for the quarter and 21.83% for the year while the Dow was up 10.96% for the quarter and 28.11% for the year. Growth outperformed Value for the year 31.15% to 15.09%. The 50 largest stocks in the S&P 500 returned 19.42% vs 7.21% for the 50 smallest (2). There were 71 record closes and not a single 5% correction for the year. In fact, there were no 2% up or down days and only eight 1% days for the year. Volatility as measured by the VIX was minimal (see page 3). Some have referred to it as a Goldilocks market as there was enough uncertainty (North Korea, Tax Reform, Health Care, the Middle East, etc) to keep the wall of worry in sight but enough clarity from the Fed to keep the faith.

DJIA Third Quarter 2017



These gains left the market at fairly lofty levels. How lofty depends on how you measure it. Based on consensus forward earnings it is selling at 20 times, which is high but somewhat justified by dividend discount models. When using the Shiller 10 year backward P/E though, it is selling at 31.5 times earnings, which is the highest it has been since the late 1990s and a cause for concern.

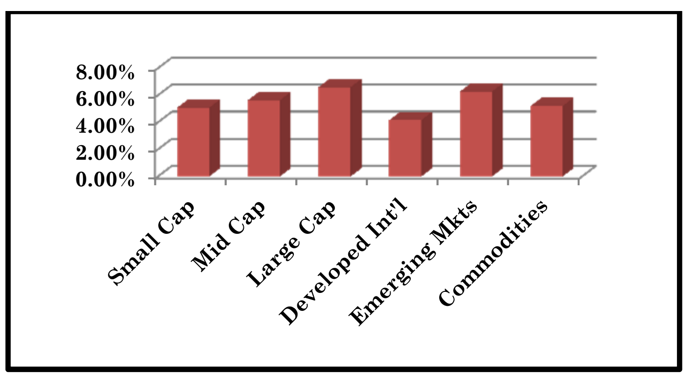
Fourth Qtr 2017 Sector Performance



The performance of the various sectors was rather vexing. Outperformance by Consumer Discretion and Financials and underperformance by Utilities and Telecom is typically an early cycle indicator. After 9 years of expansion, one would normally expect mid to late cycle performance. A feasible explanation is that some unusual rotation occurred because of tax reform and the possibility of rising interest rates.

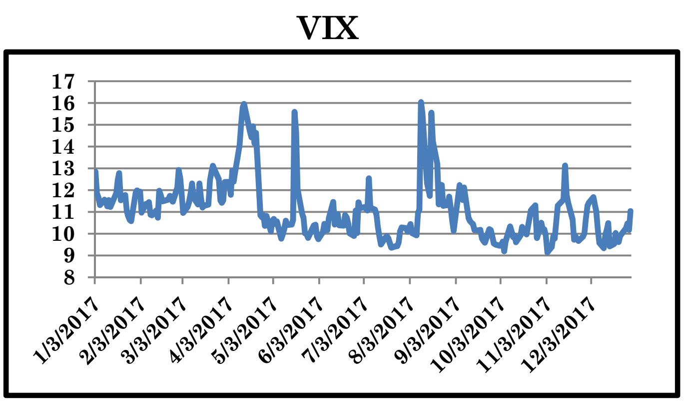
The performance of the asset classes was evidence of the global recovery. Both Developed and Emerging Markets rebounded, which buoyed Commodities. Large Cap still outperformed, but as noted earlier, results within the class were widely varied.

Fourth Quarter 2017
Asset Class Performance



Concerns

Given the length of this bull market and the current lack of volatility, many are concerned about the severity of a downturn when it does come. We often hear justifications like, "bull markets don't die of old age or high valuations" or "the trend is your friend". While that may be historically correct, it ignors the fact that the further the market gets wound up, the further it is likely to snap back when it unwinds. The VIX is not the only indicator of complacency. The Bull/Bear Ratio is the highest it has been since 1987. Bespoke Investment Group examined the daily performance of the market and found that Fridays were the best performing days in 2017. Traditionally traders have sold on Fridays, so they would not be exposed to unforeseen events over the weekend. Now we are seeing traders afraid of missing events over the weekend and loading up on Fridays.



Strategy

As we have said many times before, we do not recommend sweeping changes to portfolios or attempts to time the market. It is very difficult to predict when momentum will shift and a reversion to mean will occur. What we do advocate is fine tuning sector weights and asset class allocations so that when the eventual downturn occurs, investors are prepared and view it as a buying opportunity rather than a reason to panic. To that end, we would suggest the following tactical adjustments.

Consumer Discretion-Underweight. While many companies will benefit from tax reform, consumers are migrating to online retailers from bricks and mortar stores.

Consumer Staples-Slight Overweight. These companies are usually good late cycle performers and should benefit from tax reform.

Energy- Underweight. Now that disruptions have been resolved, supply should outweigh demand and since most lost money before tax reform they will see little immediate relief.

