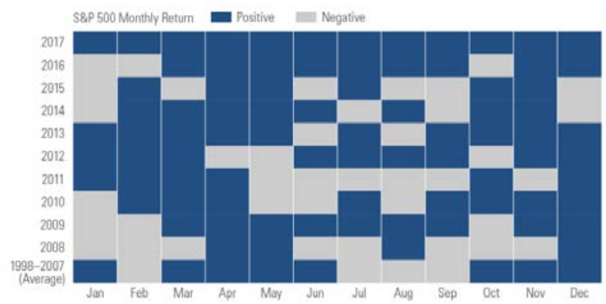
Executive Summary:

- Pervasive positive performance. 2017 was a year when taking risk paid off handsomely. Improving economic activity sparked strong returns in various asset classes across the globe.
- Synchronized global growth continues. The economic cycle and the stock market are inextricably linked and so we tend to discuss them together. Bear markets and recessions tend to coincide with one another. For now, there is little sign of recession
- Beauty is in the eye of the beholder. After a long bull run, a persistent question centers around whether stocks are expensive. Low interest rates and inflation provide a positive backdrop for stocks, but valuations are elevated tempering future return expectations.
- Risks, more of the same. The primary risk may be that the economy is too strong and ultimately overheats. Unemployment is low but wage growth and inflation have remained benign. Historically there has been a lag from when employment improves to when wage growth and inflation start to pick up.
- Outlook for 2018. Naturally investors are wondering how much room is left for the bull market to run. Economic fundamentals are improving, and thus we are hard pressed to be anything but constructive on the outlook for equities with international stocks poised to have another good year.

"It's the lure of easy money, it's got a very strong appeal." Glenn Frey

In a big year for stocks across the globe it was the surge in the price of bitcoin late in the year that seemed to catch the public's attention. The second longest bull run in stock market history (the last bear market ended in March 2009, and there has not been a 20% drop in stocks since) still lacks the enthusiastic frenzy of previous cycles, at least when viewed through the lens of professional money managers who remain largely skeptical. (According to *The Wall Street Journal,* 68% of money managers responding to a survey believe the equity market is overvalued.) Instead it was cryptocurrencies, primarily bitcoin but also ethereum and litecoin, that have cab drivers and hairstylists talking about how much money they are making "investing" in these modern mining technologies.



Source: GSAM. As of December 29, 2017.
*Based on S&P 500 Index from January 1998 through December 2007. **Past performance does not guarantee future results, which may vary.**

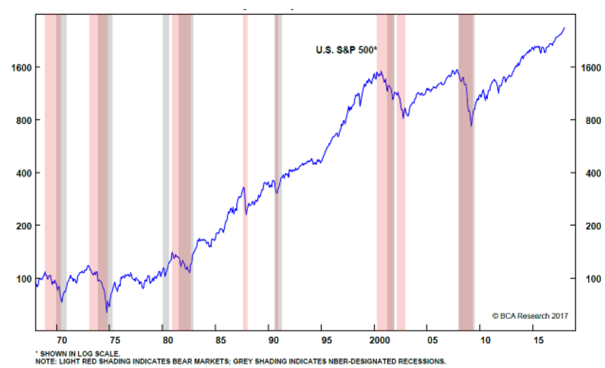
Skepticism over the bull run in stocks is not terribly surprising. After all, we have been through this before and not all that long ago. The tech and housing bubbles ended with sharp declines and painful losses (if you sold, which many did). With December up 1.1%, the S&P 500 just posted, for the first time in a single calendar year, a positive performance in each month of 2017 ending with a cumulative gain of just under 22%. As the chart at left shows, it is not unusual for the market to be down four or five months during a calendar year. With the worst correction of this year at less than 3%, a casual observer may be thinking this all too reminiscent of bubbles past.

Pervasive positive performance. 2017 was a year when taking risk paid off handsomely. Emerging markets snapped back after an extended downturn notching an impressive total return of nearly 38%. Some of the same economic spark pushed developed market equities to a 25.6% gain while the S&P 500 lagged with a still stellar 21.8% increase. Small cap stocks marked time for much of the year but caught a bid when the tax legislation passed and posted a 14.6% total return. Cash parked in money market funds continued to yield almost zero extending the hunt for yield and boosting the performance of REITs and the high yield markets. Fears over rising interest rates and the potential for risk in fixed income did not materialize with the ten-year yield remaining below 2.5% all year.

While positive performance was indeed pervasive, there was wide divergence within the S&P 500. Technology stocks turned in a stellar year with a total return of 38.8%. Much has been made of the strength in large tech stocks and the FANG stocks in particular, but there was money to made in Materials, Financials and Health Care as well. Energy and Telecom lagged all year, but

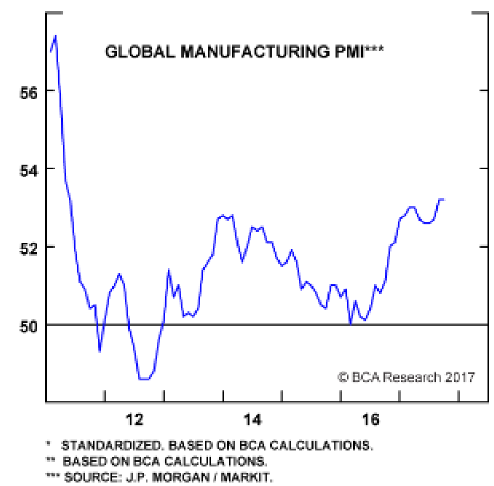
energy stocks made a dash to turn positive, ending the year down 1%. Stubbornly high oil inventories started to clear at long last and the price of crude was $60 per barrel at year-end having toiled in the $40s earlier in 2017. The Energy sector seems poised to carry the positive momentum into 2018 given balanced supply and demand fueled by strong global growth.

Synchronized global growth continues. The economic cycle and the stock market are inextricably linked and so we tend to discuss them together. As the chart below shows, bear markets and recessions tend to coincide with one another with stocks typically leading the way down into an economic contraction.



For now, there is little sign of a recession. If anything, economies both here and abroad are gaining strength. The global manufacturing PMI hit a seven-year high in December. Manufacturing activity is improving in nearly all major economies. The euro-zone stands out with the highest PMI and with its three largest economies, Germany, France and Italy all showing marked improvement during 2017.

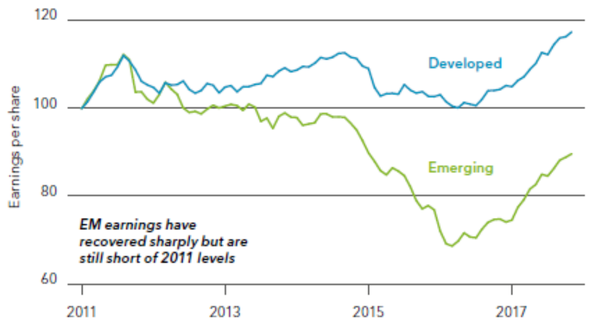
Manufacturing activity in the U.S. is at a 13-year high. Fourth quarter economic growth in the U.S. is likely to be over 3% with December marking 102 consecutive months of expansion (the average expansion is 47 months). Odds are that this current U.S. economic expansion will end up being the longest in history.



Global economic strength is driving an improved earnings outlook. Both in developed markets (DM) and emerging markets (EM), earnings have surged and are well off their cycle lows. Earnings in the DM and EM bottomed at about the same time, but EM earnings fell much farther. The sector is coming out of a four to five-year earnings recession. Reforms put in place in recent years are bearing fruit and a transition to consumer-driven economies, less dependent on cyclical sectors like energy and mining, continues.

That said, DM earnings are about 20% above 2011 levels while EM earnings are still below where they were in 2011. This suggests continued room to run for EM.