Financials-Slight Overweight. Rising rates help banks and insurers and P/Es are relatively low.

Health Care-Underweight. Removal of the individual mandate and the possibility of executive orders will add even more uncertainity to the sector.

Industrials-Slight Overweight. Faster Capex depreciation and possible infrastructure projects bode well for the sector which is usually a poor late stage performer.

Info Tech-Slight Overweight. Although valuations are already high, repatriation of cash could help many of these companies as could greater capex spending,

Materials-Overweight. The global economic recovery should keep the momentum going for the sector.

Real Estate-Underweight. REITs get little benefit from tax reform since they pay out most of their income. Big box stores and malls are hurting and the sector tends to trade like a bond equivalent.

Telecom-Slight Underweight. Although they have relatively low P/Es, these stocks have poor momentum and usually do not shine in a late cycle economy.

Utilities-Underweight. While these fully valued companies should benefit from tax reform, regulators may pass the savings on to customers.

Developed International-Slight Overweight. A rising euro will probably slow the recovery slightly, but on the whole valuations look cheaper than the US.

Emerging Markets-Market Weight. While GDP growth and momentum look strong, a slowdown in China could affect the many of these economies.

Small & Mid Cap-Slight Underweight. These companies are fairly valued and are usually the first to feel a credit crunch if a downturn comes.

Large Cap- Market Weight. Even though valuations seem a little rich, momentum and tax reform are on their side.

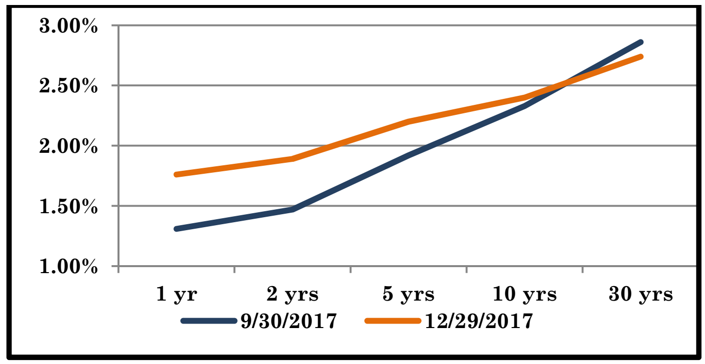
Fixed Income Markets – 4th quarter 2017

The last quarter of 2017 continued with the near perfect mix of steady economic growth, strong corporate earnings, low levels of inflation and accommodative monetary policies. The markets anticipated the rate hike that took place in December, and the FOMC hinted at additional increases in 2018 and 2019. President Trump appointed Jerome Powell as the new Fed Chair to replace Janet Yellen at the end of her term in February. The markets will pay close attention to any changes in tone on monetary policy from the new Fed Chair. While it does not appear that Powell intends to alter the current path of Fed policy, there are other changes to the makeup of the Committee that could have an impact. There are several unfilled seats at the FOMC and as new members come on board in 2018, the current slant could change.

The Treasury Yield Curve

Market strategists are watching the slope of the yield curve. The yield curve measures the difference between short and long term U.S. Treasury yields. Short term interest rates have risen and will continue to move higher as the Fed becomes less accommodative with monetary policy. However, longer term yields have actually fallen since the first part of the year. Historically, a flattening yield curve has predicted economic slowdown or in some cases recession and lower stock prices. Some are even predicting that the curve will invert (shorter yields higher than longer term yields.) An inverted yield curve has preceded each of the last seven recessions. But in the aftermath of quantitative easing, it really may be different this time. There are several factors that are contributing to the spread compression.

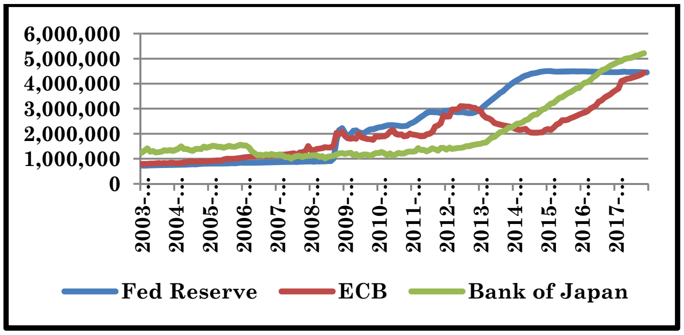
U.S. Treasury Yield Curve



Inflation is stubbornly low, which is the driving force of longer term yields. Even with unemployment at the lowest levels since 2000, wage pressures remain muted. Additionally, the Fed seems somewhat conflicted on what the yield curve is telling the markets. Minutes from the December meeting revealed a lengthy discussion on the topic, sighting their projections for an inverted yield curve in 2020 as a result of the committee's increase in the Fed Funds target rate.