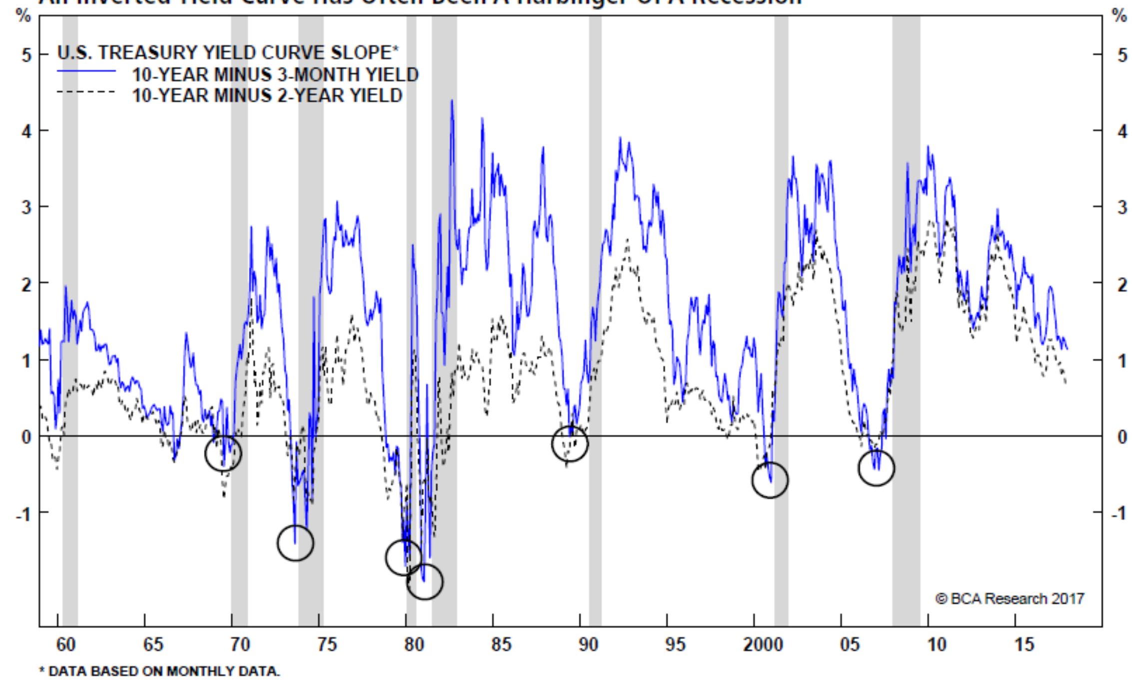
Developed and emerging equity earnings, 2011-2017



Sources: BlackRock Investment Institute, with data from Thomson Reuters, November 2017.
Notes: The lines show analysts' 12-month forward earnings-per-share estimates for the MSCI World and MSCI Emerging Markets indexes, rebased to 100 at the start of 2011.

What many people do watch as a harbinger of a recession is the yield curve, i.e. the difference between long-term interest rates--usually the ten-year yield--and short-term interest rates--usually the two-year yield. Much discussion has occurred recently in the media over the flattening of the yield curve and whether this is signaling increased risk of recession. It is the case that an inverted yield curve—short-term interest rates being higher than long-term rates—has often been a harbinger of a recession. However, as our friends at BCA Research point out, the risk occurs when the yield curve actually inverts, not

An Inverted Yield Curve Has Often Been A Harbinger Of A Recession



when it has flattened but still remains positive. Moreover, the current flattening of the yield curve is being driven by higher short rates as the economy has strengthened, which we view as a positive development

Finally, stock returns heading into a recession are usually positive. This makes intuitive sense given it typically coincides with the latter stages of an economic cycle when the economy is heating up, or even overheating. The S&P 500 has returned 8% annualized in the 7-to-12 months prior to past recessions, and this performance has improved in more recent business cycles with an average annualized return of nearly 19% 7-to-12 months before the last three recessions.