In addition to below trend inflationary pressures, accommodative monetary policies embraced by the European Central Bank and the Bank of Japan has played a role in keeping long term yields low. Globally, central banks have been expanding their balance sheets and the bond market has benefited from increased demand. Over the past few years, as the spread between U.S. Treasuries and German bunds has become wider, overseas investors have turned to U.S. debt. But this trend is expected to turn, as policymakers have announced plans to cut back on the amount of bonds they are buying. Even with a reduction in stimulus measures, there will still be substantial demand for some time. As long as there is demand in the long end of the yield curve, rates will stay on the low end of the spectrum.

Central Banks' Balance Sheets

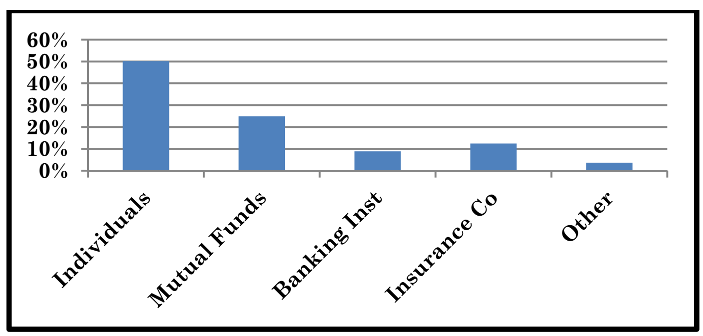


Tax Cuts and Jobs Act

The biggest event for the quarter (and the year) was the signing into law the Tax Cuts and Jobs Act in December. Tax cuts for individuals and corporations are expected to provide a modest boost to the U.S. economy as consumers and business increase spending. Estimates for an increase in GDP range from 0.2% - 0.4%. But what is the potential impact on the credit markets? For corporations which issue taxable bonds, the reduction in the corporate rate from 35% to 21% should benefit their bottom line, which could result in an improvement in credit quality and would reduce their funding costs (lower yields). Currently, corporations that issue debt can deduct the bond interest payments made to investors, but that deduction will now be capped based on a percentage of their earnings. For investment grade issuers, with relatively low debt levels, the cap will not have a huge impact. Demand for investment grade bonds should remain solid due to historically low interest rates and funding needs, but a shift may occur in the amount of debt issued by certain sectors. This could result in a reduction in overall supply, prohibiting a dramatic rise in rates. However, for those companies which are highly leveraged and are issuing high yield bonds, the cap on interest deduction is viewed as a penalty. Issuing debt by these types of companies may not be as attractive as once was. Over time, this could result in the better firms within the high yield arena issuing less debt and a smaller, higher quality-high yield market with less default risk.

As for the municipal bond market, due to a lack of certainty surrounding the tax reform bill, municipal bond issuers rushed to the debt market in the 4th quarter to get ahead of potential changes. It is expected that the muni market will rally in the first quarter of 2018 as supply will decrease. With lower corporate tax rates and the elimination of corporate Alternative Minimum Tax (AMT), the benefits of owning tax-exempt bonds may not be as compelling as it once was for certain institutions. Insurance companies and banks have been sizeable buyer/holders of municipal debt and this change may have a negative effect on demand going forward. But there is the thought that excess supply will be picked up by other institutions, mutual funds and exchange traded funds and pressure on rates will be minimal.

Municipal Bond Holders



Another provision to the Tax Cuts and Jobs Act is beginning in 2018, issuers will no longer be able to advance refund their outstanding debt with tax-exempt bonds. Similarly to refinancing a mortgage, bond issuers can issue new debt at lower rates to pay off old debt. The practice is typically done by state and local governments and allows municipal bond issuers the flexibility to reduce their cost of finance and frees up the borrowing authority for additional capital improvement or infrastructure projects at a lower cost to the taxpayer. The municipal market as a whole should benefit as there will be a reduction in supply from this new provision.

Even though individual tax rates will move lower, most in the top brackets will still benefit from owning tax-exempt bonds when comparing relative attractiveness to taxable bonds. There are conflicting factors which could give rise to higher yields, but also may scenarios that imply demand will outweigh supply. Markets have weathered reductions in tax rates before and this time should not be any different. Yields will adjust to new levels, but will always be influenced by supply and demand. As we have stated before, as demographics change and the populating ages, the safety, security and tax advantage of municipal bonds should keep demand steady.

With continued expectations of economic growth and upward movement in inflationary pressures, we would expect for interest rates to rise. But this is not a reason to exit the bond market. As long as rates are rising for the right reasons (steady growth), it is a good thing for the economy. We have recommended staying in the short to intermediate term duration target in anticipation of rates moving higher and feel that our portfolios are well positioned. Rationale for owning fixed income assets remains the same; to provide a dependable level of income and reduce overall portfolio volatility.

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December 31, 2017

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