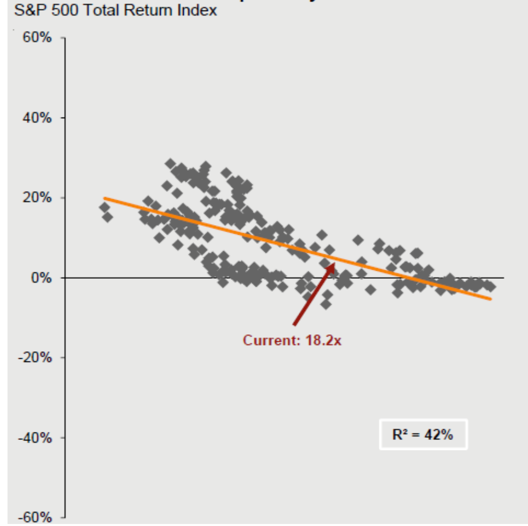
Beauty is in the eye of the beholder. President Trump signed into law the Tax Cuts and Jobs Act just before Christmas. This comprehensive piece of legislation contained material changes to both corporate and individual tax rates and provisions. The corporate tax rate was lowered to 21% from 35%, and there is a one-time repatriation tax of 15.5% for cash brought back into the U.S. Many large companies do not pay the statutory tax rate of 35% owing to overseas operations, where tax rates are often lower, and other provisions (expensing of R&D, for example). The average tax rate for the S&P 500 is about 27%, so going to 21% is a material reduction but not to the order of magnitude for small cap, domestically-oriented companies that usually pay close to the 35% statutory rate.

Earnings estimates are already being raised because of the tax law, and there will likely be more improvements to the outlook for corporate earnings in the coming weeks. Based on 2017 earnings and including the potential benefits of tax legislation, it appears to us that S&P 500 earnings will at least be in the range of $145-$150 per share this year. At the low end of this range the index is trading at nearly 18.5x earnings.

After a long bull run, a persistent question centers around whether stocks are expensive. Is an 18x-19x price-to-earnings ratio on stocks too high? The 25-year average p/e is 16.0x. Based on this measure alone stocks appear slightly expensive. Other metrics suggest stocks are even pricier. Take the CAPE ratio (cyclical-adjusted p/e ratio), which is based on the average inflation-adjusted earnings from the previous ten years. The CAPE ratio, often-cited in the media and by analysts, stands at 32.4x, well above the 25-year average of 26.4x. On a price-to-book value or price-to-cash flow basis stocks are similarly trading above their long-term averages but not by wide margins.

There are some observations about valuation that we think are critically important. First, while stocks are above their long-term average, it is also clear that over a long period of time stocks tend to stay above the average for extended periods. That is to say, the average is pulled down by the sharp declines during bear markets but these episodes, while dramatic, tend to be short-lived. Second, valuation by itself does not necessarily tell us that stocks are about to decline. The p/e ratio in March 2000 right before the tech boom ended was 27.2x, but the p/e ratio in October 2007 right before the Great Financial Crisis was 15.7x. Third, the economic context must be considered when evaluating stock valuations. Currently, we enjoy low inflation and low interest rates, which serve to support valuations both in terms of alternative investment choices and the discount rate on stocks.

Forward P/E and subsequent 5-yr. annualized returns
S&P 500 Total Return Index

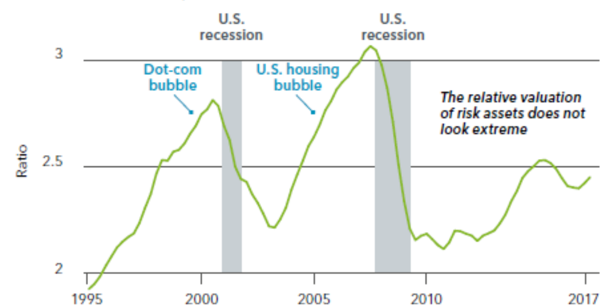


Source: JP Morgan

Valuation levels do inform us that the prospects for future returns are lower when valuations are higher. Over a one-year horizon stocks can perform well even from above-average valuations, but when the horizon is extended to five years prospective stock returns are more modest.

In their 2018 outlook report, BlackRock discusses a gauge they call the “risk ratio” as an indicator of exuberance in the market. This ratio measures the value of risk assets relative to safe-haven assets like cash and government bonds. Even with the stock market making new highs the ratio is nowhere near the euphoric levels of previous peaks, e.g. the dot.com boom and the housing bubble.

BlackRock U.S. risk ratio, 1995-2017



Sources: BlackRock Investment Institute, with data from the U.S. Federal Reserve, November 2017.
Notes: The risk ratio is calculated by taking the value of outstanding U.S. risk assets (defined as equities, corporate bonds, mortgages and bank loans) and dividing this by the value of perceived safe-haven assets (government and agency mortgage securities and bank deposits). We exclude central bank holdings.

Risks, more of the same. Geopolitical risks remain prevalent in investors’ minds. Ongoing tensions with North Korea and Iran but also unpredictable foreign policy that increases the chances for a surprise conflict remain problematic. For now, however, geopolitical concerns have taken a back seat to the improving economic fundamentals in both DM and EM. There is no evidence of tension in the credit markets, the primary contributor to previous downturns.

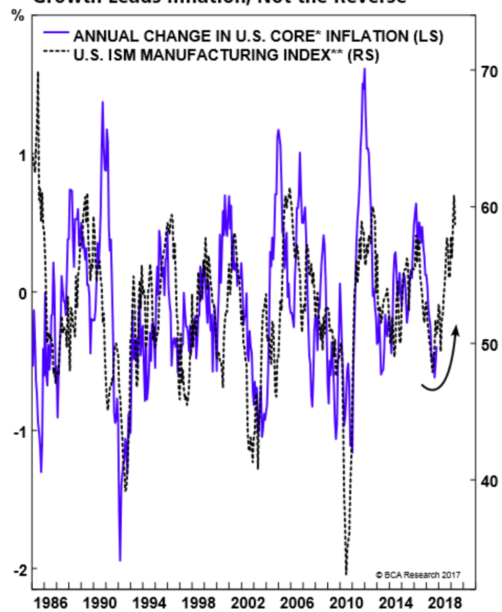
Ironically then, the primary risk may be that the economy is too strong and ultimately overheats. The unemployment rate stands at 4.1%. Wage growth has been sluggish and so inflation has remained benign and interest rates have remained low, but there has historically been a lag from when employment improves to when wage growth starts to pick up.

BCA Research points out that growth leads inflation. As the chart at right shows, a close relationship exists between manufacturing activity--which as depicted earlier is improving both here and abroad--and inflation with the lag between the two about 18 months.

There are factors that could affect this relationship. Technology has clearly made an impact on efficiency and the ability to do more with fewer people. Labor participation has been historically low as well, but there is evidence that participation rates are rising and this will further tighten the economy.

The Federal Reserve has started the process of tightening monetary policy by raising interest rates. Thus far, the interest rate increases have been in the context of a strengthening economy and a normalization of policy. Were inflation to accelerate the Fed would likely raise interest rates more aggressively with negative effects on the economy and therefore the stock market.

Growth Leads Inflation, Not the Reverse



* EXCLUDING FOOD AND ENERGY, YEAR-OVER-YEAR CHANGE.
** ADVANCED BY 18 MONTHS; SOURCE: INSTITUTE FOR SUPPLY MANAGEMENT.

Outlook for 2018. Naturally investors are wondering how much room is left for the bull market to run. As we write this commentary the Dow Jones Industrial Average is piercing the 25,000 level for the first time. Stock volatility remains low and is seen as a sign of complacency among investors. We have a bit of a different take on low volatility. Volatility is being influenced by the lack of variability in the economic data. Inflation and interest rates are low and have remained contained, economies all over the world are improving, and earnings are not only trending up but they have continued to surprise Wall St.

Simply put, there is no sign of a recession. If anything, economic fundamentals are improving. Given this we are hard pressed to be anything but constructive on the outlook for equities. International stocks seemed poised to have another good year. The ACWI-ex U.S. all world index is trading at 14.3x earnings, which is just a hair *below* its 20-year average of 14.5x. The gap in valuations between U.S. stocks and international stocks seems too wide, in our opinion. We do believe interest rates will break out of the current range and likely press toward the 2.75%-3.0% range. This leaves us a bit cautious on fixed income due to the interest rate risk.

In closing, we want to reiterate our appreciation for the trust our clients have bestowed upon us. As we move forward, we are committed to retaining your confidence and serving your specific needs.